Structuring Ownership of Privately-Owned Businesses:

Tax and Estate Planning Implications

Steven B. Gorin
Thompson Coburn LLP
One US Bank Plaza
505 N. 7th St.
St. Louis, MO 63101
sgorin@thompsoncoburn.com
phone 314-552-6151
http://www.thompsoncoburn.com/people/steve-gorin
http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions

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Structuring Ownership of Privately-Owned Businesses:

Tax and Estate Planning Implications

by Steven B. Gorin[*]

I. Introduction

This document discusses how federal income, employment and transfer taxes and estate planning and trust administration considerations affect how one might structure a business and then transition the business through ownership changes, focusing on structural issues so that readers can plan the choice of entity or engage in estate planning with an eye towards eventual transfer of ownership in the business.

With rapid changes in our global economy, flexibility in structuring a business entity is more important than ever. This document focuses on income tax flexibility in buying into a business and also exiting from or dividing a business, also discussing particular aspects of the taxation of operations, as well as individual and fiduciary income taxation (including the 3.8% tax on net investment income) on the income relating to a business entity that is taxable to them. It also discusses estate planning issues, including transfer tax issues and drafting and administering trusts to hold business interests. In addition to

[*] Steve Gorin is a partner in the Private Client practice group of Thompson Coburn LLP. He is a past chair of the Business Planning group of committees of the Real Property, Trust & Estate Law Section of the American Bar Association. Steve is a member of the Business Planning Committee of the American College of Trust and Estate Counsel. He is a past chair of the Business Law Section of the Bar Association of Metropolitan St. Louis. In addition to helping clients directly with their needs, Steve serves as a consultant to other attorneys in various areas of the country, primarily regarding the subject matter of these materials. For more details about the author, see http://www.thompsoncoburn.com/people/steve-gorin. He would welcome any questions or comments the reader might have regarding these materials; please email him at sgorin@thompsoncoburn.com. For those who wish to use part of these materials for presentations for professional organizations, Steve might prepare an excerpt that the presenter can use, with full attribution and without charge.
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the issues covered in this document, consider whether a family-controlled entity requires a legitimate and significant nontax reason.[1]

The author sends a link to the most recent version in his free electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive this newsletter, please complete http://www.thompsoncoburn.com/forms/gorin-newsletter or email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line; the newsletter email list is opt-in only. Please include your complete contact information; to comply with the anti-spam laws, we must have a physical mailing address, even though delivery is electronic. Please also add ThompsonCoburnNews@tcinstitute.com to your "trusted" list so that your spam blocker will not block it. Send any inquiries to the author at sgorin@thompsoncoburn.com and not to ThompsonCoburnNews@tcinstitute.com, which is not the author's email address but rather is an address used to transmit newsletters.

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II. Income Tax Flexibility

Income tax flexibility is divided into general considerations for corporations, LLCs and partnerships; buying into a business; income taxation of operations; and exiting from or dividing a business.

For an excellent overview of choice-of-entity issues, see "Selected Issues Relating to Choice of Business Entity," The Joint Committee on Taxation, JCX-66-12 (7/27/2012), https://www.jct.gov/publications.html?func=startdown&id=4478, which was scheduled for a public hearing before the Senate Finance Committee on August 1, 2012. See also McNulty and Kwon, "Tax Considerations in Choice of Entity Decisions," *Business Entities* (Jan./Feb. 2014).

II.A. Corporation

II.A.1. C Corporation

II.A.1.a. C Corporations Generally

A C corporation is a corporation[2] that is not taxed as an S corporation.[3] It pays income taxes on its own earnings, and its shareholders pay income tax on any dividends they receive. Corporations whose stock is publicly traded are C corporations.

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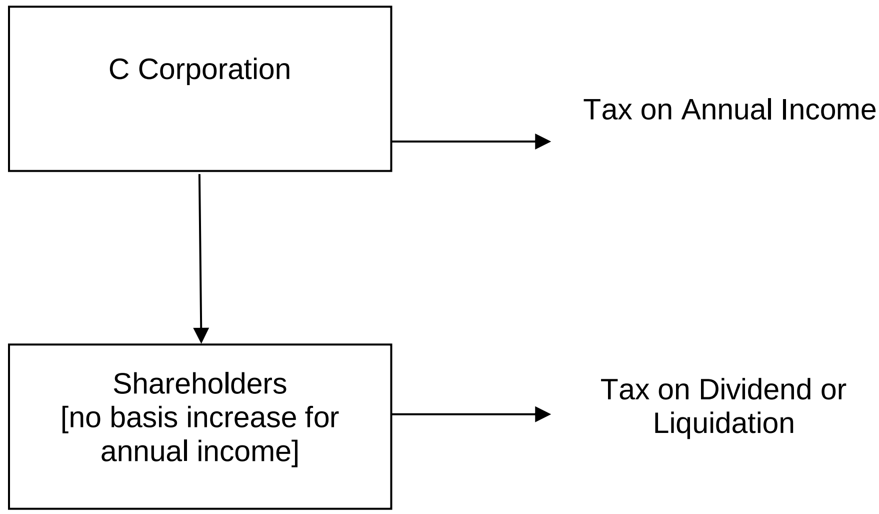
[1] Such a reason may be necessary to ensure estate tax recognition of the entity and to avoid double inclusion of the post-formation appreciation in the value of any business interest the decedent owned within three years of death. See fns. 88-89 in part II.A.2.e.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.

[2] Including a limited liability company, partnership, or other entity that elects taxation as a corporation. Reg. § 301.7701-3.

[3] S corporations are described in part II.A.2 S Corporation.



Some corporations are C corporations simply because they were formed before S corporation taxation was even available. They may have ignored or been unaware of tax planning opportunities. Or, they may not be eligible to be taxed as an S corporation, because they have too many shareholders, shareholders who are not eligible to own stock in an S corporation, or a capital structure that is inconsistent with an S corporation's requirement that all shares of stock have the same distribution and liquidation rights.

Other corporations are C corporations to minimize taxes. The income tax on the first $50,000 of a corporation's taxable income is only 21% (15% federal plus 6.25% Missouri).[4] The shareholders are not subject to income tax or self-employment tax on the reinvested income. More fringe benefits are allowed to C corporation shareholders than the owners of any other entity. However, C corporations do not receive lower capital gain rates[5] on the sale of capital assets or business assets,[6] so C corporations in the top bracket pay higher taxes on the business' sale of such assets than do owners of S corporations or partnerships.[7]

If the shareholders do not take dividends, and later sell the company, even the wealthiest taxpayer could eventually pay federal capital gains tax of only 23.8% (20% plus 3.8% tax on net investment income). Some special rules provide an

[4] Note that, even with a lower dividend income tax rate, 15% federal plus over 6.25% Missouri corporate income tax, together with the shareholder paying 23.8% federal and 6% Missouri income tax, is not really a bargain at all unless the corporation retained its earnings for a while for some business purpose. If at some point favorable dividend rates do not apply, this possible bargain turns into a trap for the shortsighted. See also Evans and Castilla, "Despite Higher Tax Rates, S corporations Retain Advantages Over C corporations," *Practical Tax Strategies* (Dec. 2013).

[5] Code § 11 provides C corporations' income tax rates. All references to a "Code" section are to the Internal Revenue Code, 26 U.S.C.

[6] For the sale of business assets, see part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 955 (business assets often are not capital assets and therefore require a special provision to receive capital gain tax rates).

[7] Code § 1(h).

exclusion on the sale of certain stock in a C corporation;[8] however, this exclusion is not necessarily the advantage that one might initially think.[9] See also parts II.G.9 Personal Service Corporations and II.G.10 Planning for C Corporation Using the Lowest Corporate Brackets and Is Owned by Taxpayer with Modest Wealth.

Corporations may exclude from income 50%-100% of dividends received from most other corporations.[10] For taxable years beginning after December 31, 2017, the following deductions are allowed against taxable dividends from a domestic[11] corporation:

- 100% for a dividend received within certain affiliated groups[12] or by small business investment company operating under the Small Business Investment Act of 1958.

- 65% for a dividend received from a 20%-owned corporation,[13] which effectively reduces the tax rate to 7.35% (21% corporation tax rate multiplied by the 35% excess of 100% over 65%).

- 50% for a dividend received from other corporations,[14] which effectively reduces the tax rate to 10.5% (21% corporation tax rate multiplied by 50%).

Generally, a corporation can be formed tax-free,[15] but distributions may trigger taxation at the corporate level, shareholder level, or both.[16] Prof. Sam Donaldson compared a C corporation to a roach motel – easy to get in but difficult to leave.[17]

II.A.1.b. C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment

For tax years beginning before January 1, 2018: To take advantage of low corporate income tax rates, C corporations often pay just enough compensation to take advantage of the lowest corporate brackets. However, all of the taxable income of a "qualified

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[8] See part II.Q.7.j.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[9] See part II.Q.7.j.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S Corporation or a Partnership?

[10] Code § 243.

[11] Code § 243(e) provides:

> *Certain dividends from foreign corporations*. For purposes of subsection (a) and for purposes of section 245, any dividend from a foreign corporation from earnings and profits accumulated by a domestic corporation during a period with respect to which such domestic corporation was subject to taxation under this chapter (or corresponding provisions of prior law) shall be treated as a dividend from a domestic corporation which is subject to taxation under this chapter.

[12] Code § 243(a)(3), (b).

[13] Code § 243(c)(1). Code § 243(c)(2) looks to whether the taxpayer owns 20% or more of the stock of the payor corporation (by vote and value).

[14] Code § 243(a)(1).

[15] See part II.M.2 Buying into or Forming a Corporation.

[16] See part II.Q.7 Exiting From or Dividing a Corporation.

[17] Remarks at the 2016 Heckerling Institute on Estate Planning.

personal service corporation" is taxed at a flat 35%;[18] see part II.G.9 Personal Service Corporations. For the latter, zeroing out taxable income is frequently the goal.

For tax years beginning after December 31, 2017, all taxable income of every corporation is taxed at 21%.[19] Given that federal income rates that apply to individuals exceed those of corporations, in the short run one may be less inclined to pay as much compensation to shareholder-employees. Consider the following factors:

- The top individual federal income tax rate is higher than the corporate income tax rate. Remember also to compare state and local income tax rates imposed on corporations and individuals.

- Compensation is subject to FICA.[20]

- A corporation is not limited to the amount of state income tax it may deduct, whereas an individual's deduction for state and local income and property tax is limited to $10,000.[21]

- When the shareholder-employee would like to receive the business' earnings. See part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment. Also consider part II.E.2 Comparing Exit Strategies from C Corporations and Pass-Through Entities.

A business may deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered", with compensation deductible if "reasonable" and "purely for services."[22]

"Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible."[23] Payments may be disguised dividends[24] or purchase price for the business.[25]

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[18] Code § 11(b)(2).
[19] Code § 11(b).
[20] See part II.L.1 FICA: Corporation. For the amount of wages subject to the highest FICA rates (the taxable wage base), see fn 2350 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.
[21] Code § 164(b)(6).
[22] Reg. § 1.162-7(a).
[23] Reg. § 1.162-7(b)(1).
[24] Reg. § 1.162-7(b)(1), providing:

> An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

[25] Reg. § 1.162-7(b)(1), providing:

> An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the

"While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate."[26]

One may not deduct compensation in excess of "what is reasonable under all the circumstances."[27]

II.A.1.b.i. Compensating Individuals

Because an independent investor would require a return on investment, a C corporation needs to be wary of relying too much on this strategy, which has been a point of contention in many cases over the years.[28]

> former partners are not merely for services, but in part constitute payment for the transfer of their business.

[26] Reg. § 1.162-7(b)(2), providing:

> Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

[27] Reg. § 1.162-7(b)(3), providing:

> It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

[28] Code § 162 requires any business deduction to be reasonable and necessary. If the future payments relate to compensation earned in the current year, then the taxpayer must prove that (a) the total compensation (current and deferred payments) earned that year is reasonable (to obtain a Code § 162 deduction) and (b) that it was entered into before January 1 of calendar year in which the services were provided (to satisfy Code § 409A(a)(4)(B)(i) and Reg. § 1.409A-2(a)(1)). For a summary of cases, see Looney and Levitt, "Compensation Reclassification Risks for C and S corporations," *Journal of Taxation* (May 2015) and Moran, "The Independent Investor Test for Reasonable Compensation: Lens, Laser or Labyrinth?" *TM Memorandum* (BNA) (12/26/2016).

In *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012), affirming 20% penalty on excess compensation, Judge Posner pointed out that a going concern with value requires a reasonable return as an investor. He commented:

> We note in closing our puzzlement that the firm chose to organize as a conventional business corporation in the first place. But that was in 1979 and there were fewer pass-through options then than there are now; a general partnership would have been the obvious alternative but it would not have conferred limited liability, which protects members' personal assets from a firm's creditors. Why the firm continued as a C corporation and sought to avoid double taxation by overstating deductions for business expenses, when reorganizing as a passthrough entity would have achieved the same result without inviting a legal challenge, see 1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 5.01[5], p. 5-8 (7th ed. 2006), is a greater puzzle. But "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice,

whether contemplated or not," *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974)—consequences that in this case include a large tax deficiency and a hefty penalty. The Tax Court was correct to disallow the deduction of the "consulting fees" from the firm's taxable income and likewise correct to impose the 20 percent penalty.

That an *accounting* firm should so screw up its taxes is the most remarkable feature of the case.

Cases discussing reasonable compensation include *Davis v. Commissioner*, T.C. Memo. 2011-286 ($37 million deduction relating to stock option was reasonable), *aff'd* 111 A.F.T.R.2d 2013-1979 (11th Cir. 2013); *Multi-Pak Corporation v. Commissioner*, T.C. Memo. 2010-139, following *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983), which reversed T.C. Memo 1980-282 (although ultimately the Tax Court applied the Ninth Circuit's standards to arrive at the same result – T.C. Memo 1984-516); *Trucks, Inc. v. U.S.*, 588 F.Supp. 638 (D. Neb. 1984), aff'd 763 F.2d 339 (8th Cir. 1985) (reasonable compensation not an issue presented on appeal); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315 (5th Cir. 1987); *Shaffstall Corp. v. U.S.*, 639 F.Supp. 1041 (S.D. Ind. 1986); *Donald Palmer Co., Inc. v. Commissioner*, 84 F.3d 431 (5th Cir. 1996); *Rapco, Inc. v. Commissioner*, 85 F.3d 950 (2nd Cir. 1996); *Alpha Medical, Inc. v. Commissioner*, 172 F.3d 942 (6th Cir. 1999); *Dexsil Corp. v. Commissioner*, 147 F.3d 96 (2nd Cir. 1998); *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999); *Labelgraphics, Inc. v. Commissioner*, 221 F.3d 1091 (9th Cir. 2000); *Eberl's Claim Service, Inc. v. Commissioner*, 249 F.3d 994 (10th Cir. 2001); *Haffner's Service Stations v. Commissioner*, 326 F.3d 1 (1st Cir. 2003); *Menard, Inc. v. Commissioner*, 560 F.3d 620 (7th Cir. 2009); *K & K Veterinary Supply, Inc.* v. *Commissioner*, T.C. Memo. 2013-84 (considering employee qualifications; the nature, extent, and scope of the employee's work; the size and complexity of the business; prevailing general economic conditions; the employee's compensation as a percentage of gross and net income; the employee shareholders' compensation compared with distributions to shareholders; the employee-shareholders' compensation compared with that paid to non-shareholder-employees; prevailing rates of compensation for comparable positions in comparable concerns; and comparison of compensation paid to a particular shareholder-employee in previous years where the corporation has a limited number of officers, citing *Charles Schneider & Co. v. Commissioner*, 500 F.2d 148, 151-152 (8th Cir. 1974), *aff'g* T.C. Memo. 1973-130); *Midwest Eye Center, S.C. v. Commissioner*, T.C. Memo. 2015-53 (C corp. zeroed out taxable income by paying compensation; 7th Cir. independent investor test provides rebuttable presumption that the compensation payment was reasonable; parties agreed that the presumption did not apply; taxpayer failed to provide evidence of "would ordinarily be paid for like services by like enterprises under like circumstances" under Reg. § 1.162-7(b)(3); negligence penalty imposed); *Brinks Gilson & Lione A Professional Corporation v. Commissioner*, T.C. Memo. 2016-20 (independent investor test makes zeroing out taxable income prima facie unreasonable, citing *Elliotts, supra*; court accepted IRS' use of cash basis balance sheet net worth to infer reasonable dividends; note that *Pediatric Surgical Associates P.C. v. Commissioner*, T.C. Memo. 2001-81, found ridiculous the taxpayer's argument that a medical practice earned no profits on its physician-employees' work). Also, Code § 162(m) limits publicly-traded corporations generally to a $1 million deduction unless they follow certain procedures. See also McCoskey, "Reasonable Compensation: Do You Know Where Your Circuit Stands?" *Journal of Taxation*, October 2008. Downs and Stetson, "Interpreting 'Reasonable' Compensation," *Practical Tax Strategies* (Jan. 2011), concludes that generally the Tax Court finds reasonable compensation when:

- The taxpayer pays dividends and earns a high return on equity.
- General economic conditions are not favorable, but the taxpayer's return on equity is at least positive.
- The taxpayer pays dividends to outside stockholders and earns a relatively high rate of return.

The IRS' web page on "Valuation of Assets"[29] includes:

- "Reasonable Compensation - Job Aid for IRS Valuation Professionals"[30]
- "Appendix to Reasonable Compensation - Job Aid for IRS Valuation Professionals"[31]

H.W. Johnson, Inc. v. Commissioner, T.C. Memo. 2016-95, approved millions of dollars of compensation when the corporation reported only a few hundred thousand dollars in base compensation and perhaps a couple hundred thousand in dividends. It set forth the test it applied:[32]

> The Court of Appeals for the Ninth Circuit, to which an appeal in this case would normally lie, applies five factors to determine the reasonableness of compensation, with no factor being determinative: (1) the employee's role in the company; (2) a comparison of compensation paid by similar companies for similar services; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) the internal consistency of compensation arrangements.

In analyzing the officer-shareholders' role in the company, the court pointed to not only their reputation for excellence and hands-on management but also their guaranteeing the corporation's indebtedness to purchase materials and supplies.[33]

In comparing compensation to other taxpayers, the court said:

> This factor compares the employee's compensation with that paid by similar companies for similar services. *Elliotts, Inc. v. Commissioner*, 716 F.2d at 1246; sec. 1.162-7(b)(3), Income Tax Regs. Respondent concedes that petitioner's performance so exceeded that of any of the companies identified by the parties' experts as comparable that compensation comparisons are not meaningful. Petitioner's expert calculated that petitioner's officers' compensation as a percentage of gross revenue was 18.4% and 20.9% for 2003 and 2004,

[29] https://www.irs.gov/businesses/valuation-of-assets.

[30] https://www.irs.gov/pub/irs-utl/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf.

[31] https://www.irs.gov/pub/irs-utl/Appendix%20to%20Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf.

[32] At the end of the quote below, the court continued:

> *Elliotts v. Commissioner*, 716 F.2d at 1245-1247. In analyzing the fourth factor, the Court of Appeals emphasizes evaluating the reasonableness of compensation payments from the perspective of a hypothetical independent investor, focusing on whether the investor would receive a reasonable return on equity after payment of the compensation. *Id.* At 1247; see also *Metro Leasing Dev. Corp. v. Commissioner*, 376 F.3d 1015, 1019 (9th Cir. 2004), aff'g T.C. Memo. 2001-119.

[33] When mentioning the latter, the court cited *Leonard Pipeline Contractors, Ltd. v. Commissioner*, T.C. Memo. 1998-315, *aff'd* without published opinion, 210 F.3d 384 (9th Cir. 2000); *Owensby & Kritikos, Inc. v. Commissioner*, T.C. Memo. 1985-267, *aff'd*, 819 F.2d 1315 (5th Cir. 1987).

> respectively, whereas the industry average for those years was 2.2%. Petitioner contends that its performance so exceeded the industry average that the divergence of its compensation from the average is justified. On this record we lack any reliable benchmarks from which to assess petitioner's claim and therefore find it unpersuasive. In view of this and respondent's concession, we conclude that this factor is essentially neutral. See *Multi-Pak Corp. v. Commissioner*, T.C. Memo. 2010-139.

The court suggested that "conflict of interest" factor cited above applies when the shareholders are the officers being compensated, in such a case the court should scrutinize the issue, applying the independent investor test. The court rejected the IRS' expert's reliance on (a) "guideline" companies that the court found not to be comparable, (b) Risk Management Association's annual statement that RMA itself cautions might include small sample sizes, (c) the Construction Financial Management Association's annual financial survey, the court commenting that many of the companies in that data sample operated in industries dissimilar from the taxpayer's, and (d) a "market required return on equity" that the IRS' expert derived from data published by Ibbotson Associates, which data the court characterized and being from companies engaged in the construction industry generally, not the concrete contracting sector of which the taxpayer is a part. Instead, the court found credible the taxpayer's expert's use of Integra data from 33 companies falling under the SIC code that closely described the taxpayer's line of business. In response to the taxpayer's contention that its return on equity was in line with the industry average and therefore would have satisfied an independent investor, the court said:

> We agree with petitioner. Respondent cites no authority for the proposition that the required return on equity for purposes of the independent investor test must significantly exceed the industry average when the subject company has been especially successful, and we have found none in the caselaw. Instead, in applying the independent investor test the courts have typically found that a return on equity of at least 10% tends to indicate that an independent investor would be satisfied and thus payment of compensation that leaves that rate of return for the investor is reasonable. See, *e.g.*, *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*, T.C. Memo. 2013-10; *Multi-Pak Corp. v. Commissioner*, T.C. Memo. 2010-139. Indeed, compensation payments that resulted in a return on equity of 2.9% have been found reasonable. *Multi-Pak Corp. v. Commissioner*, T.C. Memo. 2010-139. It is compensation that results in returns on equity of zero or less than zero that has been found to be unreasonable. See, *e.g.*, *Mulcahy, Pauritsch, Salvador & Co., Ltd. v. Commissioner*, 680 F.3d 867 (7th Cir. 2012), *aff'g* T.C. Memo. 2011-74; *Multi-Pak Corp. v. Commissioner*, T.C. Memo. 2010-139. We consequently find that petitioner's returns on equity of 10.2% and 9% for 2003 and 2004, respectively, tend to show that the compensation paid to Donald and Bruce for those years was reasonable. As petitioner's expert points out, mere reductions in their collective compensation of $9,847 and $75,277 in 2003 and 2004, respectively — differences of approximately 1% — would have placed petitioner's return on equity at exactly the average for comparable companies in the concrete business. Consequently, this factor favors a finding that the compensation at issue was reasonable.

The court said that he internal consistency of compensation factor focuses on whether the compensation was paid pursuant to a structured, formal, and consistently applied program and that bonuses not awarded under such plans are suspect. In this case, the taxpayer had such a program in effect for a dozen years before the years at issue.

In addition to upholding the compensation deduction, the court upheld a $500,000 fee paid to a concrete supply company formed by the two brothers whose compensation was at issue. The court noted that the supply company had significant outside investors who performed essential functions, that the supply company provided unique benefits to the taxpayer that provided a significant advantage over its competitors, and rebuffed the IRS' criticism that the fee was not pursuant to a written agreement:

> In view of the foregoing, respondent's contention that petitioner's payment to DBJ was voluntary, given the absence of a written agreement or evidence of an oral agreement to compensate DBJ, is unavailing. "Closely held corporations, as is well known, often act informally, their decisions being made in conversations, and oftentimes recorded not in the minutes, but by action." *Levenson & Klein, Inc. v. Commissioner*, 67 T.C. 694, 714 (1977) (quoting *Reub Isaacs & Co. v. Commissioner*, 1 B.T.A. 45, 48 (1924)). We are satisfied that petitioner's board, including majority shareholder Margaret, concluded at the close of 2004 that the $500,000 payment to DBJ was appropriate to compensate Bruce and Donald for the substantial benefit they conferred on petitioner in their individual capacities. In short, the action in making the payment undoubtedly reflected an informal understanding among petitioner's shareholders, Margaret, Bruce, and Donald, that the latter two ought to be compensated for their individual efforts and their assumption of the risks entailed in averting the consequences of a concrete shortage for petitioner during 2004.

Leaving that case, consider that a taxpayer who litigates this issue needs to coordinate the statute of limitations on the corporation's and employee's income and payroll tax returns. *K & K Veterinary Supply, Inc.*, T.C. Memo. 2013-84 denied equitable recoupment, holding:[34]

> In order to establish that equitable recoupment applies, a party must prove the following elements: (1) the overpayment or deficiency for which recoupment is sought by way of offset is barred by an expired period of limitation; (2) the time-barred overpayment or deficiency arose out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) the transaction, item, or taxable event has been inconsistently subjected to two taxes; and (4) if the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one.

[34] The court cited as authority for the quoted analysis:

> *United States v. Dalm*, 494 U.S. 596, 604-605 (1990); *Menard, Inc. v. Commissioner*, 130 T.C. at 62; *Estate of Branson v. Commissioner*, 113 T.C. 6, 15 (1999), *aff'd*, 264 F.3d 904 (9th Cir. 2001); *Estate of Orenstein v. Commissioner*, T.C. Memo. 2000-150.

The court agreed with the IRS' citation of a case holding that an S corporation and its shareholder were two separate taxpayers that should not be treated as one.[35] The court pointed out that, if an S corporation should be treated as separate from its shareholder, then a C corporation certainly would also be treated as separate, given that the C corporation is not even a pass-through entity.

A 2016 Tax Court case penalized a personal service corporation that had significant net assets and zeroed out its taxable income.[36] Another one penalized a wholesaler that paid the founder's sons compensation based on skilled officer positions when the sons actually had little skill and mainly did menial work.[37]

Perhaps one might be able to reward the original owners for prior services rendered,[38] but at some point one should consider an S election to be able to avoid double taxation on distributions.[39]

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[35] *Catalano v. Commissioner*, T.C. Memo. 1998-447, *aff'd* 240 F.3d 842 (9th Cir. 2001).

[36] *Brinks Gilson & Lione A Professional Corporation v. Commissioner*, T.C. Memo. 2016-20, discussed in fn. 28.

[37] *Transupport, Inc. v. Commissioner*, T.C. Memo. 2016-216, stated:

> In *Transupport I*, we quoted portions of the testimony of each of the Foote sons in which each denied knowledge of principles basic to the performance of his respective functions on behalf of petitioner. Because petitioner ignores the evidence, we repeat our observations here: K. Foote worked closely with purchases and sales but had "no clue" as to how much the inventory was worth and did not know how costs of goods sold were determined. J. Foote, who acted as petitioner's chief financial officer, testified that he had "no idea" or "not a clue" about petitioner's inventory at cost in 2007. J. Foote provided to petitioner's accountant the numbers used in preparing petitioner's tax returns, but he had no idea whether the amounts reported on the returns were correct. W. Foote, whose duties included inventory management, asserted that "nobody understands … our inventory" or that nobody can put a total valuation on it. As to a specific part in the inventory, he had "no earthly clue" as to the purchase price.
>
> None of the Foote sons had special experience or educational background. Each of the four sons testified that they had overlapping duties, but those duties included menial tasks as well as managerial ones because there were no other employees. Foote testified that he intended to treat his sons equally, that he alone determined their compensation, and that he was aware of their marginal tax rates, obviously intending to minimize petitioner's tax liability. The amounts and equivalency of the brothers' compensation, the proportionality to their stock interests, the disproportionality to Foote's compensation, the manner in which Foote alone dictated the amounts, the reduction of reported taxable income to minimal amounts, and the admissions in the promotional materials relating to their compensation all justify skepticism toward petitioner's assertions that the amounts claimed on the returns are reasonable.

In this case, the taxpayers arbitrarily and grossly overstated their cost of goods sold, and their compensation experts testified as if the sons had skill sets they clearly did not. This was a horrible set of facts, and the court called "nonsense" the taxpayer's comparison of its case to *H.W. Johnson, Inc. v. Commissioner*, T.C. Memo. 2016-95:

> The circumstances in *H.W. Johnson* are dissimilar and clearly distinguishable. In that case the company had over 200 employees, and the sons of the founder each supervised over 100 employees. Compensation was determined by a formula consistently applied by the board of directors, and, upon the advice of the company accountant, cash dividends were paid.

[38] See part II.Q.1.d.ii Using Nonqualified Deferred Compensation to Facilitate a Sale.

See also part II.O.4 Effect of Buy-Sell on Reasonable Compensation Arguments.

II.A.1.b.ii. Compensating Corporate Parent with Management Fees

A corporate subsidiary cannot deduct an ostensible management fee paid to its parent unless the parent actually provides services.[40]

II.A.1.c. Using a C Corporation to Facilitate Future Public Offering

Generally, when a company goes public, it does so as a C corporation. Entrepreneurs with that dream are tempted to do business using a C corporation.

As part II.E Recommended Structure for Entities discusses, using an LLC taxed as a sole proprietorship or partnership tends to be best. When planning to go public, one needs to view that as any other sale and consider part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations – the sale of a partnership interest generates an insider basis step-up, whereas the sale of C corporation stock does not. The purchaser of a partnership interest should be willing to pay more for a partnership interest than would the purchaser of stock in a C corporation, because the purchase of a partnership interest generates the tax benefit of inside basis step-up that the purchase of stock in a C corporation.

The "Up-C" structure takes advantage of this difference:[41] First, the owners of a partnership orchestrate a public offering of a C corporation shell. The C corporation

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[39] See parts II.A.2.b Existing Corporation - Paying Retired Shareholder-Officers and II.P.3.c Conversion from C Corporation to S corporation.

[40] *Home Team Transition Management v. Commissioner*, T.C. Memo. 2017-51, holding:

> In this case, we have four individuals who were equal corporate shareholders in a home care business, petitioner, that they had acquired in 1994. During 2010 the same four shareholders incorporated another corporation, Sacer Cor, in which they were equal shareholders, and Sacer Cor acquired ownership of petitioner, the existing home healthcare business. Two of the shareholders were employees of petitioner, and they were paid for their services, which included day-to-day operation of petitioner. The other two shareholders were not employees of petitioner. None of the four shareholders were employees of Sacer Cor, and no one, including the four shareholders, was paid a salary for any services rendered to or on behalf of Sacer Cor. Periodically, the four shareholders of Sacer Cor were paid equal amounts as director's fees. There is no credible evidence showing that any management services were performed by the shareholders or other employees of Sacer Cor for petitioner.
>
> Given those facts, petitioner has failed to meet its burden of showing that the deducted management fees it paid to Sacer Cor were for services rendered and/or "reasonable" within the meaning of section 162. Exacerbating those circumstances are the facts that the alleged management fees were originally booked as loan payments and that the amounts corresponded to petitioner's ability to pay; *i.e.*, they varied depending on petitioner's revenues. We accordingly hold that respondent's disallowance of the management fee deductions that petitioner claimed for 2011, 2012, and 2013 is not in error and is sustained.

[41] See Polsky and Rosenzweig, "The Up-C Revolution" (10/13/2016), University of Georgia School of Law Legal Studies Research Paper No. 2016-40, available at SSRN: https://ssrn.com/abstract=2851872.

uses the proceeds to buy the LLC interests. The resulting inside basis step-up[42] generates valuable tax benefits. Generally, the market supports a tax reimbursement agreement (TRA) passing along to the selling LLC owners about 85% of the tax benefits. By increasing the purchase price, the TRA generates even more tax benefits – a taxpayer-friendly circular calculation.

Entrepreneurs also like the idea of attracting venture capital investors. Some VC investors appreciate the tax benefits of a partnership. Others might set up a C corporation to own the LLC so that the corporation pays all of the taxes and the investment does not complicate the VC investors' tax returns. Sometimes the VC investors force the business to be a C corporation. As described in part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation, founders and others to whom a C corporation issues stock may exclude a portion of their gain from income.[43] Founders may get the best tax results under that exclusion by starting as a partnership and then converting to that partnership just over 5 years before they cash out.[44]

II.A.1.d. Monetizing Founder's Remaining Shares After Going Public

A founder or other person with low basis stock might agree to deliver shares at a future date in exchange for cash now, which cash could be used to buy a diversified portfolio of stock. Also, the cash proceeds may be transferred using leveraged estate planning tools, while maintaining a security interest in the founder's stock.[45]

This agreement regarding the low basis shares might be done in a way that is not an installment sale that produces income in respect of a decedent but rather an open transaction that generates a basis step-up in the shares that have not yet been delivered. (Note that part of the proceeds of a founder's stock in a qualified C corporation might be excluded from regular taxation.)[46]

The key is using a prepaid variable forward contract (VPFC), which the Tax Court explained:[47]

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[42] See part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[43] Partnerships and S corporations have less need for this exclusion than do C corporations, because reinvested earnings increase the outside basis of the owners of partnerships and S corporations, whereas reinvested earnings do not have that effect of C corporation shareholders. For a comparison of taxation of gain not reflected by reinvested earnings, see part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

[44] See part II.Q.7.j.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S Corporation or a Partnership? for that recommendation.

[45] See part II.H.10 Extracting Equity to Fund Large Gift.

[46] See part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[47] *Estate of Andrew J. McKelvey v. Commissioner*, 148 T.C. No. 13 (2017). The court's official syllabus characterized the case as follows:

> Decedent (D) entered into variable prepaid forward contracts (original VPFCs) with two investment banks in 2007. Pursuant to the terms of the original VPFCs, the investment banks made prepaid cash payments to D, and D was obligated to deliver variable quantities of stock to the investment banks on specified future settlement dates in 2008 (original settlement dates). D treated the execution of the original VPFCs as open

> A standard forward contract is an executory contract in which a forward buyer agrees to purchase from a forward seller a fixed quantity of property at a fixed price, with both payment and delivery occurring on a specified future date. See *Anschutz Co. v. Commissioner*, 135 T.C. 78, 81 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011). The VPFC is a variation of a standard forward contract, requiring the forward buyer (usually a bank) to pay a forward price (discounted to present value) to the forward seller on the date of contract execution, rather than on the date of contract maturity. A forward seller can use the upfront cash prepayment however he or she deems fit, but the proceeds are often used by the forward seller to diversify a concentrated stock position into other securities or financial instruments. In exchange for the cash prepayment, the forward seller becomes obligated to deliver to the forward buyer: (1) shares of stock that have been pledged as collateral at the inception of the contract; (2) identical shares of the stock which have not been pledged as collateral; or (3) an equivalent cash amount. The actual number of shares (or cash equivalent) to be delivered by the forward seller is determined by a formula which takes into account changes in the market price of the underlying stock over the duration of the contract. *Id.* at 81-82.

The court explained why the open transaction prevents the seller from being taxed when receiving the cash payment up front:

> In Rev. Rul. 2003-7, 2003-1 C.B. 363, the IRS recognized that VPFCs are open transactions when executed and do not result in the recognition of gain or loss until future delivery. The rationale of Rev. Rul. 2003-7, *supra*, is straightforward: A taxpayer entering into a VPFC does not know the identity or amount of property that will be delivered until the future settlement date arrives and delivery is made. In the instant case, the treatment of the original VPFCs is not in dispute.

Rev. Rul. 2003-7 described the structure receiving this open transaction treatment:[48]

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transactions pursuant to Rev. Rul. 2003-7, 2003-1 C.B. 363, and did not report any gain or loss for 2007.

In 2008, before the original settlement dates, D paid consideration to the investment banks to extend the settlement dates until 2010 (VPFC extensions). D did not report any gain or loss upon the execution of the VPFC extensions and continued the open transaction treatment. D died in 2008 after the execution of the VPFC extensions. R determined that the execution of the VPFC extensions in 2008 constituted sales or exchanges of property under I.R.C. sec. 1001, and thus D should have reported gain from the transactions for 2008.

Held: D's execution of the VPFC extensions did not constitute sales or exchanges of property under I.R.C. sec. 1001, and the open transaction treatment afforded to the original VPFCs under Rev. Rul. 2003-7, *supra*, continues until the transactions are closed by the future delivery of stock.

Held, further, D did not engage in constructive sales of stock in 2008 pursuant to I.R.C. sec. 1259.

[48] Rev. Rul. 2003-7 involved the following transaction:

An individual ("Shareholder") held shares of common stock in Y corporation, which is publicly traded. Shareholder's basis in the shares of Y corporation is less than $20 per share. On September 15, 2002 (the "Execution Date"), Shareholder entered into an arm's length agreement (the "Agreement") with Investment Bank, at which time a share of common stock in Y corporation had a fair market value of $20. Shareholder received $z of cash upon execution of the Agreement. In return, Shareholder became obligated to deliver to Investment Bank on September 15, 2005 (the "Exchange Date"), a number of shares of common stock of Y corporation to be determined by a formula. Under the formula, if the market price of a share of Y corporation common stock is less than $20 on the Exchange Date, Investment Bank will receive 100 shares of common stock. If the market price of a share is at least $20 and no more than $25 on the Exchange Date, Investment Bank will receive a number of shares having a total market value equal to $2000. If the market price of a share exceeds $25 on the Exchange Date, Investment Bank will receive 80 shares of common stock. In addition, Shareholder has the right to deliver to Investment Bank on the Exchange Date cash equal to the value of the common stock that Shareholder would otherwise be required to deliver under the formula.

> In order to secure Shareholder's obligations under the Agreement, Shareholder pledged to Investment Bank on the Execution Date 100 shares (that is, the maximum number of shares that Shareholder could be required to deliver under the Agreement). Shareholder effected this pledge by transferring the shares in trust to a third-party trustee, unrelated to Investment Bank. Under the declaration of trust, Shareholder retained the right to vote the pledged shares and to receive dividends.

> Under the Agreement, Shareholder had the unrestricted legal right to deliver the pledged shares, cash, or shares other than the pledged shares to satisfy its obligation under the Agreement. Shareholder is not otherwise economically compelled to deliver the pledged shares. At the time Shareholder and Investment Bank entered into the Agreement, however, Shareholder intended to deliver the pledged shares to Investment Bank on the Exchange Date in order to satisfy Shareholder's obligations under the Agreement.

Rev. Rul. 2003-7 analyzed the situation as follows, citing *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977), *Richardson v. Commissioner*, 121 F.2d 1 (2nd Cir.), *cert. denied*, 314 U.S. 684 (1941), and *Hope v. Commissioner*, 55 T.C. 1020 (1971), *aff'd*, 471 F.2d 738 (3rd Cir.), *cert. denied*, 414 U.S. 824 (1973):

> In the present case, on the Execution Date, Shareholder received a fixed payment without any restriction on its use and also transferred in trust the maximum number of shares that might be required to be delivered under the Agreement. Like the taxpayers in *Miami National Bank* and *Richardson*, but unlike the taxpayer in *Hope*, Shareholder retained the right to receive dividends and exercise voting rights with respect to the pledged shares. Also unlike *Hope*, the legal title to, and actual possession of, the shares were transferred to an unrelated trustee rather than to Investment Bank. Moreover, Shareholder was not required by the terms of the Agreement to surrender the shares to Investment Bank on the Exchange Date. Rather, Shareholder had a right, unrestricted by agreement or economic circumstances, to reacquire the shares on the Exchange Date by delivering cash or other shares. See *Miami National Bank* and *Richardson*. Accordingly, the execution of the Agreement did not cause a sale or other disposition of the shares.

> A different outcome may be warranted if a shareholder is under any legal restraint or requirement or under any economic compulsion to deliver pledged shares rather than to exercise a right to deliver cash or other shares. For example, restrictions placed upon a shareholder's right to own pledged common stock after the Exchange Date, or an expectation that a shareholder will lack sufficient resources to exercise the right to deliver cash or shares other than pledged shares, would be significant factors to be weighed in determining whether a sale has occurred.

> Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale. Under § 1259(b), the term "appreciated financial position" means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. Furthermore, for purposes of § 1259, the term "position" means an interest, including a futures or forward

> Shareholder has neither sold stock currently nor caused a constructive sale of stock if Shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not economically compelled to deliver the pledged shares.

When the seller has received all of the cash up front, the VPFC is properly characterized as purely an obligation, not property.[49] Suppose the settlement date approaches, and

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> contract, short sale, or option. Under § 1259(c)(1)(C), a taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) enters into a futures or forward contract to deliver the same or substantially identical property. The term "forward contract" is defined under § 1259(d)(1) as a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. The legislative history indicates that a forward contract that provides for the delivery of an amount of stock that is subject to "significant variation" under the terms of the contract is not within the statutory definition of a forward contract. S. Rep. No. 33, 105th Cong., 1st Sess. 125-26 (1997), 1997-4 (Vol. 2) C.B. 1067, 1205-06.
>
> Under these facts, the Agreement does not cause a constructive sale of the shares under § 1259(c)(1)(C). According to the Agreement, delivery of a number of shares, which may vary between 80 and 100 shares, depends on the fair market value of the stock on the Exchange Date. Because this variation in the number of shares that may be delivered under the Agreement is a significant variation, the Agreement is not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1). As a result, the Agreement does not meet the definition of a forward contract under § 1259(d)(1) and does not cause a constructive sale under § 1259(c)(1)(C).

[49] *Estate of Andrew J. McKelvey v. Commissioner*, 148 T.C. No. 13 (2017), characterized the IRS' arguments that the VPFCs constituted "property":

> … respondent argues that decedent possessed three valuable rights in the original VPFCs: (1) the right to the cash prepayments; (2) the right to determine how the VPFCs would be settled (i.e., whether with stock or in cash, and if stock, which specific shares); and (3) the right to substitute other collateral.[15]
>
> > [15] Respondent attempts to disaggregate the VPFCs into three components: (1) a discount loan; (2) a long put option; and (3) a short call option. Although the economic value of a VPFC can be calculated by valuing these separate parts, respondent appears to argue that decedent had contract rights in each of these distinct components. We disagree. VPFCs are comprehensive financial products, and decedent did not have the ability to transact separately in discount loans or call and put options. See *Chock Full O' Nuts Corp. v. United States*, 453 F.2d 300, 305 (2nd Cir. 1971).

The court disagreed:

> Respondent first argues that decedent's right to cash prepayments constituted a valuable property right… . Although the original VPFCs did provide decedent with a right to receive cash prepayments, once these prepayments were received..., decedent was left only with obligations to deliver under the terms of the VPFCs and retained no further property rights with respect to the contracts…. All decedent had under the terms of the VPFCs were obligations that might increase or decrease in amount.
>
> Respondent next argues that decedent had the right to settle the VPFCs with stock or in cash and the right to substitute other collateral for the shares pledged to BofA and MSI. We are not persuaded by respondent's argument. The VPFCs contained contractual

the seller would like to defer gain? The buyer might be willing to receive a payment to extend settlement; such a payment does not do anything to close the transaction or otherwise trigger gain[50] and does not constitute a constructive sale under Code § 1259.[51]

> provisions that allowed decedent to determine his method of delivery. However, the contractual provisions allowing decedent to choose settlement with stock or in cash and to substitute collateral did not equate to property rights. These provisions had no value that decedent could dispose of in an arm's-length transaction; we cannot foresee a hypothetical buyer willing to pay value for the "right" to deliver stock or cash or the "right" to substitute collateral. Furthermore, decedent's ability to substitute collateral was not absolute; it was subject to the approval of his counterparties. Thus, these contractual provisions are not property rights but rather procedural mechanisms designed to facilitate decedent's delivery obligations.

[50] *Estate of Andrew J. McKelvey v. Commissioner*, 148 T.C. No. 13 (2017), held:

> At the time decedent extended the original VPFCs, he had only delivery obligations and not property rights in the contracts. These were purely liabilities as shown in Dr. Bessembinder's expert report. We hold that the MSI and BofA extensions, executed on July 15 and 24, 2008, did not constitute exchanges of decedent's "property" in the original VPFCs under section 1001.

The court later explained:

> The issue is what tax consequences occurred when decedent extended the settlement and averaging dates of the original VPFCs on July 15 and 24, 2008. Respondent argues that the extensions to the original VPFCs closed the original VPFCs and that decedent should have realized gain or loss upon executing the extensions. Petitioner argues that decedent's extensions to the original VPFCs did not close the original transactions and the open transaction treatment afforded to the original VPFCs should continue until the VPFCs were settled by delivery of Monster stock on the extended settlement dates. We agree with petitioner.
>
> The rationale for affording open transaction treatment to VPFCs is the existence of uncertainty regarding the property to be delivered at settlement. As explained above, a section 1001 computation requires both an amount realized and an adjusted basis; however, only an amount realized (*i.e.*, the cash prepayment) was known to decedent when the original VPFCs were executed. The original VPFCs provided decedent with the discretion to settle the contracts by delivering: (1) Monster shares pledged as collateral; (2) other shares that were not pledged as collateral; or (3) a cash equivalent. Decedent had not yet discharged his delivery obligations under the original VPFCs when he executed the extensions, and the original VPFCs were still open transactions. The MSI and BofA extensions made only one change to the original VPFCs: The settlement and averaging dates were postponed. Thus, by only extending the settlement and averaging dates, the extensions did not clarify the uncertainty of which property decedent would ultimately deliver to settle the contracts. Decedent had the discretion to settle the VPFCs using stock with a higher or lower basis than the stock pledged as collateral. Because decedent's obligation to deliver a variable number of shares (or the cash equivalent) was continuing, it remained uncertain whether decedent would realize a gain or loss upon discharge of his obligations, not to mention the characterization of such gain or loss.
>
> Although a VPFC is not an option, an option is a familiar type of open transaction from which we can distill applicable principles. See Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279. Upon executing the original VPFC decedent was similarly situated to the writer of a call option, as he received an upfront payment and maintained an obligation to deliver property at a future date. The writer of a call option (optionor) receives an upfront premium in exchange for the obligation to sell property at a specified strike price if the option is exercised by the option holder (optionee) by a certain date. The premium received by the optionor for writing a call is not included in income at the

time of receipt but is carried in a deferred account until either (1) the option expires; (2) the option is exercised; or (3) the optionor engages in a closing transaction. Rev. Rul. 78-182, *supra*; Rev. Rul. 58-234, *supra*. If the call option is exercised, the premium received by the optionor is includable in the total amount realized when determining the optionor's total gain or loss, and the gain or loss will be characterized as either short term or long term depending on the holding period of the underlying stock. Rev. Rul. 58-234, *supra*. If the option expires unexercised, the upfront premium constitutes short-term capital gain to the optionor upon expiration. Sec. 1234(b); Rev. Rul. 78-182, *supra*. Thus, until exercise, expiration, or termination of the option, uncertainty exists regarding the taxpayer's treatment of the option premium.

Virginia Iron Coal & Coke Co. v. Commissioner (*Virginia Coal*), 37 B.T.A. 195 (1938), *aff'd*, 99 F.2d 919 (4th Cir. 1938), and *Fed. Home Loan Mortg. Corp. v. Commissioner* (*Freddie Mac*), 125 T.C. 248 (2005), are both instructive regarding options and open transaction treatment. In *Virginia Coal*, 37 B.T.A. at 196, the taxpayer wrote an option in exchange for an upfront cash premium. The option contract provided the optionee with the right to extend the option from year-to-year by making annual payments to the taxpayer on or before the first day of August. *Id.* The optionee failed to make a timely extension payment for the third year, which allowed the option to lapse; however, the parties modified the option and agreed to continue it. *Id.* The Board of Tax Appeals held that the continuation of the option prevented the taxpayer from realizing gain or loss in the year of lapse because the taxpayer maintained a continuing obligation to perform. *Id.* at 197-198. The Board of Tax Appeals also reasoned that continuing open transaction treatment was appropriate because it was uncertain whether the premium payments would ultimately be included in the computation of gain or loss from the sale of the underlying property or would constitute income to the taxpayer in connection with the expiration of the option. *Id.*

In *Freddie Mac*, 125 T.C. at 253, the taxpayer entered into prior approval purchase contracts to purchase mortgages from loan originators in exchange for a nonrefundable commitment fee. The Government argued that the upfront commitment fees did not constitute option premiums because it was a virtual certainty that the transactions would be consummated. *Id.* at 265. First, we found the prior approval purchase contracts to have the economic substance of options and applied the law and policy rationale governing options. *Id.* at 264-265. Despite the high level of certainty that a transaction would be consummated, we held that some uncertainty remained whether the loan originator would exercise the right to sell the mortgage to the taxpayer, and whether the option was exercised or allowed to expire affected the tax treatment of the upfront premiums. *Id.* at 266.

In *Virginia Coal* and *Freddie Mac* we approved open transaction treatment because it was uncertain whether the options would be exercised or allowed to expire, and the uncertainty directly affected the taxpayer's treatment of the upfront option premium. In the instant case, ample uncertainty existed regarding the nature and amount of the gain or loss. When decedent entered into the original VPFCs, he had the right to receive a cash prepayment in exchange for his obligation to deliver an undetermined number of Monster shares or cash equivalent. Although the amount of the prepayment was known to the parties at inception, the amount and character of gain or loss could not be determined until decedent determined what property he would deliver at settlement. If decedent delivered Monster shares in settlement of the VPFCs, the gain or loss would be determined by comparing the amount realized (i.e., the prepayment cash) with the basis in the particular shares delivered, and the character of the gain or loss would be determined by the holding period of the shares delivered. If decedent delivered a cash equivalent to settle the VPFCs, the gain or loss would have been determined by comparing the amount realized (*i.e.*, the prepayment cash) to the amount paid to settle the contract. This uncertainty existed with respect to the original VPFCs, and the extensions to the VPFCs did not resolve what property decedent would deliver at settlement.

[51] *Estate of Andrew J. McKelvey v. Commissioner*, 148 T.C. No. 13 (2017), held:

Congress enacted section 1259 because it was concerned that taxpayers holding appreciated equity positions were entering into certain complex financial transactions without paying any tax. *Anschutz Co. v. Commissioner*, 135 T.C. at 109. In the event there is a constructive sale of an appreciated financial position,[18] the taxpayer shall recognize gain as if that position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Sec. 1259(a)(1). Section 1259(c)(1)(C) provides that the taxpayer will be treated as having made a constructive sale of an appreciated financial position if the taxpayer "enters into a future or forward contract to deliver the same or substantially identical property." Section 1259(d)(1) defines a forward contract as "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price." A forward contract that calls for the delivery of "an amount of property, such as shares of stock, that is subject to significant variation under the contract terms" is not a forward contract pursuant to section 1259 and does not result in a constructive sale of stock. S. Rept. No. 105-33, at 125-126 (1997), 1997-4 C.B. (Vol. 2) 1067, 1205-1206.

[18] The term "appreciated financial position" means any position with respect to stock if there would be a gain if the position were sold at its fair market value. Sec. 1259(b)(1). Petitioner concedes that decedent's Monster stock represents an appreciated financial position at the time the original VPFCs and extensions were executed.

Decedent's extensions to the original VPFCs do not constitute constructive sales under section 1259, because the original VPFCs are the only contracts subject to evaluation. Respondent acknowledges that decedent's execution of the original VPFCs satisfied Rev. Rul. 2003-7, *supra*. Implicit in this acknowledgment is that the original VPFCs did not trigger constructive sales of stock under section 1259 because the original VPFCs required the future delivery of Monster stock subject to significant variation. Respondent's argument that the extensions to the original VPFCs triggered constructive sales under section 1259 is predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs under section 1001. As we concluded above, the open transaction treatment afforded to the original VPFCs continued when decedent extended the settlement and averaging dates, and there was no exchange of property under section 1001. Accordingly, because respondent concedes that the original VPFCs were properly afforded open transaction treatment under section 1001—and because the open transaction treatment continued when decedent executed the extensions—there is no merit to respondent's contention that the extended VPFCs should be viewed as separate and comprehensive financial instruments under section 1259.

Anschutz Co. v. Commissioner, 135 T.C. 78, 111-112 (2010), *aff'd* 664 F3d 313 (10th Cir. 2011), described Code § 1259:

… a forward contract is treated as a constructive sale if it is for a substantially fixed amount of property for a substantially fixed price. Sec. 1259(c)(1)(C), (d)(1). Section 1259 does not define the terms "substantially fixed amount of property" or "substantially fixed price". Section 1259 gives the Secretary two sources of authority for issuing regulations to carry out Congress' intent— section 1259(c)(1)(E) and (f)—but no regulations have been issued defining either phrase.

The legislative history provides some guidance as to determining whether a transaction is treated as a constructive sale under section 1259. The Senate Finance Committee report, S. Rept. 105-33, at 125-126 (1997), 1997-4 C.B. (Vol. 2) 1067, 1205-1206, in stating that a forward contract results in a constructive sale only if it provides for delivery of a substantially fixed amount of property at a substantially fixed price, goes on to say that "a forward contract providing for delivery of an amount of property, such as shares of stock, that is subject to significant variation under the contract terms does not result in a constructive sale." The report does not define or provide any guidance relative to the

Be careful not to couple the VPFC with a share lending transaction[52] that limits the seller's risk of loss,[53] which may result in recognizing gain up front,[54] because the coupled transaction constitutes a sale.[55]

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term "significant variation" and the Secretary has not issued any regulations interpreting this term.

The Senate Finance Committee report provides more detailed guidance when discussing the Secretary's regulatory authority under section 1259(c)(1)(E) to issue regulations to carry out the purpose of section 1259. *Id.* at 126, 1997-4 C.B. (Vol. 2) at 1206. Congress anticipated that the Secretary would use his authority to issue regulations treating as constructive sales financial transactions which, like those listed in section 1259(c)(1), have the effect of eliminating "substantially all of the taxpayer's risk of loss and opportunity for income or gain" with respect to the appreciated financial position. *Id.* However, transactions in which the taxpayer eliminated his risk of loss, or opportunity for income or gain, but not both, were not to be treated as constructive sales under section 1259. *Id.*

The report goes on to state that it is not intended that risk of loss and opportunity for gain be considered separately. If a transaction has the effect of eliminating substantially all of the taxpayer's risk of loss and substantially all of the taxpayer's opportunity for gain with respect to an appreciated financial position, it is intended that the Secretary's regulations would treat the transaction as a constructive sale. *Id.* Again, however, section 1259 and the legislative history do Id. not define "substantially all".

Rev. Rul. 2003-7, *supra*, provides some limited guidance in evaluating whether TAC's PVFCs trigger constructive sale treatment. In that revenue ruling the taxpayer entered into a forward contract to deliver a variable number of shares of stock, depending on the fair market value of the stock on the delivery date. The taxpayer received an upfront payment in exchange for his obligation to deliver stock at a later date. The taxpayer's delivery obligation varied by 20 shares: the taxpayer would have to deliver no fewer than 80, and no more than 100, shares of the stock at issue. The revenue ruling held that the taxpayer had not entered into a constructive sale under section 1259(c)(1)(C) because the variation in the number of shares deliverable, 20, was significant, and the agreement was not a contract to deliver a substantially fixed amount of property for purposes of section 1259(d)(1).

TAC's stock transactions were not forward contract constructive sales because they were not forward contracts as defined in section 1259(d)(1)—they did not provide for delivery of a substantially fixed amount of property for a substantially fixed price. Section 1259 does not define the term "substantial", and the Secretary has not issued regulations providing any additional guidance. TAC's ultimate delivery obligation may vary by as much as 33.3 percent; this is in excess TAC may ultimately of the variance in Rev. Rul. 2003-7, *supra*. deliver between 6,025,261 and 9,037,903 shares of stock to settle the PVFCs. We find this variance in TAC's delivery obligation to be substantial. TAC did not cause a constructive sale under section 1259(c)(1)(C).

[52] *Anschutz Co. v. Commissioner*, 135 T.C. 78, 81-82 (2010) , *aff'd* 664 F3d 313 (10th Cir. 2011), described share-lending:

Share-lending agreements are often entered into by equity holders who have taken a long position with respect to a stock and plan on holding it for an extended period. The equity owner can agree to lend the stock to a counterparty, who can then use the borrowed shares to increase market liquidity and facilitate stock sales. For example, the equity owner can lend shares to an investment bank, which could then use the lent shares to execute short sales on behalf of its clients.

The borrower will normally pledge cash collateral, and the lender will derive a profit lending the shares by retaining a portion of the interest earned by this cash collateral. At the end of the lending period, the counterparty will return the borrowed shares to the equity owner/lender.

The court described the safe harbor for avoiding tax on an SLA:

> Section 1058(a) provides that if a taxpayer transfers securities subject to an agreement that meets the requirements of section 1058(b), no gain or loss shall be recognized on the transfer in exchange for a promise to return identical shares at the end of the agreement period. Section 1058(b) imposes four requirements that must be met in order to satisfy that subsection.
>
> (1) The agreement must provide for the return of identical securities. Sec. 1058(b)(1).
>
> (2) If dividends, interest, or equivalent payments are made between the initial transfer by the transferor and the return of identical securities by the transferee with respect to the transferred shares, the agreement must provide for the payment of those amounts to the transferor. Sec. 1058(b)(2).
>
> (3) The agreement must not reduce the risk of loss or opportunity for gain of the transferor in the securities transferred. Sec. 1058(b)(3).
>
> (4) The agreement must meet any further requirements that the Secretary has prescribed by regulation. Sec. 1058(b)(4).

[53] *Anschutz Co. v. Commissioner*, 135 T.C. 78, 108 (2010), *aff'd* 664 F3d 313 (10th Cir. 2011), discussed that coupling a PVFC with a share-lending agreement (SLA) can cause a transaction to be taxed as closed:

> The parties entered into an agreement to sell and lend shares by integrated transactions. The PVFCs and SLAs were clearly related. One could not occur without the other. To the extent that petitioners argue TAC and DLJ could have entered into the PVFCs without corresponding share-lending agreements, that hypothetical transaction is not before the Court. The transaction before the Court transferred the benefits and burdens of ownership of the lent shares, and petitioners do not satisfy the section 1058 safe harbor.

In affirming the Tax Court, the Tenth Circuit reasoned and held:

> The problem with petitioners' reliance on Revenue Ruling 2003-7 is that the transactions at issue in this case, considered as a whole, are different from the entirety of the transactions at issue in Revenue Ruling 2003-7. Whereas the circumstances underlying Revenue Ruling 2003-7 involved only a VPFC, in the instant case the parties entered into a series of related transactions that included not only a VPFC, but also the MSPA and the Share-Lending Agreements. The result of these related transactions was that DLJ obtained possession, and most of the incidents of ownership, of TAC's pledged shares. TAC, in turn, obtained cash payments and an elimination of any risk of loss in the pledged stock's value at the end of the term of the transactions. Thus, we conclude that petitioners' reliance on Revenue Ruling 2003-7 is misplaced….
>
> For the reasons we have already discussed, we conclude that the transactions at issue in this case cannot satisfy the requirements set forth in § 1058(b)(2) or (3). To begin with, the transactions at issue did not ensure that TAC would receive "amounts equivalent to all interest, dividends, and other distributions" to which TAC was otherwise entitled on the pledged stock. 26 U.S.C. § 1058(b)(2). Further, the transactions at issue effectively "reduce[d] [TAC's] risk of loss [and] opportunity for gain" in the pledged shares. 26 U.S.C. § 1058(b)(3). Indeed, as we have discussed, the transactions effectively eliminated TAC's risk of loss and substantially reduced TAC's opportunity for gain. Consequently, petitioners are not entitled to the so-called "safe harbor" afforded by § 1058.

[54] The official Tax Court syllabus of *Anschutz Co. v. Commissioner*, 135 T.C. 78, *aff'd* 664 F3d 313 (10th Cir. 2011), provides:

> P-PA, an individual, owned P-AC, an S corporation. TAC is a wholly owned qualified subch. S subsidiary of P-AC, and its items of income and gain are reported on P-AC's Federal tax return. P-PA used TAC as an investment vehicle. TAC held the stock of companies that P-PA decided to invest in. TAC entered into a master stock purchase agreement (MSPA) for the sale of some of those corporate stocks in 2000 and 2001 to

DLJ, an investment bank. The MSPA consisted of forward contracts and share-lending agreements. The forward contracts were prepaid in cash and would be settled with variable numbers of shares of stock. The share-lending agreements called for TAC to lend the shares of stock subject to the forward contracts to DLJ.

P-PA and P-AC treated the MSPA as an open transaction and did not report any gain or loss on the transfers of stock. R determined that the MSPA was a sale of stock and that P-AC was liable for built-in gains tax pursuant to sec. 1374, I.R.C., as a result of TAC's income and gain being reported on P-AC's return. R also determined that there were deficiencies in the personal income tax of P-PA, the sole shareholder of P-AC, as a result of adjustments including in his income a distributive share of the built-in gain.

Under sec. 1058, I.R.C., no gain or loss is recognized by a taxpayer who transfers securities pursuant to an agreement that meets the requirements of sec. 1058(b), I.R.C. Sec. 1259, I.R.C., provides for constructive sale treatment if a taxpayer enters into a transaction listed in sec. 1259(c)(1), I.R.C.

Held: The MSPA constituted a sale and TAC and P-AC must recognize gain to the extent of the upfront cash payments received in 2000 and 2001; the MSPA called for the lending of shares but did not meet the requirements of sec. 1058(b), I.R.C., because it limited TAC's risk of loss.

Held, further: TAC did not engage in constructive sales of stock in 2000 and 2001 pursuant to sec. 1259, I.R.C.

The official Tax Court syllabus of *Calloway v. Commissioner*, 135 T.C. 26 (2010), *aff'd* 691 F3d 1315 (11th Cir. 2012) provides:

In August 2001 P entered into an agreement with Derivium whereby P transferred 990 shares of IBM common stock to Derivium in exchange for $93,586.23. The terms of the agreement characterized the transaction as a loan of 90 percent of the value of the IBM stock pledged as collateral. The purported loan was nonrecourse and prohibited P from making any interest or principal payments during the 3-year term of the purported loan. The terms of the agreement allowed Derivium to sell the stock, which it did immediately upon receipt. At maturity P had the option of either paying the balance due and having an equivalent amount of IBM stock returned to him, renewing the purported loan for an additional term, or satisfying the "loan" by surrendering any right to receive IBM stock. At maturity in August 2004 the balance due was $40,924.57 more than the then value of the IBM stock. P elected to satisfy his purported loan by surrendering any right to receive IBM stock. P was not required to and did not make any payments toward either principal or interest on the purported loan.

1. *Held*: The transaction between P and Derivium in August 2001 was a sale. P transferred all the benefits and burdens of ownership of the stock to Derivium for $93,586.23 with no obligation to repay that amount.
2. Held, further, the transaction was not analogous to the securities lending arrangement in Rev. Rul. 57-451, 1957-2 C.B. 295, nor was it equivalent to a securities lending arrangement under sec. 1058, I.R.C.
3. Held, further, Ps are liable for an addition to tax under sec. 6651(a)(1), I.R.C., for the late filing of their 2001 Federal income tax return.
4. Held, further, Ps are liable for the accuracy-related penalty pursuant to sec. 6662, I.R.C.

[55] *Anschutz Co. v. Commissioner*, 664 F3d 313 (10th Cir. 2011), discussed what constitutes a sale:

For purposes of the IRC, the term "sale" is given its ordinary meaning and is generally defined as a transfer of property for money or a promise to pay money. *Commissioner v. Brown*, 380 U.S. 563, 570-71 (1965). Whether a sale has occurred depends upon whether, as a matter of historical fact, there has been a transfer of the benefits and burdens of ownership. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981). "Some of the factors that have been considered by courts in making this determination are: (1) Whether legal title passes; (2) how the parties treat the transaction;

I mentioned *McKelvey* (the case discussed in fns. 47 and 49-51) to a nationally recognized speaker who had suggested over the year using prepaid variable forward contracts. He speculated that the decedent might have used the cash he received up front to buy stock from an irrevocable grantor trust, thus obtaining a basis step-up on not only the stock he retained but also stock that he bought from the irrevocable grantor trust.

II.A.1.e. Personal Holding Company Tax

Code § 541 provides that any personal holding company is taxed on 20% of its undistributed personal holding company income.

Code § 541 is intended to require most C Corporations with excess investment income to pay dividends.[56] "Undistributed personal holding company income" is the excess of a personal holding company's adjusted taxable income[57] over dividends paid or deemed paid.[58] Dividends paid or deemed paid include dividends paid during or shortly after[59] the taxable year, consent dividends[60] for the taxable year, and dividends carried over from a prior year[61] for purposes of this test.[62]

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(3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damages to the property; and (8) which party receives the profits from the operation and sale of the property." *Id.* (internal citations omitted). With respect to stock transactions in particular, the following factors are also considered relevant to this determination: "(i) whether the purchaser bears the risk of loss and opportunity for gain; (ii) which party receives the right to any current income from the property; (iii) whether legal title has passed; and (iv) whether an equity interest was acquired in the property." *H.J. Heinz Co. and Subsidiaries v. United States*, 76 Fed. Cl. 570, 581 (Fed. Cl. 2007).

[56] "Dividend" means a taxable dividend paid from the corporation's current or accumulated earnings and profits. Code § 562(a). Preferred dividends do not count, except from a publicly offered regulated investment company or a publicly offered REIT. Code § 562(c)(1).

[57] Code § 545(b) adjusts taxable income for various federal income tax and similar taxes, adjusts the charitable contribution deduction, disallows certain dividend-received deductions, adjusts the deduction for net operating losses, deducts U.S. net after-tax capital gain, and limits depreciation to that allowed with respect to rental income.

[58] Code § 545(a).

[59] Code § 563 allows a corporation to elect to treat a dividend paid after the close of any taxable year and on or before the 15th day of the fourth month following the close of such taxable year to be considered as paid on the last day of that taxable year. However, the amount so elected cannot exceed either the corporation's undistributed personal holding company income for the taxable year, computed without regard to this rule, or 20% of the sum of the dividends paid during the taxable year, computed without regard to this rule.

[60] A corporation and its shareholders may agree to deem dividends as paid on the last day of the corporation's taxable year, Code § 565(a), and contributed to the capital of the corporation by the shareholder on that last day. Code § 565(c). However, generally the deemed dividend must qualify under fn 56. Code § 565(b).

[61] Code § 564(b) determines the dividend carryover as follows:

(1) For each of the 2 preceding taxable years there shall be determined the taxable income computed with the adjustments provided in section 545 (whether or not the taxpayer was a personal holding company for either of such preceding taxable

Code § 542(a) provides that, unless excluded from this tax,[63] a corporation is a "personal holding company" if:

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years), and there shall also be determined for each such year the deduction for dividends paid during such year as provided in section 561 (but determined without regard to the dividend carryover to such year).

(2) There shall be determined for each such taxable year whether there is an excess of such taxable income over such deduction for dividends paid or an excess of such deduction for dividends paid over such taxable income, and the amount of each such excess.

(3) If there is an excess of such deductions for dividends paid over such taxable income for the first preceding taxable year, such excess shall be allowed as a dividend carryover to the taxable year.

(4) If there is an excess of such deduction for dividends paid over such taxable income for the second preceding taxable year, such excess shall be reduced by the amount determined in paragraph (5), and the remainder of such excess shall be allowed as a dividend carryover to the taxable year.

(5) The amount of the reduction specified in paragraph (4) shall be the amount of the excess of the taxable income, if any, for the first preceding taxable year over such deduction for dividends paid, if any, for the first preceding taxable year.

[62] Code § 561.

[63] Code § 542(c) excludes the following:

(1) a corporation exempt from tax under subchapter F (sec. 501 and following);
(2) a bank as defined in section 581, or a domestic building and loan association within the meaning of section 7701(a)(19);
(3) a life insurance company;
(4) a surety company;
(5) a foreign corporation,
(6) a lending or finance company if-
    (A) 60 percent or more of its ordinary gross income (as defined in section 543(b)(1)) is derived directly from the active and regular conduct of a lending or finance business;
    (B) the personal holding company income for the taxable year (computed without regard to income described in subsection (d)(3) and income derived directly from the active and regular conduct of a lending or finance business, and computed by including as personal holding company income the entire amount of the gross income from rents, royalties, produced film rents, and compensation for use of corporate property by shareholders) is not more than 20 percent of the ordinary gross income;
    (C) the sum of the deductions which are directly allocable to the active and regular conduct of its lending or finance business equals or exceeds the sum of-
        (i) 15 percent of so much of the ordinary gross income derived therefrom as does not exceed $500,000, plus
        (ii) 5 percent of so much of the ordinary gross income derived therefrom as exceeds $500,000; and
    (D) the loans to a person who is a shareholder in such company during the taxable year by or for whom 10 percent or more in value of its outstanding stock is owned directly or indirectly (including, in the case of an individual, stock owned by members of his family as defined in section 544(a)(2)), outstanding at any time during such year do not exceed $5,000 in principal amount;
(7) a small business investment company which is licensed by the Small Business Administration and operating under the Small Business Investment Act of 1958 (15 U.S.C. 661 and following) and which is actively engaged in the business of

(1) *Adjusted ordinary gross income requirement*. At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and

(2) *Stock ownership requirement*. At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. For purposes of this paragraph, an organization described in section 401(a), 501(c)(17), or 509(a) or a portion of a trust permanently set aside or to be used exclusively for the purposes described in section 642(c) or a corresponding provision of a prior income tax law shall be considered an individual.

Code § 543(a) provides that "personal holding company income" means the portion of the adjusted ordinary gross income consisting of:

(1) *Dividends, etc.* Dividends, interest, royalties (other than mineral, oil, or gas royalties or copyright royalties), and annuities. This paragraph shall not apply to-

(A) interest constituting rent (as defined in subsection (b)(3)),

(B) interest on amounts set aside in a reserve fund under chapter 533 or 535 of title 46, United States Code,

(C) dividends received by a United States shareholder (as defined in section 951(b)) from a controlled foreign corporation (as defined in section 957(a)).

(D) active business computer software royalties (within the meaning of subsection (d)), and

(E) interest received by a broker or dealer (within the meaning of section 3(a)(4) or (5) of the Securities and Exchange Act of 1934) in connection with-

(i) any securities or money market instruments held as property described in section 1221(a)(1),

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providing funds to small business concerns under that Act. This paragraph shall not apply if any shareholder of the small business investment company owns at any time during the taxable year directly or indirectly (including, in the case of an individual, ownership by the members of his family as defined in section 544(a)(2)) a 5 per centum or more proprietary interest in a small business concern to which funds are provided by the investment company or 5 per centum or more in value of the outstanding stock of such concern; and

(8) a corporation which is subject to the jurisdiction of the court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) unless a major purpose of instituting or continuing such case is the avoidance of the tax imposed by section 541.

Code § 542(d) further describes Code § 542(c)(6).

(ii) margin accounts, or

(iii) any financing for a customer secured by securities or money market instruments.

(2) *Rents*. The adjusted income from rents; except that such adjusted income shall not be included if-

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income, and

(B) the sum of-

(i) the dividends paid during the taxable year (determined under section 562),

(ii) the dividends considered as paid on the last day of the taxable year under section 563(d) (as limited by the second sentence of section 563(b)), and

(iii) the consent dividends for the taxable year (determined under section 565),

equals or exceeds the amount, if any, by which the personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (6), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) exceeds 10 percent of the ordinary gross income.

(3) *Mineral, oil, and gas royalties*. The adjusted income from mineral, oil, and gas royalties; except that such adjusted income shall not be included if-

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income,

(B) the personal holding company income for the taxable year (computed without regard to this paragraph, and computed by including as personal holding company income copyright royalties and the adjusted income from rents) is not more than 10 percent of the ordinary gross income, and

(C) the sum of the deductions which are allowable under section 162 (relating to trade or business expenses) other than-

(i) deductions for compensation for personal services rendered by the shareholders, and

(ii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 15 percent of the adjusted ordinary gross income.

(4) *Copyright royalties*. Copyright royalties; except that copyright royalties shall not be included if-

(A) such royalties (exclusive of royalties received for the use of, or right to use, copyrights or interests in copyrights on works created in whole, or in part, by any shareholder) constitute 50 percent or more of the ordinary gross income,

(B) the personal holding company income for the taxable year computed-

(i) without regard to copyright royalties, other than royalties received for the use of, or right to use, copyrights or interests in copyrights in works created in whole, or in part, by any shareholder owning more than 10 percent of the total outstanding capital stock of the corporation,

(ii) without regard to dividends from any corporation in which the taxpayer owns at least 50 percent of all classes of stock entitled to vote and at least 50 percent of the total value of all classes of stock and which corporation meets the requirements of this subparagraph and subparagraphs (A) and (C), and

(iii) by including as personal holding company income the adjusted income from rents and the adjusted income from mineral, oil, and gas royalties,

is not more than 10 percent of the ordinary gross income, and

(C) the sum of the deductions which are properly allocable to such royalties and which are allowable under section 162, other than-

(i) deductions for compensation for personal services rendered by the shareholders,

(ii) deductions for royalties paid or accrued, and

(iii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 25 percent of the amount by which the ordinary gross income exceeds the sum of the royalties paid or accrued and the amounts allowable as deductions under section 167 (relating to depreciation) with respect to copyright royalties.

For purposes of this subsection, the term “copyright royalties” means compensation, however designated, for the use of, or the right to use, copyrights in works protected by copyright issued under title 17 of the United States Code and to which copyright protection is also extended by the laws of any country other than the United States of America by virtue of any international treaty, convention, or agreement, or interests in any such copyrighted works, and includes payments from any person for performing rights in any such copyrighted work and payments (other than produced film rents as defined in paragraph (5)(B)) received for the use of, or right to use, films. For purposes of this paragraph , the term "shareholder" shall include any person who owns stock within the meaning of section 544. This paragraph shall not apply to active business computer software royalties.

(5) *Produced film rents*.

(A) Produced film rents; except that such rents shall not be included if such rents constitute 50 percent or more of the ordinary gross income.

(B) For purposes of this section, the term "produced film rents" means payments received with respect to an interest in a film for the use of, or right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film. In the case of a producer who actively participates in the production of the film, such term includes an interest in the proceeds or profits from the film, but only to the extent such interest is attributable to such active participation.

(6) *Use of corporate property by shareholder*.

(A) Amounts received as compensation (however designated and from whomever received) for the use of, or the right to use, tangible property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property (whether such right is obtained directly from the corporation or by means of a sublease or other arrangement).

(B) Subparagraph (A) shall apply only to a corporation which has personal holding company income in excess of 10 percent of its ordinary gross income.

(C) For purposes of the limitation in subparagraph (B), personal holding company income shall be computed-

(i) without regard to subparagraph (A) or paragraph (2),

(ii) by excluding amounts received as compensation for the use of (or right to use) intangible property (other than mineral, oil, or gas royalties or copyright royalties) if a substantial part of the tangible property used in connection with such intangible property is owned by the corporation and all such tangible and intangible property is used in the active conduct of a trade or business by an individual or individuals described in subparagraph (A), and

(iii) by including copyright royalties and adjusted income from mineral, oil, and gas royalties.

(7) *Personal service contracts*.

(A) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and

(B) amounts received from the sale or other disposition of such a contract.

This paragraph shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(8) *Estates and trusts*. Amounts includible in computing the taxable income of the corporation under part I of subchapter J (sec. 641 and following, relating to estates, trusts, and beneficiaries).

Code § 543(b)(2) provides that ordinary gross income is adjusted as follows to determine "adjusted ordinary gross income":

(A) *Rents*. From the gross income from rents (as defined in the second sentence of paragraph (3) of this subsection) subtract the amount allowable as deductions for-

(i) exhaustion, wear and tear, obsolescence, and amortization of property other than tangible personal property which is not customarily retained by any one lessee for more than three years,

(ii) property taxes,

(iii) interest, and

(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary, to such gross income from rents. The amount subtracted under this subparagraph shall not exceed such gross income from rents.

(B) *Mineral royalties, etc.* From the gross income from mineral, oil, and gas royalties described in paragraph (4), and from the gross income from working interests in an oil or gas well, subtract the amount allowable as deductions for—-

(i) exhaustion, wear and tear, obsolescence, amortization, and depletion,

(ii) property and severance taxes,

(iii) interest, and

(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary, to such gross income from royalties or such gross income from working interests in oil or gas wells. The amount subtracted under this subparagraph with respect to royalties shall not exceed the gross income from such royalties, and the amount subtracted under this subparagraph with respect to working interests shall not exceed the gross income from such working interests.

(C) *Interest*. There shall be excluded-

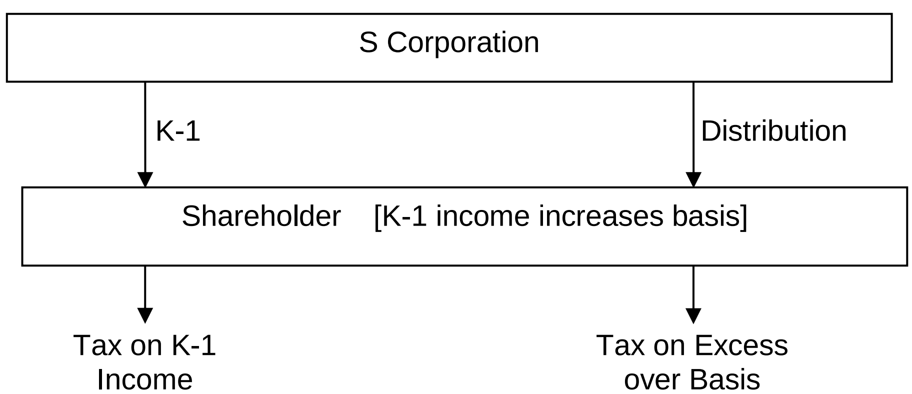
(i) interest received on a direct obligation of the United States held for sale to customers in the ordinary course of trade or business by a regular dealer who is making a primary market in such obligations, and

(ii) interest on a condemnation award, a judgment, and a tax refund.

(D) *Certain excluded rents*. From the gross income consisting of compensation described in subparagraph (D) of paragraph (3) subtract the amount allowable as deductions for the items described in clauses (i), (ii), (iii), and (iv) of subparagraph (A) to the extent allocable, under regulations prescribed by the Secretary, to such gross income. The amount subtracted under this subparagraph shall not exceed such gross income.

II.A.2. S Corporation

An S corporation is an entity taxed as a corporation whose income generally is taxed to its owners rather than being taxed to the entity itself;[64] the entity issues a Schedule K-1 to its owners each year to report the income. If the entity was never a C corporation:



Rather than using a corporation as the state law entity, consider using a limited liability company (or other unincorporated entity) that elects taxation as an S corporation.[65] Compared to a traditional corporation, an LLC or other unincorporated entity might offer

[64] Code § 1363. See Hill and Anderson, "Computing S corporation Taxable Income: Unraveling the Mysteries of Section 1363(b)," *Business Entities* (WG&L), July/Aug. 2009.
[65] See text accompanying fn. 295 for how such an entity makes an S election.

better protection from an owner's creditors,[66] provide more flexibility in making distributions to pay the seller's taxes after a change in control,[67] allow the parties to control future actions,[68] and provide a nongrantor trust a better opportunity to materially participate[69] to avoid the 3.8% tax on net investment income.[70] However, there might be a slight risk that the LLC might not qualify for the S corporation exemption from self-employment tax.[71]

Note that, in the case of a seller-financed sale of goodwill, using a C corporation causes a triple tax, an S corporation causes a double tax, and a partnership causes a single tax.[72] When an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[73] For what might be an ideal structure, see part II.E Recommended Structure for Entities.

Below are some examples of when it is possible that an S corporation may be appropriate.

II.A.2.a. Existing Corporation - Avoiding Double Taxation

An existing corporation would like to start paying dividends to its shareholders. However, as a regular corporation (described by tax practitioners as a C corporation), it would pay tax on its earnings, and its shareholders would pay tax on the dividends. The shareholders make an S election, so that they (rather than the corporation itself) are taxed on the corporation's earnings. The shareholders will not be taxed on dividends, to the extent that the dividends represent earnings that constitute reinvested earnings while the corporation was an S corporation.[74]

II.A.2.b. Existing Corporation - Paying Retired Shareholder-Officers

One of the shareholders decides to retire but would still like the company to pay him the substantial salary he is used to receiving. The shareholders have never formally agreed what would happen when one of them retires. If the company pays "compensation" to a shareholder who is not working, the IRS could try to disallow a deduction for the payment, claiming that it is really a dividend. The shareholders make an "S" election, so

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[66] See part II.F.1 Business Entities and Creditors Generally.
[67] See part III.B.2.j.ii.(f) Distribution after Transfer.
[68] See part II.F.3 Limited Partnerships and LLCs as Control Vehicles.
[69] See parts II.K.1.a Counting Work as Participation and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues (under II.K.2.b Participation by an Estate or Nongrantor Trust).
[70] See parts II.I 3.8% Tax on Excess Net Investment Income and II.I.8.a General Application of 3.8% Tax to Business Income.
[71] See part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.
[72] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.
[73] See part II.H.2 Basis Step-Up Issues.
[74] See part II.Q.7.b.i Redemptions or Distributions Involving S Corporations - Generally, especially fn. 3507.

that they (rather than the corporation itself) are taxed on the corporation's earnings. Each shareholder receives a pro rata share of the corporation's earnings. The shareholders will not be taxed on dividends, to the extent that the dividends represent earnings while the corporation was an S corporation. At the same time, the shareholders agree on a formula for how much compensation each shareholder-officer will receive, so that the retired shareholder can be sure that the remaining shareholders do not receive all of the profits through compensation.

II.A.2.c. New Corporation - Avoiding Double Taxation and Self-Employment Tax

As new business owners, clients should be concerned with double taxation - once when the company earns profits, and again when the company pays dividends. Even if a reduced capital gain tax rate applies to dividends, one must add up two levels of federal income tax and two levels of state income tax. However, partnership income tax might not be desirable, either, since the owners generally must pay self-employment tax (under which the owner in effect pays the company's and the employee's share of Social Security and Medicare tax) on all of her share of the company's earnings. Instead, the client might want to pay payroll taxes on only what they receive as compensation and not pay self-employment tax on money that is reinvested in the business. As the business grows, clients do not want to pay self-employment tax on a return of their investment, just on compensation they receive for services they perform. It is possible that an S corporation may be an appropriate entity. However, in many cases taxpayers are better off starting as an LLC taxed as a partnership until undistributed self-employment earnings become material, then switch to a limited partnership with an S corporation general partner. See part II.E Recommended Structure for Entities, especially parts II.E.2.b Converting from S Corporation to C Corporation
See part II.P.3.e Conversion from S Corporation to C Corporation for short-term planning. Ideas include:

A conversion may be taxable, with the main issue being that an S corporation that was on the cash method that may be required to convert to the accrual method.

Additional steps may be needed to preserve or distribute the S corporation's accumulated adjustment account (which generally lets S corporations distribute its reinvested taxable earnings later without taxing it shareholders – see part II.Q.7.b Redemptions or Distributions Involving S Corporations). Note that, if the corporation distributes a note before converting, interest income on the note will be taxable at its shareholders' full ordinary income rates and subject to net investment income tax, which together combine to impose a 40.8% federal tax rate, whereas the corporation may receive (see part II.G.19.a Limitations on Deducting Business Interest Expense) a deduction at a 21% federal rate.

However, one always needs to consider what if that decision needs to be reversed when a new Congress changes the income tax paradigm. See parts II.P.3.c Conversion from C Corporation to S corporation and II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation.

Converting a C Corporation to an S Corporation

A C corporation that revoked its S election must wait 5 years to convert back to an S corporation. See part II.A.2.l Terminating S Election.

See part II.P.3.c Conversion from C Corporation to S corporation, including II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation. Issues discussed there include the following:

Generally, an asset sold within 5 years after converting from a C corporation to an S corporation will be taxed at the entity level and again to the shareholders. See part II.P.3.c.ii Built-in Gain Tax on Former C Corporations under Code § 1374. Therefore, before converting, one might sell assets that are likely to sold within 5 years. If the taxpayer uses the cash receipts and disbursements method of accounting, consider switching to accrual before convertings, so that accoutns receiveable do not get hit with this tax.

Although an S corporation that has accumulated earnings and profits from when it was a C corporation cannot have excess passive investment income, that issue is easily managed through the corporation's investment mix – if one considers the issue and plans for it. See part II.P.3.c.iii Excess Passive Investment Income, especially fns 2865-2868.

Also, an S corporation that has accumulated earnings and profits from when it was a C corporation should not invest in tax-exempt investments, the income from which does not generate AAA and therefore may trigger a taxable dividend when distributed. See part II.P.3.c.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

If the corporation maintains an inventory, converting from a C corporation to an S corporation may incur tax. See part II.P.3.c.i LIFO Recapture.

and II.E.7.b Flowcharts: Migrating LLC into Preferred Structure.

Some tax professionals advise using an S corporation instead of a partnership to avoid Self-Employment (FICA) tax.[75] We will see later how a partnership is a much better entity for exit strategies than is a C corporation or even an S corporation.[76] Furthermore, aggressively characterizing payments to employee-shareholders as distributions rather than compensation can lead to penalties[77] and potentially loss of the tax preparer's

[75] For a discussion of SE tax and FICA generally, see part II.L Self-Employment Tax (FICA). Within that, see parts II.L.1 FICA: Corporation and II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

[76] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

[77] For a summary of cases, see Looney and Levitt, "Compensation Reclassification Risks for C and S corporations," *Journal of Taxation* (May 2015). Note the tips provided by Kirkland, "Helping S corporations avoid unreasonable compensation audits: Find out what entries on Forms 1120S may trigger these audits," *Journal of Accountancy* (6/1/2015). See IRS Fact Sheet 2008-25, "Wage Compensation for S corporation Officers," http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers and "S Corporation Compensation and Medical

license;[78] to avoid that problem, consider using a partnership of S corporations, so that any income that each corporation accumulates is not subject to FICA/self-employment tax and any payments actually made to the owner are subjected to FICA to the extent they constitute reasonable compensation.[79]

At http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporation-Compensation-and-Medical-Insurance-Issues (checked 2/16/2015) (not precedent), the IRS commented:

Insurance Issues," https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues (lasted visited 9/2/2017), as well as http://www.irs.gov/Businesses/Valuation-of-Assets (which includes reasonable compensation issues); Rev. Rul. 74-44; *Radtke v. U.S.*, 895 F.2d 1196 (7th Cir. 1990) (law firm); *Joly v. Commissioner*, T.C. Memo 1998-361 (20% penalty assessed when S corporation treated compensation as loans); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990) (accounting firm); *Dunn & Clark, P.A. v. Commissioner*, 853 F.Supp. 365 (D. Idaho 1994) (law firm); *Wiley L. Barron, CPA, Ltd. v. Commissioner*, T.C. Summary Opinion 2001-10 (CPA firm); *Yeagle Drywall Co. v. Commissioner*, T.C. Memo. 2001-284 (drywall construction business); *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001) (consulting and surgical services provided to veterinarians); *Joseph M. Grey, P.C. v. Commissioner*, 119 T.C. 121 (2002) (accounting firm); *Nu-Look Design Inc. v. Commissioner*, 356 F.3d 290 (3rd Cir. 2004) (residential home improvement company); see *Herbert v. Commissioner*, T.C. Summary Opinion 2012-124 (taxpayer claimed only $2,400 of compensation; IRS alleged $55,000 in compensation; court used taxpayer's approximately $30,000 average annual compensation; penalties do not appear to have been imposed on wages but were imposed on other items); *Sean McAlary Ltd, Inc. v. Commissioner*, T.C. Summary Opinion 2013-62 (taxpayer penalized for failing to report any compensation; court reject IRS' expert's reliance on merely a percentage of gross receipts, instead computing an hourly wage based on its view of the cases: "the employee's qualifications, the nature, extent, and scope of the employee's work, the size and complexity of the business, prevailing general economic conditions, the employee's compensation as a percentage of gross and net income, the employee/shareholder's compensation compared with distributions to shareholders, the employee/shareholder's compensation compared with that paid to non-shareholder/employees, prevailing rates of compensation for comparable positions in comparable concerns, and comparable compensation paid to a particular shareholder/employee in previous years where the corporation has a limited number of officers"). The IRS might even recharacterize purported repayments of open account indebtedness as compensation, even when the amounts significantly exceed the K-1 income; see *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180, discussed in fn. 839. For more detailed summaries and additional cases, see Christian & Grant, "¶34.06. Reasons for Payment of Salaries," *Subchapter S Taxation* (WG&L). However, it appears that, in a professional services firm, the IRS might concede that a significant portion of distributions are not subject to FICA. See footnote 2446.

[78] *In the matter of Biyu Wong*, Case No. AC-2009-26, found at https://www.google.com/url?q=http://www.dca.ca.gov/cba/communications-and-outreach/meetings/materials/2010/mat0510cba.pdf&sa=U&ved=0ahUKEwiPjb-kqdrVAhVh2oMKHY7EDfoQFggLMAI&client=internal-uds-cse&usg=AFQjCNEKVa2vuUQVwhUrMuW3rKtQeAffag, the California Board of Accountancy, Department of Consumer Affairs, suspended a CPA for preparing an S corporation's return that reported "minimal or no officer compensation," resulting in the corporation being "assessed significant payroll taxes and penalties." Wong's license was revoked, but the revocation was stayed and Wong was suspended from practice for 60 days and placed on probation for 3 years.

[79] See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

> The key to establishing reasonable compensation is determining what the shareholder-employee did for the S corporation. As such, we need to look to the source of the S corporation's gross receipts.
>
> The three major sources are:
>
> 1. Services of shareholder,
>
> 2. Services of non-shareholder employees, or
>
> 3. Capital and equipment.
>
> If the gross receipts and profits come from items 2 and 3, then that should not be associated with the shareholder-employee's personal services and it is reasonable that the shareholder would receive distributions along with compensations.
>
> On the other hand, if most of the gross receipts and profits are associated with the shareholder's personal services, then most of the profit distribution should be allocated as compensation.
>
> In addition to the shareholder-employee direct generation of gross receipts, the shareholder-employee should also be compensated for administrative work performed for the other income producing employees or assets. For example, a manager may not directly produce gross receipts, but he assists the other employees or assets which are producing the day-to-day gross receipts.

Some owners who are also officers try to pay themselves outside of the payroll system and call it nonemployee compensation. However, as officers, they are employees,[80] and

[80] Reg. § 31.3121(d)-1(b) provides:

> *Corporate officers*. Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation. A director of a corporation in his capacity as such is not an employee of the corporation.

Rev. Rul. 71-86 addressed the following:

> *A*, an individual, is the president of the *N* Corporation and is the sole stockholder thereof with the exception of qualifying shares. In his capacity as president, *A* fixes the amount of his salary and hours of employment and prescribes his own duties. He is not responsible to anyone with respect to his activities.

The ruling concluded:

> Accordingly, it is held that *A* is an employee of the N Corporation for purposes of chapters 21, 23, and 24 of the Code. The fact that the *N* Corporation is a closely held corporation and that *A* is the sole stockholder and is in charge of its activities is immaterial since *A*'s services are material to the operation of the corporation and he is entitled to and receives remuneration for the services from the corporation.

Rev. Rul. 73-361 also applies this rule to the majority shareholder who was an officer of an S corporation and performed substantial services for the corporation in that capacity for which he received remuneration:

payments to them for services are wages.[81] Based on a couple of dismissals it procured, the IRS takes the position that the Tax Court has no jurisdiction to review the IRS' determinations of employment taxes on shareholder-employees and has instructed its examiners how to attain this result;[82] the IRS asserts that the analysis does not

> Accordingly, the "wages" he received in 1972 for his services as an officer are subject to the taxes imposed by the Federal Insurance Contributions Act. This conclusion is also applicable for purposes of the Federal Unemployment Tax Act and the Collection of Income Tax at Source on Wages (chapters 23 and 24, respectively, subtitle C of the Code).

In denying relief under section 530 of the Revenue Act of 1978, which allows independent contractor treatment for those meeting certain longstanding industry practiced, Rev. Rul. 82-83 held:

> It is a question of fact in all cases whether officers of a corporation are performing services within the scope of their duties as officers or whether they are performing services as independent contractors. Here, the duties being performed customarily fall within the scope of duties of corporate officers. Involved are fundamental decisions regarding the operation of the corporation. Such decisions are rarely delegated to independent contractors, and are customarily made by corporate officers or other employees. Thus, since the officers are performing substantial services typical of officers and are paid for those services, they are employees of the corporation for purposes of federal tax law. Therefore, even though the corporation calls the officers' pay "draws" rather than "salaries," there is no reasonable basis for treating the officers as other than employees, even under a liberal application of the reasonable basis rule of section 530 of the Act.

Directors are independent contractors who may be in a trade or business of being a director. See Rev. Ruls. 68-595 (serving on committee of a board of directors), 72-86 (attending quarterly board meetings), and 80-87 (honorary directors who previously performed service but are now compensated whether or not they attend meetings).

[81] See fn. 80 and *Veterinary Surgical Consultants P.C. v. Commissioner*, 117 T.C. 141 (2001) (consulting and surgical services provided to veterinarians); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90 (9th Cir. 1990) (accounting firm); *Durando v. U.S.*, 70 F.3d 548 (9th Cir. 1995) (amount shown on Form 1099-MISC did not constitute earnings that a shareholder could use to create a self-employed person's retirement plan).

[82] PMTA 2017-05, "Notice of Employment Tax Determination under IRC §7436 - Additional Compensation to Officer Employees," POSTN-110684-17 (written 3/30/2017 and released 4/5/2017):

> In the scenario you provided, there is no dispute that the corporate officers are employees of the taxpayer under section 3121(d)(1) and that certain amounts were treated as wages for employment tax purposes. Rather, the dispute is limited to the correct amount of payments required to be treated as "wages" for employment tax purposes, *i.e.* whether the additional payments constitute wages, rather than dividends or distributions, return of capital, loan repayments, distributions in excess of reasonable compensation, or other non-service related type payments. Nor is there any dispute concerning entitlement to Section 530 relief.
>
> Accordingly, the Service is not making a determination regarding the employment status of the corporate officers when it recharacterizes certain payments as wages that were not treated as wages. The Service is also not making a determination with respect to the taxpayer's entitlement to Section 530 relief. Since the Service has not made a determination with respect to either of the two requisite matters specified in § 7436(a)(1) or (2), the Tax Court lacks jurisdiction to determine the correct amount of employment taxes due as a result of the employment tax assessment under section 6201 on the additional wages.

change when the service recipient uses a professional employer organization (PEO) to pay compensation to its sole corporate officer, even when the PEO issues Forms W-2

The position taken in this memorandum is consistent with two recent Tax Court Orders with respect to cases described below. (Copies of the Orders are attached to this memorandum).

In *Martin S. Azarian, P.A. v. Commissioner*, Docket No. 28957-15, Petitioner, an S corporation, treated its sole owner and officer, Mr. Azarian, as an employee during the taxable periods at issue and reported wages paid to Mr. Azarian on Forms W-2. Respondent sent petitioner Forms 4668, Employment Tax Examination Changes Report, which (1) concluded that petitioner failed to report reasonable compensation paid to Mr. Azarian for the taxable periods at issue, (2) proposed increased annual wages to Mr. Azarian for those periods, and (3) concluded that petitioner was liable for proposed employment tax increases and additions to tax. Respondent did not issue a Letter 3523 to petitioner.

Nevertheless, petitioner filed a petition requesting the Court overturn respondent's findings. Respondent filed a Motion to Dismiss for Lack of Jurisdiction on the grounds that (1) no Notice of Determination of Worker Classification was sent to petitioner, and (2) no other determination was made by respondent which would confer jurisdiction on the Court.[3]

[3] Motions to dismiss for lack of jurisdiction, citing the grounds that a Notice of Determination of Worker Classification was not issued, were filed in several cases before the Service concluded that such notices were no longer a jurisdictional prerequisite to Tax Court Review in line with the Court's decision in *SECC*. See Chief Counsel Notice 2016-002.

On February 21, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction. The Court found that respondent did not make a determination under section 7436(a)(2) regarding whether petitioner was entitled to relief under Section 530. The Court also found that since petitioner consistently treated Mr. Azarian as an employee for the taxable periods at issue, respondent did not make a determination that Mr. Azarian was an employee of petitioner under section 7436(a)(1). The Court stated, "Section 7436(a)(1) only confers jurisdiction upon this Court to determine the ["]correct and the proper amount of employment tax["] when respondent makes a worker classification determination, not when respondent concludes that petitioner underreported reasonable wage compensation, as is the case here."

Similarly, in *Patricia Arroyo DDS, Corp., Alex Mansilla and Mercedes P. Arroyo v. Commissioner* , Docket No. 5874-15, the Tax Court dismissed the case with respect to Patricia Arroyo DDS Corp. (DDS Corp.) for lack of jurisdiction finding that the Service had not made any determinations for purposes of section 7436. In this case the Service determined that the amounts treated as salaries paid to the corporate officers and reported on Form W-2 as wages were artificially low, recharacterized higher amounts as salaries, and thus as wages, based on nationwide market information, and assessed additional employment taxes. Petitioners asserted that the amounts treated as salaries paid by DDS Corp were appropriate and contended the Court had jurisdiction as to the amount of employment taxes owed.

On February 23, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction. The Tax Court stated that petitioner consistently treated the corporate officers as employees and contested only respondent's determination that the compensation paid to the corporate officers was inadequate. The Court stated that because respondent did not make a determination with respect to either of the two requisite matters specified in section 7436(a)(1) or (2), the Court lacked jurisdiction to determine the correct amount of employment taxes due as a result of respondent's determination that DDS Corp under-reported corporate officers' wages during the tax years at issue.

using its own EIN.[83] In this context, employment taxes mean Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and Federal income tax withholding.[84]

Here are some ways that taxpayers trip themselves up:

- Sometimes they try to deduct various expenses on Schedule C, which reports income as a sole proprietor. This position asserts that expenses are netted against their income.

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[83] CCA 201735021, in which:

> The duties of the PEO under the contract include: 1) administering Taxpayer payroll, designated benefits, and personnel policies and procedures related to the Assigned Employees; 2) providing human resource administration and payroll administration with respect to the Assigned Employees; 3) furnishing and keeping workers compensation insurance covering the Assigned Employees; 4) processing and paying wages from its own accounts to the Assigned Employees based on the hours and wage information reported by the Taxpayer and 5) filing all employment tax returns (i.e., Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and Form 941, Employer's Quarterly Federal Tax Return) with the Government and furnishing information returns to the workers.
>
> The PEO's duties under the contract, however, were limited to only those wages that were reported and verified by the Taxpayer to the PEO for each pay period. In the event the Taxpayer paid wages to the Assigned Employees that were not reported to the PEO, the contract provides that the Taxpayer will be "solely responsible for damages of any nature out of the Client's failure to report payment of unreported wages to any of the Assigned Employees".
>
> For the taxable quarters included in the [Redacted Text] taxable year, as well as the [Redacted Text] taxable year, the Taxpayer's corporate officer received wage payments through the PEO. These wages were reported on a Form W-2, Wage and Tax Statement, issued by the PEO (under the PEO's EIN) and included on Forms 940 and 941 filed under the PEO's EIN. During this same year, the corporate officer also received distributions directly from the Taxpayer reported on a Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc., under the Taxpayer's EIN. The distributions were not reported or verified by the Taxpayer to the PEO as wages so were not included on the employment tax returns filed under the PEO EIN.

The CCA asserted:

> For [Redacted Text], the corporate officer also received a Form W-2 reporting wages for services rendered to the Taxpayer, and the wages were also reported on Forms 940 and 941, however, the Forms were filed under the PEO's EIN and not the Taxpayer's. The use of a PEO by the Taxpayer as a conduit for paying wages to its corporate officer, however, does not affect whether the audit for [Redacted Text] with respect to the distribution made by the Taxpayer to its corporate officer is considered a worker classification audit. The contractual arrangement demonstrates that no underlying issue of employment tax classification status exists because the Taxpayer specifically contracted with the PEO to fulfill its obligations as an employer with respect to the treatment of the corporate officer as its employee. Thus, the dispute is not whether the corporate officer performed more than minor services for the Taxpayer and received compensation for those services, *i.e.*, whether the corporate officer was an employee. Rather, the dispute is limited to the amount of compensation required to be treated as "wages" paid to the corporate officer - including distributions paid directly by the Taxpayer that did not flow through the PEO - for employment tax purposes, *i.e.* whether the additional payments constitute wages, rather than distributions.

[84] Footnote 1 of PMTA 2017-05, cited in fn. 82.

- The IRS will say that the income constitutes Form W-2 wages, and the expenses are deductible as employee business expenses (Form 2106). Employee business expenses constitute miscellaneous itemized deductions, from which 2% of the taxpayer's adjusted gross income is subtracted. This reduced number is subject to other limitations imposed on itemized deductions and also is disallowed in computing alternative minimum tax.

- If the owner-employee had run these expenses through the company using an "accountable plan,"[85] then they would be fully deductible (subject to any limitations imposed on business deductions) and netted against business income. By not using this mechanism, the owner-employee forgoes the benefits of an accountable plan.

- Qualified retirement plans (including Code § 401(k) plans) provide current deductions and provide tax-deferred income and growth (as well as protection from creditors). For an S corporation, contributions are based only on wage income (as one taxpayer discovered the hard way).[86] Properly declaring wages gives the owner-employee an opportunity to develop a thoughtful qualified retirement plan.

For the S corporation's earnings to avoid self-employment tax, the S corporation must actually have received the income. See part II.G.23 Taxing Entity or Individual Performing Services.

II.A.2.e. Estate Planning Strategies Available Only for S Corporation Shareholders

II.A.2.e.i. Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders

A trust owning stock in an S corporation may be converted into a QSST – a trust in which the beneficiary pays the tax on the trust's current and accumulated income.[87] See part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs for discussions of how to:

- Tax the beneficiary on the trust's taxable income to avoid it being taxed at the trust's high income tax rates, a tax differential that has become more pronounced after 2012.

- Avoid unfavorable income taxation of a trust for a spouse after divorce.

- Sell the beneficiary's assets to a trust to freeze the beneficiary's estate while allowing the beneficiary to benefit from the assets' income.

The courts have created special rules expanding Code § 2036 to cause partnerships to be disregarded for estate tax purposes, artificially increasing the value included in the

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[85] Reg. § 1.62-2.

[86] *Durando v. U.S.*, 70 F.3d 548 (9th Cir. 1995) (amount shown on Form 1099-MISC did not constitute earnings that a shareholder could use to create a self-employed person's retirement plan).

[87] See part III.A.3.e QSSTs and ESBTs for a description of how QSSTs work and creative planning opportunities.

owner's estate unless the taxpayer proves that each entity was created for a "legitimate and significant nontax reason;"[88] this increase may cause double inclusion of the appreciation of the retained partnership interest.[89] S corporation owners can avoid this issue by retaining voting stock and transferring nonvoting stock.[90]

Code § 6166 provides estate tax deferral for closely-held businesses.[91] Tiered structures create significant limitations on the election and sometimes uncertainty as to whether the election is available.[92] However, if an S corporation is structured with multiple wholly owned subsidiaries, the parent all of the subsidiaries should be treated as one entity for purposes of Code § 6166;[93] no authority directly addresses this conclusion, so one might consider obtaining a private letter ruling confirming this result (if the IRS is willing to rule on this issue, which likely would be only for a decedent).[94]

II.A.2.e.ii. Estate Planning and Income Tax Disadvantages of S Corporations

S corporations include the following disadvantages relative to partnership taxation:

- Perhaps more difficult to deduct start-up losses.[95]

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[88] See *Bongard v. Commissioner*, 124 T.C. 95 (reviewed decision, 2005), and a host of other cases before and after, including *Purdue v. Commissioner*, T.C. Memo. 2015-249, including another reviewed decision, *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (5/18/2017).

[89] *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (5/18/2017) (contrast majority and concurring opinions). Footnote 7 of the majority opinion stated:

> More precisely, the net inclusion required by applying sec. 2036(a) to a transfer to a family limited partnership would equal any discounts applied in valuing the partnership interest the decedent received plus any appreciation (or less any depreciation) in the value of the transferred assets between the date of the transfer and the decedent's date of death. Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the value of the partnership interest on the date of the transfer. To the extent that any post-transfer increase in the value of the transferred assets is reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.) In the present cases, however, the parties appear to have agreed to disregard any change in the value of the cash and securities transferred to NHP between the date of their transfer, on August 8, 2008, and decedent's death one week later. See infra note 12. Therefore, if no discount appropriately applies to value the interest in NHP issued in exchange for decedent's cash and securities, as respondent claimed in the estate tax notice of deficiency, then the application of either sec. 2036(a) or sec. 2038(a) to the transfer of those assets to NHP would add nothing to her gross estate.

[90] See part II.A.2.j.i Voting and Nonvoting Stock, especially part II.A.2.j.i.(b) Why Nonvoting Shares Are Needed for Estate Planning.

[91] See part III.B.5.d.ii Code § 6166 Deferral.

[92] See part III.B.5.d.ii.(b) Tiered Structures.

[93] See part II.A.2.h Qualified Subchapter S Subsidiary, especially the text accompanying fns. 162-170.

[94] Rev. Proc. 2016-3, Section 3.1(118) says that the IRS will not rule on Code § 6166 "if there is no decedent."

[95] See part II.G.3.c Basis Limitations for Deducting Partnership and S Corporation Losses.

- Less advantageous seller-financed sales to key employees or others.[96]

- No inside basis step-up when an owner sells in a taxable sale or dies.[97]

- Possible unavailability of a tax-free split-up of the entity, which might be very important when a trust terminates and is divided among beneficiaries.[98]

- The sale of S corporation stock and an S corporation's actual or deemed sale of its assets constitute unrelated business income per se, so charitable strategies are much less attractive.[99]

A structure that avoids these concerns, saves self-employment tax the way an S corporation would, and reduces the possibility of the 3.8% tax on net investment income being imposed on rent income is described in part II.E Recommended Structure for Entities. This structure is a limited partnership that has an S corporation general partner, which can avoid Code § 2036 issues and provide a limited partnership's superior income tax attributes. Owners of entities taxed as partnerships and owners of S corporations should consider migrating towards this structure.[100]

II.A.2.e.iii. Which Type of Entity for Which Situation?

For a business' original owner, generally exit strategies and inside basis step-up suggest using the partnership structure described in part II.E Recommended Structure for Entities.

When that owner dies, one can take another look at the merits of each type of business entity. If an S corporation is ideal, then:

- If the limited partnership has owners other than the deceased owner or if the deceased owner's successors differ regarding whether to use an S corporation, those deceased owner's successors who wish S corporation treatment can simply assign their limited partnership interest into their own new S corporation.

- If the limited partnership has no other owners and all of the deceased owner's successors want S corporation status, then the limited partnership could elect S corporation status; note, however, that a limited partnership must have at least two

[96] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.
[97] See parts II.H.2 Basis Step-Up Issues and II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.
[98] See generally part II.Q.7 Exiting From or Dividing a Corporation; for the steps required to have a tax-free corporate split-up, see part II.Q.7.f.ii Code § 355 Requirements. For partnership divisions, see part II.Q.8 Exiting From or Dividing a Partnership.
[99] See part II.Q.6 Contributing a Business Interest to Charity to place context to part II.Q.6.d.ii UBTI Related to an S Corporation. Also, a charitable remainder trust cannot hold stock in an S corporation. See fn. 3529 in part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity.
[100] For migrating an S corporation, see parts II.Q.7.h Distributing Assets; Drop-Down into Partnership and II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

separate owners – a general partner and a limited partner.[101] However, because an S corporation cannot have another S corporation as a shareholder unless the other latter is the former's sole shareholder,[102] the general partner needs to be dissolved, which would be a taxable event.[103]

For additional considerations, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs, including part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

II.A.2.e.iv. Asset Protection: Which State Law Entity Should Be Used for S Corporation Income Taxation

For asset protection planning purposes,[104] consider using a limited liability limited partnership (LLLP) that makes an S election.[105] An LLLP is a limited partnership that uses the registration process for a limited liability partnership to protect the general partner from liability.

To avoid creating a second class of stock, be careful not to include partnership capital account provisions in the partnership agreement.[106]

An existing corporation may convert to such an entity on a tax-free basis.[107]

II.A.2.f. Making the S Election

II.A.2.f.i. Try to Make as of Date Entity is Taxed as a Corporation

Converting from C corporation to S corporation might generate tax immediately or over the course of several years. See part II.P.3.c Conversion from C Corporation to S corporation.

Also, distributions from a former C corporation may be taxable dividends, if they exceed certain S corporation earnings. See part II.Q.7.b.iv.(a) S Corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations. If the S election is not made effective until after the entity is first taxed as a C corporation, then one needs to determine whether the entity earned any earning and profits as a C corporation that

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[101] See part II.C.11 Limited Partnership.
[102] See part II.A.2.f.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity

Shareholders.
[103] See part II.Q.7.a.vii Corporate Liquidation.
[104] See part II.F Asset Protection Planning.
[105] For why I suggest a limited partnership over an LLC, see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.
[106] See part II.A.2.j Single Class of Stock Rules and especially fn. 297 in part II.B Limited Liability Company (LLC).
[107] Code § 368(a)(1)(F), described more fully in part II.F.1 Business Entities and Creditors Generally.

generate a taxable dividend for distributions in excess of those S corporation earnings.[108]

II.A.2.f.ii. Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election

S elections are made on IRS Form 2553, filed no later than two months and 15 days after the beginning of the tax year the election is to take effect;[109] an S corporation elects to treat its subsidiary as a disregarded entity[110] using Form 8869, with the same deadline and similar relied for later filing. The instructions to IRS Form 2553 and 8869 discuss when an extension of time to file might be granted. The S election may be rescinded during the period during which an election could have been made timely.[111]

An election on Form 2553 is valid only if all persons who are shareholders[112] in the corporation on the day on which such election is made consent to such election.[113] An executor or administrator of the shareholder's estate may consent to a new S election on behalf of a decedent.[114] When a married couple owns stock as tenants in common, joint

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[108] *Franklin v. Commissioner*, T.C. Memo. 2016-207, explained:

> An S corporation may have accumulated earnings and profits from a variety of sources, including (1) as a carryover from years in which it was a C corporation, before it became as S corporation, see *Cameron v. Commissioner*, 105 T.C. 380, 384 (1995), *aff'd sub nom. Broadaway v. Commissioner*, 111 F.3d 593 (8th Cir. 1997), and (2) as the result of certain reorganizations and the like, see sec. 1371(c)(2); see also James S. Eustice, Joel D. Kuntz, and John A. Bogdanski, *Federal Income Taxation of S Corporations*, para. 8.04[8][b], at 8-74 (5th ed. 2015). FDI was incorporated on March 24, 1989, and elected S corporation status effective March 27, 1989. Given the three-day period between its incorporation and S election, it is likely that FDI never accumulated earnings and profits as a C corporation. Moreover, although the record is silent, from the nature of its business as construction/contractor it also seems likely that it was never involved in reorganizations or other transactions referred to in section 1371(c)(2). See *Briggs v. Commissioner*, T.C. Memo. 2000-380, 2000 WL 1847580, at *4 n. 9. We find, accordingly, that FDI had no accumulated earnings and profits.

[109] The procedure for corporations electing S corporation status also applies to unincorporated entities, which do not need to (and usually should not) elect corporate income taxation before making the S election. See text accompanying fns. 295-296 in part II.B Limited Liability Company (LLC).

[110] See fn. 132, which also recommends that the corporate subsidiary convert into a limited liability company that is treated a disregarded entity to avoid potential issues relating to future ownership.

[111] See text accompanying fns. 2959-2961.

[112] A person who has beneficial ownership of stock might be considered a shareholder, even if no stock certificates were issued to that person. *Cabintaxi Corp. v. Commissioner*, 63 F.3d 614 (7th Cir. 1995) (nevertheless holding that the persons in question did not count), *aff'g* T.C. Memo. 1994-316.

[113] Code § 1362(a)(2). An executor or administrator of the shareholder's may consent to a new S election on behalf of a decedent. Rev. Rul. 92-82.

[114] Rev. Rul. 92-82, which addressed the following facts:

> X is a small business corporation described in section 1361(b) of the Code. X's taxable year is the calendar year. A, an eligible S corporation shareholder and an owner of X stock, died on March 1, 1991. A's stock in X passed to A's estate; however, E, the executor of A's estate, was not appointed until April 1, 1991. On March 15, 1991, X filed Form 2553, Election by a Small Business Corporation, electing to be an S corporation

tenants, or tenants by the entirety, each tenant in common, joint tenant and tenant by the entirety must consent to the election.[115] Although the consent of each spouse who has a community property interest is required,[116] the IRS waives the consent requirement if certain procedures are followed, the election failed to include the signature of a community property spouse who was a shareholder solely pursuant to state community property law, and both spouses have reported all their K-1 items on all affected federal income tax returns.[117] The deemed owner (whether the grantor or, in the case of a QSST election, the beneficiary) of a grantor trust must sign the consent.[118]

One may verify that Form 2553 was filed by filing Form 8821 with the Internal Revenue Service.[119] Obtain a signed Form 8821, call the IRS, then fax Form 8821 to the person who will provide the verification.[120]

> effective January 1, 1991. Except for A and A's estate, all of the persons who held stock in X on March 15, 1991, or during 1991 and before that date, consented to the election.

It held:

> In this case, E, like the executors in the revenue rulings discussed above, acts in a fiduciary capacity on behalf of both A and A's estate and, as such, is in the position to decide whether to consent to X's S corporation election on behalf of both A and A's estate. Thus, consistent with the extension of rights and privileges to a fiduciary under section 6903 of the Code, E may consent to X's S corporation election on behalf of both A and A's estate. Furthermore, even though E was not appointed until April 1, 1991, the consents E provides on behalf of A and A's estate will be considered made for X's taxable year beginning January 1, 1991, upon the approval by the Service of an application for an extension of time for filing consents under section 18.1362-2(c) of the temporary regulations.
>
> Accordingly, X's S corporation election will be valid for X's taxable year beginning January 1, 1991, so long as (1) the Service grants an extension of time to file the consents to the election, (2) E consents to the election on behalf of both A and A's estate, and (3) consents are filed within the extended time period granted by the Service by all persons (other than A) who were shareholders of X at any time during the period beginning January 1, 1991, and ending on the date the Service grants an extension of time.
>
> If the stock instead had been held by A and A's spouse as joint tenants with the right of survivorship or as tenants by the entirety, the result would be similar. Upon A's death, the X stock would pass directly to A's spouse. X's S corporation election would be effective for X's taxable year beginning January 1, 1991, if: (1) A's spouse consents to the election (A's spouse's consent would apply to both the interest in X stock A's spouse would have owned as a joint tenant or as a tenant by the entirety before A's death and the interest in X stock A's spouse would own after A's death); and (2) E consents to the election on behalf of A (E would not have to consent on behalf of A's estate because the estate would not be a shareholder of X at any time).

[115] Reg. § 1.1362-6(b)(2)(i).

[116] Reg. § 1.1362-6(b)(2)(i). For a community property trust's eligibility to hold stock, see fn. 4362, found in part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust.

[117] Rev. Proc. 2004-35. Letter Ruling 201644003 granted relief where the spouses had failed to sign and the number of shares owned by each shareholder was inaccurate.

[118] Letter Ruling 201516009.

[119] When I checked 6/7/2016, the Instructions for Form 8821 (Rev. 3-2015) listed Form 2553 as one of the items for which Form 8821, Line 4, Specific Use Not Recorded on CAF, can be completed.

An election that is timely filed for any taxable year and that would be valid except for the failure of any shareholder to file a timely consent can be granted additional time to file by the district director or director of the service center with which the corporation files its income tax return if (1) there was reasonable cause for the failure to file the consent, (2) the request for the extension of time is made within a reasonable time under the circumstances, and (3) treating the election as valid will not jeopardize the government's interest.[121] Consents must be filed within the extended period of time by all persons who have not previously consented to the election and were shareholders of the corporation at any time during the period beginning as of the date of the invalid election and ending on the date on which an extension of time is granted.[122]

Letter Ruling 201644003 granted an extension of time to file Forms 8869 that inadvertently were not filed. It also held that, when Form 8869 was validly filed but ineffective because the parent's Form 2553 was defective, Form 8869 was effective retroactive to the originally intended date when the defects to Form 2553 were cured under the extension to file Form 2553 that the ruling also granted.

Letter Ruling 201714014 provided relief for a late S election and a late QSub[123] election.[124]

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[120] ACTEC Fellow Robert L. Hallenberg reported success using this method when he called the IRS at 513-977-8237. I am not sure when he called the IRS and have not checked this process myself.

[121] Reg. § 1.1362-6(b)(3)(iii)(A). For IRS processing procedures, see IRM 3.13.2.22.1 (01-01-2015).

Regarding whether the government's interests are prejudiced, Letter Ruling 200333017 denied relief under the following circumstances:

> [Corporation] X generated a loss in Year 1 and a gain in Year 2. Shareholder claimed the loss in Year 1, which reduced his reported tax liability, but because X claimed the same loss as a carryforward in Year 2, its tax liability was also reduced. If the relief is granted, the loss claimed on Shareholder's Year 1 return would be validated. In addition, if relief is granted, Shareholder should be required to take into account his distributive share of X's Year 2 income calculated without regard to the inappropriate carryforward loss. However, because the statute of limitations on assessment has expired, Shareholder's Year 2 return cannot be adjusted. Thus, if the relief is granted, Shareholder will have a lower aggregate tax liability than if the election had been timely made.

If the government's interests are not prejudiced, the IRS might be required to grant consent. See *Kean v. Commissioner*, 469 F.2d 1183 (9th Cir. 1972) (prior regulations) (needed to provide additional time to make election once who was required to sign was determined), *rev'g* 51 T.C. 337 (1968) (Tax Court rejected consent as not being authorized without addressing granting additional time to consent) as to that issue.

[122] Reg. § 1.1362-6(b)(3)(iii)(B).

[123] See part II.A.2.h Qualified Subchapter S Subsidiary (QSub).

[124] The following paragraphs are the facts, followed by a description of the effect of following through with the granted extensions of time to file (skipping what was in between):

> X was formed on D1 under the laws of State. X's initial shareholders are trusts that X represents are eligible S corporation shareholders. X represents that it filed Form 2553, Election by a Small Business Corporation, to be treated as an S corporation effective D2. However, X received no acceptance notice from the service center and does not know whether the service center received the election.
>
> On D3, an unrelated S corporation, Y, acquired shares of stock in X. Because Y is an ineligible S corporation shareholder, X's S corporation election, had it been effective,

If the corporation comes in for relief for late filing due to mistakes and not all eligible shareholders have consented, the IRS might grant relief while requiring the corporation to work out with the District Director those eligible shareholders' late consents.[125]

If the corporation has an ineligible shareholder at the time of the election and does not realize the issue, the election is invalid, but inadvertent termination relief would give the S election retroactive application if the ineligible shareholder is eliminated.[126]

The following parts reproduce in their entirety (including apparently non-substantive typos) flowcharts the IRS kindly provided when it kindly gave taxpayers 3 years and 75 days from the effective date of the S election:[127]

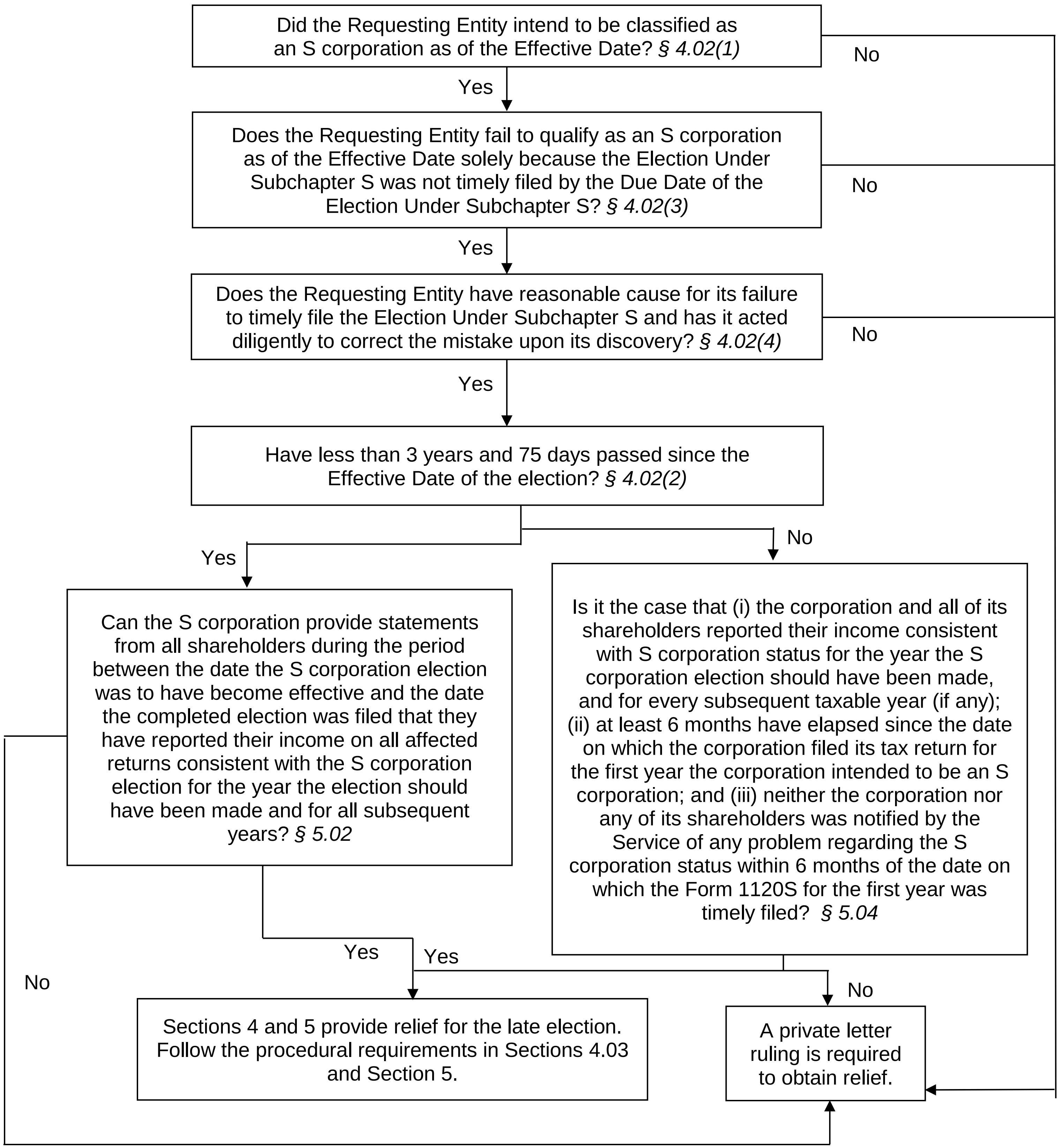
> would have terminated on D3. In D4, X learned that Y is an ineligible S corporation shareholder and that as of D3 it no longer qualified as an S corporation. On D5, the trusts transferred their X stock to Y in exchange for Y stock. Y plans to elect under § 1361(b)(3) to treat wholly owned X as a qualified subchapter S subsidiary (QSub) effective D5.
>
> … if X makes an election to be an S corporation by filing a completed Form 2553 with the appropriate service center effective D2, within 120 days from the date of this letter, then such election will be treated as timely made.
>
> X failed to timely file an election to be treated as an S corporation effective D2. Had X timely filed the election, it would have terminated on D3 when shares of X stock were transferred to Y, an ineligible S corporation shareholder. Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on D3 when shares of X stock were transferred to Y. However, we conclude that the circumstances surrounding the termination were inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D3 to D5, provided that X's S corporation election is otherwise valid and was not otherwise terminated under § 1362(d).

[125] Letter Ruling 201714018, referring to the relief in the text accompanying fns. 121-122.

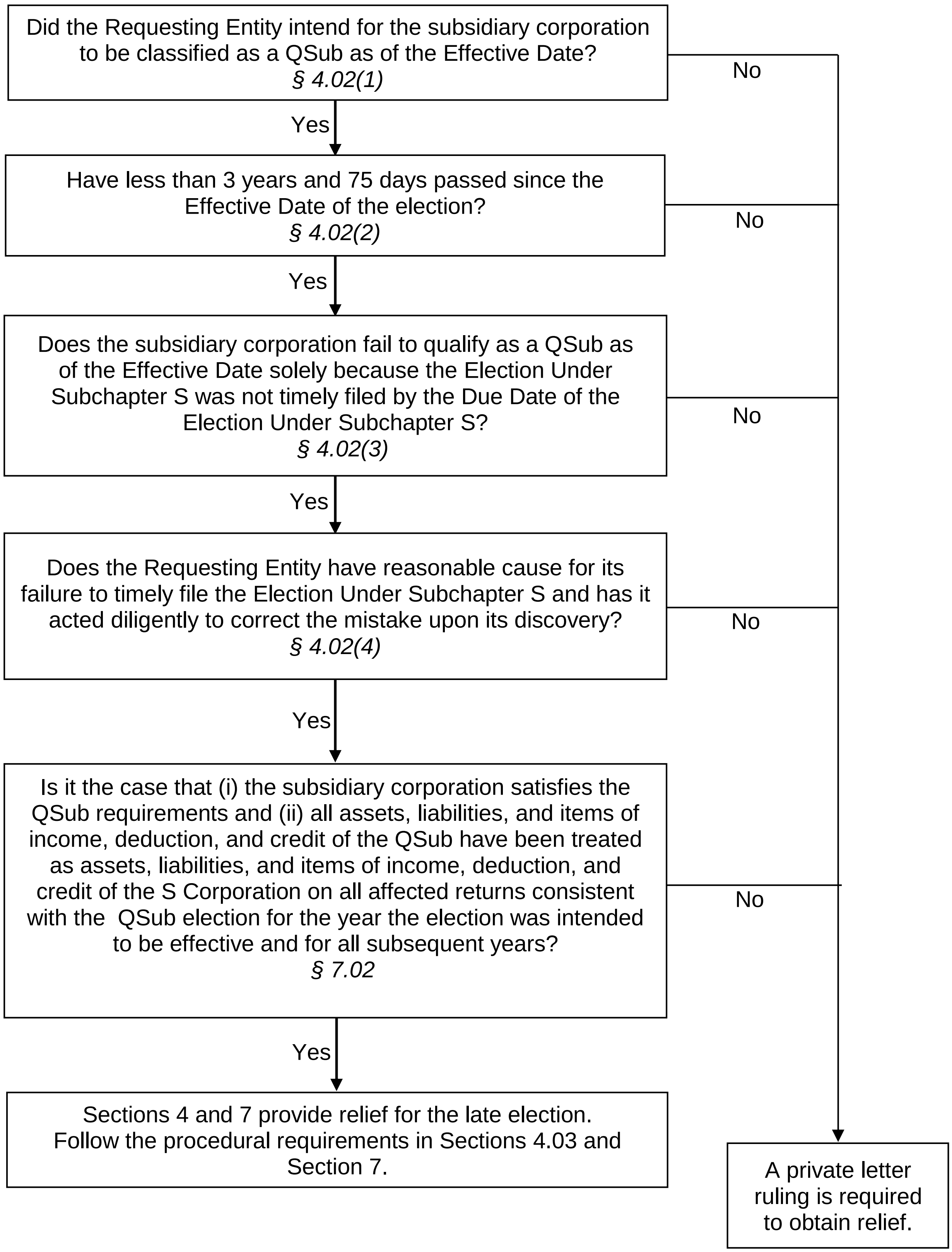
[126] Letter Rulings 201427007 and 201427017, which also included relief for possible flaws in the single class of stock rules that were cured.

[127] Rev. Proc. 2013-30, modifying and superseding Rev. Procs. 97-48, 2003-43, and 2004-49. One might consider checking the most recent annual Revenue Procedure for issuing letter rulings, the successor to Rev. Proc. 2015-1. The relevant IRS web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.

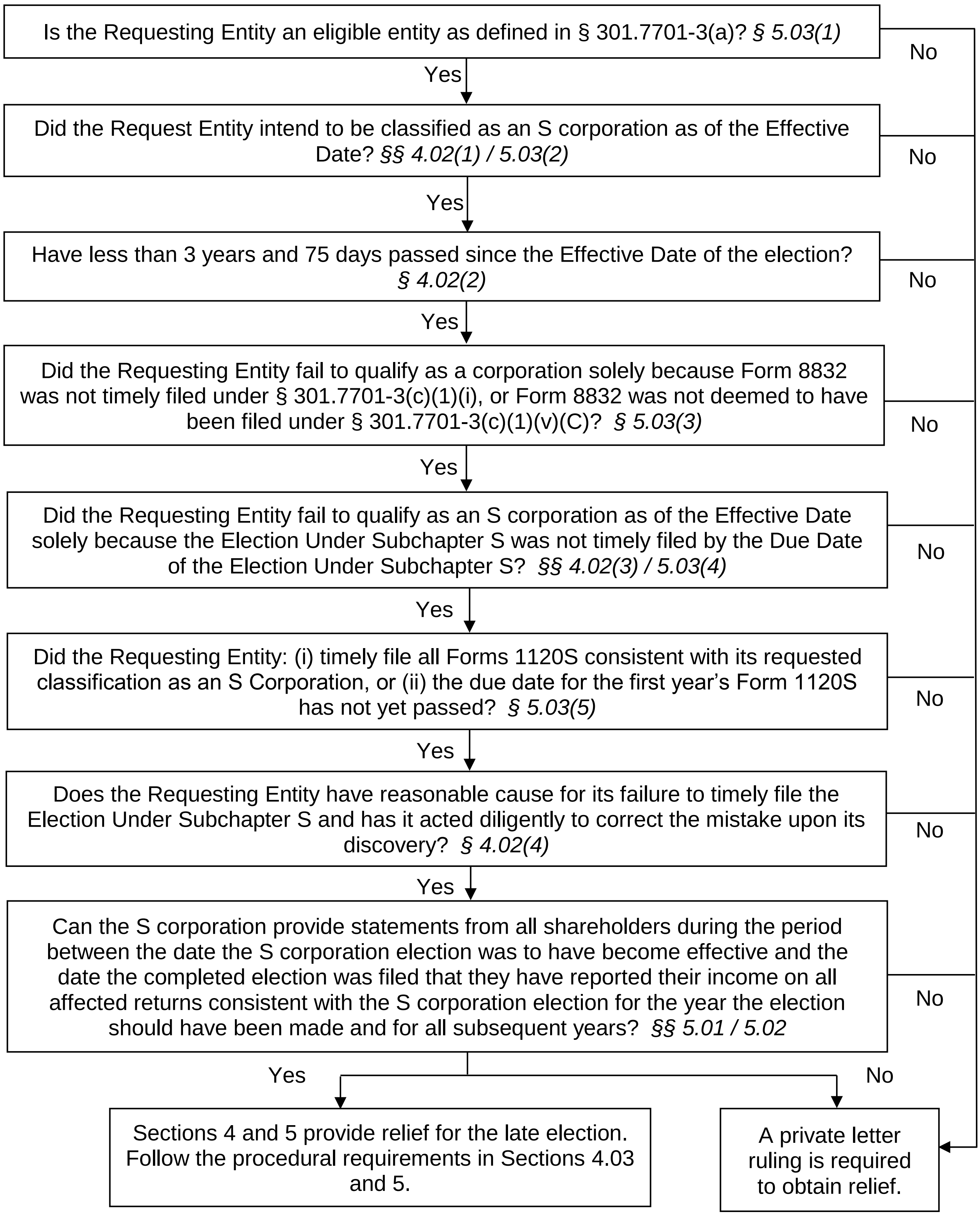
II.A.2.f.iii. Relief for Late S Corporation Elections Within 3+ Years



II.A.2.f.iv. Relief for Late QSub Elections



II.A.2.f.v. Relief for Late S Corporation and Entity Classification Elections for the Same Entity



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II.A.2.g. Shareholders Eligible to Hold S Corporation Stock

To be eligible for an S election, a corporation must be a domestic corporation that is not an ineligible corporation and does not have:[128]

- more than 100 shareholders,
- a shareholder who is a person (other than an estate, an eligible trust,[129] or a qualified retirement plan[130] or charity[131]) who is not an individual,[132]
- a nonresident alien as a shareholder, and
- more than 1 class of stock.

As mentioned above, a person who does not hold formal legal title but has a community property interest in stock is counted as a shareholder whose consent is required.[133] Accordingly, consider making sure that the spouse of each shareholder, who lives or has lived in a community property state, is not and does not become a nonresident alien.

If an individual holds S corporation stock through a disregarded entity, the individual and not the disregarded entity is treated as the shareholder, whether the disregarded entity is a single member LLC,[134] is a partnership of disregarded entities all taxed to the same person (and therefore the partnership itself is disregarded),[135] or is an unincorporated entity owned by a married couple as community property that the couple elects to treat as disregarded.[136] Note, of course, that such a disregarded entity[137] or nominee[138] could

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[128] Code § 1361(b)(1).
[129] Code § 1361(c)(2) describes eligible trusts, which are described in more detail in part III.A.3 Trusts Holding Stock in S Corporations.
[130] Described in Code § 401(a) and exempt from taxation under Code § 501(a).
[131] Described in Code § 501(c)(3) and exempt from taxation under Code § 501(a).
[132] Although a corporation cannot hold stock in an S corporation, a parent S corporation may elect to treat its wholly owned subsidiary as a "qualified subchapter S subsidiary," which is treated as a disregarded entity. See part II.A.2.h Qualified Subchapter S Subsidiary.
[133] See part II.A.2.f.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election, especially fns. 116-117.
[134] Letter Rulings 9739014 and 200008015, which are implicitly reinforced by fn. 138.
[135] Letter Rulings 200008015 and 200513001 (the latter expressly mentioning that Rev. Rul. 2004-77 disregards a partnership of disregarded entities all taxed to the same person), which are implicitly reinforced by fn. 138. Also see fn. 272 in part II.B Limited Liability Company (LLC), discussing generally when an LLC with more than one member constitutes a disregarded entity.
[136] Letter Ruling 201610007. For disregarding such an entity, see Rev. Proc. 2002-69, which is described in fn. 290, found in part II.B Limited Liability Company (LLC). Rev. Proc. 2002-69 allows a married couple to disregard the entity by reporting its activity directly on their tax returns. In Letter Ruling 201610007, the couple filed partnership tax returns, which the Letter Ruling ruled was an inadvertent termination. The IRS approved the S election so long as the couple elected to disregard the entity as provided in Rev. Proc. 2002-69 for all open taxable years.
[137] Regarding a partnership of disregarded entities, Letter Ruling 201730002 granted inadvertent termination relief for the following:

> On Date 2, A, the sole shareholder of X, transferred A's entire interest in X to Y, a limited liability company wholly owned by A and treated as a disregarded entity for federal tax purposes. On Date 3, A transferred a n% interest in Y to Trust, a grantor trust that was

easily be transformed into a partnership, thereby becoming an ineligible shareholder; however, inadvertent termination relief may be available.[139] Bequeathing a partnership interest to the only other partner through one's will generally is not enough to prevent the partnership from being a separate entity, because the process of estate administration causes the estate itself to have a legal life.[140] Query whether a nonprobate transfer through a transfer on death statute[141] might be considered instantaneous, because any claims are asserted after the transfer to the beneficiary, not before. Having the

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> treated (under subpart E of part I of subchapter J of chapter 1) as entirely owned by A. Trust was an eligible shareholder under § 1361(c)(2)(A)(i). On Date 4, A died, causing Trust to cease being a grantor trust. On Date 4, X's S corporation election terminated as Y, the sole owner of X, became a partnership for federal tax purposes, an ineligible shareholder. On Date 5, Y redeemed the shares of Estate (which were received by Estate at A's death), causing Y to be treated as a disregarded entity owned by Trust for federal tax purposes.

[138] Reg. § 1.1361-1(e)(1), added by T.D. 8600 (7/20/1995), includes:

> The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. For example, a partnership may be a nominee of S corporation stock for a person who qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation.

In light of the regulation expressly authorizing nominees, the Letter Rulings in fns. 134 and 135 ignoring disregarded entities seem doubly well-grounded (grounded in the check-the-box regulations and this regulation).

Note also that a partnership that has long ago wound up its operations might be an eligible shareholder. See fn. 142.

[139] Letter Ruling 200841007 granted relief as follows:

> A, an individual, owned X stock indirectly through Y, A's wholly-owned limited liability company, which was a disregarded entity for federal tax purposes. On D2 of Year 1, A transferred interests in Y to each of Trust 1, Trust 2, Trust 3, Trust 4, and Trust 5 (collectively, the Trusts), which are represented as having been wholly-owned grantor trusts under § 671 with respect to A. A died on D3 of Year 1 and Y became a partnership for federal tax purposes. A partnership is not an eligible S corporation shareholder and therefore, X's S corporation election terminated on D3 of Year 1. On D4 of Year 1, Y liquidated and distributed its X stock among the Trusts.
>
> … we conclude that X's S corporation election terminated on D3 of Year 1 and that the termination was inadvertent within the meaning of § 1362(f). We further hold that, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from D3 to D4 of Year 1 and thereafter….

Letter Rulings 201709015, 200237011 and 200237014 also granted inadvertent termination relief for a partnership owning S corporation stock. In granting relief, Letter Ruling 201709015 treated the partners as the shareholders, allowing QSST and ESBT elections retroactive to when the partnership first obtained the stock.

Letter Rulings 8948015 (partnership and individuals transfer to empty shell), 8934020 (transfer to empty shell), 8926016 (transfer to empty shell), 9010042 (transfer to empty shell), and 9421022 (transfer to empty shell) ignored transitory ownership by a partnership of an S corporation as part of a series of immediately effective transactions. See also parts II.A.2.k.ii Disregarding Transitory Owners and II.P.3.d.i Formless Conversion, text accompanying fn. 2895 (formless conversion of a partnership to an S corporation the same as a Code § 351 followed by a liquidation of the partnership, and the transitory ownership of the S corporation by the partnership is disregarded).

[140] Rev. Rul. 62-116.

[141] See, *e.g.*, RSMo Chapter 461.

partnership term end upon the death of the grantor of multiple grantor trusts that are the sole partners might prevent the stock from being considered owned by a partnership,[142] but I would not recommend that in planning mode. Rather than hold S corporation stock in a partnership that is a disregarded entity and risk the need for an inadvertent termination ruling, consider whether the S corporation's business can be moved to a partnership;[143] such an arrangement can be done seamlessly via merger or conversion statutes through a reorganization under Code § 368(a)(1)(F),[144] and the IRS generally accepts using a partnership to avoid concerns over ineligible shareholders.[145]

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[142] *Guzowski v. Commissioner*, T.C. Memo. 1967-145, approved ownership of S corporation stock by a partnership that had terminated, but its termination had occurred long before the S election was made:

> In the final analysis, our decision turns on whether paper transfer of the shares from the Partnership to the individual Guzowskis was required. The Partnership discontinued manufacturing operations by February 28, 1953 and all other operations by June 30, 1953. Sometime after that date all of the assets were disposed of. The term of the Partnership expired on January 2, 1957, and there is not one scintilla of evidence that there was any intent or action on the part of the partners to extend the term. Long prior to September 2, 1958—the critical date for our purposes—the Partnership was in limbo. The only possible remaining vestige of partnership identity stems from the fact that a certificate for 100,000 shares of stock of the Corporation was registered in the name of the Partnership. Even assuming that this certificate had not been cancelled and new certificates had not been issued in the names of the individual partners—as to which there was considerable confusing and conflicting testimony—we are satisfied that the ownership of the stock had passed to the partners individually. Stock certificates and stock record books are only one indication of who the real shareholders are. *Bijou Park Properties*, 47 T.C. 207 (1966). Sections 761 and 7701 define "partnership" as an unincorporated organization "through or by means of which any business, financial operation, or venture is carried on." *Cf.* sec. 1.708-1, Income Tax Regs. The touchstone of a partnership is activity. *Cf. Seattle Renton Lumber Co. v. United States*, 135 F.2d 989 (C.A. 9, 1943); *Albert Bettens*, 19 B.T.A. 1166 (1930); *Royal Wet Wash Laundry, Inc.*, 14 B.T.A. 470 (1928). Mere common ownership of property is not to be equated with the existence of a partnership. *Cf. George Rothenberg*, 48 T.C. — (June 21, 1967); see 6 Mertens, *Law of Federal Income Taxation* (Zimet Revision), sec. 35.02.
>
> We have previously held that the absence of formal steps to change the identity of a stockholder is not critical in determining the applicability of Subchapter S. *Old Virginia Brick Co.*, 44 T.C. 724 (1965), *affd.* 367 F.2d 276 (C.A. 4, 1966). We hold that, under the circumstances of this case, the stock of the corporation was owned by the four Guzowskis in their individual capacities at all times from and after September 2, 1958 and that the Subchapter S election was valid.

This case preceded Reg. § 1.1361-1(e)(1), which allows a partnership to hold S corporation stock as a nominee; see fn. 138.

[143] As described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart, a partnership (whether LLC or limited partnership) generally has tax characteristics better than that of an S corporation.

[144] See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure, especially part II.E.7.c.i.(b) Use F Reorganization to Form LLC. See also part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[145] See part II.A.2.k.i Using a Partnership to Avoid S Corporation Limitations on Identity or Number of Owners or to Permit Non-Pro Rata Equity Interests.

If an S corporation that is a partner in a partnership gives its stock to an employee of the partnership as compensation, which presumably would be treated as contributing the stock to the partnership and the partnership then transferring the stock as compensation to the employee,[146] the partnership will not be treated as a momentary owner of the S corporation stock.[147]

In counting the number of shareholders, the following are treated as 1 shareholder:[148]

- a husband and wife (and their estates), and
- all members of a family (and their estates).

The term "members of a family" means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant.[149]

An individual is considered to be a common ancestor only if, on the applicable date, the individual is not more than six generations removed from the youngest generation of shareholders who otherwise would be members of the family.[150] "Applicable date" means the latest of the date the S election is made, the earliest date that a member of the family holds stock in the S corporation, or October 22, 2004.[151] The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date.[152]

The members of a family are treated as one shareholder solely for purposes of counting shareholders.[153] Each member of the family who owns or is deemed to own stock must be an eligible shareholder.[154] Although a person may be a member of more than one family under these rules, each family (not all of whose members are also members of the other family) will be treated as one shareholder.[155]

In counting shareholders, the estate or grantor trust of a deceased member of the family will be considered to be a member of the family during the period in which the estate or

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146 Presumably such a transfer would be analogous to a shareholder's transfer of stock to an employee of the corporation described in part II.M.4.c.i When a Gift to an Employee Is Compensation and Not a Gift, fn. 2599.
147 Letter Ruling 200009029.
148 Code § 1361(c)(1)(A).
149 Code § 1361(c)(1)(B)(i). Any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by the individual, and any eligible foster child of an individual (under Code § 152(f)(1)(C)), shall be treated as a child of such individual by blood. Code § 1361(c)(1)(C).
150 Code § 1361(c)(1)(B)(ii). For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to whom such spouse is (or was) married.
151 Code § 1361(c)(1)(B)(iii).
152 Reg. § 1.1361-1(e)(3)(i).
153 Reg. § 1.1361-1(e)(3)(i).
154 Reg. § 1.1361-1(e)(3)(i).
155 Reg. § 1.1361-1(e)(3)(i).

trust (such trust during the two years the trust is eligible) holds stock in the S corporation, and the members of the family also include:[156]

- In the case of an ESBT, each potential current beneficiary who is a member of the family;
- In the case of a QSST, the income beneficiary who makes the QSST election, if that income beneficiary is a member of the family;
- In the case of a qualified voting trust, each beneficiary who is a member of the family;
- The deemed owner of a grantor trust if that deemed owner is a member of the family; and
- The owner of an entity disregarded as an entity separate from its owner under the check-the-box rules, if that owner is a member of the family.

II.A.2.h. Qualified Subchapter S Subsidiary (QSub)

An S corporation can own a wholly owned subsidiary, which the Code calls a "qualified subchapter S subsidiary"[157] and the regulations and this author refer to as a QSub.[158]

A QSub is any domestic corporation that is not an ineligible corporation,[159] is wholly owned by an S corporation, and that the parent elects to treat as a QSub.[160] The parent files Form 8869 no more than 12 months before or 2 months and 15 days after the election's effective date.[161] For relief for a late election, see part II.A.2.f.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election, especially part II.A.2.f.iv Relief for Late QSub Elections.

A QSub is not treated as a separate corporation, and all of the QSub's assets, liabilities, and items of income, deduction, and credit are treated as assets, liabilities, and such items (as the case may be) of its parent;[162] this treatment applies for all purposes of the

[156] Reg. § 1.1361-1(e)(3)(ii).
[157] Code § 1361(b)(3), especially Code § 1361(b)(3)(B).
[158] Reg. § 1.1361-2(a).
[159] Referring to Code § 1362(b)(2), which provides that the following are ineligible to make an S election:

(A) a financial institution which uses the reserve method of accounting for bad debts described in section 585,
(B) an insurance company subject to tax under subchapter L,
(C) a corporation to which an election under section 936 applies, or
(D) a DISC or former DISC.

[160] Code § 1361(b)(3)(B); Reg. § 1.1361-2(a).
[161] Reg. § 1.1361-3(a)(4).
[162] CCA 201552026 asserts that a parent may not take a Code § 165(g)(3) worthless stock deduction with respect to its QSub's stock.

Code, except as provided in regulations.[163] Reg. § 1.1361-4(a)(1) states that this rule applies "for Federal tax purposes," except for certain provisions it references:

- If the parent or a QSub is a bank, then the special bank rules govern items of income, deduction, and credit at the bank entity level; however, after applying those rules, all of the QSub's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as the parent's.[164]

- A QSub is treated as a separate corporation for purposes of its Federal tax liabilities with respect to any taxable period for which the QSub was treated as a separate corporation, Federal tax liabilities of any other entity for which the QSub is liable, and refunds or credits of Federal tax.[165]

- A QSub is treated as a separate corporation for purposes of Federal employment taxes and withholding.[166]

- A QSub is treated as a separate corporation for purposes of certain excise taxes,[167] none of which seem to have anything to do with estate, gift, or generation-skipping transfer taxes.[168]

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[163] Code § 1361(b)(3)(A).

[164] Reg. § 1.1361-4(a)(3), especially Reg. § 1.1361-4(a)(3)(ii), Example (2).

[165] Reg. § 1.1361-4(a)(6).

[166] Reg. § 1.1361-4(a)(7) provides:

(i) *In general*. A QSub is treated as a separate corporation for purposes of Subtitle C—Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

(ii) *Effective/applicability date*. This paragraph (a)(7) applies with respect to wages paid on or after January 1, 2009.

[167] Reg. § 1.1361-4(a)(8) provides:

(i) *In general*. A QSub is treated as a separate corporation for purposes of—

(A) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), 38, and 49 of the Internal Revenue Code, or any floor stocks tax imposed on articles subject to any of these taxes;

(B) Collection of tax imposed by Chapters 33 and 49 of the Internal Revenue Code;

(C) Registration under sections 4101, 4222, and 4412;

(D) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (a)(8)(i)(A) of this section or under section 6426 or 6427; and

(E) Assessment and collection of an assessable payment imposed by section 4980H and reporting required by section 6056.

(ii) *Effective/applicability date*.

(A) Except as provided in this paragraph (a)(8)(ii), paragraph (a)(8) of this section applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.

(B) References to Chapter 49 in paragraph (a)(8) of this section apply to taxes imposed on amounts paid on or after July 1, 2012.

(C) Paragraph (a)(8)(i)(E) of this section applies for periods after December 31, 2014.

- QSubs separately file certain information returns,[169] none of which seem to have anything to do with estate, gift, or generation-skipping transfer taxes.[170]

QSubs have some nice uses. First, suppose one would like to drop all of an S corporation's assets into a partnership, per part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. The shareholders can contribute their stock to a new corporation and make a QSub election for the old S corporation, both as part of a tax-free reorganization,[171] then merge the QSub into a new disregarded LLC as a disregarded transaction, even if the new LLC converts to a partnership immediately thereafter;[172] this transaction is diagrammed and explained in

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Reg. § 1.1361-4T(a)(8)(iii)(A) treated a QSub as a separate corporation for purposes of Chapter 49, the latter of which imposed a tax on indoor tanning services. Reg. § 1.1361-4T(a)(8)(iii)(C) provided that Reg. § 1.1361-4T(a)(8)(iii)(A) expired June 22, 2015.

[168] Estate, gift, or generation-skipping transfer taxes are imposed by Chapters 11, 12, and 13, respectively. Special valuation rules are in Chapter 14. Code §§ 6161, 6163, 6165 and 6166, relating to estate tax extensions, are in Chapter 62. Liens, including Code §§ 6324, 6324A, and 6324B (relating to estate and gift taxes, Code § 6166 deferral, and special use valuation) are in Chapter 64.

[169] Reg. § 1.1361-4(a)(9) provides:

(i) *In general*. Except to the extent provided by the Secretary or Commissioner in guidance (including forms or instructions), paragraph (a)(1) of this section shall not apply to part III of subchapter A of chapter 61, relating to information returns.

(ii) *Effective/applicability date*. This paragraph (a)(9) is effective on August 14, 2008.

[170] Part III of subchapter A of chapter 61 consists of Code §§ 6031-6060. Although Code §§ 6034, 6034A, and 6035 deal with information returns filed by trusts and estates, they are meaningless in a QSub context because a trust or estate would own the parent, not the QSub (given that a QSub must be wholly owned by a parent corporation). Estate and gift tax returns are required by Code §§ 6018 and 6019, respectively, which are in Part II, not Part III, of subchapter A of chapter 61. Generation-skipping transfer tax returns are required by Code § 2662, which is in Chapter 13.

[171] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn. 2978, which includes the procedure when one combines such a reorganization with a QSub election. Consider whether the election to treat the old S corporation as a QSub should be made before merging into the LLC, out of concern that the surviving LLC is not taxed as a corporation and therefore can no longer make a QSub election on behalf of the old S corporation. See Letter Rulings 201501007 and 201724013.

[172] Reg. § 1.1361-5(b)(3), Example (2) clarifies that the merger into a wholly owned LLC has no federal income tax consequences, even if immediately thereafter the LLC is converted into a partnership, with the partnership tax rules governing the formation of such a partnership:

(i) X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. As part of a plan to sell a portion of Y, X causes Y to merge into T, a limited liability company wholly owned by X that is disregarded as an entity separate from its owner for Federal tax purposes. X then sells 21 percent of T to Z, an unrelated corporation, for cash. Following the sale, no entity classification election is made under § 301.7701-3(c) of this chapter to treat the limited liability company as an association for Federal tax purposes.

(ii) The merger of Y into T causes a termination of Y's QSub election. The new corporation Newco) that is formed as a result of the termination is immediately merged into T, an entity that is disregarded for Federal tax purposes. Because, at the end of the series of transactions, the assets continue to be held by X for Federal tax purposes, under step transaction principles, the formation of Newco and the transfer of assets pursuant to the merger of Newco into T are disregarded. The sale of 21 percent of T is treated as a sale of a 21 percent undivided interest in each of T's part II.E.7.c.i.(b) Use F Reorganization to Form LLC. A QSub might also allow a tiered structure to qualify for Code § 6166 estate tax deferral[173] when it might not have qualified or on more favorable terms than might otherwise have applied.[174] It might also be used to preserve the AAA of a corporation whose S election is revoked.[175]

If the parent later owns less than all of the stock of the subsidiary, the subsidiary becomes a C corporation.[176] Consider merging a QSub into a wholly owned LLC that is a disregarded entity, so that its pass-flow status is not lost if ownership of part of the entity is transferred or if potential changes in capital structure cause equity to be deemed to be issued (it was suggested to me that an underpriced warrant issued in a financing might cause problems), but beware state income taxation if a state in which the company is subject to income tax does not treat a QSub as a disregarded entity[177] and that a disregarded entity subsidiary might not have as strong an argument that Code § 6166 estate tax deferral applies.[178]

On the reverse side, if an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation.[179]

II.A.2.i. Important Protections for S Corporation Shareholder Agreements

Always provide that stock cannot be transferred to any person if such a transfer would make the corporation fail to be a "small business corporation" under Code § 1361(b)(1).[180] Because the tax laws change, the restriction should be as simple and broad as the preceding sentence. Define "transfer" to be any event that causes federal tax law to treat ownership as having changed, which might include a trust no

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assets. Immediately thereafter, X and Z are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

(iii) Under section 1001, X recognizes gain or loss from the deemed sale of the 21 percent interest in each asset of the limited liability company to Z. Under section 721(a), no gain or loss is recognized by X and Z as a result of the deemed contribution of their respective interests in the assets to the partnership in exchange for ownership interests in the partnership.

[173] See part III.B.5.d.ii Code § 6166 Deferral, especially part III.B.5.d.ii.(b) Tiered Structures.

[174] See part II.A.2.e.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders, especially the text accompanying fns. 91-94.

[175] See part II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation, especially fns. 2887-2889.

[176] Reg. § 1.1361-5.

[177] On the other hand, converting sooner rather than later might save higher state income tax on some later event, if the state does not recognize QSubs.

[178] See part II.A.2.e.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders, especially the text accompanying fns. 91-93.

[179] Reg. § 1.1361-4(a)(2)(i), which further provides that, subject to certain transition rules that apply to pre-2001 QSub elections, "the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine." Reg. § 1.1361-4(a)(2)(ii) illustrates this liquidation concept, including the idea of a Code § 332 tax-free liquidation.

[180] See part II.A.2.g Shareholders Eligible to Hold S Corporation Stock.

longer being a wholly-owned grantor trust[181] even though shares have not changed hands.

Notwithstanding these protections, problems might occur – especially if the company does not have a qualified tax advisor approve every transfer other than to an individual who is a US citizen. If caught and corrected soon enough (generally 3 years and 75 days after the transfer), one can obtain automatic relief;[182] otherwise, correction might require an expensive and potentially time-consuming private letter ruling. Either relief has the stated requirement that all shareholders consent to relief for inadvertent termination.[183] Obtaining such consent might be difficult, for example, if the owner is no longer a shareholder or is incapacitated, deceased, or simply uncooperative. A shareholder agreement should grant the company an irrevocable[184] durable power of attorney to sign such consents.

The shareholder agreement should also prohibit any shareholder from intentionally revoking the S election unless a particular threshold vote is attained. Consider addressing not only express revocations but also allowing the corporation's S election to be terminated by excess passive income. See part II.A.2.l Terminating S Election.

A shareholder agreement might also address allocations of income upon a change in ownership or termination of the S election. Generally, S corporation allocations of income are pro-rata, per-share, per-day, which can cause unexpected results if income (including from a sale of the business) is not earned evenly throughout the year. See part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

Consider using provisions found in the ACTEC Shareholders Agreement Form 2007,[185] which uses as a general reference the ACTEC Shareholders Agreement Outline 2011.[186]

II.A.2.j. Single Class of Stock Rules

S corporations cannot have more than one class of stock.[187]

Preferred stock having been issued when an S election is made makes the election ineffective, but the IRS may grant relief retroactively if all defects are cured.[188]

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181 See part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures.

182 Rev. Proc. 2013-30, which is described in other parts of this document. The relevant IRS web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.

183 Code § 1362(f).

184 Generally, a principal may revoke a durable power of attorney. However, a power coupled with an interest, such as in a shareholder agreement, may be irrevocable.

185 http://apps.americanbar.org/webupload/commupload/RP519000/relatedresources/ACTEC-ShareholdersAgreementForm_9.20.07.pdf.

186 http://apps.americanbar.org/webupload/commupload/RP519000/relatedresources/ACTEC-ShareholdersAgreementOutline_12.27.11.pdf

187 Code § 1361(b)(1)(D).

188 Letter Ruling 201716009.

II.A.2.j.i. Voting and Nonvoting Stock

II.A.2.j.i.(a). Nonvoting Stock Permitted for S Corporations

Differences in voting rights do not by themselves create a second class of stock.[189] Generally, if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds (using great caution to strip any partnership tax and accounting provisions from any operating agreement or partnership agreement forms if an unincorporated entity makes the election),[190] a corporation is treated as having only one class of stock.[191] Thus, the corporation may issue voting and nonvoting stock, each of which confers identical rights to distribution and liquidation proceeds. This capital structure also avoids gift and estate tax problems under the anti-freeze valuation rules of Chapter 14.[192]

II.A.2.j.i.(b). Why Nonvoting Shares Are Needed for Estate Planning

The retention of the right to vote (directly or indirectly) shares of stock of a "controlled corporation" causes estate inclusion of the transferred stock.[193]

A corporation is a "controlled corporation" if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (or was deemed to own under certain income tax family attribution rules), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20% of the total combined voting power of all classes of stock.

If the trustee consults with the grantor regarding how to vote stock the trust owns, the IRS may take the position that the grantor has indirectly retained the right to vote in conjunction with the trustee and that therefore the stock is includible in the grantor's estate for estate tax purposes.[194] If the grantor is the trustee over transferred nonvoting stock, the fact that nonvoting stock can vote in extraordinary matters, such as mergers or liquidations, will not cause Code § 2036 inclusion.[195]

However, if the grantor transfers nonvoting stock and retains the voting stock, the transferred nonvoting stock will not be includible in the grantor's estate for estate tax purposes.[196]

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[189] Code § 1361(c)(4).

[190] See fn. 297 in part II.B Limited Liability Company (LLC).

[191] Reg. § 1.1361-1(l)(1). All references to a "Reg." section are to U.S. Treasury Regulations promulgated under the Code.

[192] Code § 2701(a)(2)(C) provides that Code § 2701 does not apply to such a capital structure.

[193] Code § 2036(b)(1).

[194] Rev. Rul. 80-346.

[195] Prop. Reg. § 20.2036-2(a) (concluding two sentences).

[196] See Code § 2036(b) (transfers of voting stock in a controlled corporation can be included in the transferor's estate for estate tax purposes if the transferor retains strings such as voting rights), Rev. Rul. 80-346 (even informal strings on voting stock held in trust can bring it into the settlor's estate), and both Rev. Rul. 81-15 and Prop. Reg. § 20.2036-2 (the settlor's retention of voting stock outside of a trust will not cause the Code § 2036(b) inclusion of nonvoting stock transferred in trust); *Boykin v. Commissioner*, T.C. Memo. 1987-134 (same conclusion as Rev. Rul. 81-15 but without citing it). Rev. Rul. 81-15 does not appear to recognize that even

Typically, the S corporation starts with one type of voting stock. Then it issues a stock dividend of nonvoting stock. The stock dividend does not constitute a taxable distribution.[197] The author's tendency is to distribute 19 shares of nonvoting stock for each share of voting stock. This allows the voting stock to retain a significant portion, yet allows the original owner to shift 95% of the distribution and liquidation rights when transferring the nonvoting stock to the next generation.

II.A.2.j.i.(c). Cautions in Issuing Nonvoting Stock

One should consider filing Form 8937 to report the issuance of nonvoting shares.[198] It is due 45 days after issuing the shares or, if earlier, on January 15 following the calendar year of the issuance.[199] However, "an S corporation can satisfy the reporting requirement for any organizational action that affects the basis if it reports the effect of the organizational action on a timely filed Schedule K-1 (Form 1120S) for each shareholder and timely gives a copy to all proper parties."[200] These deadlines and exceptions are from the December 2011 instructions to Form 8937; be sure to check the instructions, as well as the IRS' webpage for future developments regarding Form 8937.[201]

Issuing more shares might increase the corporation's franchise tax. Check not only the stat in which the corporation was formed but also each state in which the corporation registers to do business. If the issuance would increase franchise tax, consider doing a reverse split to decrease the number of shares before issuing the nonvoting stock.

Issue nonvoting shares will not remove grandfathering from Code § 2703.[202]

II.A.2.j.i.(d). Reallocations between Voting and Nonvoting Stock

Future reallocations between voting and nonvoting stock would not create income tax consequences.[203] However, to avoid a taxable gift, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in their values.[204] It is not unusual for even minority voting shares to have 3%-5% more value than nonvoting shares, so one might consider consulting a qualified appraiser when doing a swap like this.

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nonvoting stock has some limited voting rights; fortunately, Prop. Reg. § 20.2036-2(a) seems to recognize and approve of such a retention, as mentioned in fn. 195. Given that estate tax definitions regarding business entities tend to be sparse, one might also look to income tax rules regarding when the right to vote is significant. For purposes of determining whether a corporation was eligible to file a consolidated return, which turned on the presence of voting stock, voting for directors constituted a critical part of the right to vote. *Alumax Inc. v. Commissioner*, 109 T.C. 133 (1197), *aff'd* 165 F.3d 822 (11th Cir. 1999).

[197] Code § 301(a) taxes only a distribution of property, and refers to the Code § 317(a) definition of "property." Code § 317(a) provides that "property" does not include stock in the corporation making the distribution.

[198] Code § 6045(g).

[199] Instructions for Form 8937 (revised December 2011). See www.irs.gov/pub/irs-pdf/i8937.pdf.

[200] Instructions for Form 8937 (revised December 2011). See www.irs.gov/pub/irs-pdf/i8937.pdf.

[201] See www.irs.gov/form8937.

[202] See part II.Q.4.h Establishing Estate Tax Values, especially fn. 3267.

[203] Code § 1036. Voting trust certificates are also eligible for an income tax-free swap. Letter Ruling 200618004.

[204] *Bosca v. Commissioner*, T.C. Memo. 1998-251.

A redemption plan did not cause second-class-of-stock issues when its purposes were to ensure that voting power and economic ownership between A and A's family and B and B's family remain approximately equal and to prevent an individual shareholder from owning a disproportionate amount of voting versus nonvoting common stock.[205]

II.A.2.j.ii. Temporary Timing Differences; Other Varying Differences

Suppose an S corporation, has two equal shareholders, A and B. Under its bylaws, A and B are entitled to equal distributions. The corporation distributes $50,000 to A in the current year, but does not distribute $50,000 to B until one year later. The circumstances indicate that the difference in timing did not occur by reason of a binding agreement relating to distribution or liquidation proceeds. The difference in timing of the distributions to A and B does not cause the corporation to be treated as having more than one class of stock;[206] however, Code § 7872 or other recharacterization principles may apply to determine the appropriate tax consequences.[207]

The single class of stock rule is not violated by a governing provision providing that, "as a result of a change in stock ownership, distributions in a taxable year are to be made on the basis of the shareholders' varying interests in the S corporation's income in the current or immediately preceding taxable year."[208] For example, distributions in year 2 to pay taxes on income earned in year 1 that are based on ownership in year 1 will not violate the single class of stock rules; note, however, that the corporation would need to satisfy any state law restrictions on the timing of setting the record date for such distributions.

Paying state taxes might lead to temporary timing differences, if the shareholders have different state income tax situations. As long as any resulting disproportionate distributions are only temporary, the timing differences should not jeopardize the S election.[209] Letter Ruling 201608007 approved correction of disproportionate

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[205] Letter Ruling 201506003.

[206] Reg. § 1.1361-1(*l*)(2)(i) provides:

> *In general*. The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (*l*). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

[207] Reg. § 1.1361-1(l)(2)(vi), Example (2).

[208] Reg. § 1.1361-1(*l*)(2)(iv), which further provides:

> If distributions pursuant to the provision are not made within a reasonable time after the close of the taxable year in which the varying interests occur, the distributions may be recharacterized depending on the facts and circumstances, but will not result in a second class of stock.

[209] Reg. § 1.1361-1(*l*)(2)(ii) provides:

distributions related to composite state income tax filings, and the corporation implemented policies and procedures to ensure that future state composite and withholding taxes paid by the corporation for the benefit of the applicable shareholders will be equalized annually with reciprocal cash distributions to the other shareholders. So did Letter Ruling 201633017, in which the corporation treated excess distributions as interest-free loans that were not necessarily repaid; the ruling pointed out, however, that disproportionate and corrective distributions must be given appropriate tax effect.

Letter Ruling 200944018 held that, when disproportionate distributions were made in one year, corrective action taken in the following year should cure any inadvertent termination that might have occurred.[210] The fact that the corrective action was necessarily non-pro-rata did not itself cause any second-class-of stock problem.

Letter Ruling 201444020 allowed two years of disproportionate distributions to be cured in the third year. In year Y1, an S corporation made disproportionate distributions to its shareholders by failing to make certain distributions to certain of its shareholders. The corporation discovered this in year Y2 and has rectified the situation by making the necessary corrective distributions. The IRS concluded that X's S election may have terminated because X may have had more than one class of stock. It further ruled, however, that, if the S election was terminated, such a termination was inadvertent. Further, the IRS held that the corrective action taken by the corporation and the shareholders for Y1 does not create a second class of stock. Consequently, it ruled that the corporation will be treated as continuing to be an S corporation from when it first became an S corporation, and thereafter, provided that the S election otherwise is not terminated for any other reason.

Letter Rulings 201236003 and 201608006 authorized an unspecified number of years of disproportionate distributions to be corrected when the governing documents did not permit disproportionate distributions.

Alternatively, excess distributions might be characterized as advances, then documented as loans and repaid with interest.[211]

The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of

> *State law requirements for payment and withholding of income tax*. State laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of paragraph (*l*)(1) of this section, provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

[210] Letter Ruling 201220024 had a similar result.

[211] Letter Ruling 201150030.

incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions).[212]

A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement.

Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

This ruling reinforced my view that the IRS does not appear to be concerned with temporary timing differences, so long as they are corrected promptly after being discovered, presumably when the corporation's income tax return is prepared.

The IRS has also approved a mechanism for addressing varying interests in stock. In Letter Ruling 200709004, the shareholders agreement contained provisions relating to minimum distributions to shareholders by Company. Distributions under those provisions are to be made based on the shareholders' varying interests in company's income in the current or immediately preceding taxable year (or earlier if such earlier year's taxable income is adjusted by company or the IRS) ("Varying Interests Distributions"). The Varying Interests Distributions entail year-end and quarterly distributions that enable shareholders to make timely estimated and final tax payments. The distributions are made directly to the shareholders rather than to their respective taxing authorities on behalf of the shareholders.

In addition to Varying Interests Distributions, the corporation would declare dividends and make pro rata distributions to its shareholders based on the number of shares owned by the shareholders as of the record date ("Record Date Distributions"). Record Date Distributions are to be made in accordance with the corporate laws of State, which provides that all shares of the same class are equal. The shareholders agreement and applicable state corporate law constituted the governing provisions of Company.

The IRS concluded that the governing provisions relating to Varying Interests Distributions and to Record Date Distributions did not cause the corporation to have more than one class of stock.

Letter Ruling 201017019 took this concept one step further in approving distributions: (1) made in accordance with the shareholders' respective interests in taxable income or loss for that taxable year; (2) that may take into account any interest, penalties, or the like attributable to a post-filing adjustment; and (3) that will be made at a reasonable time after the relevant post-filing adjustment is finally determined. Similarly, Letter Ruling 201306005 approved an agreement under which the corporation will make distributions (including to enable shareholders to pay their quarterly estimated taxes) based on the shareholders' varying interests in its income in the current or immediately

[212] Reg. § 1.1361-1(l)(2)(i).

preceding taxable year or earlier if such earlier year's taxable income is adjusted after X's original return for the such earlier year is filed. Be sure, however, to check whether applicable state law permits such a lengthy delay from the record date to the distribution date.

Unfortunately, the IRS has not issued any formal guidance upon which taxpayers are permitted to rely, as Letter Rulings do not bind the IRS. From a tax perspective, the safest approach is to mandate pro rata distributions and be silent about what happens if the distributions are not pro rata. This is important not only for income tax purposes but also to fall within the Code § 2701(a)(2)(B) safe harbor for valuing transfers of interests in family businesses. Then one would administratively fix any noncompliance that might occur, and generally these fixes would be required under state law and respected by the IRS because pro rata distributions are legally mandated under the governing instruments.

If one wishes to adopt more elaborate formal procedures, one should consider obtaining a Letter Ruling, with one exception: state law requirements for payment and withholding of income tax. Regulations recognize that state laws might require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, so long as the deemed distributions and actual distributions wind up being pro rata in the aggregate. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.[213]

What if these tax payments are disproportionate and the corporation does not realize they need to be fixed? In Letter Ruling 201129023, for several years the corporation intentionally made disproportionate distributions to defray shareholders' income taxes. Eventually, the corporation learned that it shouldn't have been doing that, so it made a corrective distribution to make up for the cumulative disproportionate distributions. Without ruling whether the distributions violated the single class of stock rule, IRS granted inadvertent termination relief, just in case a violation had occurred.

II.A.2.j.iii. Disproportionate Distributions

Disproportionate distributions that are not contemplated by the governing provisions do not necessarily violate the rules against a second class of stock.[214] They are often fixed

[213] Reg. § 1.1361-1(l)(2)(ii).

[214] Reg. § 1.1361-1(l)(2)(i) provides:

> *In general*. The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation

by make-up distributions to those who received less; see part II.A.2.j.ii Temporary Timing Differences.

In *Minton v. Commissioner*,[215] the Tax Court held, and the Fifth Circuit affirmed, that distributions that were allegedly disproportionate did not violate the rules against a second class of stock because the shareholders that received the alleged distributions were not legally entitled to receive disproportionate distributions; that case involved minority shareholders arguing that the corporation's S election had terminated.[216] *Kumar v. Commissioner*[217] held that a shareholder who was effectively shut out of management remained a shareholder of record and was taxed on his distributive share of income.

Furthermore, when some shareholders of an S corporation sought compensation for financial damages they sustained due to some inadequate advice the corporation had received, the corporation's payments to compensate them did not constitute issuance of a second class of stock.[218]

II.A.2.j.iv. Providing Equity-Type Incentives without Violating the Single Class of Stock Rules

As discussed earlier, S corporations cannot have more than one class of stock.[219] The single-class-of-stock rules focus on rights to distribution and liquidation proceeds.[220] However, many techniques allow employees to be compensated in a manner similar to a shareholder without being considered to be a shareholder. Or, employees could hold actual stock whose liquidation rights materially differ from the other stock but is not deemed a second class of stock because of special exceptions that apply only to shareholders who are employees. For additional aspects of equity compensation or issuing stock to employees, see part II.M.4.b.i Income Tax Recognition Timing Rules re Equity Incentives, especially part II.M.4.e.i Issuing Stock to an Employee - Generally (particularly noting fns. 2636-2641).

Certainly, an employer can give an employee a bonus based on the company's profitability. Reg. § 1.1361-1(b)(4) provides:

> *Treatment of deferred compensation plans*. For purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it—
>
> (i) Does not convey the right to vote;
>
> (ii) Is an unfunded and unsecured promise to pay money or property in the future;

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rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

[215] 562 F.3d 730 (5th Cir. 2009) (per curiam), *aff'g* T.C. Memo. 2007-372.

[216] *Minton* is summarized in Steve Leimberg's Business Entities Email Newsletter - Archive Message #124.

[217] T.C. Memo. 2013-184.

[218] Letter Ruling 201016040.

[219] Code § 1361(b)(1)(D).

[220] Reg. § 1.1361-1(l)(1).

(iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and

(iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

A deferred compensation plan that has a current payment feature (e.g., payment of dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded from this paragraph (b)(4).

Beyond that, how far can an employer go in providing compensation that functions like stock ownership without actually being stock? (See part II.M.4 Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules.)

- An employment agreement is not a binding agreement relating to distribution and liquidation proceeds (and therefore is not a second class of stock) unless a principal purpose of the agreement is to circumvent the single class of stock rules.[221] Even if the IRS finds that one shareholder's compensation is excessive, that finding will not violate the single class of stock rules unless a principal purpose of the agreement is to circumvent those rules.[222] Same with disparate fringe benefits.[223]

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[221] Reg. § 1.1361-1(l)(2)(i). See also Letter Ruling 200924019 ("informal unwritten employment agreement" did not constitute a "governing provision" under this regulation and therefore did not create a second class of stock.

[222] Reg. § 1.1361-1(l)(2)(v), Example (3); Letter Ruling 201607001 (at will employee without a written compensation agreement). Example (3), "Treatment of excessive compensation," provides:

(i) S, a corporation, has two equal shareholders, C and D, who are each employed by S and have binding employment agreements with S. The compensation paid by S to C under C's employment agreement is reasonable. The compensation paid by S to D under D's employment agreement, however, is found to be excessive. The facts and circumstances do not reflect that a principal purpose to D's employment agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the employment agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by reason of the employment agreements, even though S is not allowed a deduction for the excessive compensation paid to D.

[223] Reg. § 1.1361-1(l)(2)(v), Example (4), "Agreement to pay fringe benefits," which provides:

(i) S, a corporation, is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S for each employee-shareholder. The facts and circumstances do not reflect that a principal purpose of the agreements is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l).

(ii) Under paragraph (l)(2)(i) of this section, the agreements are not governing provisions. Accordingly, S is not treated as having more than one class of stock by

- If a call option issued to an employee does not constitute excessive compensation, the option is not treated as a second class of stock if it is nontransferable and does not have a readily ascertainable fair market value when issued.[224] However, if the strike price is substantially below the stock's fair market value when the option becomes transferable, it may be treated as a second class of stock if the option is materially modified or transferred to an ineligible shareholder.[225] The safest course of action would be to (1) make the option always be nontransferable without a readily ascertainable fair market value as described above, or (2) start with an option that is transferable only to eligible shareholders and has a strike price that, at inception, is at least 90% of the stock's fair market value.[226]

Reg. § 1.1361-1(b)(4) provides:[227]

> *Treatment of restricted stock*. For purposes of subchapter S, stock that is issued in connection with the performance of services (within the meaning of § 1.83-3(f)) and that is substantially nonvested (within the meaning of § 1.83-3(b)) is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes an election with respect to the stock under section 83(b). In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S. See paragraphs (*l*)(1) and (3) of this section for rules for determining whether substantially nonvested stock with respect to which an election under section 83(b) has been made is treated as a second class of stock.

Under certain circumstances, an employer may issue stock to an employee and repurchase it at a bargain price without violating the single class of stock rules:[228]

> Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of section 1.83-3(b))[229] is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded.

> reason of the agreements. In addition, S is not treated as having more than one class of stock by reason of the payment of fringe benefits.

Letter Ruling 200914019 (equity split-dollar where corporation is reimbursed the term cost and receives cash value when agreement terminates).

224 Reg. § 1.1361-1(l)(4)(iii)(B)(2).

225 Reg. § 1.1361-1(l)(4)(v), Example (2). Letter Ruling 200724010 held than an option to acquire stock in an S corporation without an exercise price being required constituted a second class of stock.

226 Reg. § 1.1361-1(l)(4)(iii)(C).

227 See part II.M.4.e.i Issuing Stock to an Employee - Generally, especially text accompanying fns. 2636-2641.

228 Reg. § 1.1361-1(l)(2)(iii)(B). But see Letter Ruling 200632004, in which the IRS ruled that a bargain repurchase of stock held by a director would constitute a second class of stock.

229 See part II.M.4.b When is an Award or Transfer to an Employee Includible in the Employee's Income.

The company can redeem an employee's stock for an amount significantly below its fair market value on the termination of employment or if the company's sales fall below certain levels, when the employee did not receive the stock in connection with his performing services and a principal purpose of the agreement is not to circumvent the single class of stock rules.[230] Could a sale price that is nominal be considered not to be bona fide or be considered to make the stock forfeitable, throwing it into the rules that apply to forfeitable stock? The author has not researched whether this is a legitimate issue, but generally would feel comfortable with a redemption price at book value,[231] because Reg. § 1.1361-1(*l*)(2)(iii)(A) provides (emphasis added):

> Buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless --
>
> (1) A principal purpose of the agreement is to circumvent the one class of stock requirement of section 1361(b)(1)(D) and this paragraph (l), and
>
> (2) The agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock.
>
> **Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.** For purposes of this paragraph (*l*)(2)(iii)(A), a good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence. Although an agreement may be disregarded in determining whether shares of stock confer identical distribution and liquidation rights, payments pursuant to the agreement may have income or transfer tax consequences.

Such a price would prevent the terminated employee from benefiting from valuation methods based on earnings or unrealized appreciation in the company's tangible or intangible assets. Also, the IRS approved a bonus plan to be funded by a portion of any

[230] Reg. § 1.1361-1(l)(2)(vi), Example (9). However, this rule does not appear to apply to directors: Letter Ruling 200632004 rejected a mandatory redemption agreement for directors, where they were required to sell stock in termination of their relationship with the company for the same price for which they bought it. The ruling did not mention whether the price was above or below book value; however, it's not difficult to imagine situations in which the book value increases in the future above the original purchase price. As a condition to a favorable ruling, the IRS required the mandatory redemption to be at fair market value.

[231] Letter Ruling 200708018 approved a stock option plan where the employee could buy at book value and the corporation could repurchase at the same value one year later if the employee transferred the stock. The corporation also had an ongoing right to redeem the shares; the ruling did not disclose the redemption price.

future recovery from a claim against a third party; the plan would award certain of its employees for their work on the matter relating to that claim.[232]

The shareholder agreement can go even further and provide that an employee's shares are to be redeemed at less than fair market value on the termination of employment or if the corporation's sales fall below certain levels, even though the shares were not issued to the employee, in connection with the performance of services; the regulations permit this unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement.[233] Stock issued to key employees may be subjected to transfer restrictions and service-related risks of forfeiture.[234]

II.A.2.j.v. Post-Redemption or Post-Sale Price Adjustments

Relying on Reg. § 1.1361-1(*l*)(2)(iii)(A), Letter Ruling 201218004 allowed redemption proceeds to be adjusted such that the redeemed shareholders would receive additional payments if the corporation engages in certain sales transactions specified in the redemption agreement. Similarly, Letter Ruling 201309003 approved a clause allowing the value of a certain claim against a third party to benefit members who sold their interest if any recovery is made and allows a person to purchase the S corporation's stock without requiring the selling original shareholder and purchaser to come to an agreement on the value of the claim.

II.A.2.j.vi. Special Price Protection for Leveraged ESOP Approved

Letter Ruling 201038001 involved the following regarding an ESOP:[235]

> On Date4, Company undertook a series of transactions that resulted in ESOP becoming the sole owner of Company's outstanding stock. First, Company made a loan, secured by Company stock, to ESOP (ESOP Loan). Next, ESOP used the ESOP Loan proceeds to purchase all of the remaining outstanding shares of Company stock (Second Purchase Shares).
>
> Among its provisions, ESOP provides generally that benefits are distributed to participants at stated periods of time following their termination of employment due to retirement, disability, death, or other reason. Provision A of ESOP provides generally that for purposes of distributions under the plan, the value of the shares held by ESOP is determined by an independent appraiser. The independent appraiser calculates the fair market value of ESOP's assets and reduces that value by any liabilities of ESOP, including the outstanding balance of the ESOP Loan.

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[232] Letter Ruling 201309003.

[233] Reg. § 1.1361-1(l)(2)(vi), Ex. (9).

[234] Letter Ruling 201405005 involved a corporation's redemption of its two only shareholders in exchange for installment notes issued to each. Key employees were issued stock with the restrictions and made Code § 83(b) elections so that the stock was considered outstanding. It is a good example of a transition plan.

[235] See part II.G.20 Employee Stock Ownership Plans (ESOPs) and Other Code § 401(a) Qualified Retirement Plans Investing in Businesses.

> Provision B of ESOP provides a special valuation rule with respect to First Purchase Shares for purposes of distributions under the plan. Provision B provides that the value of Company shares purchased in connection with the First Purchase Shares will not be decreased or otherwise affected by the outstanding balance of the ESOP Loan proceeds used to purchase the Second Purchase Shares.
>
> Company represents that the purpose of Provision B is to protect the value of the First Purchase Shares from a steep decline in value that is normally associated with a highly leveraged employee stock ownership plan transaction. Company further represents that a serious employee relations problem would have occurred if a voluntary corporate action had the effect of reducing the value of First Purchase Shares already owned by ESOP. This would have negatively impacted employees who were close to retirement or who had previously terminated employment and were waiting for distributions. According to Company, First Purchase Shares continue to fluctuate in value with the fortunes of Company and general market conditions, as would occur in the absence of a leveraged employee stock ownership plan transaction.

Because the ESOP participants were employee-shareholders rather than investor shareholders, Reg. § 1.1361-1(*l*)(2)(iii)(B) caused Provision B to be disregarded in determining whether the outstanding shares of Company stock confer identical rights.

II.A.2.j.vii. Warrants Designed to Restore Original Shareholders' Equity Position

As described by a court:[236]

> During the late 1990s, the national accounting firm KPMG, LLP ("KPMG") developed a tax shelter product known as the S Corporation Charitable Contribution strategy ("SC2"). Pursuant to SC2, an S corporation's shareholders temporarily transfer most of the corporation's stock to a tax-exempt charitable entity via a "donation." Because an S corporation's annual income is "passed through" to its shareholders on a pro rata basis for purposes of calculating taxes, the effect of this transfer is to render most of the corporation's income tax-exempt. The "donated" shares to remain "parked" in the charity for a pre-determined period of time. During this period, the S corporation's income accumulates in the corporation; distributions are minimized or avoided. After the pre-determined period of time has elapsed, the charity sells the "donated" shares back to the original shareholders. Tax has been avoided for the period of time that the shares were "parked" in the charity, and the accumulated income of the S corporation may be distributed to the original shareholders either tax-free or at the favorable long-term capital gains rate.
>
> The original shareholders retain control over the S corporation by donating only non-voting stock while retaining all shares of voting stock. Moreover, to protect against the possibility that the donee charity might refuse to sell its majority stock back to the original shareholders after the agreed-upon length of time, warrants

[236] *Santa Clara Valley Housing Group, Inc. v. U.S.*, 108 AFTR.2d 2011-6361.

> are issued to the original shareholders prior to the “donation.” The warrants enable the original shareholders to purchase a large number of new shares in the corporation; if exercised, the warrants would dilute the stock held by the charity to such an extent that the original shareholders would end up owning approximately ninety percent of the outstanding shares. Thus the warrants allow the original shareholders to retain their equity interest in the corporation even though the charity nominally is the majority shareholder.

The court concluded that the warrants constituted a second class of stock:[237]

> The warrants obviously were designed to permit the Schott family to retain nominal ownership of approximately 90% of the corporation even though 90% of the actual shares had been “donated” to LAPF [a governmental pension fund]. If LAPF refused to sell the shares back, the Schotts could exercise the warrants, thereby diluting LAPF’s 900 shares such that LAPF would go from owning ninety percent to approximately ten percent of the outstanding shares. Accordingly, it fairly may be said that the warrants “constitute equity,” and were intended to prevent LAPF from enjoying the rights of distribution or liquidation that ordinarily would come with ownership of the majority of a successful company’s shares. There is no evidence that the warrants were issued for any purpose other than to protect the Schott family’s equity in Santa Clara for the period of time that the majority shares were “parked” in LAPF.

II.A.2.j.viii. Debt other than Straight Debt

Reg. § 1.1361-1(l)(2)(i) provides a safe harbor for a:

> commercial contractual agreement, such as a … loan agreement, … unless a principal purpose of the agreement is to circumvent the one class of stock requirement….

However, debt is treated as a second class of stock of the corporation if it constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles of Federal tax law and a principal purpose of creating the debt is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders.[238] This rule does not apply to unwritten advances from a shareholder that do not exceed $10,000 in the aggregate at any time during the taxable year of the corporation, are treated as debt by the parties, and are expected to be repaid within a reasonable time.[239] It also does not apply to obligations of the same class that are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock.[240] Obligations that are considered equity that do not meet this safe harbor will not result in a second class of stock unless a principal purpose of the

[237] Pursuant to Reg. § 1.1361-1(l)(4)(ii).
[238] Reg. § 1.1361-1(l)(4)(ii)(A).
[239] Reg. § 1.1361-1(l)(4)(ii)(B)(1).
[240] Reg. § 1.1361-1(l)(4)(ii)(B)(2), which further provides:

> Furthermore, an obligation or obligations owned by the sole shareholder of a corporation are always held proportionately to the corporation’s outstanding stock.

obligations is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders.[241]

A convertible debt instrument is considered a second class of stock if it (A) would be treated as a second class of stock under provisions relating to instruments, obligations, or arrangements treated as equity under general principles, or (B) embodies rights equivalent to those of a call option that would be treated as a second class of stock under provisions relating to certain call options, warrants, and similar instruments.[242] Allowing for conversion of debt to equity using the stock's value at the time the debt instrument is issued is not a second class of stock under this rule.[243]

II.A.2.j.ix. Straight Debt

"Straight debt" does not constitute a second class of stock.[244] This rule applied notwithstanding part II.A.2.j.viii Debt.[245]

"Straight debt" means a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date, if it:[246]

(A) Does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors;

(B) Is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; and

(C) Is held by an individual (other than a nonresident alien), an estate, or a trust described in section 1361(c)(2).

Code § 1361(c)(2) is described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. Clause (C) above omits another type of creditor who qualifies under Code § 1361(c)(5)(B)(iii): "a person which is actively and regularly engaged in the business of lending money." The regulation quoted above was promulgated before the statute referred to commercial lenders; legislative history suggests that commercial lender qualification not include individuals who are commercial lenders.[247]

Being subordinated to other debt does not prevent the obligation from qualifying as straight debt.[248]

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241 Reg. § 1.1361-1(l)(4)(ii)(B)(2).
242 Reg. § 1.1361-1(l)(4)(iv).
243 Letter Ruling 201326012.
244 Reg. § 1.1361-1(l)(5)(i).
245 Reg. § 1.1361-1(l)(5)(i).
246 Reg. § 1.1361-1(l)(5)(i).
247 House Report 104-586 (5/20/1996) for P.L. 104-188 (the Small Business Job Protection Act of 1996) expressed an intent that this cover "creditors, other than individuals, that are actively and regularly engaged in the business of lending money."
248 Reg. § 1.1361-1(l)(5)(ii).

An obligation can lose its "straight debt" qualification by being materially modified or transferred to a third party who is not an eligible shareholder.[249]

Being "considered equity under general principles of Federal tax law"[250] does not disqualify the obligation from being straight debt under this rule.[251] Thus, interest on a straight debt obligation is generally treated as interest by the corporation and the recipient and does not constitute a distribution.[252] However, if the interest rate is unreasonably high, an appropriate portion of the interest may be recharacterized and treated as a payment that is not interest (without resulting in a second class of stock).[253]

Conversion from C corporation status to S corporation status is not treated as an exchange of debt for stock with respect to "straight debt" that is considered equity under general principles of Federal tax law.[254]

II.A.2.k. Overcoming Above Rules

II.A.2.k.i. Using a Partnership to Avoid S Corporation Limitations on Identity or Number of Owners or to Permit Non-Pro Rata Equity Interests

The S Corporation can contribute its assets to an entity taxed as a partnership with an ineligible shareholder as a member,[255] with another S corporation as a member (to avoid the limitation on number of shareholders),[256] or with an investor who wants a non-pro rata equity interest in the business.

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[249] Reg. § 1.1361-1(l)(5)(iii).
[250] See part II.G.19 Debt vs. Equity.
[251] Reg. § 1.1361-1(l)(5)(iv).
[252] Reg. § 1.1361-1(l)(5)(iv).
[253] Reg. § 1.1361-1(l)(5)(iv).
[254] Reg. § 1.1361-1(l)(5)(v).
[255] Reg. § 1.701-2(d), Example (2).
[256] Rev. Rul. 94-43, which Letter Ruling 201544020 cited as authority for holding that the following did not cause a violation of the 100-shareholder limit:

> X was incorporated under State law on D1 and elected to be treated as an S corporation effective D2. Y and Z were both incorporated under State law on D3 and elected to be treated as S corporations effective D3. X currently has close to 100 shareholders.
>
> The shareholders of X plan to restructure its business by undertaking several steps, the result of which is that X will become a general partnership under State law, and Y and Z together will own all of the interests in X (the "Restructuring"). The shareholders of X will become shareholders in either Y or Z, and Y and Z will be governed by identical boards of directors pursuant to a voting agreement entered into by their shareholders. Following the Restructuring, the parties anticipate that both Y and Z will issue additional shares to new shareholders over time, so that the total number of shareholders in Y and Z together may exceed 100. However, neither Y nor Z will separately have more than 100 shareholders.

It is unclear whether whatever steps they took to have the shareholders divide their shares into two companies were nontaxable; see part II.Q.7.f Corporate Division. Generally, I would have envisioned the old corporation contributing its assets to a partnership and new shareholders forming a new corporation that contributed cash to the partnership, which generally would have been nontaxable under part II.M.3 Buying into or Forming a Partnership. Perhaps one or more shareholders in X wanted to sell the shareholder's shares to multiple unrelated parties.

II.A.2.k.ii. Disregarding Transitory Owners

In corporate reorganizations, sometime transitory entities are created or transitory stock ownership occurs to achieve some state law objective. For example:[257]

> …the creation of Y followed by the merger of Y into X with A exchanging X stock for Y stock, with the minority shareholders receiving cash and the conversion of the Y stock into X stock is disregarded for Federal income tax purposes. Rev. Rul. 73-427. The transaction is treated as if A never transferred any X stock, with the net effect that the minority shareholders of X received cash in exchange for their stock. Such cash is treated as received by the minority shareholders as distributions in redemption of their X stock subject to the provisions and limitations of section 302 of the Code.

If a corporation owns stock in an S corporation that is undergoing such a transaction so that the ownership is transitory, the transaction's being disregarded also means that the transitory stock ownership does not terminate the S corporation's S election.[258]

For disregarding transitory partnerships that own S corporation stock, see part II.A.2.g Shareholders Eligible to Hold S Corporation Stock, especially fn. 139.

II.A.2.l. Terminating S Election

The effects of terminating an S election, see part II.P.3.e Conversion from S Corporation to C Corporation.

Code § 1362(d) terminates an S election if:

(1) Shareholders holding more than one-half of the shares consent to the revocation.[259]

(2) The corporation ceases to be eligible.[260]

(3) The corporation has prior C corporation earnings and profits at the close of each of three consecutive taxable years and has gross receipts for each of such taxable years more than 25% of which are passive investment income.[261]

If an S election has been terminated under Code § 1362(d), the corporation may not make another S election under before its fifth taxable year which begins after the first taxable year for which such termination is effective, unless the IRS consents to such election.[262]

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[257] Rev. Rul. 78-250.
[258] Letter Ruling 201330018. See also Letter Ruling 201314031 (transitory ownership in a split-off). For a discussion of F reorganizations, see part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization, especially fn. 2978.
[259] Code § 1361(d)(1)(B).
[260] Code § 1361(b)(2)(A).
[261] Code § 1361(b)(3)(A). See part II.P.3.c.iii Excess Passive Investment Income.
[262] Code § 1362(g).

If an S corporation intentionally permits an ineligible shareholder because a third party prevented it from making tax distributions, the IRS will not consent to making the S election again until this waiting period has run.[263]

On the other hand, when eligible shareholders sold stock to ineligible shareholders without anyone intending to terminate the S election, the IRS consented to waiving the waiting period.[264] But when the sole shareholder sold all of the stock in the S corporation to an ineligible shareholder, the IRS denied the waiver.[265]

A Code § 1362(d) termination generates a pro-rata, per-share, per-day allocation,[266] except that an accounting cut-off applies:

- To the extent that the corporation is deemed to have sold its assets under Code § 338 (see, *e.g.*, part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold),[267] or

- If the shareholders elect to use an accounting cut-off.[268]

II.B. Limited Liability Company (LLC)

A limited liability company (LLC) is a business entity[269] that generally has liability protection similar to that of a corporation. However, for federal tax purposes,[270] an LLC is treated as follows:[271]

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[263] Letter Ruling 201403001.
[264] Letter Ruling 201550022.
[265] Letter Ruling 201636033.
[266] Code § 1362(e)(2).
[267] Code § 1362(e)(6)(C); Reg. § 1.1362-3(b)(2).
[268] Reg. § 1.1362-3(b)(1).
[269] Reg. § 301.7701-2(a) provides:

> For purposes of this section and § 301.7701-3, a business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code.

[270] For some examples of federal civil procedure and state real estate transfer tax issues involving single-member LLCs, see Kleinberger and Bishop, "The Single-Member Limited Liability Company as Disregarded Entity: Now You See It, Now You Don't," *Business Law Today* (8/2/2010), found at http://www.abanet.org/buslaw/blt/content/articles/2010/08/0002.html. For creditor issues, see part II.F Asset Protection Planning.
[271] REG-119921-09 (9/14/2010) proposes regulations recognizing series as separate entities. Prop. Reg. § 301.7701-1(a)(5)(x), Example (1) provides (emphasis added):

> Domestic Series LLC. (i) Facts. Series LLC is a series organization (within the meaning of paragraph (a)(5)(viii)(A) of this section). Series LLC has three members (1, 2, and 3). Series LLC establishes two series (A and B) pursuant to the LLC statute of state Y, a series statute within the meaning of paragraph (a)(5)(viii)(B) of this section. Under general tax principles, Members 1 and 2 are the owners of Series A, and Member 3 is the owner of Series B. **Series A and B** are not described in § 301.7701-2(b) or paragraph (a)(3) of this section and **are not trusts within the meaning of § 301.7701-4**.

- **Disregarded Entity**. If it has only one member (owner),[272] it is disregarded for federal tax purposes unless it elects otherwise.[273] If the sole member sells the LLC, the sole member is deemed to have sold the LLC's assets;[274] thus, generally, the owner of the LLC is deemed to directly own the LLC's assets for income tax purposes.[275] If a charity is the sole owner of an LLC, then contributions to the LLC

> (ii) Analysis. Under paragraph (a)(5)(i) of this section, Series A and Series B are each treated as an entity formed under local law. The classification of Series A and Series B is determined under paragraph (b) of this section. The default classification under §301.7701-3 of Series A is a partnership and of Series B is a disregarded entity.

The language emphasized above implies that a series LLC might establish an entity that is taxed as a trust. I know someone who talked with the person who did substantially all of the work in drafting the proposed regulation. The person who did that drafting confirmed my reading of the above language and stated that this inference was not intended. Hopefully this will be clarified in the final regulations.

[272] An entity is treated as a disregarded entity if it has two owners for state law purposes that are considered to be the same entity for tax purposes. Rev. Rul. 2004-77, interpreting Reg. § 301.7701-2(c)(2); see also Letter Rulings 201349001 and 200102037, as well as the authority in fn. 135 (disregarded entity with more than one owner is not an ineligible shareholder of an S corporation by reason of having more than one state law owner).

Reg. § 1.6031(a)-1(d)(1) provides that, for purposes of the partnership filing requirements, a partnership is defined in Reg. § 1.761-1(a). Reg. § 1.761-1(a) refers to the entity classification rules under Reg. §§ 301.7701-1, 301.7701-2, and 301.7701-3. Thus, Rev. Rul. 2004-77 determines whether a partnership income tax return is appropriate for the LLC.

What are the consequences if an entity that Rev. Rul. 2004-77 deems disregarded files partnership tax returns? Although I am unaware of any penalties for doing so, I am concerned about how the IRS might treat elections that have particular deadlines and are made on such a return rather than on the true owner's tax return. I am also concerned that taxpayers might not think to consider issues relevant to partnership formation when the owners are no longer treated as the same taxpayer, such as when a grantor trust loses its grantor trust status.

[273] Reg. § 301.7701-3(b)(1)(ii), which provides that such an entity is "Disregarded as an entity separate from its owner if it has a single owner," was upheld as valid by *Littriello v. United States*, 99 A.F.T.R.2d 2007-2210 (6th Cir. 2007), and *McNamee v. Dept. of Treasury*, 99 AFTR.2d 2007-2871 (2nd Cir. 2007).

Reg. § 301.7701-2(a) provides:

> A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. But see paragraphs (c)(2)(iii) through (vi) of this section for special rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.

Because an entity may use a different accounting method for each separate trade or business, a single member LLC that is a disregarded entity may use a different accounting method than its parent if the single member LLC engages in a separate trade or business. CCA 201430013, applying Code § 446(d).

[274] See part II.P.3.g Conversions from Partnership to Sole Proprietorships and Vice Versa, fns. 2935-2936. However, the parties can avoid this result; see fns. 2937-2940.

[275] AM 2012-001 reasoned:

> Rev. Rul. 99-5 does not ever mention a taxpayer's outside basis in his disregarded entity interest, because the owner of a disregarded entity has no outside basis in the entity for federal tax purposes. Therefore, outside basis has no relevance to a taxpayer's disposition of his interest in a disregarded entity.
>
> Likewise, a disregarded entity cannot make distributions in a manner where the federal income tax consequences would turn on the member's nonexistent outside basis. Section 301.7701-2(a) provides that if the entity is disregarded, its activities are treated in

are deductible.[276] An S corporation that has a Qualified Subchapter S Subsidiary should convert the subsidiary to a single member LLC if the conversion is not more trouble than it's worth.[277] Ordinarily, a disregarded entity uses its owner's taxpayer ID.[278] However, if it has employees (other than the owner), the LLC has the same employment filing requirements as a corporation,[279] but that separate status has no effect on the fact that the entity is disregarded in determining self-employment income[280] or its employees' eligibility for the employer's benefit plans.[281] It is also treated as a separate taxpayer for purposes of certain excise taxes[282] and for certain other purposes as well.[283] However, in valuing the transfer of an interest in a single-member LLC, the interest in the LLC – and not just the LLC's assets

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the same manner as a sole proprietorship, branch, or division of the owner. For federal tax purposes, the member already owns all of the disregarded entity's property. Therefore, while a preferred interest in an eligible entity may entitle the owner of the preferred interest to preferential distribution or liquidation rights under state law, such preferences have no meaning for federal tax purposes while the same taxpayer owns one-hundred percent of all classes of interests.

[276] Notice 2012-52, expanding the scope of Ann. 99-102. The Notice requested the charity owning the LLC "to disclose, in the acknowledgment or another statement, that the SMLLC is wholly owned by the U.S. charity and treated by the U.S. charity as a disregarded entity." This Notice cleared up longstanding concern. See Vishnepolskaya, "Deductibility of Gifts to Domestic, Single-Member LLCs as Contributions 'to the Charity' Under Recent Guidance," *The Exempt Organization Tax Review*, vol. 69, no. 2, at 135-147 (Feb. 2012). Ann. 99-102 provides that "an owner that is exempt from taxation under section 501(a) of the Internal Revenue Code must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return." Also note that IRS Information Letter 2010-0052, which described itself as "a well-established interpretation or principle of tax law" but also as a document that cannot be relied on the way a Revenue Ruling can be, stated that a contribution to an LLC wholly owned by a public charity generally will be treated as a qualifying distribution to the public charity for purposes of Code § 4942 and as a distribution with respect to which a grant-making private foundation will not be required to exercise expenditure responsibility under Code § 4945(d).

[277] See text accompanying fn. 132 for the reason and consequences.

[278] Reg. § 301.6109-1(h), T.D. 8844 (preamble) (11/29/99), and IRS Notice 99-6. Form SS-4's instructions (Rev. 1/2011) authorize obtaining an EIN for a disregarded entity only for employment and excise taxes or for non-federal purposes such as a state requirement.

[279] Reg. § 301.7701-2(c)(2)(iv). Under a prior version of that regulation, the sole member of an LLC and the LLC itself were personally liable for purposes of employment tax reporting and wages paid before January 1, 2009. *Costello, LLC v. Commissioner*, T.C. Memo. 2016-184, citing *Med. Practice Sols., LLC v. Commissioner*, 132 T.C. 125, 127 (2009), *aff'd without published opinion sub nom. Britton v. Shulman*, 2010 U.S. App. LEXIS 19925 (1st Cir. 2010).

[280] Reg. § 301.7701-2T(c)(2)(iv)(C)(2). For more on self-employment tax, see parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor and II.L.4 Self-Employment Tax Exclusion for Limited Partner.

[281] CCA 201634021 held that employees of an LLC disregarded from its Code § 501(c)(3) parent could participate in the parent's Code § 457(b) retirement plan.

[282] Reg. § 301.7701-2(c)(2)(v).

[283] The check-the-box regulations do not apply to tax administered by the Alcohol and Tobacco Tax and Trade Bureau (TTB) or the U.S. Customs and Border Protection (Customs), because rules in 26 CFR part 301 generally do not apply for purposes of those taxes. See T.D. 9553 (effective 10/26/2011). For treatment of otherwise-disregarded single member LLCs under the TEFRA partnership audit rules, see fn. 1145 in part II.G.18.c.i Overview of Rules Before and After TEFRA Repeal.

themselves – must be valued[284] before applying the results of that transfer to each asset.[285] Query how the at-risk rules of Code § 465 treat a disregarded LLC.[286]

- **Partnership**. If it has more than one member[287] for tax purposes, it is taxed as a partnership for federal tax purposes, unless it elects otherwise[288] or is publicly traded.[289] However, if the sole owners are a married couple, then the LLC may be treated as a disregarded entity if it held as community property.[290] For information on co-ownership rising to the level of a partnership and the consequences of failing to file partnership returns, see part II.C.9 Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership. In Missouri, an LLC is assumed owned equally by the members unless they agree otherwise or make different contributions.[291]

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[284] *Pierre*, a reviewed Tax Court opinion described in fn. 2943, held that, for gift tax purposes, the transfer of a partial interest in an LLC must be valued as an interest in the LLC as an entity rather than an interest in the underlying assets, even though before the transfer all of the assets were deemed owned directly by the sole member for income tax purposes. *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014), held that the gift tax rule applied for income tax purposes as well – for charitable purposes of the charitable deduction, a gift of the sole member interest in an LLC needed to have the LLC member interest valued. However, listing the LLC on Form 8283 (substantiation for a noncash charitable contribution) and the possibility that the sole member interest in an LLC might have a value identical to that of the underlying assets were enough to make proper substantiation a fact issue rather than a matter of summary judgment. Ultimately, the taxpayer lost for other reasons and was penalized; see fn. 1774 in part II.J.4.c Charitable Distributions.

[285] See fn. 274-275, the former re: selling an interest in a single member LLC that was a disregarded entity before the sale.

[286] See part II.G.3.g At Risk Rules.

[287] Banoff and Lipton, "How Small Can a Partner's Interest Be: Is 0.1% (or 0.01%) the 'New' 1%?", *Journal of Taxation* (WG&L), Vol. 114, No. 3 (March 2011), explores when an interest in a partnership might be too small to be considered.

[288] Reg. § 301.7701-3(b)(1)(i).

[289] See part II.C.2 Publicly Traded Partnerships for when a corporate treatment is mandated for a publicly traded partnership.

[290] Rev. Proc. 2002-69, relating to community property ownership of 100% of an entity that the taxpayers may treat as a disregarded entity. That Rev. Proc. applies only to community property ownership, not to joint tenants or tenants-by-the-entirety (TBE). A number of years ago, I called the author of the Rev. Proc. and asked why limit to community property when TBE was an even stronger unity of interest, and he said that people in community property states couldn't always determine whether property transferred to a single member LLC was separate property or community property, and the Rev. Proc. was offered to avoid inadvertently violating the rules. He said the IRS was not even considering extending it to joint or TBE property. Query whether this rule would be extended to registered domestic partners under California law under Letter Ruling 201021048 and CCAs 201021049 and 201021050 or under similar laws; Rev. Rul. 2013-17 makes me assume (announcing the IRS' response to the *Windsor* case recognizing same-sex marriages but not civil unions) that will not be the case. The IRS informally takes the position that an LLC does not qualify to be disregarded as a qualified joint venture under this provision; see fn. 490.

[291] An operating agreement is required, RSMo § 347.081.1, found at http://www.moga.mo.gov/mostatutes/stathtml/34700000811.html. However, it may be oral, RSMo § 347.015(13), found at http://www.moga.mo.gov/mostatutes/stathtml/34700000151.html. I would assume that everything was equal, unless evidence suggests otherwise.

- **Corporation**. An LLC can elect to be taxed as a corporation for federal tax purposes.[292]
  - LLCs electing taxation as a C corporation must file IRS Form 8832[293] no later than 75 days after the effective date of an election for an LLC to be taxed as a corporation (or for a foreign unincorporated entity to be taxed as a partnership). However, if a taxpayer has reasonable cause for failing to meet the deadline, the taxpayer might be able to file IRS Form 8832 as late as 3 years after its due date.[294]
  - LLCs electing taxation as an S corporation file Form 2553 without needing to file Form 8832.[295] Generally, it's better to file only Form 2553 so that a failure of Form 2553 to be valid will revert the LLC back to a flow-through entity; this reversion applies to only the failure of the initial election and not to any subsequent terminating events, the latter which would convert the LLC to a C corporation unless cured.[296] Note that every unit of ownership must have identical rights to distributions and liquidation proceeds.[297] If the LLC had been taxed as a partnership, make sure that distributions upon liquidation are made

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RSMo §§ 347.101 and 347.111, found at http://www.moga.mo.gov/mostatutes/stathtml/34700001011.html and http://www.moga.mo.gov/mostatutes/stathtml/34700001111.html.

[292] Reg. § 301.7701-3(c)(1)(i) provides that the election is made on IRS Form 8832.

[293] If the IRS accepts Forms 1120 filed by an LLC, the IRS is not estopped from treating the LLC as a disregarded entity because it failed to file Form 8832. *Costello, LLC v. Commissioner*, T.C. Memo. 2016-184.

[294] Rev. Proc. 2009-41.

[295] Reg. § 301.7701-3(c)(1)(v)(C). The instructions to IRS Form 2553 originally provided that, to be taxed as an S corporation, an LLC must elect taxation as an association under IRS Form 8832 and make the S election using IRS Form 2553. Reg. § 301.7701-3(c)(1)(v)(C) changed that and allows LLCs that file Form 2553 to skip the step of filing IRS Form 8832. Reg. § 301.7701-3(h)(3) allows taxpayers who filed Form 2553 before the July 20, 2004 effective date of Reg. § 301.7701-3(c)(1)(v)(C) to treat that regulation as effective.

[296] Reg. § 301.7701-3(c)(1)(v)(C) provides:

> *S corporations*. An eligible entity that timely elects to be an S corporation under section 1362(a)(1) is treated as having made an election under this section to be classified as an association, provided that (as of the effective date of the election under section 1362(a)(1)) the entity meets all other requirements to qualify as a small business corporation under section 1361(b). Subject to § 301.7701-3(c)(1)(iv), the deemed election to be classified as an association will apply as of the effective date of the S corporation election and will remain in effect until the entity makes a valid election, under § 301.7701-3(c)(1)(i), to be classified as other than an association.

For cures, see part II.A.2.f Making the S Election and III.A.3.c.iii Deadlines for QSST and ESBT Elections.

[297] See part II.A.2.j Single Class of Stock Rules. Letter Ruling 200548021 refers to the operating agreement as a governing provision for purposes of Reg. § 1.1361-1(l)(2)(i). Letter Rulings 201136004 and 201351017 allowed relief for inadvertent ineligibility to make an S election where perhaps the capital account partnership provisions had not been stripped out and were later caught; same with Letter Ruling 201528025, which definitely involved capital account partnership provisions that had not been stripped out and were later caught. The IRS will not rule on whether a state law limited partnership violates the single class of stock rules. Rev. Proc. 2007-3, § 5.09, which rule originated in Rev. Proc. 99-51.

pro rata instead of according to capital accounts. Be sure to consider part II.A.2.i Important Protections for S Corporation Shareholder Agreements.

- Regulations appear to question whether an LLC that makes an S election is subject to self-employment tax, but those regulations appear to be obsolete.[298]

Information on conversions by LLCs to corporate tax status is covered at part II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations. To the extent that a topic is not fully covered there, consider reading, "Now You See It, Now You Don't: The Comings and Goings of Disregarded Entities."[299]

Below are examples of situations when an LLC taxed as a sole proprietorship or partnership might be the best bet.

- **Real Estate - Sole Owner**. A client holds one or more parcels of real estate. The client would like to insulate his/her other assets from liability for what occurs on his/her real estate. Furthermore, the client would like each parcel to be insulated from liability for what happens on each other parcel. A possible solution may be to form a separate LLC to hold each parcel. Because each LLC would be disregarded for federal tax purposes, forming the LLCs would not complicate his/her tax situation. However, if the client holds the property for investment (and is not a dealer) but later wants to develop the property, the client should consider some pre-development tax planning.[300]

- **Real Estate - Co-Owners**. A client owns real estate with one or more other co-owners. One of the client's co-owners manages the property, or perhaps the client has a management company manage the property. In some situations, co-ownership is considered a general partnership even if no formal partnership agreement exists.[301]

  If the client is considered a general partner under state law, the client is jointly and severally liable for acts or omissions by the client's co-owners or those the client's "partnership" hires. Furthermore, if most, but not all, of the co-owners agree to sell or lease the property, the sale or lease cannot proceed without unanimous consent or court action. One dissenter could cause the client to lose valuable business opportunities. Finally, if a co-owner gets into creditor problems, the creditor may take his place and try to sell the property prematurely, perhaps even going to court to force a sale.

  A possible solution may be to form an LLC to hold the property. The LLC may relieve the client from joint and several liability and provide a mechanism for a

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[298] See part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.
[299] McMahon, pages 259-307 of the *Tax Lawyer*, Vol. 65, No. 2 (Winter 2012).
[300] See part II.G.12, Future Development of Real Estate If the client started with a single-member LLC before making these plans, the client might sell his/her interest in the LLC to an S corporation.
[301] In addition to state law liability, for federal income tax purposes a tenancy-in-common might be treated as a partnership. See part II.C.9 Whether an Arrangement (Including Tenancy-in-Common.

majority to control the property. Any creditor who obtains an interest in the LLC would have no right to vote on how the LLC is run and should not be able to get a court order to sell the property. Rarely is a corporation an appropriate entity for real estate;[302] however, his analysis does not consider foreign tax issues.[303]

- **Sole Proprietorship - Unsure of Best Entity for Tax Purposes**. A client starts his/her own business. Initially, the client wants to keep it simple, as a sole proprietorship. Later, the client may want to become an S corporation to avoid self-employment tax or a C corporation after making a public offering. The client starts as an LLC. Instead of transferring all of his/her assets to a new corporation when he/she later decides to change the LLC's tax treatment, he/she simply makes an election for the LLC to be taxed as an S corporation or a C corporation.

- **Sole Proprietorship - Future Co-Owner**. A client starts his/her own business. Hershey expect to eventually have co-owners as his/her business grows. However, the client does not want to have to re-title assets when he/she adds his/her first co-owner. Perhaps the client has a valuable lease, patent, copyright, franchise right, etc. that would be difficult to transfer. The client may want to start as an LLC and admit his/her new co-owners as members of the LLC.

- **Multiple Owners, Coming and Going**: In a client's profession or industry, it is common for new people to invest in his/her business or perhaps even to become co-owners without investing any cash (providing services instead). Similarly, it is possible that the business may split up some time in the future, each person taking his/her own share of the business with him/her, as often happens in professional firms. For federal tax purposes, partnership income tax may provide the most opportunity to minimize tax on new co-owners or on split-ups. As the only business entity taxed as a partnership in which generally no co-owner is personally liable, it is possible that an LLC may be appropriate.

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[302] If the owners want to go in separate directions without a current taxable event, each shareholder must receive an interest in an active business that has been carried for five years (among many other requirements of Code § 355). A distribution of real estate from a corporation to a shareholder is taxed as a sale of the distributed property (see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders), even if the corporation is an S corporation; if the corporation converted from a C corporation to an S corporation during the past 10 years, built-in gain tax might apply, as described in part II.P.3.c.ii Built-in Gain Tax. If the shareholders disagree on whether to do a like-kind exchange, it is difficult to satisfy all parties. When a shareholder dies, the real estate does not receive a basis step-up. However, see part II.G.12, Future Development of Real Estate, discussing tax strategies for converting investment real estate into property that is subdivided and held for sale. For a possible opportunity to replicate a basis step-up by liquidating the S corporation in the same year all of its assets are sold to an unrelated third party, see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.

[303] See, e.g., Lipton and McDonald, "Planning Can Minimize U.S. Taxation of Foreign Investment in U.S. Real Estate," *Journal of Taxation* (Sept. 2010), suggesting:

> In considering how to structure a foreign investor's ownership of U.S. real estate, various alternatives must be considered. These depend on whether U.S. tax will be paid directly by the foreign investor or by a U.S. or foreign entity. Other factors, including the status of the investor (e.g., individual or corporation) and the existence of an income tax treaty between the U.S. and the investor's country under which U.S. withholding or tax rates might be reduced, also must be taken into account.

- **One Business, Multiple Locations**. A client's business has several locations, whether in the same city or even in different states. He or she would like each location to be insulated from the liabilities of other locations. His or her business could set up a separate LLC for each location, but for federal income tax purposes nothing has changed.

- **Bankruptcy-Remote LLC to Facilitate Borrowing**. The lender insists that legal title be held by a bankruptcy remote entity. To satisfy this requirement, the borrower forms an LLC between the borrower and a corporation wholly owned by the borrower. To protect the lender's interest, one of the members of the corporation's board of directors will be a representative of the lender. The corporation has management rights only in certain events, and all of the LLC's profits, losses, and credits will be allocated to the borrower. Also, all distributions of net cash flow and capital proceeds will be made entirely to the borrower. Furthermore, when the dissolves, the borrower will wind up the LLC's affairs in any manner permitted or required by law, but the payment of any outstanding obligations owed to the lender will have priority over all other expenses or liabilities. The borrower is treated as owning the LLC's property directly.[304]

- **Facilitating Transfers**. Sometimes transfers need to be done expeditiously, and some assets are difficult to move around. For example:

    - Suppose private equity is being transferred to a GRAT,[305] and part of it needs to be transferred back to the donor to make annuity payments. Effectuating transfers working with the private equity fund might prove cumbersome. Putting the private equity in an LLC and transferring LLC interests back to the donor might be easier. Furthermore, formula transfers[306] of LLC interests might be done, whereas a formula transfer of the private equity fund might be awkward to explain and for which to obtain consent.

    - Suppose some pre-mortem planning needs to be done and the banks are not open or setting up new accounts takes more time than one has. LLC assignments, however, do not depend on working through financial institutions.

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[304] Letter Ruling 199911033, which also held that the borrower could use the LLC's property for a Code § 1031 nontaxable deferred exchange (See part II.G.15 Like-Kind Exchanges). The lender's consent was required for the LLC to:

> (1) file or consent to the filing of a bankruptcy or insolvency petition or otherwise institute insolvency proceedings; (2) dissolve, liquidate, merge, consolidate, or sell substantially all of its assets; (3) engage in any business activity other than those specified in its Certificate of Formation; (4) borrow money or incur indebtedness other than the normal trade accounts payable and any other indebtedness expressly permitted by the documents evidencing and securing the loan from Lender; (5) take or permit any action that would violate any provision of any of the documents evidencing or securing the loan from Lender; (6) amend the Certificate of Formation concerning any of the aforesaid items; or (7) amend any provision of the [Operating] Agreement concerning any of the aforesaid items.

See also Letter Rulings 199914006 and 200201024.

[305] See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

[306] See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

- LLCs can be used to centralize management of assets when a trust is distributed to its remaindermen.[307]

- An LLC might avoid a state's rule against perpetuities (RAP). For example, a perpetual trust buys real estate in a state that imposes the RAP. That state's laws might very well cause the real estate (and perhaps proceeds from its sale) to be subject to the RAP. Suppose instead that the trust forms an LLC to hold the real estate. The LLC constitutes personal property, so that the trust never owns real estate in that state. Presumably that state would not be able to impose the RAP against the real estate.

- An LLC might facilitate community property (CP) or tenants by the entirety (TBE) treatment. Suppose a married couple lives in a state that recognizes CP or TBE and wants its real estate to be owned as CP or TBE. However, the couple wants to buy real estate in a state that does not recognize CP or TBE. To try to obtain CP or TBE treatment for the real estate, the couple might form an LLC in its home state, perhaps register the LLC to do business in the other state, and then have the LLC buy the real estate. The extent to which CP or TBE would be recognized depends on conflict of laws issues, but presumably the couple would be better off with the LLC than without the LLC.

- An LLC might also help when a person living in a state that does not impose estate tax buys real estate in a state that does impose an estate tax. Real estate in the latter state would be subject to estate tax. However, if the person owns the property through an LLC, the person has converted the real property to personal property, as far as his estate's legal title is concerned. Beware that, just as the federal and most states' income tax laws disregard single member LLCs, state estate taxing authorities would also tend to disregard a single member LLC[308] – perhaps disregarding even an LLC owned by more than one person if the state views the LLC as a mere tax avoidance measure.

These are just some of the possible reasons to consider forming an LLC. Consider clients' business objectives and estate planning goals, the latter as pass-through entities often are ideal for transferring interests free from estate and gift taxes.

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[307] In Letter Ruling 201421001, a trust used two series LLCs – one invested in equities (X) and the other in fixed income securities (Y) – to distribute its investment assets to remaindermen. For details, see fn. 2793, found in part II.P.1.a.i.(b) Special Rule for Allocations of Income in Securities Partnerships.

[308] See, *e.g.*, New York State Department of Taxation and Finance, Office of Counsel, Advisory Opinion Unit, opinion no. TSB-A-15(1)M (5/29/2015) found at http://www.tax.ny.gov/pdf/advisory_opinions/estate_&_gift/a15_1m.pdf; however, opinion no. TSB-A-08(1)M (10/24/2008) held that, if the owner elects to treat the LLC as a corporation, New York would treat the LLC as personal property. If the latter strategy is pursued, consider using an S corporation whose only asset is that property (and an associated bank account through which to conduct the LLC's business), as described in part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation (discussing how an S corporation owning a single asset can capture the federal tax effect of an inside basis step-up on the sale of the asset, but also warning of a state income tax mismatch in part II.H.8.a.ii State Income Tax Disconnect).

Although it is not uncommon for operating agreements to refer to LLC units, the nomenclature of units might mislead members into believing that their ownership is treated as stock rather than as a partnership interest, so I prefer to avoid that practice.[309]

An LLC can be managed by its members or managers. To simplify signature lines, I use the manager-managed model.[310] Death or other dissociation can cause voting and other rights to lapse. This is especially a concern for a single-member LLC owned by an individual, so be sure to plan for how the governing documents handle that situation.[311]

An LLC formed in Missouri needs to register with the Secretary of State at inception. Future registrations are not necessary, except to the extent that the registration information changes. Missouri follows federal tax laws.

An LLC formed in Missouri can do business in another state. It just needs to register with that other state, and such foreign registrations generally are as simple as if the LLC had been formed in that state originally. Missouri apportions its state income tax consistent with the way many other states do. If all the business activities are conducted in that other state, generally the other state, not Missouri, would tax those activities.

Some states impose high annual registration fees, and registered agent fees can also mount. To make registration easier, some states (including Missouri) offer "Series LLCs," in which one registration is done describing various compartments, each of which is treated as a separate entity for liability protection purposes.[312] The IRS appears to be willing to respect these "Series" as separate entities.[313] Whether other states would respect this compartmentalization of groups of assets is uncertain in many states.[314]

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309 Immerman, "Is There Any Such Thing As An LLC Unit?" *Business Entities* (WG&L), July/Aug. 2009.

310 When a revocable trust is a member, having the trustee sign on behalf of the trust, which signs on behalf of the LLC is more complicated than simply naming the trustee as manager in that person's capacity as an individual. If the members want to manage the LLC themselves, the operating agreement can provide that each member is a manager. Then, when a member does estate planning, the operating agreement can be amended without needing to amend the articles of organization.

311 See Manns and Todd, "Issues Arising Upon The Death Of The Sole Member Of A Single Member LLC," 99 *Marquette Law Review* 725 (2016), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2805469. The article also discusses whether transfer on death provisions will be respected under various state laws.

312 For a list of jurisdictions, see fn. 314.

313 REG-119921-09 (9/14/2010) proposes regulations recognizing series as separate entities, with special rules for the insurance area; see Prop. Reg. § §301.7701-1(a)(5)(viii)(A). Letter Ruling 200803004 previously indicated the IRS' willingness to respect these "Series" as separate entities. See also Rev. Rul. 2008-8, Notice 2008-19, and Letter Rulings 200241008 and 200241009.

314 Rutledge, "The Internal Affairs Doctrine And Limited Liability Of Individual Series Within A Series LLC - Never The Twain Shall Meet?" *Business Entities* (WG&L) (May/June 2015), concluding, "It remains to be resolved whether the limited liability shield afforded to a series in the state of organization will be respected in a state that does not similarly provide for series, and how that analysis should be undertaken is open to dispute," and listing in fn. 1 of his article the jurisdictions that offer series LLCs:

> The LLC acts that authorize series are: Alabama (Ala. Code §10A-5A-11.01); District of Columbia (D.C. Code §29-802.06); Illinois (805 ILCS 180/37-40); Iowa (Iowa Code Ann.

Although generally I do not recommend them, in some cases their use may be appropriate.

II.C. Partnership

II.C.1. General Overview of Partnerships

Clients doing business as a partnership (whether an intentional or not, the latter as described in part II.C.9 Whether an Arrangement (Including Tenancy-in-Common), who are concerned about protection from liabilities incurred by the business, might consider whether registering as an LLP, converting to an LLC, converting a general partner to an LLC, or forming one or more LLC subsidiaries might be an appropriate strategy.

Note that, in the case of a seller-financed sale of goodwill, using a C corporation causes a triple tax, an S corporation causes a double tax, and a partnership causes a single tax.[315] When an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[316] For what might be an ideal structure involving a partnership, see part II.E Recommended Structure for Entities.

Special rules apply if a partnership interest is created by gift. See part III.B.1.a.iv.(b) Income Tax Aspects of Family Partnerships.

For other aspects when a partnership interest's owner changes for income tax purposes, see generally parts II.P.1.a.i Allocations of Income in Partnerships and III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership regarding allocating income.

Other changes are described in parts II.M.3 Buying into or Forming a Partnership and II.Q.8 Exiting From or Dividing a Partnership.

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§489.1201); Kansas (Kan. Stat. Ann. §17-76,143); Missouri (Mo. Rev. Stat. §347.186); Montana (Mont. Code Ann. §35-8-304(4)); Nevada (Nev. Rev. Stat. § 86.296.3); Oklahoma (18 Okla. Stat. §18-2054.4B); Puerto Rico (P.R. Laws Ann. Tit. 14, §3967 (General Corporations Act 2009)); Tennessee (Tenn. Code Ann. §48-249-309); Texas (Tex. Bus. Org. §101.601); Utah (Utah Code Ann. §48-3-1201). Series are also provided for in the ABA's Revised Prototype Limited Liability Act, 67 Bus. Law. 117 (November 2011) at §§1101 through 1116. Delaware alone has series limited partnerships. See Del. Code Ann. Tit. 6, §17-218. Several other states have series in their business/statutory trust acts: Conn. Gen. Stat. §§34-5167(b)(2), §34-502(b); Del. Code Ann. tit. 12, §§3804(a), 3805(h), 3806(b); D.C. Code §29-1204.01 et seq.; Ky. Rev. Stat. Ann. §§386A.4-010 through 386A.4-110; Va. Code Ann. §§13.1-1219, 13.1-1231, 13.1-1240; Wyo. Stat. §§17-23-106, 17-23-108. See also the Revised Uniform Statutory Trust Entity Act (2009). The Uniform Law Commission has in place a series statute drafting committee, which presented a first draft of its work at the 2014 annual meeting. While the present author is a member of that drafting committee, all views expressed herein are his own.

[315] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

[316] See part II.H.2 Basis Step-Up Issues.

This document covers other partnership tax issues in many other places.

II.C.2. Publicly Traded Partnerships

If interests in a partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof), then the partnership constitutes a "publicly traded partnership"[317] and may be taxed as a corporation.[318]

If, for the taxable year and each preceding taxable year beginning after December 31, 1987 during which the partnership (or any predecessor) existed, 90% or more of the gross income of a publicly traded partnership consists of qualifying income, the rule mandating corporate treatment may not apply.[319]

"Qualifying income" generally includes most interest, dividends, real property rents, gain from the sale of real property, income and gains from various energy or natural resource activities, any gain from the sale or disposition of a capital asset (or property described in Code § 1231(b))[320] held for the production of income described above, and certain income and gain related to commodities.[321]

II.C.3. Allocating Liabilities (Including Debt)

How debt is allocated is central to partnership income tax. Debt allocations interact with allocations of income and loss[322] and the consequences of entering into, exiting from, dividing, or merging a partnership.

"New Partnership Regulations under Sections 707 and 752," a discussion at the January 2017 meeting of the ABA's Section on Taxation that included those who write the regulations, discussed 2016 changes to regulations and included slides with charts explaining some key changes.[323]

II.C.3.a. Basic Consequences of Changes in Liability Allocations

Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, is deemed a contribution of money by such partner to the partnership.[324]

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such

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[317] Code § 7704(b).
[318] Code § 7704(a).
[319] Code § 7704(c).
[320] See part II.G.5.a Code § 1231 Property.
[321] Code § 7704(d).
[322] See part II.G.3.c.ii Basis Limitations for Partners in a Partnership.
[323] The text above references a two-part panel discussion chaired by Eric Sloan. The slides, "New Partnership Regulations under Sections 707 and 752," are saved as Thompson Coburn LLP doc. no. 6591807.
[324] Code § 752(a).

individual liabilities, is deemed a distribution of money to the partner by the partnership.[325]

In applying the above rules, a liability to which property is subject is, to the extent of the fair market value of such property, deemed a liability of the owner of the property.[326]

When a partnership interest is sold or exchanged, liabilities are treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.[327]

II.C.3.b. What Is a "Liability"

An obligation is a liability for purposes of part II.C.3 Allocating Liabilities (Including Debt) only if, when, and to the extent that incurring the obligation:[328]

(A) Creates or increases the basis of any of the obligor's assets (including cash);

(B) Gives rise to an immediate deduction to the obligor; or

(C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

An "obligation" is:[329]

> any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.

See part II.G.19 Debt vs. Equity, especially fn. 1232.

II.C.3.c. Allocations of Recourse and Nonrecourse Liabilities

II.C.3.c.i. Definition of "Recourse" or "Nonrecourse"

"A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss" under Reg. § 1.752-2.[330]

"A partnership liability is a nonrecourse liability to the extent that no partner or related person bears economic risk of loss for that liability" under Reg. § 1.752-2.[331]

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325 Code § 752(b).
326 Code § 752(c).
327 Code § 752(d).
328 Reg. § 1.752-1(a)(4)(i).
329 Reg. § 1.752-1(a)(4)(ii).
330 Reg. § 1.752-1(a)(1).
331 Reg. § 1.752-1(a)(2).

"A partner's share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss."[332]

II.C.3.c.ii. Allocating Economic Risk of Loss to Recourse Liabilities

II.C.3.c.ii.(a). Permanent Rules Allocating Economic Risk of Loss to Recourse Liabilities

Except as otherwise provided in this part II.C.3.c.ii.(a), as modified by part :[333]

> a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously:
>
> (i) All of the partnership's liabilities become payable in full;
>
> (ii) With the exception of property contributed to secure a partnership liability (see § 1.752-2(h)(2)), all of the partnership's assets, including cash, have a value of zero;
>
> (iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditors' right to repayment is limited solely to one or more assets of the partnership);
>
> (iv) All items of income, gain, loss, or deduction are allocated among the partners; and
>
> (v) The partnership liquidates.

The following rules apply in computing gain or loss on the deemed disposition of the partnership's assets:

- If the creditor's right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis[334] in those assets.[335]

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[332] Reg. § 1.752-2(a).
[333] Reg. § 1.752-2(b)(1).
[334] Or book value, to the extent Code § 704(c) or Reg. § 1.704-1(b)(4)(i) applies. See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.
[335] Reg. § 1.752-2(b)(2)(i).

- A loss is recognized equal to the remaining tax basis[336] of all the partnership's assets not taken into account in the bullet point above.[337]

A payment obligation is ignored if "subject to contingencies that make it unlikely that the obligation will ever be discharged."[338] Also, if a payment obligation "would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs."[339]

A partner's or related person's payment obligation with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner.[340] For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, all partners and related persons who have obligations to make payments are assumed to actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation,[341] with consideration given to an abusive situation[342] or limitations regarding a disregarded entity.[343]

If and to the extent that a partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for a liability is not borne by another partner, that partner bears the economic risk of loss for that liability,[344] unless the partnership interest involved is no more than 10% and the loan is qualified nonrecourse financing.[345] However, wrapped debt nonrecourse debt is allocated to the partner involved only to the extent that the partner added to the amount advanced by the other lender.[346] On the other hand, substantial partners who guarantee the interest on a nonrecourse debt may be treated as having economic risk of loss of part of the loan.[347]

Present value principles may reduce the amount of a payment obligation allocated to a partner if it is not required to be satisfied before the later of a reasonable time after the

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[336] Or book value, to the extent Code § 704(c) or Reg. § 1.704-1(b)(4)(i) applies. See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.
[337] Reg. § 1.752-2(b)(2)(ii).
[338] Reg. § 1.752-2(b)(4).
[339] Reg. § 1.752-2(b)(4).
[340] Reg. § 1.752-2(b)(5).
[341] Reg. § 1.752-2(b)(6).
[342] Reg. § 1.752-2(b)(6) cross-references Reg. § 1.752-2(j), which is described further below in this part II.C.3.c.ii.
[343] Reg. § 1.752-2(b)(6) cross-references Reg. § 1.752-2(k), which is described further below in this part II.C.3.c.ii.
[344] Reg. § 1.752-2(c)(1).
[345] Reg. § 1.752-2(d)(1). Reg. § 1.752-2(d)(2) provides that guarantees of such loans related to such small ownership do not cause the partner to have economic risk of loss. The reference to qualified nonrecourse financing for the loan or guarantee refers to Code § 465(b)(6) but applies it without regard to the type of activity financed.
[346] Reg. § 1.752-2(c)(2).
[347] Reg. § 1.752-2(e).

liability becomes due and payable, the end of the year in which the partner's interest is liquidated, or 90 days after the liquidation.[348]

Pledging property to secure a loan or contributing property to a partnership to secure a loan may cause part or all of the loan to be allocated to the partner who does this.[349]

Special rules apply to tiered partnerships.[350]

The IRS may rearrange the allocation of liabilities if "a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise."[351]

In determining the extent to which a partner bears the economic risk of loss for a partnership liability, an obligation of a business entity that is disregarded as an entity separate from its owner[352] (disregarded entity) is taken into account only to the extent of the net value of the disregarded entity as of the allocation date[353] that is allocated to the partnership liability as determined under special rules.[354] These special rules apply to a only to the extent that the owner of the disregarded entity is not otherwise required to make a payment with respect to the obligation of the disregarded entity.[355] The net value of a disregarded entity equals:[356]

(A) The fair market value of all assets owned by the disregarded entity that may be subject to creditors' claims under local law (including the disregarded entity's enforceable rights to contributions from its owner and the fair market value of an interest in any partnership other than the partnership for which net value is being determined, but excluding the disregarded entity's interest in the partnership for which the net value is being determined and the net fair market value of property pledged to secure a liability of the partnership under paragraph (h)(1) of this section); less

(B) All obligations of the disregarded entity that do not constitute § 1.752-2(b)(1) payment obligations of the disregarded entity.

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348 Reg. § 1.752-2(g).
349 Reg. § 1.752-2(h).
350 Reg. § 1.752-2(i).
351 Reg. § 1.752-2(j).
352 Referring to Code § 856(i) or 1361(b)(3) and Reg. §§ 301.7701-1 through 301.7701-3 (the latter the "check-the-box" rules). For Code § 1361(b)(3), see part II.A.2.h Qualified Subchapter S Subsidiary (QSub). For the check-the-box rules, see part II.B Limited Liability Company (LLC).
353 Referring to Reg. § 1.752-2(k)(2)(iv).
354 Reg. § 1.752-2(k).
355 Reg. § 1.752-2(k)(1).
356 Reg. § 1.752-2(k)(2)(i).

II.C.3.c.ii.(b). Temporary Rules Allocating Economic Risk of Loss to Recourse Liabilities

Reg. § 1.752-2T provides rules that apply until October 4 or 11, 2019.[357] All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this part II.C.3.c.ii, including:[358]

(A) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors, to other partners, or to the partnership;

(B) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in § 1.704-1(b)(2)(ii)(b)(3) (taking into account § 1.704-1(b)(2)(ii)(c)); and

(C) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state or local law, including the governing state or local law partnership statute.

Reg. § 1.752-2T(b)(3)(ii) disregards a "bottom dollar payment obligation" unless, taking into account an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is liable for at least 90% of the partner's or related person's initial payment obligation.[359] Subject to an exception, a "bottom dollar payment obligation" is one of the following:[360]

(i) With respect to a guarantee or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

(ii) With respect to an indemnity or similar arrangement, any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation, if, and to the extent that, any amount of the indemnitee's or benefited party's payment obligation that is recognized under this paragraph (b)(3) is satisfied.

(iii) An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements,

[357] Reg. § 1.752-2T(m), added by T.D. 9788 (10/4/2016), as amended by T.D. 9790 (10/13/2016).
[358] Reg. § 1.752-2T(b)(3)(i).
[359] Reg. § 1.752-2T(b)(3)(ii)(A), (B).
[360] Reg. § 1.752-2T(b)(3)(ii)(C)(1).

> and with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation as described in … (i) or (ii) [above].

However:[361]

> A payment obligation is not a bottom dollar payment obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

A partnership must disclose to the Internal Revenue Service a bottom dollar payment obligation (including a bottom dollar payment obligation that is respected) with respect to a partnership liability on a completed Form 8275, Disclosure Statement, for the taxable year in which the bottom dollar payment obligation is undertaken or modified.[362]

An indemnity, reimbursement agreement, or similar arrangement will be recognized under the above rules only if, before taking into account the indemnity, reimbursement agreement, or similar arrangement, the indemnitee's or other benefited party's payment obligation is recognized under these rules, or would be recognized under these rules if such person were a partner or related person.[363] A "benefited party" is "the person to whom a partner or related person has the payment obligation."[364]

The IRS may disregard form and treat a partner as bearing the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that all of the following are present:[365]

- The partner or related person undertakes one or more contractual obligations so that the partnership may obtain or retain a loan;
- The contractual obligations of the partner or related person significantly reduce the risk to the lender that the partnership will not satisfy its obligations under the loan, or a portion thereof; and
- With respect to the above, ether one of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests, or another partner, or a person related to another partner, enters into a payment obligation and a principal purpose of the arrangement is to cause the payment obligation described above to be disregarded under this part II.C.3.c.ii.(b).

361 Reg. § 1.752-2T(b)(3)(ii)(C)(2).
362 Reg. § 1.752-2T(b)(3)(ii)(D).
363 Reg. § 1.752-2T(b)(3)(iii).
364 Reg. § 1.752-2T(b)(3)(ii)(C)(3).
365 Reg. § 1.752-2T(j)(2)(i).

For purposes of the above three bullet points:[366]

> partners are considered to bear the economic risk of loss for a liability in accordance with their relative economic burdens for the liability pursuant to the contractual obligations. For example, a lease between a partner and a partnership that is not on commercially reasonable terms may be tantamount to a guarantee by the partner of the partnership liability.

Prop. Reg. § 1.752-2(j)(3)[367] would attack plans to circumvent an obligation. An obligation of a partner or related person to make a payment would not be recognized under Reg. § 1.752-2(b) (the general rules for allocating recourse liabilities) if the facts and circumstances evidence a plan to circumvent or avoid the obligation.[368] Here are some factors that may indicate a plan to circumvent or avoid the payment obligation, the weight of which may vary (and sometimes a single factor may be determinative):[369]

> (A) The partner or related person is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including, for example, restrictions on transfers for inadequate consideration or distributions by the partner or related person to equity owners in the partner or related person.
>
> (B) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party.
>
> (C) The term of the payment obligation ends prior to the term of the partnership liability, or the partner or related person has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party (for example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases). This factor typically will not be present if the termination of the obligation occurs by reason of an event or events that decrease the risk of

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366 Reg. § 1.752-2T(j)(2)(ii).

367 REG-122855-15, promulgated 10/5/2016.

368 Prop. Reg. § 1.752-2(j)(3)(i).

369 Prop. Reg. § 1.752-2(j)(3)(ii) lists the factors quoted in the text that immediately follows, explaining:

> The presence or absence of a factor is based on all of the facts and circumstances at the time the partner or related person makes the payment obligation or if the obligation is modified, at the time of the modification. For purposes of making determinations under this paragraph (j)(3), the weight to be given to any particular factor depends on the particular case and the presence or absence of a factor is not necessarily indicative of whether a payment obligation is or is not recognized under paragraph (b) of this section.

Oral remarks by Clifford Warren of the Internal Revenue Service at the ABA Tax Section Midyear Meeting on January 19, 2017 (which of course do not necessarily represent the government's view) suggested that one factor may show such an intent. I don't remember the example he gave, but it seemed to make a lot of sense when I heard it in the recording.

economic loss to the guarantor or benefited party (for example, the payment obligation terminates upon the completion of a building construction project, upon the leasing of a building, or when certain income and asset coverage ratios are satisfied for a specified number of quarters).

(D) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.

(E) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(F) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(G) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

For example, under the proposed regulation:

- A guarantee not requested by the lender and not restricting the guarantor's asset transfers may indicate a plan to circumvent or avoid the guarantor's payment obligation.[370]

[370] Prop. Reg. § 1.752-2(j)(4), Example (1), "Gratuitous guarantee," provides:

(i) In 2016, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2016, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under § 1.752-1(a)(2) in 2016. In 2018, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

(ii) Under paragraph (j)(3) of this section, A's 2018 guarantee (payment obligation) is not recognized under paragraph (b)(3) of this section if the facts and circumstances evidence a plan to circumvent or avoid the payment obligation. In this case, the following factors indicate a plan to circumvent or avoid A's payment obligation: (1) The partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, such as restrictions on transfers for inadequate consideration or equity distributions; (2) the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; (3) in the case of a guarantee or similar arrangement, the terms of the liability are the same as they would have been without the guarantee; and (4) the creditor did not receive executed

- The unlimited liability an LLC general partner that has no assets may be disregarded.[371]

Furthermore, evidence of a plan to circumvent or avoid an obligation would be deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable.[372]

Transition rules apply to certain liabilities existing on October 5, 2016.[373]

II.C.3.c.iii. Allocating Nonrecourse (Remaining) Liabilities

After liabilities are allocated to those partners bearing the economic risk under part II.C.3.c.ii Allocating Economic Risk of Loss to Recourse Liabilities, the remaining

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> documents with respect to the payment obligation from the partner or related person at the time the obligation was created. Absent the existence of other facts or circumstances that would weigh in favor of respecting A's guarantee, evidence of a plan to circumvent or avoid the obligation exists and, pursuant to paragraph (j)(3)(i) of this section, A's guarantee is not recognized under paragraph (b) of this section. As a result, LLC's liability continues to be treated as nonrecourse.

[371] Prop. Reg. § 1.752-2(j)(4), Example (2), "Underfunded disregarded entity payment obligor," provides:

> (i) In 2016, A forms a wholly owned domestic limited liability company, LLC, with a contribution of $100,000. A has no liability for LLC's debts, and LLC has no enforceable right to a contribution from A. Under § 301.7701-3(b)(1)(ii) of this chapter, LLC is a treated for federal tax purposes as a disregarded entity. Also in 2016, LLC contributes $100,000 to LP, a limited partnership with a calendar year taxable year, in exchange for a general partnership interest in LP, and B and C each contributes $100,000 to LP in exchange for a limited partnership interest in LP. The partnership agreement provides that only LLC is required to restore any deficit in its capital account. On January 1, 2017, LP borrows $300,000 from a bank and uses $600,000 to purchase nondepreciable property. The $300,000 is secured by the property and is also a general obligation of LP. LP makes payments of only interest on its $300,000 debt during 2017. LP has a net taxable loss in 2017, and, under Sec. § 1.705-1(a) and 1.752-4(d), LP determines its partners' shares of the $300,000 debt at the end of its taxable year, December 31, 2017. As of that date, LLC holds no assets other than its interest in LP.
>
> (ii) Because LLC is a disregarded entity, A is treated as the partner in LP for federal income tax purposes. Only LLC has an obligation to make a payment on account of the $300,000 debt if LP were to constructively liquidate as described in paragraph (b)(1) of this section. Therefore, paragraph (j)(3)(iii) of this section is applied to the LLC and not to A. LLC has no assets with which to pay if the payment obligation becomes due and payable. As such, evidence of a plan to circumvent or avoid the obligation is deemed to exist and, pursuant to paragraph (j)(3)(i) of this section, LLC's obligation to restore its deficit capital account is not recognized under paragraph (b) of this section. As a result, LP's $300,000 debt is characterized as nonrecourse under § 1.752-1(a)(2) and is allocated among A, B, and C under § 1.752-3.

[372] Prop. Reg. § 1.752-2(j)(3)(iii), which continues:

> For purposes of this section, a payment obligor includes an entity disregarded as an entity separate from its owner under section 856(i), section 1361(b)(3), or Sec. § 301.7701-1 through 301.7701-3 of this chapter (a disregarded entity), and a trust to which subpart E of part I of subchapter J of chapter 1 of the Code applies.

[373] Reg. § 1.752-2T(*l*).

liabilities constitute nonrecourse liabilities[374] are allocated as described below in this part II.C.3.c.iii.

A partner's share of the nonrecourse liabilities of a partnership equals the sum of:[375]

(1) The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;

(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner's share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner's share of partnership profits.

Regulations provide additional rules to determine a partner's share of partnership profits in allocating excess nonrecourse liabilities.[376] They also provide that some of these rules of not apply for purposes of the disguised sale rules.[377]

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[374] See part II.C.3.c.i Definition of "Recourse" or "Nonrecourse".

[375] Reg. § 1.752-3(a).

[376] Reg. § 1.752-3(a)(3) continues:

> The partner's interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners' interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (significant item method). Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated (alternative method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under § 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in § 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property (additional method). The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.

[377] The excerpt from Reg. § 1.752-3(a)(3) in fn. 376 included, "The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2)." See part II.M.3.e.i.(a) Distributions Presumed to Be Disguised Sales, especially fn. 2533.

In applying the above rules re Code § 704(c) gain, if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method.[378] When the outstanding principal of a partnership liability is reduced, the reduction of outstanding principal is allocated among the multiple properties in the same proportion that the partnership liability originally was allocated to the properties under the preceding sentence.[379]

II.C.3.c.iv. Assumption of Liabilities

If a partner contributes property to the partnership or the partnership distributes property to a partner and the property is subject to a liability of the transferor, the transferee is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the property's fair market value at the time of the contribution or distribution.[380]

Except for such a deemed assumption, a person is considered to assume a liability only to the extent that the assuming person is personally obligated to pay the liability.[381] However, if a partner or related person assumes a partnership liability, the person to whom the liability is owed must know of the assumption and be able to directly enforce the partner's or related person's obligation for the liability, and no other partner or person that is a related person to another partner can bear the economic risk of loss for the liability immediately after the assumption.[382]

If a general partner, who is jointly and severally liable for a partnership's debt, terminates that partner's interest but remains personally liable on part of that debt, the former partner may have been treated as having assumed the debt under case law that applied before the rules in the two preceding paragraphs were adopted.[383]

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[378] Reg. § 1.752-3(b)(1) further provides:

> A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan under paragraph (a)(2) of this section. In general, a partnership may not change the method of allocating a single nonrecourse liability under this paragraph (b) while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.

[379] Reg. § 1.752-3(b)(2).

[380] Reg. § 1.752-1(e).

[381] Reg. § 1.752-1(d)(1).

[382] Reg. § 1.752-1(d)(2).

[383] *Weiss v. Commissioner*, 956 F.2d 242 (11th Cir. 1992) (tax year 1979), *rev'g* T.C. Memo. 1990-492.

II.C.4. Mandatory Allocations of Certain Losses or Gains

This part II.C.4 discusses certain allocations. Note, however, that losses might be suspended by the passive loss[384] or at-risk[385] rules or basis limitations.[386]

Notwithstanding any other provision in Reg. §§ 1.704-1 and 1.704-2, allocations of partner nonrecourse deductions, nonrecourse deductions, and minimum gain chargebacks are made before any other allocations. Furthermore, partnership agreements tend to apply income in later years to reverse those special allocations until capital accounts reach their proportions to each other generally contemplated under the agreement.

II.C.4.a. Partner Nonrecourse Deductions

Partnership losses, deductions, and Code § 705(a)(2)(B) expenditures are treated as partner nonrecourse deductions in the amount determined under Reg. § 1.704-2(i)(2) (determining partner nonrecourse deductions) in the following order:[387]

1. First, depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt;

2. Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and Code § 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to a partnership nonrecourse liability is first treated as a partnership nonrecourse deduction under part II.C.4.b and any excess is treated as a partner nonrecourse deduction under this part II.C.4.a.[388]

If the amount of partner nonrecourse deductions or nonrecourse deductions exceeds the partnership's losses, deductions, and Code § 705(a)(2)(B) expenditures for the taxable year (determined under parts II.C.4.a and II.C.4.b), the excess is treated as an increase in partner nonrecourse debt minimum gain or partnership minimum gain in the immediately succeeding partnership taxable year.[389]

II.C.4.b. Partnership Nonrecourse Deduction

Partnership losses, deductions, and Code § 705(a)(2)(B) expenditures are treated as partnership nonrecourse deductions in the amount determined under Reg. 1.704-2(c) (determining nonrecourse deductions) in the following order:[390]

1. First, depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse liabilities;

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[384] See parts II.G.3.f Passive Loss Limitations and II.K Passive Loss Rules.
[385] See part II.G.3.g At Risk Rules.
[386] See part II.G.3.c.ii Basis Limitations for Partners in a Partnership.
[387] Reg. § 1.704-2(j)(1)(i).
[388] Reg. § 1.704-2(j)(1)(i) (flush language).
[389] Reg. § 1.704-2(j)(1)(i), which also cross-references Reg. § 1.704-2(m), Example (1)(vi).
[390] Reg. § 1.704-2(j)(1)(ii).

2. Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and Code § 705(a)(2)(B) items.

Depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt is first treated as a partner nonrecourse deduction under part II.C.4.a and any excess is treated as a partnership nonrecourse deduction under this part II.C.4.b.[391] Any other item that is treated as a partner nonrecourse deduction will in no event be treated as a partnership nonrecourse deduction.[392]

If the amount of partner nonrecourse deductions or nonrecourse deductions exceeds the partnership's losses, deductions, and Code § 705(a)(2)(B) expenditures for the taxable year (determined under parts II.C.4.a and II.C.4.b), the excess is treated as an increase in partner nonrecourse debt minimum gain or partnership minimum gain in the immediately succeeding partnership taxable year.[393]

II.C.4.c. Minimum Gain Chargeback

Items of partnership income and gain equal to the minimum gain chargeback requirement (determined under Reg. § 1.704-2(f) of this section) are allocated as a minimum gain chargeback in the following order:[394]

1. First, a pro rata portion of gain from the disposition of property subject to partnership nonrecourse liabilities and discharge of indebtedness income relating to partnership nonrecourse liabilities to which property is subject;

2. Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to partner nonrecourse debt is allocated to satisfy a minimum gain chargeback requirement for partnership nonrecourse debt only to the extent not allocated under Reg. § 1.704-2(j)(2)(ii).[395]

If a minimum gain chargeback requirement (determined under part II.C.4.c and II.C.4.d) exceeds the partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the immediately succeeding partnership taxable years until fully charged back.[396]

[391] Reg. § 1.704-2(j)(ii) (flush language).
[392] Reg. § 1.704-2(j)(ii) (flush language).
[393] Reg. § 1.704-2(j)(1)(i), which also cross-references Reg. § 1.704-2(m), Example (1)(vi).
[394] Reg. § 1.704-2(j)(2)(i).
[395] Reg. § 1.704-2(j)(2)(i) (flush language).
[396] Reg. § 1.704-2(j)(2)(iii).

II.C.4.d. Chargeback Attributable To Decrease In Partner Nonrecourse Debt Minimum Gain

Items of partnership income and gain equal to the partner nonrecourse debt minimum gain chargeback (determined under Reg. § 1.704-2(i)(4)) are allocated to satisfy a partner nonrecourse debt minimum gain chargeback in the following order:[397]

1. First, a pro rata portion of gain from the disposition of property subject to partner nonrecourse debt and discharge of indebtedness income relating to partner nonrecourse debt to which property is subject.

2. Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.

Gain from the disposition of property subject to a partnership nonrecourse liability is allocated to satisfy a partner nonrecourse debt minimum gain chargeback only to the extent not allocated under Reg. § 1.704-2(j)(2)(i).[398] An item of partnership income and gain that is allocated to satisfy a minimum gain chargeback under Reg. § 1.704-2(f) is not allocated to satisfy a minimum gain chargeback under Reg. § 1.704-2(i)(4).[399]

If a minimum gain chargeback requirement (determined under part II.C.4.c and II.C.4.d) exceeds the partnership's income and gains for the taxable year, the excess is treated as a minimum gain chargeback requirement in the immediately succeeding partnership taxable years until fully charged back.[400]

II.C.5. Converting from One Entity Taxed as a Partnership to Another

Generally, a partnership's conversion from one type of state law entity to another (that is still taxed as a partnership) will not trigger income taxation absent a shift in liabilities[401] allocated to various partners.[402] The first formal reliance guidance on this was Rev. Rul. 84-52, which addressed the following situation:

> In 1975, X was formed as a general partnership under the Uniform Partnership Act of state M. X is engaged in the business of farming. The partners of X are A, B, C, and D. The partners have equal interest in the partnership.
>
> The partners propose to amend the partnership agreement to convert the general partnership into a limited partnership under the Uniform Limited Partnership Act of State M, a statute that corresponds in all material respects to the Uniform Limited Partnership Act. Under the certificate of limited partnership, A and B will be limited partners, and both C and D will be general partners and limited partners. Each partner's total percent interest in the partnership's profits, losses,

[397] Reg. § 1.704-2(j)(2)(ii).
[398] Reg. § 1.704-2(j)(2)(ii) (flush language).
[399] Reg. § 1.704-2(j)(2)(ii) (flush language).
[400] Reg. § 1.704-2(j)(2)(iii).
[401] See part II.C.3 Allocating Liabilities (Including Debt).
[402] See Rev. Rul. 95-37 (converted to an LLC), amplifying Rev. Ruls. 84-52 (converting a general partnership to a limited partnership) and 86-111 (a conversion does not close the partnership's tax year).

and capital will remain the same when the general partnership is converted into a limited partnership. The business of the general partnership will continue to be carried on after the conversion.

The IRS ruled:

(1) Except as provided below, pursuant to section 721 of the Code, no gain or loss will be recognized by A, B, C, or D under section 741 or section 1001 of the Code as a result of the conversion of a general partnership interest in X into a limited partnership in X.

(2) Because the business of X will continue after the conversion and because, under section 1.708-1(b)(1)(ii) of the regulations, a transaction governed by section 721 of the Code is not treated as a sale or exchange for purposes of section 708 of the Code, X will not be terminated under section 708 of the Code.

(3) If, as a result of the conversion, there is no change in the partners' shares of X's liabilities under section 1.752-1(e) of the regulations, there will be no change to the adjusted basis of any partner's interest in X, and C and D will each have a single adjusted basis with respect to each partner's interest in X (both as limited partner and general partner) equal to the adjusted basis of each partner's respective general partner interest in X prior to the conversion. See Rev. Rul. 84-53, page 159, this Bulletin.

(4) If, as a result of the conversion, there is a change in the partners' shares of X's liabilities under section 1.752-1(e) of the regulations, and such change causes a deemed contribution of money to X by a partner under section 752(a) of the Code, then the adjusted basis of that partner's interest shall, under section 722 of the Code, be increased by the amount of such deemed contribution. If the change in the partners' shares of X's liabilities causes a deemed distribution of money by X to a partner under section 752(b) of the Code, then the basis of that partner's interest shall, under section 733 of the Code, be reduced (but not below zero) by the amount of such deemed distribution, and gain will be recognized by that partner under section 731 of the Code to the extent the deemed distribution exceeds the adjusted basis of that partner's interest in X.

(5) Pursuant to section 1223(1) of the Code, there will be no change to the holding period of any partner's total interest in X.

The holdings contained herein would apply with equal force if the conversion had been of a limited partnership to a general partnership.

Rev. Rul. 95-37 held:[403]

(1) The federal income tax consequences described in Rev. Rul. 84-52 apply to the conversion of an interest in a domestic partnership into an interest in a

[403] Letter Ruling 200414013 followed this result.

domestic LLC that is classified as a partnership for federal tax purposes. The federal tax consequences are the same whether the resulting LLC is formed in the same state or in a different state than the converting domestic partnership.

(2) The taxable year of the converting domestic partnership does not close with respect to all the partners or with respect to any partner.

(3) The resulting domestic LLC does not need to obtain a new taxpayer identification number.

The holdings contained herein would apply in a similar manner if the conversion had been of an interest in a domestic LLC that is classified as a partnership for federal tax purposes into an interest in a domestic partnership. The holdings contained herein apply regardless of the manner in which the conversion is achieved under state law.

For more information on the liability issues described above, see part II.C.3 Allocating Liabilities (Including Debt).

It has been suggested that implicit in these rulings is the following approach to converting a partnership to an LLC:[404]

> The partners contribute their partnership interests to the limited liability company in exchange for LLC interests. The partnership is then instantaneously dissolved, wound up, and terminated for state law purposes by virtue of the limited liability company's ownership of all of the interests therein (the "two-partner" rule).

This approach seems to me to be the cleanest method as a matter of general state law, unless the state's laws have a statute specifically addressing the conversion of a partnership into an LLC. Regardless of the method of conversion, any assets that require formal written title will need to be retitled so that third parties know of the LLC's existence.

Converting a limited partnership into an LLC is not a taxable event, absent a liability shift.[405] Same with converting a general partnership into a limited partnership[406] or the registration of a general partnership as a limited liability partnership.[407] When an LLC was converted to a limited partnership and the managing members formed disregarded LLC that became the general partners, the conversion was not a taxable event.[408] Rearranging interests in limited partnerships without any substantive change in ownership might be disregarded.[409]

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[404] Bishop & Kleinberger, *Limited Liability Companies: Tax and Business Law*, ¶12.04, "Conversion of General Partnership to Limited Liability Company."
[405] Letter Rulings 9210019, 9210019.
[406] Letter Rulings 9029019, 9119029 (the most helpful), and 200538005.
[407] Rev. Rul. 95-55.
[408] Letter Ruling 201745005, which contained so many representations about factual and tax issues that one wonders what the point was. The ruling cited Rev. Ruls. 84-52 and 95-37.
[409] Letter Ruling 201605004, which was a little convoluted, involved these facts:

That the like-kind exchange rules do not apply to an exchange of partnership interests[410] does not affect these principles.[411]

II.C.6. Shifting Rights to Future Profits

Shifting partners' rights to future profits within a partnership, without any change in capital accounts [412] or allocation of liabilities, would not have any income tax consequences;[413] however, a shift might have unexpected gift tax consequences.[414]

> According to the information submitted, PRS 1 is a limited partnership organized under the laws of State on Date 1, PRS 2, through disregarded entities, owned all of the general and limited partnership interests in PRS 1. PRS 1 was classified as a disregarded entity for federal income tax purposes. PRS 1 owned a a% interest in PRS 3, a State limited partnership.
>
> On Date 2, PRS 4 acquired an interest in PRS 3. Also on Date 2, PRS 4 exchanged its interest in PRS 3 for an interest in PRS 1, causing PRS 3 to become a disregarded entity and PRS 1 to become a partnership for federal income tax purposes. Effectively PRS 3 was converted into PRS 1. On Date 3, PRS 4 sold its b% interest in PRS 1 and PRS 2 sold a c% interest in PRS 1 to PRS 5. The transfer of interests in PRS 1 during the 12-month period was less than 50%.

Pointing to Code §§ 708 and 721(a), Reg. § 1.708-1(b)(1)(ii), and Rev. Ruls. 84-52 and 95-37, Letter Ruling 201605004 held:

> Based on the representations and the facts submitted, we conclude that PRS 1 will be considered a continuation of the partnership, PRS 3, and there was no termination of the partnership under § 708. Other than with respect to the sale of the partnership interests sold, the conversion of PRS 3 into PRS 1 did not cause the partners in PRS 3 or PRS 1 to recognize gain or loss under §§ 741 or 1001, except as provided in § 752. The holding period of the partners' interests in PRS 1 includes the period of time during which those interests were held as partners in PRS 3. The conversion of PRS 3 into PRS 1 did not cause the taxable year of the partnership to close under § 706. PRS 1 does not need to obtain a new taxpayer identification number. The basis of the assets held by PRS 1 is the same as the basis of the assets in the hands of PRS 3 prior to the conversion. Finally, the conversion PRS 3 into PRS 1 did not result in the assets of the partnership being contributed or distributed to the partners of the partnership.

[410] Code § 1031(a)(2)(D); Reg. § 1.1031(a)-1(a)(1)(iv).

[411] T.D. 8346 provides:

> The final regulations otherwise retain the provisions of the proposed regulations regarding exchanges of interests in a partnership. Under the proposed and final regulations, an exchange of partnership interests will not qualify for nonrecognition of gain or loss under section 1031(a) regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or different partnerships. No inference is to be drawn from these regulations, however, with respect to the application of other Code sections that allow nonrecognition of gain of loss in an exchange of interests in a partnership. For example, as stated in the preamble to the proposed regulations, these regulations are not intended to affect the applicability of Rev. Rul. 84-52, 1984-1 C.B. 157, concerning conversions of partnership interests. More generally, the regulations are not intended to restrict in any way the application of the rules of subchapter K of the Code to exchanges of partnership interests.

[412] See Reg. § 1.704-1(b)(2)(iv)(b), which is reproduced in the text accompanying fn. 418 in part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), describing when capital accounts should be booked up. Also, when partners are admitted later, the existing partners' built-in gain needs to be taken into account in some manner, as described in the text accompanying fns. 3932-3935 in part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 –

The parties should consider having a revaluation event before this shift, so that each partner's economic rights are reflected in its capital accounts and the shifting of rights to profits does not move any value based on the partners' rights immediately before the shift.[415]

Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value. Thus, one might consider whether reallocating profits might constitute a disguised shift of an unbooked asset.

[413] Letter Ruling 200345007 involved the following situation:

> According to the representations made, X is a State LLC taxed as a partnership for Federal tax purposes. X began operations on D1. X has more than a members. There are currently b shares of A Units outstanding.
>
> X intends to (1) designate A Unit as B Unit, (2) create C Unit, D Unit, and E Unit, each of which has different rights, preferences, privileges, and restrictions from one another and (3) allow its members to convert, on a one-to-one basis, (i) B Units into C Units, D Units, or E Units, (ii) C Units into E Units, (iii) D Units into C Units or E Units, and (iv) E Units into C Units.
>
> The following has been further represented. X is not a publicly traded partnership as defined under § 7704 of the Internal Revenue Code. Each member's proportionate share in X's capital will remain the same after the planned conversion of the membership interests. The conversion will not change each member's proportionate share of X's liabilities.

The ruling held:

> (1) No gain or loss will be recognized by the members of X as a result of the designation of A Units as B Units, the conversion of B Units into C Units, D Units, or E Units, the conversion of C Units into E Units, the conversion of D Units into C Units or E Units, and the conversion of E Units into C Units, on a one-to-one basis.
>
> (2) No termination of X will occur under § 708, regardless whether more than 50 percent of the existing membership interest units are converted into other newly created membership interest units.
>
> (3) No gain or loss will be recognized by any converting members upon the proposed conversions of their existing membership interest units.
>
> (4) Provided that there will be no change in the members' shares of X's liabilities as a result of the conversions, the adjusted basis of a converting member will not be affected by the conversion.
>
> (5) Pursuant to § 1223(1), there will be no change to the holding period of any member's membership interest in X.
>
> (6) The designation of A Units as B Units and the subsequent conversions of units will not constitute an issuance of additional units as described in § 1.7704-1(e)(4)(i) of the Procedure and Administration Regulations.

[414] See parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[415] See CCA 201517006, which addressed the question, "Did a taxable exchange result when the general partner of a publicly traded partnership restructured its interest in the partnership, including exchanging its Incentive Distribution Rights for newly issued publicly-traded common units?" Here were the facts:

> Taxpayer, a corporation, is the general partner of Partnership, a publicly traded partnership within the meaning of § 7704(b) that is treated as a partnership for federal tax purposes through the operation of § 7704(c). Partnership was formed on Date 1, and its original partnership agreement granted Taxpayer an a percent general partner interest in profits, losses, and capital, and in addition granted Taxpayer certain "Incentive Distribution Rights" (IDRs). The IDRs are a form of non-publicly-traded limited

If they do not have a revaluation event, they might want to consider memorializing allocations of unrealized gains and losses at the time of the event. But, if the partnership agreement does not clarify the partners' rights, a clarification will not be a taxable event.[416]

> partnership profits interest that did not carry any interest in partnership capital on Date 1, but entitled Taxpayer to share in future partnership profits and quarterly distributions. The original partnership agreement provided that, as Partnership's total quarterly distributions reached certain thresholds, distributions and income allocations to Taxpayer under the IDRs increased, up to a maximum of b percent. Additionally, the IDRs entitled Taxpayer to a share of Partnership's proceeds on liquidation if Partnership's assets appreciated after Date 1.
>
> On Date 2, Taxpayer and Partnership consummated an exchange agreement and amended the partnership agreement to replace Taxpayer's IDRs with common units and less valuable IDRs. Specifically, Taxpayer's interest was restructured as follows: Taxpayer continued to hold its a percent general partner interest; Taxpayer's old IDRs were cancelled; Partnership granted Taxpayer c newly-issued publicly-traded common units; Taxpayer also received new, less valuable, IDRs containing higher thresholds and a lower maximum (d percent rather than b percent). The terms of the newly-issued IDRs and the number of newly-issued publicly-traded common units were calculated to produce the same distribution to Taxpayer as the old IDRs had produced the prior quarter.
>
> Although Taxpayer's IDRs did not carry any capital interest on Date 1, by Date 2 Partnership had significant appreciation in its assets, and if Partnership were to have liquidated immediately before the Date 2 restructuring, a substantial amount of the proceeds would have been allocated to Taxpayer under the old IDRs. However, before Date 2, Partnership had not experienced a revaluation event in some time, and as a result its significant unrealized appreciation in its assets had not been "booked-up" and reflected in the capital accounts of its partners. Thus, Taxpayer's capital account at the beginning of Date 2 did not reflect Taxpayer's full economic entitlements upon liquidation. Thus, Taxpayer's capital account with respect to its newly-issued publicly-traded common units would have been below the capital account of the other publicly-traded common units, which would have meant that Partnership's publicly-traded common units were no longer fungible. However, also on Date 2, Taxpayer's corporate owner Parent contributed approximately $e to Partnership in exchange for newly-issued publicly-traded common units of Partnership. As a result of this contribution, Partnership revalued its assets, crediting its partners' capital accounts to reflect how its built-in gain would be allocated if Partnership sold the assets. Partnership had sufficient unbooked built-in gain to equalize Taxpayer's capital account with respect to the c newly-issued publicly-traded common units without needing to shift capital from other partners or allocate extra taxable income to Taxpayer.

The CCA reasoned:

> The restructuring of Taxpayer's interest in Partnership was a readjustment of partnership items among existing partners, not a taxable exchange. Additionally, no taxable capital shift occurred; although the restructuring of Taxpayer's rights under the partnership agreement was not a revaluation event under § 1.704-1(b)(2)(iv)(f)(5) and did not itself affect Taxpayer's capital account, Parent's Date 2 contribution was a revaluation event under § 1.704-1(b)(2)(iv)(f)(5)(i) and Partnership had sufficient unbooked built-in gain in its assets to increase Taxpayer's capital account with respect to the newly issued common units without needing to shift capital from other partners.

[416] Letter Ruling 9821051, which did not mentions any state law rights absent clarification, ruled that an amendment the following situation "will not result in the realization of income by the Partnership, Limited, or any of their respective partners:

Additional resources discussing this issue are in the accompanying footnote.[417]

II.C.7. Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts)

Reg. § 1.704-1(b)(2)(iv) encourages keeping capital accounts, generally applying the following rules:[418]

> *Basic rules*. Except as otherwise provided in this paragraph (b)(2)(iv), the partners' capital accounts will be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) if, and only if, each partner's capital account is increased by

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> The Partnership conducts a medical practice and currently owns a units in Limited (the Units). Limited is a limited partnership that provides management services to the Partnership and other medical groups.
>
> Under the general partnership agreement (the Agreement), the Partnership does not have a fixed method to determine the current and future allocations of the Partnership's profits or losses from its disposition of the Units. The Partnership's profits and losses from the disposition of the Units are currently allocated based on the determinations of an executive committee, subject to certain minimum allocation requirements.
>
> Because of the financial success of Limited, the partners of the Partnership believe it is important to have a method of reasonably determining their respective shares of the proceeds from Partnership's disposition of the Units. To accomplish this, the Partnership intends to amend the Agreement to provide a mechanism to determine each partner's minimum share of the proceeds from the Partnership's disposition of the Units (the Amendments). As explained above, the potential gain or loss that would be realized from the Partnership's disposition of the Units has not been allocated among the partners and is not reflected in the capital account of any partner.
>
> Under the Amendments, until a Liquidity Event occurs, the Partnership retains the legal title to the Units, all distributions and other profits on the Units will be paid to the Partnership, and to the extent the executive committee of the Partnership determines the distributions and profits on the Units are to be distributed to the partners, the allocation of any such items will be made by the executive committee under the terms of the Agreement. A Liquidity Event is any one of the following events: (1) Limited makes an initial public offering of its equity securities through a registration statement under the Securities Act of 1933, (2) Limited or its owners enter into a transaction with a party that, prior to such transaction, does not own an interest in Limited so that such party acquires equity securities of Limited resulting in such party having the power to elect a majority of Limited's governing body, or (3) Limited enters into a merger, reorganization, combination or acquisition transaction with another company and in such transaction the equity securities of Limited outstanding immediately prior to such transaction do not constitute, or are not converted into or exchanged for, a majority of the equity securities of the resulting entity outstanding immediately after such transaction. On the occurrence of a Liquidity Event, the Partnership will transfer to each partner the partner's share of the Units.

[417] Gaughan and Wilkinson, "Proposed Regulations On Recapitalizations, *Journal of Real Estate Taxation* (Third Quarter 2015); Banoff, "Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalizations, and Conversions: What Are the Tax Consequences?" 83 *Taxes* 105 (2005) (doc. no. 6217476), summarized by Postlewaite, "The Transmogrification of Subchapter K," *Taxes* 3/1/2005 (doc. no. 6217488).

[418] Reg. § 1.704-1(b)(2)(iv)(b). I added some formatting not found in the regulation but have not changed a single word.

(1) the amount of money contributed by him to the partnership,

(2) the fair market value of property contributed by him to the partnership (net of liabilities that the partnership is considered to assume or take subject to), and

(3) allocations to him of partnership income and gain (or items thereof), including income and gain exempt from tax and income and gain described in paragraph (b)(2)(iv)(g) of this section, but excluding income and gain described in paragraph (b)(4)(i) of this section; and

is decreased by

(4) the amount of money distributed to him by the partnership,

(5) the fair market value of property distributed to him by the partnership (net of liabilities that such partner is considered to assume or take subject to),

(6) allocations to him of expenditures of the partnership described in section 705(a)(2)(B), and

(7) allocations of partnership loss and deduction (or item thereof), including loss and deduction described in paragraph (b)(2)(iv)(g) of this section, but excluding items described in (6) above and loss or deduction described in paragraphs (b)(4)(i) or (b)(4)(iii) of this section; and is otherwise adjusted in accordance with the additional rules set forth in this paragraph (b)(2)(iv).

For purposes of this paragraph, a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired. For liabilities assumed before June 24, 2003, references to liabilities in this paragraph (b)(2)(iv)(b) shall include only liabilities secured by the contributed or distributed property that are taken into account under section 752(a) and (b).

Note that references to fair market value above mean that frequently capital accounts are different than tax basis. Thus, so-called "tax basis" capital accounts that many tax preparers like to keep (using the basis of assets contributed or distributed rather than their fair market value) are inconsistent with partnership accounting generally provided under Code § 704(b). When a capital account differs from tax basis, be careful to comply with part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.[419] Part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value deals with differences between value

[419] See Reg. § 1.704-1(b)(2)(iv)(d)(3) for applying these rules in maintaining capital accounts.

and capital accounts, not only for contributions of property but also when partners enter or exit when the value of the partnership's property differs from its basis.[420]

Each partner has a unitary capital account (and unitary basis).[421]

When a partner enters or exits or makes a non-pro-rata contribution or takes a non-pro-rata distribution, often the partnership's property is revalued and capital accounts adjusted (without changing tax basis).[422]

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[420] See fns. 3932-3935 (describing reverse-Code § 704(c) allocations, which is where a partner makes a disproportionate contribution or receives a disproportionate distribution when the partner has assets with values not equal to basis, which book-tax difference needs to be accounted for) and II.P.1.a.i.(b) Special Rule for Allocations of Income in Securities Partnerships.

[421] See fn. 4104 (unitary capital account), found in part II.Q.8.e.ii.(a) Unitary Basis.

[422] Reg. § 1.704-1(b)(2)(iv)(f) provides:

> *Revaluations of property*. A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—
>
> (1) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined under paragraph (b)(2)(iv)(h) of this section. See Example 33 of paragraph (b)(5) of this section.
>
> (2) The adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date, and
>
> (3) The partnership agreement requires that the partners' capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(g) of this section for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property, and
>
> (4) The partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) (see paragraph (b)(4)(i) of this section), and
>
> (5) The adjustments are made principally for a substantial non-tax business purpose—
>
> (i) In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or
>
> (ii) In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or
>
> (iii) In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner, or
>
> (iv) In connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or
>
> (v) Under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities,

Many partnership (or LLC operating) agreements require maintaining Code § 704(b) capital accounts; failure to keep such records might lead to IRS assertions of income tax or estate/gift tax adjustments. For family partnerships, maintaining such capital accounts is important to avoiding taxable gifts[423] and in analyzing Code § 2701.[424]

When part or all of a partnership interest is transferred, the transferor's capital account attributable to the transferred interest must carry over to the transferee partner.[425] Generally, when transfers trigger adjustment as a result of a Code § 754 election, adjustments to the adjusted tax basis of partnership property shall not be reflected in the capital account of the transferee partner or on the books of the partnership, and subsequent capital account adjustments for distributions and for depreciation, depletion, amortization, and gain or loss with respect to such property will disregard the effect of such basis adjustment; however, adjustments that affect the partnership's common basis (as contrasted with partner-specific Code § 743(b) adjustments) might need to be reflected.[426]

When considering the practical issues of maintaining a chart of accounts and a fixed asset system and implementing a Code § 754 basis step-up, consider setting up a separate capital account on the system for the Code § 754 basis step-up and for the stepped-up assets. Use these items on the tax return but eliminate them when preparing financial statements, because they are not GAAP. Thus, the stepped-up assets would be in a separate grouping in the system to facilitate their elimination on financial statements.

II.C.8. Effect of Employee Becoming a Partner

When an employee becomes a partner,[427] that person is no longer an employee.[428]

> commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

423 See part III.B.1.a.iv.(a) Gift/Estate Tax Uses and Issues Regarding Family Partnerships, especially fn. 4744.

424 See part III.B.7.b Code § 2701 Overview, especially fn. 5571.

425 Reg. § 1.704-1(b)(2)(iv)(*l*).

426 Reg. § 1.704-1(b)(2)(iv)(m). The description in the text above does not capture exceptions provided by the regulation, so read the regulation to get the full flavor. If capital account adjustments are made, Reg. § 1.704-1(b)(2)(iv)(m) limits them:

> Adjustments may be made to the capital account of a partner (or his successor in interest) in respect of basis adjustments to partnership property under sections 732, 734, and 743 only to the extent that such basis adjustments (i) are permitted to be made to one or more items of partnership property under section 755, and (ii) result in an increase or a decrease in the amount at which such property is carried on the partnership's balance sheet, as computed for book purposes. For example, if the book value of partnership property exceeds the adjusted tax basis of such property, a basis adjustment to such property may be reflected in a partner's capital account only to the extent such adjustment exceeds the difference between the book value of such property and the adjusted tax basis of such property prior to such adjustment.

427 See part II.M.4.f Issuing a Profits Interest to an Employee.

428 See parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor (especially fn. 2403, regarding wages paid to partners), II.P.2 C Corporation Advantage Regarding Fringe Benefits (especially fn. 2813) and III.B.7.c.viii Creative Bonus Arrangements (especially fn. 5633).

II.C.8.a. Code § 707 - Compensating a Partner for Services Performed

Code § 707(a)(1) provides that, if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in Code § 707, be considered as occurring between the partnership and one who is not a partner.

Code § 707(a)(2)(A) provides that, under regulations, if a partner performs services for a partnership, there is a related direct or indirect allocation and distribution to such partner, and the performance of such services and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in Code § 707(a)(1).

Code § 707(c), "Guaranteed payments," provides that, to the extent determined without regard to the income of the partnership, payments to a partner for are considered as made to one who is not a member of the partnership, but only for the purposes of including the payments in the partner's income or the partnership deducting or capitalizing the payments.[429]

Although Code § 707(a)(2)(A) and (c) and Reg. § 1.707-1(c) (cited below) refer to payments for services or for the use of capital, this part II.C.8.a focuses on services performed.

Payments made by a partnership to a partner for services (as used in this part II.C.8.a, "guaranteed payments") are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership.[430]

The construct of Code § 707 is really intended to create three separate kinds of arrangements for services provided:

- If a partner performs services as a partner – exercising authority under the partnership agreement and fulfilling duties as a partner – the partner may be compensated through two types of arrangements:
    - The partner's interest in the partnership's profits (non-Code § 707 distributions), or

[429] Referring to Code §§ 61(a), 162(a), and 263 ad the only Code sections affected. As to the partnership deducting or capitalizing payments, Reg. § 1.707-1(c) provides:

> For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest.

For the latter, see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[430] Reg. § 1.707-1(c).

- Payments that are based on something other than the partnership's profits, which are Code § 707(c) guaranteed payments.[431]

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[431] Former Rev. Rul. 81-300 reasoned:

> In *Pratt v. Commissioner*, 64 T.C. 203 (1975), *aff'd in part, rev'd in part*, 550 F.2d 1023 (5th Cir. 1977), under substantially similar facts to those in this case, both the United States Tax Court and the United States Court of Appeals for the Fifth Circuit held that management fees based on a percentage of gross rentals were not payments described in section 707(a) of the Code. The courts found that the terms of the partnership agreement and the actions of the parties indicated that the taxpayers were performing the management services in their capacities as general partners. *Compare* Rev. Rul. 81-301, this page, this Bulletin.
>
> When a determination is made that a partner is performing services in the capacity of a partner, a question arises whether the compensation for the services is a guaranteed payment under section 707(c) of the Code or a distributive share of partnership income under section 704. In *Pratt*, the Tax Court held that the management fees were not guaranteed payments because they were computed as a percentage of gross rental income received by the partnership. The court reasoned that the gross rental income was income of the partnerships and, thus, the statutory test for a guaranteed payment, that it be determined without regard to the income of the partnership, was not satisfied. On appeal, the taxpayer's argument was limited to the section 707(a) issue and the Fifth Circuit found it unnecessary to consider the application of section 707(c).
>
> The legislative history of the Internal Revenue Code of 1954 indicates the intent of Congress to treat partnerships as entities in the case of certain transactions between partners and their partnerships. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 92 (1954). The Internal Revenue Code of 1939 and prior Revenue Acts contain no comparable provision and the courts had split on the question of whether a partner could deal with the partnership as an outsider. *Compare Lloyd v. Commissioner*, 15 B.T.A. 82 (1929) and *Wegener v. Commissioner*, 119 F.2d 49 (5th Cir. 1941), *aff'g* 41 B.T.A. 857 (1940), *cert. denied* 314 U.S. 643 (1941). This resulted both in uncertainty and in substantial computational problems when an aggregate theory was applied and the payment to a partner exceeded the partnership income. In such situations, the fixed salary was treated as a withdrawal of capital, taxable to the salaried partner to the extent that the withdrawal was made from the capital of other partners. *See*, for example, Rev. Rul. 55-30, 1955-1 C.B. 430. Terming such treatment as unrealistic and unnecessarily complicated, Congress enacted section 707(a) and (c) of the Code of 1954. Under section 707(a) the partnership is considered an unrelated entity for all purposes. Under section 707(c), the partnership is considered an unrelated entity for purposes of sections 61 and 162 to the extent that it makes a guaranteed payment for services or for the use of capital.
>
> Although a fixed amount is the most obvious form of guaranteed payment, there are situations in which compensation for services is determined by reference to an item of gross income. For example, it is not unusual to compensate a manager of real property by reference to the gross rental income that the property produces. Such compensation arrangements do not give the provider of the service a share in the profits of the enterprise, but are designed to accurately measure the value of the services that are provided.
>
> Thus, and [sic] view of the legislative history and the purpose underlying section 707 of the Code, the term guaranteed payment should not be limited to fixed amounts. A payment for services determined by reference to an item of gross income will be a guaranteed payment if, on the basis of all of the facts and circumstances, the payment is compensation rather than a share of partnership profits. Relevant facts would include the reasonableness of the payment for the services provided and whether the method used

- If the partner performs services as an independent contractor and not as a partner, then Code § 707(a) applies.[432]

Whether a particular compensation arrangement is a guaranteed payment or a distributive share of profits is a fluid concept. Generally, a payment based on gross income constitutes a guaranteed payment (such as a fixed percentage of gross rent), whereas a payment based on net income constitutes a distributive share (such as rental income net of all allocable expenses).[433] Reg. § 1.707-1(c) provides some examples:

> *Example (1)*. Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed

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> to determine the amount of the payment would have been used to compensate an unrelated party for the services.
>
> It is the position of the Internal Revenue Service that in *Pratt* the management fees were guaranteed payments under section 707(c) of the Code. On the facts presented, the payments were not disguised distributions of partnership net income, but were compensation for services payable without regard to partnership income.

However, the IRS has revoked Rev. Rul. 81-300; see fn. 434. Its text is reproduced to distinguish between services that are or are not subject to Code § 707 rather than to distinguish between Code § 707(a) and (c).

[432] See The Lost Regulations—Section 707 and the Definition of Partner Capacity, *Business Entities* (WG&L), Jan./Feb. 2009. Rev Rul. 81-301 reasoned that Code § 707(a), rather than Code § 707(c), governed the following arrangement:

> Although the adviser is identified in the agreement as an adviser general partner, the adviser provides similar services to others as part of its regular trade or business, and its management of the investment and reinvestment of ABC's assets is supervised by the directors. Also it can be relieved of its duties and right to compensation at any time (with 60 days notice) by a majority vote of the directors. Further, the adviser pays its own expenses and is not personally liable to the other partners for any losses incurred in the investment and reinvestment of ABC's assets. The services performed by the adviser are, in substance, not performed in the capacity of a general partner, but are performed in the capacity of a person who is not a partner.

It held:

> The 10 percent daily gross income allocation paid to the adviser is subject to section 707(a) of the Code and taxable to the adviser under section 61 as compensation for services rendered. The amount paid is deductible by the partnership under section 162, subject to the provisions of section 265.

[433] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 14.03 Partners Acting in Their Capacities as Partners: Section 707(c) Guaranteed Payments, discusses that the Tax Court held that a management fee equal to 3% of gross rents constituted a distributive share rather than a guaranteed payment. The treatise states that the IRS disagreed with the Tax Court's ruling, both citing the Rev. Rul. and providing details in a footnote:

> Rev. Rul. 81-300, 1981-2 CB 143. The legislative history of the Deficit Reduction Act of 1984, however, states that the transaction described in Rev. Rul. 81-300 should be governed by § 707(a), not § 707(c). Moreover, it seems that § 707(a) treatment is dictated by the fact that the services rendered (real estate management) are traditionally compensated by fees that are a percentage of gross income, thus triggering § 707(a)(2)(A). 1 Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S. Rpt. No. 169, at 229, 230 (Comm. Print 1984)….

Since then, Rev. Rul. 81-300 has been obsoleted; see fn. 431. I have not looked for changes to the treatise.

payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

Example (2). Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

Example (3). Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

Example (4). Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

In 2015, the IRS announced a more aggressive posture in reclassifying arrangements as disguised payments for services.[434] Example (2) is now on the chopping block.[435]

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[434] On July 22, 2015, REG-115452-14, Disguised Payments for Services, revoked Rev. Rul. 81-300, promulgating Prop. Reg. § 1.707-2, explaining:

> Consistent with the language of section 707(a)(2)(A), § 1.707-2(b) of the proposed regulations provides that an arrangement will be treated as a disguised payment for services if (i) a person (service provider), either in a partner capacity or in anticipation of being a partner, performs services (directly or through its delegate) to or for the benefit of the partnership; (ii) there is a related direct or indirect allocation and distribution to the service provider; and (iii) the performance of the services and the allocation and distribution when viewed together, are properly characterized as a transaction occurring between the partnership and a person acting other than in that person's capacity as a partner.
>
> The proposed regulations provide a mechanism for determining whether or not an arrangement is treated as a disguised payment for services under section 707(a)(2)(A). An arrangement that is treated as a disguised payment for services under these proposed regulations will be treated as a payment for services for all purposes of the Code. Thus, the partnership must treat the payments as payments to a non-partner in determining the remaining partners' shares of taxable income or loss. Where

appropriate, the partnership must capitalize the payments or otherwise treat them in a manner consistent with the recharacterization.

> The consequence of characterizing an arrangement as a payment for services is otherwise beyond the scope of these regulations. For example, the proposed regulations do not address the timing of inclusion by the service provider or the timing of a deduction by the partnership other than to provide that each is taken into account as provided for under applicable law by applying all relevant sections of the Code and all relevant judicial doctrines. Further, if an arrangement is subject to section 707(a), taxpayers should look to relevant authorities to determine the status of the service provider as an independent contractor or employee. See, generally, Rev. Rul. 69-184, 1969-1 C.B. 256. The Treasury Department and the IRS believe that section 707(a)(2)(A) generally should not apply to arrangements that the partnership has reasonably characterized as a guaranteed payment under section 707(c).

> Allocations pursuant to an arrangement between a partnership and a service provider to which sections 707(a) and 707(c) do not apply will be treated as a distributive share under section 704(b). Rev. Proc. 93-27 and Rev. Proc. 2001-43 may apply to such an arrangement if the specific requirements of those Revenue Procedures are also satisfied. The Treasury Department and the IRS intend to modify the exceptions set forth in those revenue procedures to include an additional exception for profits interests issued in conjunction with a partner forgoing payment of a substantially fixed amount. This exception is discussed in part IV of the Explanation of Provisions section of this preamble.

REG-115452-14 immediately changed the government's position:

> The proposed regulations would be effective on the date the final regulations are published in the Federal Register and would apply to any arrangement entered into or modified on or after the date of publication of the final regulations. In the case of any arrangement entered into or modified before the final regulations are published in the Federal Register, the determination of whether an arrangement is a disguised payment for services under section 707(a)(2)(A) is made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 707(a)(2)(A). Pending the publication of final regulations, the position of the Treasury Department and the IRS is that the proposed regulations generally reflect Congressional intent as to which arrangements are appropriately treated as disguised payments for services.

The legislative history referred to above includes:

> … the committee intends that the provision will lead to the conclusions contained in Revenue Ruling 81-300, 1981-2 CB 143, and Revenue Ruling 81-301, 1981-2 CB 144, except that the transaction described in Revenue Ruling 81-300 would be treated as a transaction described in section 707(a).

Lipton, Proposed Regulations Issued on Disguised Payments for Services to a Partnership, *Journal of Taxation* (Feb. 2016), criticized certain aspects of Prop. Reg. § 1.707-2, especially certain aspects governing preferred returns.

[435] REG-115452-14, Disguised Payments for Services (July 22, 2015), commented:

> Congress's emphasis on entrepreneurial risk requires changes to existing regulations under section 707(c). Specifically, Example 2 of § 1.707-1(c) provides that if a partner is entitled to an allocation of the greater of 30 percent of partnership income or a minimum guaranteed amount, and the income allocation exceeds the minimum guaranteed amount, then the entire income allocation is treated as a distributive share under section 704(b). Example 2 also provides that if the income allocation is less than the guaranteed amount, then the partner is treated as receiving a distributive share to the extent of the income allocation and a guaranteed payment to the extent that the minimum guaranteed payment exceeds the income allocation. The treatment of the arrangements in Example 2 is inconsistent with the concept that an allocation must be subject to significant entrepreneurial risk to be treated as a distributive share under section 704(b).

Timing is also important. Code § 707(a)(2) compensation is income to the service provider when paid. A partner must include a Code § 707(c) guaranteed payment "as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership" accounted for the payment under its method of accounting.[436] Thus, the characterization between the two can make a big difference in timing.[437]

Compensation payments are reported on the Schedule K-1 that the partnership issues to the partner. Issuing Form W-2 that applies to employees violates the regulations governing FICA.[438] The government was exploring this issue in 2014 and perhaps later,

> Accordingly, the proposed regulations modify Example 2 to provide that the entire minimum amount is treated as a guaranteed payment under section 707(c) regardless of the amount of the income allocation. Rev. Rul. 66-95, 1966-1 C.B. 169, and Rev. Rul. 69-180, 1969-1 C.B. 183, are also inconsistent with these proposed regulations. The Treasury Department and the IRS intend to obsolete Rev. Rul. 66-95 and revise Rev. Rul. 69-180, when these regulations are published in final form.

[436] Reg. § 1.707-1(c), which continues, "See section 706(a) and paragraph (a) of § 1.706-1."

[437] *Herrmann v. U.S.*, 119 A.F.T.R.2d 2017-2273 (Ct. Fed Cl. 6/21/2017), held that a person who was a partner merely to comply with local (United Kingdom) employment laws, the partnership was merely a conduit for flowing through compensation payments, and the taxpayer's compensation was wildly disproportionate to the taxpayer's percentage of capital, compensation paid to the taxpayer was taxable under Code § 707(a)(2) when received; it is possible that the taxpayer was not really a partner, but the court declined to rule on that, because in either case the taxpayer was taxed as an independent contractor. The case was sympathetic in that the partnership did not provide information to the taxpayer notwithstanding the taxpayer's diligent efforts when the taxpayer's very reputable tax preparer worked on the returns; furthermore, the taxpayer was compensated the same as when she was an employee in the U.S. and viewed the arrangements the same when moving to the U.K., the move being not intended as a change in relationship to the employer but rather merely giving the taxpayer access to better resources to do her job (which she did very well – the timing of over $18 million in compensation was at issue.)

[438] Rev. Rul. 69-184 (Rev. Rul. 91-26, which was clarified by Ann. 92-16, applied this rule to fringe benefits of greater-than-2% owners of S corporations); Reg. § 1.707-1(c) ("…a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc."); Reg § 1.1402(a)-1(b); *Grubb v. Commissioner*, T.C. Memo. 1990-425; *Riether v. U.S.*, 919 F.Supp.2d 1140 (D. NM 2012) (reporting on Form W-2 was incorrect, but IRS did not complain so no consequence; remaining distributive share of income was subject to self-employment tax; 20% accuracy-related underpayment penalty applied because taxpayers did not receive a communication about self-employment tax from a professional that sets forth the professional's analysis or conclusion under Reg. § 1.6664-4(b)(1)); see fn. 2419 in part II.L.4 Self-Employment Tax Exclusion for Limited Partners' Distributive Share. For a laundry list of problems when partnership compensation is reported on Form W-2, see fn. 443 and accompanying text in part II.C.8.b Consequences of Incorrectly Reporting Partner Compensation on a W-2 Instead of As a Guaranteed Payment. See Brock, Partners as Employees? Properly Reporting Partner Compensation, *The Tax Advisor* (11/1/2013); Banoff's and Lipton's Shop Talk column, LLC Member Who Provides Services: Partner, Employee, or Both? *Journal of Taxation* (July 2014) (concluding that a tax partner is still a tax partner, even if the IRS does not challenge his W-2 reporting (and withholding), as occurred in *Riether*.); and Griffith, Passthrough Partner: Partners and W-2 Employee Status, *Taxes* (CCH) (2/2015). For self-employment tax on guaranteed payments, see text accompanying notes 2403-2404. Courts differ on whether fringe benefits paid to a partner are eligible for exclusions afforded to employees. *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1961) (see fn. 2813 In part II.P.2 C Corporation Advantage Regarding Fringe Benefits, held that the enactment of Code § 707(a), allowing partners to act in a non-

in an effort to be flexible to businesses.[439] However, given that reclassifying guaranteed payments as wages would help support a Code § 199A deduction with respect to those receiving a distributive share of profits,[440] I am skeptical.

Not being considered an employee, a partner nevertheless may remain in the Social Security system, with guaranteed payments often subjected to self-employment tax.[441]

Guaranteed payments do not constitute an interest in partnership profits for purposes of Code §§ 706(b)(3), 707(b), and 708(b). Reg. § 1.707-1(c), which continues:

> For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc.

II.C.8.b. Consequences of Incorrectly Reporting Partner Compensation on a W-2 Instead of As a Guaranteed Payment

Although reporting compensation income to a partner on Form W-2 might seem to be harmless error,[442] consequences include:[443]

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partner capacity, superseded the aggregate approach adopted by courts under the Internal Revenue Code of 1939, refusing to follow *Wilson v. U.S.*, 376 F.2d 280 (Ct. Cl. 1967) (denying a Code § 119 exclusion for meals and lodging for the employer's convenience) because Wilson had not considered Code § 707(a). *Zahler v. Commissioner*, T.C. Memo 1981-112, denied a Code § 119 exclusion to a commission salesman who was acting in his capacity as a partner; a similar result applied to an S corporation owner in *Dilts v. U.S.*, 845 F. Supp. 1505 (D. Wyo. 1994). See also McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners*, ¶ 14.02[4][b] Collateral Consequences of Section 707(a) Treatment; Willis & Postlewaite, *Partnership Taxation*, ¶ 11.03[5] Treatment of Guaranteed Payments Under Other Code Provisions; Bishop & Kleinberger, *Limited Liability Companies: Tax and Business Law*, ¶ 4.11 Availability of Fringe Benefits; and Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts*, ¶ 63.6.4 Qualified Recipients [of Code § 119 payments], ¶ 89.1.2 Guaranteed Payments, and ¶ 89.1.3 Transactions in Nonpartner Capacity Generally.

439 On December 15, 2014, the LLC/LLP Subcommittee of the Partnerships & LLCs Committee of the Section of Taxation of the American Bar Association (which is working with the Section's Employee Benefits Committee) solicited volunteers to explore this area and comment to the government on issues to consider in any guidance it might issue.

440 See part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds, fns. 637-646.

441 See part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, fns. 2401-2403

442 There is no basis for reporting compensation income to a partner on Form W-2. See fn 438.

443 Brock, "Treating Partners as Employees: Risks to Consider," *Journal of Accountancy*, pp. 55-59 (August 2014); see Griffith, "Passthrough Partner: Partners and W-2 Employee Status," *Taxes* (CCH) (2/2015). See also fn. 438 for authority in this area. On December 15, 2014, the LLC/LLP Subcommittee of the Partnerships & LLCs Committee of the Section of Taxation of the American Bar Association (which was working with the Section's Employee Benefits Committee)

- Timely filing forms W-2 helps support the 20% deduction related to qualified business income ("QBI") for owners of partnerships,[444] but W-2 income itself does not constitute QBI.[445] Thus, misclassifying partner compensation as W-2 wages could overstate the QBI-related deduction.

- The safe harbor for the nontaxable issuance of profits interests, Rev. Proc. 2001-43,[446] might not apply.

- Cafeteria plans might be disqualified, because partners cannot participate.[447]

- FICA taxes might be underpaid (due to timing issues) or overpaid. The partnership's FICA tax deduction might be overstated, because the partnership paid FICA for partners for whom it should not have paid FICA.

- The Code § 199 deduction for domestic production activities might be miscalculated, because Form W-2 income cannot properly include partner compensation.[448] This deduction has been repealed, effective taxable years beginning after December 31, 2017.

- Although guaranteed payments to partners for services might not be required to be capitalized under Code § 263A, Form W-2 wages must be capitalized.

- State tax apportionment, which can use a payroll factor, might be distorted.

- Income tax exclusions for benefits do not apply to partners, and the partnership's benefit reporting might mistakenly omit amounts taxable to the partner/former employee.[449]

- Bonuses paid after yearend are guaranteed payments deductible to the partnership and taxable to the partner in the current year[450] but might be incorrectly deferred to the next year.

- A person who has losses from self-employment in other activities can reduce FICA by offsetting those losses against self-employment income, but the losses would not reduce Form W-2 wages subject to FICA.

- A person with unreimbursed business expenses from Form W-2 employment treats them as miscellaneous itemized deductions, subject to various haircuts as well as

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solicited volunteers to explore this area and comment to the government on issues to consider in any guidance it might issue.

444 See part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds, text accompanying fns 637-646.

445 See part II.E.1.c.ii Types of Income and Activities Eligible for Deduction, fns. 621-622.

446 See part II.M.4.f Issuing a Profits Interest to an Employee.

447 Prop. Reg. § 1.125-1(g)(2).

448 Note the W-2 limitation mentioned in part II.G.24 Code § 199 Deduction for Domestic Production Activities especially fn. 1270.

449 See part II.P.2 C Corporation Advantage Regarding Fringe Benefits.

450 Reg. § 1.707-1(c). see part III.B.7.c.viii Creative Bonus Arrangements, especially fns. 437-439.

complete disallow for alternative minimum tax purposes, whereas a partner can deduct them in full (if not reimbursable under the partnership agreement).

- If the person has an interest in profits/losses, the person will get a K-1 and be subject to partnership income tax complexity notwithstanding the treatment of wages.

- If the company goes out of business and has failed to pay the withholding to the government, the person from whom the withholdings occurred will not get credit for having paid the tax withheld if the person is a partner (but will get credit if the person is an employee); it would have been better to have received the payment in full and then pay the taxes individually.

- Because such a position has no reasonable basis, the preparer will violate ethical rules. If a client sues for malpractice as a result of any harm, the lawsuit might be impossible to defend.

Local governments that impose a payroll tax might tax partner compensation as wages.[451]

II.C.9. Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership

Taxation as a partnership, although generally more flexible than corporate taxation, might be more unfavorable than taxation as co-owners who are not partners. For example, if co-owners have different goals regarding whether to reinvest sale proceeds or engage in a Code § 1031 like-kind exchange,[452] they might want to unwind anything that makes them considered partners.[453] Also, the Code § 121 exclusion for gain on the

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[451] See "California State Court of Appeals Holds Payroll Expense Tax Applies To Partnership Distributions to Law Firm's Equity Partners," *TM Real Estate Journal* (BNA), Vol. 31, No. 03 (3/4/2015).

[452] See part II.G.15 Like-Kind Exchanges.

[453] For how to unwind a partnership in anticipation of a possible Code § 1031 exchange, see "Like-Kind Exchanges of Partnership Properties," *The Tax Adviser*, page 812, December 2008. Letter Ruling 9741017 drove this point home in the following situation:

> … each of the brothers, A and B, owns a one-half interest in Taxpayer, which itself owns ten rental real properties. A and B have responsibility for making major decisions regarding their properties. Management of the properties is performed by a property management corporation of which A and B are equal stockholders, but are no longer employees. A and B represent that they have never executed any partnership agreement regarding Taxpayer or considered themselves to be anything other than equal owners of the properties. For the five consecutive tax years 19x1 to 19x5, however, all net income and losses of Taxpayer relating to the properties have been reported on Form 1065, a Partnership Return.
>
> A and B represent that irreconcilable differences have developed between them regarding their ownership of the properties. Moreover, A and B are considering estate planning issues relating to the properties. To address those issues, A and B propose a like-kind exchange between themselves involving nine of the properties. After the exchange, six of the properties will be owned entirely by B, and three will be owned by A. The tenth property will continue to be owned by A and B as co-owners.

The ruling held:

sale of a residence does not apply when spouses hold their residence in a partnership.[454] On the other hand, partnership income tax reporting generally is easier than separately listing every item on each co-owner's income tax return.

Those holding properties as tenants-in-common[455] or a trust created by its beneficiaries[456] should consider whether they are deemed to have formed a partnership. Generally, as a matter of state law, "the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."[457] Furthermore, the Uniform Partnership Act[458] provides:

> In determining whether a partnership is formed, the following rules apply:
>
> (1) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not by itself establish a partnership, even if the co-owners share profits made by the use of the property.
>
> (2) The sharing of gross returns does not by itself establish a partnership, even if the persons sharing them have a joint or common right or interest in property from which the returns are derived.
>
> (3) A person who receives a share of the profits of a business is presumed to be a partner in the business, unless the profits were received in payment:
>
> (A) of a debt by installments or otherwise;

> Without making a determination under Rev. Rul. 75-374 regarding A's and B's joint business activities relating to the properties, we note a crucial test under case law of whether the co- owners of property intended to create a partnership, as evidenced by their actions, notwithstanding the lack of characterization of their relationship. See *Estate of Levine*, 72 T.C. 780, 785 (1979). In this instance, we believe that Taxpayer's filing of partnership tax returns for several tax years indicates an intention to be taxed as a partnership. Accordingly, we conclude that A's and B's co-ownership of Taxpayer constitutes a partnership under section 761(a) and the regulations thereunder rather than a mere co-ownership.
>
> Since an exchange of partnership interests can not qualify for deferral under section 1031(a)(1) by reason of section 1031(a)(2)(D) we can not rule that the transaction qualifies for deferral as a like-kind exchange.

[454] *Farah v. Commissioner*, T.C. Memo. 2007-369, and Letter Ruling 200119014.

[455] For an excellent discussion of taxation of tenants-in-common, as well as when such an arrangement is taxed as a partnership, see Tucker and Langlieb, fn. 1041. In the real estate context, see also fn. 301.

[456] See parts II.D.1 Trust as a Business Entity and II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.

[457] Section 202(a) of the Uniform Partnership Act ("UPA"), found at http://www.uniformlaws.org/Act.aspx?title=Partnership Act (1997) (Last Amended 2013) (general description of the UPA) or http://www.uniformlaws.org/Shared/Docs/Partnership/UPA%20_Final_2014_2015aug19.pdf (text of the UPA).

[458] UPA § 202(c). 805 ILCS 202 follows the quoted language, and 805 ILCS 1201 provides that 805 ILCS Act 206, the Uniform Partnership Act (1997), shall follow the uniform law.

(B) for services as an independent contractor or of wages or other compensation to an employee;

(C) of rent;

(D) of an annuity or other retirement or health benefit to a beneficiary, representative, or designee of a deceased or retired partner;

(E) of interest or other charge on a loan, even if the amount of payment varies with the profits of the business, including a direct or indirect present or future ownership of the collateral, or rights to income, proceeds, or increase in value derived from the collateral; or

(F) for the sale of the goodwill of a business or other property by installments or otherwise.

Co-owners of real estate might form a partnership with respect to operations conducted on the real estate without the partnership applying to the ability to sell the real estate itself,[459] but equitable principles are likely to determine whether the court finds a partnership.[460]

Note some consequences to a tenancy in common being characterized as a partnership:

- Joint and several liability for all of the partnership's debts, obligations, and other liabilities, subject to various exceptions.[461]

- The right to withdraw at will,[462] even in contravention to any agreement of the parties,[463] either giving the owner the right to cash out for the greater of the

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[459] *Holton v. Guinn*, 76 F. 96 (W.D. Mo. 1896), held, "It might be conceded, for the purpose of this case, that a partnership existed between the parties in conducting a business on these lands, without affecting the legal status of the land or property, for the separate properties may be employed in partnership business." Although one of a few co-tenants might engage in conduct suggesting a partnership, that conduct must be authorized to find a partnership. Looking to the actions of all of the co-owners and finding a mere tenancy in common, *Hudson v. French*, 241 S.W. 443 (W.D. Mo. 1922), quoted *Holton*:

> "Where the conduct and acts of the parties in dealing with the estate may with reason be referred to the office of a tenant in common, the courts, in construing those acts, will prefer to attribute them to that relation."

Continuing this line of reasoning, *Thomas v. Lloyd*, 17 S.W.3d 177 (S.D. Mo. 2000), found a mere tenancy in common regarding real estate, analyzing the law as follows:

> In attempting to demonstrate that the parties intended for the real estate to be a partnership asset, Defendant points to the joint ownership of the farm and the fact that the parties operated the partnership cattle business on the farm as evidence that the two understood and intended for the farm to be a partnership asset. His reliance on those facts is misplaced, however. A joint purchase of real estate by two individuals does not, in and of itself, prove the land is a partnership asset. See *Hudson*, 241 S.W. at 446; 68 C.J.S. Partnership § 73, at 274–75 (1998). On the contrary, when land is conveyed to partnership members without any statement in the deed that the grantees hold the land as property of the firm, there is a presumption that title is in the individual grantees. 68 C.J.S. Partnership § 75, at 277 (1998). Moreover, "[e]vidence that the land is used by the firm is of itself insufficient to rebut the presumption." *Id.* The mere use of land by a partnership does little to show the land is owned by the partnership. 1 Bromberg and Ribstein on Partnership, § 3.02(b), at 3:7 (Release No. 7—1999–2 Supp.). Standing alone, evidence of partnership usage does not compel a finding that the land is a partnership asset. *Mischke v. Mischke*, 247 Neb. 752, 530 N.W.2d 235, 240 (1995); *In re Estate of Schreiber*, 227 N.W.2d 917, 925[9] (Wis. Sup. 1975). See *Shawneetown Feed and Seed Co. v. Ford*, 468 S.W.2d 54, 56 (Mo. App. 1971).

The result may be different if partnership funds were used to buy the property. *Engeman v. Engeman*, 123 S.W.3d 227 (W.D. Mo. 2003).

[460] *State Auto. and Cas. Underwriters v. Johnson*, 766 S.W.2d 113 (S.D. 1969), held that the building, furniture and fixtures destroyed by the fire constituted partnership property when a 50% tenant in common received insurance proceeds equal to 100% of the value of the property destroyed. Although the partnership agreement was terminated:

> We hold the trial court's findings that no final division had ever been made of the partnership property or partnership debts, that the partnership affairs were never wound up, and that the partnership had not been terminated at the time of the fire are supported by substantial evidence and are not against the weight of the evidence, and that in making such findings the trial court neither erroneously declared nor erroneously applied the law.

[461] UPA § 306.

[462] UPA §§ 601(1), 602(a).

liquidation value or the value based on a sale of the entire business as a going concern without the person[464] or causing the partnership to dissolve[465] and wind up its business.[466] The right to cash out might be especially troubling for the other owners. Also, federal case law[467] has established that an interest as a tenant in common is worth less (15%-20% tends to be a common valuation adjustment, but much higher adjustments may be appropriate when property is not easily partitioned) than a percentage of the property's value as a whole, this right to cash out might reduce that valuation adjustment. In the federal tax lien area, courts tend to view this valuation adjustment as ground for forcing the sale of the underlying property, because selling the tenant-in-common interest would prejudice the government's interest in collecting what is due.[468]

As a matter of federal tax law, regulations provide a fundamental definition:[469]

> *In general*. The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Further regulations provide:[470]

> *Certain joint undertakings give rise to entities for federal tax purposes*. A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons

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463 UPA § 110(c)(9).

464 UPA § 701.

465 UPA § 801.

466 UPA § 802.

467 It has been suggested to me that "the New Jersey Division of Taxation has unilaterally proclaimed that they will not accept the assertion of a valuation discount for a 50% interest as a tenant in common of real property under any circumstances. In the past, I have routinely requested such a discount, citing federal case law, and I was never denied the discount. I had encountered difficulties with respect to valuation discounts for family limited partnerships and limited liability companies, even with a valuation report, but this is something new. Luckily, New Jersey is repealing the NJ Estate tax effective 1/1/2018, but we have to deal with them in the interim."

468 See *U.S. v. Adent*, cited in fn. 5471, found in part III.B.5.d.iv.(i) Effect of Liens on Dealings with Third Parties.

469 Reg. § 301.7701-1(a)(1).

470 Reg. § 301.7701-1(a)(2). Code § 7701(a)(2) provides:

> The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

The controlling U.S. Supreme Court case held:[471]

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Presenting sufficient evidence to raise a genuine issue of material fact as to the parties' intent prevents the IRS from winning on summary judgment.[472]

The most commonly cited factors in federal tax case law, none of which is conclusive, are:[473]

- [t]he agreement of the parties and their conduct in executing its terms;

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[471] *Commissioner v. Culbertson*, 337 U.S. 733 (1949), clarifying *Commissioner v. Tower*, 327 U.S. 280 (1946).

[472] In denying summary judgment to the government, *Broadwood Investment Fund, LLC v. U.S.*, 116 A.F.T.R.2d 2015-5492 (9th Cir. 2015), held:

> In particular, Petitioners presented evidence that some of the investment materials projected that the partnerships could be profitable, and that the partners performed due diligence on the assets before acquiring them. Petitioners also presented evidence of efforts made to collect on the debts owned by the partnerships. And there is no dispute that the partnerships allocated distributions, profits, and losses to partners *pro rata*. The government also presented substantial evidence in support of its determination that the partnerships were shams, and we express no opinion on how this issue ultimately should be resolved on the merits. But the genuine factual dispute as to the partners' intent precludes summary judgment on the issue.

[473] *Luna v. Commissioner*, 42 T.C. 1067, 1077-78 (1964). Although this case dealt with an insurance agent, it has been cited in many other situations, including CCA 201323015 (joint venture between two corporations constituted a partnership because of their "sharing in the net profits and losses from the manufacture, development, and marketing of" [a particular undisclosed product]), *Holdner v. Commissioner*, T.C. Memo. 2010-175 (presumption of partners holding equal interests), *aff'd* 110 A.F.T.R.2d 2012-6324 (9th Cir. unpublished summary opinion), and *6611, Ltd., Ricardo Garcia, Tax Matters Partner, v. Commissioner*, T.C. Memo. 2013-49 (disregarding a partnership for purposes of applying IRS partnership audit procedures). In the context of whether an arrangement to provide services that awards equity-type incentives might constitute a partnership, see part III.B.7.c.viii Creative Bonus Arrangements.

- the contributions, if any, which each party has made to the venture;

- the parties' control over income and capital and the right of each to make withdrawals;[474]

- whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses,[475] or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;

- whether business was conducted in the joint names of the parties;

- whether the parties filed Federal partnership returns or otherwise represented to [the IRS] or to persons with whom they dealt that they were joint venturers;

- whether separate books of account were maintained for the venture; and

- whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Furthermore:[476]

> [T]he parties, to form a valid tax partnership, must have two separate intents: (1) the intent to act in good faith for some genuine business purpose and (2) the

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[474] This factor is not, by itself, sufficient to prove the existence of a partnership. *Azimzadeh v. Commissioner*, T.C. Memo. 2013-169.

[475] Later cases held that, if a purported partner lacks any meaningful downside or upside potential, that person is not a partner. *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012), *cert. den.* 2013 WL 249846 (5/28/2013); *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 107 AFTR.2d 2011-1523 (4th Cir. 2011). On the other hand, a mere interest in future capital appreciation might suffice. See CCA 201326018, discussed in Banoff's and. Lipton's Shop Talk column, "General Partners Who Only Share in Capital Appreciation," *Journal of Taxation* (8/2013) (in-depth discussion of the issue of treating as a partner someone with no interest in the current year's operating profits) and their follow-up, "General Partners Who Only Share in Future Years' Profits: TEFRA and Beyond," *Journal of Tax*ation (5/2014).

In response to concern about how the *Historic Boardwalk* case, Rev. Proc. 2014-12 provides a safe harbor regarding the allocation of Code § 47 rehabilitation credits. Among other requirements, Section 4.02(1) of the Rev. Proc. requires the principal to have at least a 1% interest in each material item of partnership income, gain, loss, deduction, and credit at all times during the partnership's existence, and Section 4.02(2) requires to investor to have, at all times during the period it owns an interest in the partnership, a minimum interest in each material item of Partnership income, gain, loss, deduction, and credit equal to at least 5% of the investor's percentage interest in each such item for the taxable year for which the investor's percentage share of that item is the largest (as adjusted for sales, redemptions, or dilution of the investor's interest) and must participate in profits in a manner that is not limited to a preferred return that is in the nature of a payment for capital.

[476] *Chemtech Royalty Associates, L.P. v. U.S.*, 114 A.F.T.R.2d 2014-5940 (5th Cir 2014), quoting *Southgate Master Fund, L.L.C. ex rel. Montgomery Capital Advisors, LLC v. United States*, 659 F.3d 466, 488 (5th Cir. 2011).

> intent to be partners, demonstrated by an intent to share "the profits and losses." If the parties lack either intent, then no valid tax partnership has been formed. To determine whether the parties had these intents, a court must consider "all the relevant facts and circumstances," including (a) "the agreement," (b) "the conduct of the parties in execution of its provisions," (c) the parties' statements, (d) "the testimony of disinterested persons," (e) "the relationship of the parties," (f) the parties' "respective abilities and capital contributions," (g) "the actual control of income and the purposes for which it is used," and (h) "any other facts throwing light on their true intent."

LAFA 20161101F asserted that in an investor in a coal production partnership was not entitled to the related credits because the capital contributions were based on future production and were nonrecourse and any chance of profit other than through tax credits was small.

The Tax Court has "consistently disregarded entities that attempt to generate artificial losses by exploiting the partnership tax rules."[477] When a partnership is disregarded for tax purposes, partnership income rules no longer apply, and one or more of the purported partners will be deemed to have engaged in the partnership's activities.[478]

If preferred payments are relatively fixed and certain, the following facts need to be considered:[479]

- whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both

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[477] *New Millennium Trading, LLC v. Commissioner*, T.C. Memo. 2017-9, supporting this statement with:

> See *AD Inv. 2000 Fund, LLC v. Commissioner*, T.C. Memo. 2016-226; *436, Ltd. v. Commissioner*, T.C. Memo. 2015-28; *Markell Co. v. Commissioner*, T.C. Memo. 2014-86; *6611, Ltd. v. Commissioner*, T.C. Memo. 2013-49; *Palm Canyon X Invs., LLC v. Commissioner*, T.C. Memo. 2009-288; see also *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161 (2009) (disallowing the losses because the "transaction lacked economic substance"), *aff'd*, 408 F.App'x 908 (6th Cir. 2010); *Humboldt Shelby Holding Corp. v. Commissioner*, T.C. Memo. 2014-47 (similar), *aff'd* per summary order, 606 F.App'x 20 (2d Cir. 2015). Each scheme involved an entity (partnership or LLC) whose sole purpose was to provide its members with a high-basis membership interest to be disposed of at a loss; or, on its redemption, to put high-basis entity assets into the hands of the member, who would then dispose of them at a loss.

[478] *New Millennium Trading, LLC v. Commissioner*, T.C. Memo. 2017-9, supporting this statement with:

> See, *e.g.*, *6611, Ltd. v. Commissioner*, T.C. Memo. 2013-49. A disregarded partnership has no identity separate from its owners, and we treat is as an agent or nominee. See *Tigers Eye Trading v. Commissioner*, 138 T.C. at 94, 99. Pursuant to section 6233(a) and (b), TEFRA procedures still apply to the entity, its items, and persons holding an interest in the entity as long as the purported partnership filed a return, which NMT did for tax year 1999. See sec. 6233(b); sec. 301.6233-1987). Thus, we have jurisdiction to determine any items that would have been "partnership items", as defined in section 6231(a)(3), and section 301.6231(a)(3)-1, Proced. & Admin. Regs., had NMT been a valid partnership for tax purposes. See *Tigers Eye Trading v. Commissioner*, 138 T.C. at 97.

[479] *Principal Life Ins. Co. & Subs v. U.S.*, 120 Fed. Cl. 41 (Ct. Fed. Cl. 2/4/2015).

- whether the preferred partner was a bona fide partner because the payments it expected to receive were essentially fixed and relatively secure[480]

- whether the existence of a preferred equity interest in a partnership, providing a relatively secure return, is sufficient to treat the holder of the interest as other than a partner

When one person contributes capital, another contributes management skill, and the person contributing management skill takes reduced compensation and a 20% share of the sale proceeds after the moneyed partner receives a nice preferred return, the person contributing management skill is a partner who can treat the receipt of 20% of the sale proceeds as capital gain.[481]

In light of uncertainty, generally co-owners may elect not to be treated as a partnership in either of two circumstances:[482]

(2) *Investing partnership*. Where the participants in the joint purchase, retention, sale, or exchange of investment property –

(i) Own the property as coowners,[483]

(ii) Reserve the right separately to take or dispose of their shares of any property acquired or retained, and

(iii) Do not actively conduct business or irrevocably authorize some person or persons acting in a representative capacity to purchase, sell, or

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480 The court also held:

> Even if a partnership exists, "consideration whether an interest has the prevailing character of debt or equity can be helpful in analyzing whether, for tax purposes, the interest should be deemed a bona fide equity participation in a partnership." [citations omitted] A party will not be considered a bona fide partner in a partnership if its interest is more akin to a debt-like interest, with little or no risk aside from credit risk, than to an equity participation, a share of ownership in which the party takes on true entrepreneurial risk in the partnership venture. [citations omitted] In the court's view, significant questions of fact remain as to how the interests in question should be treated in this regard, precluding a ruling on summary judgment….

481 *U.S. v. Stewart*, 116 A.F.T.R.2d 2015-5720 (S.D. Tex. 8/20/2015), relying on *Haley v. Commissioner*, 203 F.2d 815, 818 (5th Cir. 1953). *Stewart* did not cite *Luna* or any of the traditional cases defining what a partnership is.

482 Reg. § 1.761-2(a)(2), (3). CCA 201323015 asserted that a joint venture between two corporations could not make this election. It was not an investment partnership under Reg. § 1.761-2(a)(2) for either one of two reasons:

- The product produced did not qualify as "investment property" (looking to the Code § 148(b)(2) definition of "investment property" the Reg. § 1.148-1(e) definition of "investment-type property").
- It actively conducted the business of producing and selling the product.

The joint venture failed the requirements of Reg. § 1.761-2(a)(3) because the two corporations jointly sold the product.

483 [my footnote – not found in the regulations that are quoted above:] The IRS has asserted that "coowners" means direct co-ownership and not ownership through a commonly owned LLC. FSA 200216005.

exchange such investment property, although each separate participant may delegate authority to purchase, sell, or exchange his share of any such investment property for the time being for his account, but not for a period of more than a year, …. [or]

(3) *Operating agreements*. Where the participants in the joint production, extraction, or use of property—

(i) Own the property as coowners, either in fee or under lease or other form of contract granting exclusive operating rights, and

(ii) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and

(iii) Do not jointly sell services or the property produced or extracted, although each separate participant may delegate authority to sell his share of the property produced or extracted for the time being for his account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than 1 year....

This election-out of partnership treatment applies only for the purposes of the partnership income tax rules of subchapter K.[484]

A group of owners of undivided interests in rental real property[485] might seek a private letter ruling that their ownership does not rise to the level of being a partnership. To do so, they must satisfy the following conditions:[486]

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[484] In *Methvin v. Commissioner*, T.C. Memo. 2015-81, *aff'd* 117 A.F.T.R.2d 2016-XXXX (10th Cir. 6/24/2016), the Tax Court held:

> Petitioner also argues that in article 14 of the operating agreement the parties specifically elected to be excluded from the application of subchapter K and therefore cannot be considered a partnership. We have held that making this election "'does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed.'" *Cokes v. Commissioner*, 91 T.C. at 230-231 (quoting *Bryant v. Commissioner*, 46 T.C. 848, 864 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968)). Accordingly, the parties' election under section 761(a) does not prevent us from finding that the operating agreements created a partnership.
>
> We conclude that the working interest owners and well operator created a pool or joint venture for operation of the wells. Accordingly, petitioner's income from the working interests was income from a partnership of which he was a member under the broad definition of "partnership" found in section 7701(a)(2). See *Cokes v. Commissioner*, 91 T.C. at 232; *Bentex Oil Corp. v. Commissioner*, 20 T.C. 565 (1953). Therefore, petitioner is liable for self-employment tax on the net income received from his working interests.

[485] For an excellent discussion of taxation of tenants-in-common, as well as when such an arrangement is taxed as a partnership, see Tucker and Langlieb, fn. 1041. In Letter Ruling 200826005, two individuals held a number of properties together, and their tenancy-in-common agreements, which included buy-sell provisions, were held not to constitute a partnership. As natural products of the land that are attached to the land, commercial plants, that were mature,

Each of the co-owners must hold title to the Property (either directly or through a disregarded entity) as a tenant in common under local law. Thus, title to the Property as a whole may not be held by an entity recognized under local law.

The number of co-owners must be limited to no more than 35 persons. For this purpose, “person” is defined as in § 7701(a)(1), except that a husband and wife are treated as a single person and all persons who acquire interests from a co-owner by inheritance are treated as a single person.

The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value (determined as of the time the partition right is exercised) before exercising any right to partition (see section 6.06 of this revenue procedure for conditions relating to restrictions on alienation); or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the Property (see section 6.05 of this revenue procedure for conditions relating to voting).

The co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the Property, any leases of a portion or all of the Property, or the creation or modification of a blanket lien. Any sale, lease, or re-lease of a portion or all of the Property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners. For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the Property. A co-owner who has consented to an action in conformance with this section 6.05 may provide the manager or other person a power of attorney to execute a specific document with respect to that action, but may not provide the manager or other person with a global power of attorney.

If the Property is sold, any debt secured by a blanket lien must be satisfied and the remaining sales proceeds must be distributed to the co-owners.

Each co-owner must share in all revenues generated by the Property and all costs associated with the Property in proportion to the co-owner’s undivided interest in the Property. Neither the other co-owners, nor the sponsor, nor the manager may advance funds to a co-owner to meet expenses associated with the co-ownership interest, unless the advance is recourse to the co-owner (and, where the co-owner is a disregarded entity, the owner of the co-owner) and is not for a period exceeding 31 days.

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had complex root systems, and were expected to produce a commercially harvestable crop, constituted real estate under Code § 865. Letter Ruling 201424017.

[486] Rev. Proc. 2002-22, Section 6, as modified by Rev. Proc. 2003-3, Section 1.02(8), which deleted Sections 6.03 and 6.06 of Rev. Proc. 2002-22.

The co-owners must share in any indebtedness secured by a blanket lien in proportion to their undivided interests.

A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the Property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the Property is equal to the co-owner's percentage interest in the Property multiplied by the fair market value of the Property as a whole. A co-owner may not acquire an option to sell the co-owner's undivided interest (put option) to the sponsor, the lessee, another co-owner, or the lender, or any person related to the sponsor, the lessee, another co-owner, or the lender.

The co-owners' activities must be limited to those customarily performed in connection with the maintenance and repair of rental real property (customary activities). See Rev. Rul. 75-374, 1975-2 C.B. 261. Activities will be treated as customary activities for this purpose if the activities would not prevent an amount received by an organization described in § 511(a)(2) from qualifying as rent under § 512(b)(3)(A) and the regulations thereunder. In determining the co-owners' activities, all activities of the co-owners, their agents, and any persons related to the co-owners with respect to the Property will be taken into account, whether or not those activities are performed by the co-owners in their capacities as co-owners. For example, if the sponsor or a lessee is a co-owner, then all of the activities of the sponsor or lessee (or any person related to the sponsor or lessee) with respect to the Property will be taken into account in determining whether the co-owners' activities are customary activities. However, activities of a co-owner or a related person with respect to the Property (other than in the co-owner's capacity as a co-owner) will not be taken into account if the co-owner owns an undivided interest in the Property for less than 6 months.

The co-owners may enter into management or brokerage agreements, which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner (or any person related to the sponsor or a co-owner), but who may not be a lessee. The management agreement may authorize the manager to maintain a common bank account for the collection and deposit of rents and to offset expenses associated with the Property against any revenues before disbursing each co-owner's share of net revenues. In all events, however, the manager must disburse to the co-owners their shares of net revenues within 3 months from the date of receipt of those revenues. The management agreement may also authorize the manager to prepare statements for the co-owners showing their shares of revenue and costs from the Property. In addition, the management agreement may authorize the manager to obtain or modify insurance on the Property, and to negotiate modifications of the terms of any lease or any indebtedness encumbering the Property, subject to the approval of the co-owners. (See section 6.05 of this revenue procedure for conditions relating to the approval of lease and debt modifications.) The determination of any fees paid by the co-ownership to the manager must not depend in whole or in part on the income or profits derived by any person from the Property and may not exceed the fair market value of the manager's services. Any fee paid by the co-ownership to a broker must be comparable to fees paid by unrelated parties to brokers for similar services.

> All leasing arrangements must be bona fide leases for federal tax purposes. Rents paid by a lessee must reflect the fair market value for the use of the Property. The determination of the amount of the rent must not depend, in whole or in part, on the income or profits derived by any person from the Property leased (other than an amount based on a fixed percentage or percentages of receipts or sales). See section 856(d)(2)(A) and the regulations thereunder. Thus, for example, the amount of rent paid by a lessee may not be based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements.
>
> The lender with respect to any debt that encumbers the Property or with respect to any debt incurred to acquire an undivided interest in the Property may not be a related person to any co-owner, the sponsor, the manager, or any lessee of the Property.
>
> Except as otherwise provided in this revenue procedure, the amount of any payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the Property.

A co-tenancy agreement satisfied these requirements, where the initial landlord owned 100% of the property through a disregarded LLC and had the right to sell fractional interests to the tenant (or the tenant's disregarded LLC) for fair market value, determined taking the initial appraised value and increasing it annually by a flat percentage that was a reasonable appreciation factor.[487]

See also part II.D.1 Trust as a Business Entity for whether pooling together ownership interests rises to the level of a business entity, when the owners used a trust to own real estate – especially for guidelines on whether a lease arrangement might separate ownership of the real estate from the activity done on the property.

Spouses who own and operate a business as co-owners and who materially participate[488] may elect to treat the business as a disregarded entity (a "qualified joint venture")[489] if it is not in the name of a limited partnership, limited liability company or other state law entity.[490] If both spouses make that election, then "all items of income,

[487] Letter Ruling 201622008.
[488] Code § 761(f)(2)(B) cross-references Code § 469(h) but eliminates the application of Code § 469(h)(5), the latter of which would let each spouse count the other's participation. For more on Code § 469(h), see part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules.
[489] Code §761(f)(2), effective tax years beginning after December 31, 2006.
[490] If one goes to www.irs.gov, searches "qualified joint venture," and follows the hyperlink entitled "Election for Husband and Wife Unincorporated Businesses," then one can find (at https://www.irs.gov/businesses/small-businesses-self-employed/election-for-husband-and-wife-unincorporated-businesses when I last searched) the IRS' view that a state law entity owned by a married couple cannot qualify for treatment as a qualified joint venture. Similarly, an LLC owned by spouses does not qualify under special procedures for a favorable private letter ruling, which pre-date Code § 761(f) but remain in effect; see Section 6.01 of Rev. Proc. 2002-22 (which does,

gain, loss, deduction, and credit shall be divided between the spouses in accordance with their respective interests in the venture, and each spouse shall take into account such spouse's respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor.[491] Thus, each reports his or her portion of business income on a separate Schedule C or E.[492]

A purported partnership shall be treated as a lease of property if the arrangement is properly treated as a lease of property, taking into account all relevant factors.[493]

For additional ways that co-owners might escape partnership income tax treatment, see part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes.

When an LLC that is taxed as a partnership signed a revenue sharing agreement with a person, held him out as an owner, and treated him as a partner in tax filings, the person was taxed as a partner even though he never signed the LLC's operating agreement and even though the K-1 the LLC issued to him reported only guaranteed payments and no profits interest.[494]

Transitory ownership in a partnership with almost no rights does not make a person a partner:[495]

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however, allow each spouse to have a single member LLC and have those LLCs own the properties as tenants in common). The IRS' view does not appear to be confirmed or refuted by the legislative history.

[491] Code §761(f)(1), effective tax years beginning after December 31, 2006.

[492] Chief Counsel Advice 200816030 held that active rental that qualified as a Code § 761(f) trade or business did not generate self-employment income, reasoning that Code § 1402(17) is intended to allocate income one-half to each spouse rather than overriding various exceptions (including the rental exception) to self-employment tax. This CCA carries much more weight than most CCAs, as it was to the Asst. Division Counsel (Prefiling) (Small Business/Self-Employed) from the Branch Chief, Employment Tax Branch 1 (Exempt Organizations/Employment Tax/Government Entities) and recommended specific procedures for IRS Service Centers. See also "New Law Has Social Security Impact on Husband-Wife Partnerships," *Business Entities* (WG&L), Jan/Feb 2009.

[493] Code § 7701(e)(2).

[494] *Cahill v. Commissioner*, T.C. Memo. 2013-220. This case involved an insurance agent. The court pointed out:

> Petitioner entered into the memorandum of agreement and the revenue sharing agreement, both of which provided for the mechanism under which he would share in the profits of FC/CFC. Moreover, the memorandum of agreement and the revenue sharing agreement stated that FC/CFC would issue petitioner a Form 1099-MISC or a Schedule K-1 with respect to any money he received under either agreement. There is no indication in the record that petitioner objected to receiving a Schedule K-1 on the grounds that he was not a partner.

The court also pointed out that the parties held out the taxpayer as an owner and changed the LLC's name to include the taxpayer's.

[495] CCA 201507018, which also invoked Reg. § 1.701-2 to disregard a transitory interest as a partner in a partnership:

> In this case, Partner purportedly transferred Units in Partnership with a low basis and a high fair market value to Organization, for which Partner took a charitable deduction based on the fair market value of Units on Partner's personal tax return. Subsequently, Partner arranged for Organization to sell those Units to Corp for the Note. As a result of

> In the present case, Organization, as an assignee of Partner, was not a full-fledged partner of Partnership. Partner's assignment of Units to Organization entitled Organization to distributions made with respect to Units while Partner retained all other indicia of ownership of Units. Organization was only an assignee of Partner for one day before the Organization transferred it rights in Units to Corporation in exchange for Note. Partner determined the selling price of Units. Organization's momentary rights to distribution (which are totally controlled by Partner) are not sufficient to make Organization a partner in Partnership. Organization had no meaningful right to participate in Partnership's success or failure and as such, was not in substance a partner of Partnership.

II.C.10. General Partnership

In general partnerships, which are governed by the Uniform Partnership Act, all partners have management rights and are jointly and severally liable for the partnership's activities. For how to limit liability, see part II.C.12 Limited Liability Partnership Registration for General Partners in General or Limited Partnerships.

A general partnership can be formed by an express agreement or through an activity in which co-owners work together to try to earn a profit (even if a general partnership was not intended).

II.C.11. Limited Partnership

A limited partnership is formed by filing a Certificate of Limited Partnership with the secretary of state for the state in which the partnership is formed. The Uniform Limited Partnership Act limits the rights and liability of limited partners and vests control in the general partners. The rights and liabilities of the general partners among themselves, including joint and several liability for the limited partnership's activities, are governed by the Uniform Partnership Act; see part II.C.12 Limited Liability Partnership Registration for General Partners in General or Limited Partnerships.

A limited partnership needs to have at least one general partner (GP) and one limited partner, and the same person cannot be both the sole general partner and the sole limited partner. However, for example, the GP could be an individual, and the limited partner could be that individual's revocable trust. Such a limited partnership would be disregarded for income tax purposes unless it elects to be treated as a corporation. The GP being an individual simplifies the signature line and also causes the GP's liability to be extinguished with respect to any creditor that does not file a claim in probate court within the prescribed time period (one year or less under most nonclaim statutes) after the GP's death.

> this second purported transfer, Corp takes a deduction for interest payments on Note and a goodwill amortization deduction as a result of Partnership's § 743(b) adjustment. In this way, Partner and Partner affiliates take three deductions for one charitable contribution that never in substance occurred. Transaction significantly reduced Partner and Corp's tax liability. The purported transfer of Units to Organization was necessary to achieve that claimed result. Organization, an assignee of Partner with respect to Units, only momentarily had rights to distributions and no other rights to Units.

II.C.12. Limited Liability Partnership Registration for General Partners in General or Limited Partnerships

In recent years, the Uniform Partnership Act has added an optional feature to limit the liability of general partners of general or limited partnerships. This feature allows the general partners to limit their liability by registering the entity as a limited liability partnership (LLP) with the secretary of state.

A limited partnership with an LLP registration is known as a limited liability limited partnership (LLLP).

However, in Missouri, LLP (or LLLP) registration often is not quite as easy as LLC registration, and it cannot be retroactively reinstated if not renewed timely.

II.C.13. Penalty for Failure to File a Partnership Return

Failure to file a partnership return is subjected to a penalty of $125 times the number of partners or shareholders for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months.[496]

However, this penalty does not apply if ten or fewer owners are involved and each owner fully reports that owner's share of the income, deductions, and credits of the partnership;[497] this rule is based on the version of Code § 6231 that will not apply to returns filed for partnership taxable years beginning after December 31, 2017.[498]

Also, a partnership with no income, deductions, or credits for Federal income tax purposes for a taxable year is not required to file a partnership return for that year.[499]

Co-tenants of real estate who fit within this safe harbor should avoid filing partnership returns, to facilitate future like-kind exchanges of real estate.[500]

II.C.14. Partner's Right to Copy of Partnership Tax Return

Upon request, a partnership must disclose its federal return to "any person who was a member of such partnership during any part of the period covered by the return."[501]

However, "the information inspected or disclosed shall not include any supporting schedule, attachment, or list which includes the taxpayer identity information of a person other than the entity making the return or the person conducting the inspection or to whom the disclosure is made."[502]

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[496] Code § 6698(b)(1). The penalty is $89 instead of $125 for taxable years beginning before January 1, 2010. Program Manager Technical Advice (PMTA) 2013-015 provides advice on the application of failure to file penalties to S corporations and partnerships.
[497] Rev. Proc. 84-35.
[498] For changes to partnership audit rules, see part II.G.18.c Audits of Partnership.
[499] Reg. § 301.6031(a)-(1)(a)(3)(i).
[500] See Letter Ruling 9741017, described in fn. 453.
[501] Code § 6103(e)(1)(C).
[502] Code § 6103(e)(10).

II.D. Special Purpose Trusts

Sometimes multiple owners would like to hold investment or business assets together without being subjected to the complexities of partnership income tax.

Below are discussions of when a multiple owner trust might be considered to be a business entity and when the trust might be disregarded entirely.

For rules that apply to most trusts, see part II.J Fiduciary Income Taxation.

II.D.1. Trust as a Business Entity

For a traditional trust, conducting business activities does not somehow turn the trust into a business entity. For details, see part II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.

If more than one person contributes to a trust so that they can profit from investments or business activity, a trust might be classified as a business activity.

The case that set the tone for classifying arrangements as business entities for well over 60 years, *Morrissey v. Commissioner*,[503] classified a trust as a corporation:

> The trustees were authorized to add to their number and to choose their successors; to purchase, encumber, sell, lease, and operate the "described or other lands"; to construct and operate golf courses, club houses, etc.; to receive the rents, profits, and income; to make loans and investments; to make regulations; and generally to manage the trust estate as if the trustees were its absolute owners. The trustees were declared to be without power to bind the beneficiaries personally by "any act, neglect or default," and the beneficiaries and all persons dealing with the trustees were required to look for payment or indemnity to the trust property. The beneficial interests were to be evidenced solely by transferable certificates for shares which were divided into 2,000 preferred shares of the par value of $100 each, and 2,000 common shares of no par value, and the rights of the respective shareholders in the surplus, profits, and capital assets were defined. "Share ledgers" showing the names and addresses of shareholders were to be kept.

Morrissey contrasted the single grantor trust from the multi-grantor trust:

> "Association" implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust — whether created by will, deed, or declaration — by which particular property is conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons. Such beneficiaries do not ordinarily, and as mere cestuis que trust, plan a common effort or enter into a combination for the conduct of a business enterprise. Undoubtedly the terms of an association may make the taking or acquiring of shares or interests sufficient to constitute participation, and

[503] 296 U.S. 344 (1935).

> may leave the management, or even control of the enterprise, to designated persons. But the nature and purpose of the co-operative undertaking will differentiate it from an ordinary trust. In what are called "business trusts" the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains. Thus a trust may be created as a convenient method by which persons become associated for dealings in real estate, the development of tracts of land, the construction of improvements, and the purchase, management, and sale of properties; or for dealings in securities or other personal property; or for the production, or manufacture, and sale of commodities; or for commerce, or other sorts of business; where those who become beneficially interested, either by joining in the plan at the outset, or by later participation according to the terms of the arrangement, seek to share the advantages of a union of their interests in the common enterprise.

After recounting how the ownership structure was like that of a corporation, *Morrissey* explained the significant level of activity:

> They were not the less associated in that undertaking because the arrangement vested the management and control in the trustees. And the contemplated development of the tract of land held at the outset, even if other properties were not acquired, involved what was essentially a business enterprise. The arrangement provided for centralized control, continuity, and limited liability, and the analogy to corporate organization was carried still further by the provision for the issue of transferable certificates.
>
> Under the trust, a considerable portion of the property was surveyed and subdivided into lots which were sold and, to facilitate the sales, the subdivided property was improved by the construction of streets, sidewalks, and curbs. The fact that these sales were made before the beginning of the tax years here in question, and that the remaining property was conveyed to a corporation in exchange for its stock, did not alter the character of the organization. Its character was determined by the terms of the trust instrument. It was not a liquidating trust; it was still an organization for profit, and the profits were still coming in. The powers conferred on the trustees continued and could be exercised for such activities as the instrument authorized.

Although the check-the-box regulations overrode the prior regulations the arose from *Morrissey*, they did so only with respect to whether a business entity is classified as a corporation or a partnership, not whether a trust is classified as a business entity.[504] So, let's look further at *Morrissey* and the cases and ruling it spawned.

Sears v. Hassett[505] recharacterized the following trust as a business entity:

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[504] I am unaware of any case addressing this issue after the adoption of Reg. § 301.7701-4(a). The regulation's preamble, T.D. 8697, provides:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

[505] 111 F.2d 961 (1st Cir. 1940).

The trustees have wide powers to buy and sell real estate;[3] to improve and develop the same by the erection of buildings, or otherwise; to repair or rebuild any building damaged by fire or otherwise; to lease; to employ such agents here and assistants as deemed necessary; to invest and reinvest funds "in any securities they see fit"; to pay from the net income of the trust property "such dividends to the beneficiaries as they may from time to time deem expedient". In quest of profits the trustees are in effect empowered to engage in extensive real estate operations and in the business of investing and reinvesting in securities. Even if at any time all of the real estate may have been disposed of, the termination of the trust is at the absolute discretion of the trustees. In the language of the *Morrissey* case, 296 U.S. at page 357, 56 S.Ct. at page 295, 80 L.Ed. 263, this trust provides "a medium for the conduct of a business and sharing its gains". As was said in the *Coleman-Gilbert* case, *supra*, "the parties are not at liberty to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted".

[3] The trust indenture provides: "The trustees may purchase with such funds as they may from time to time have in their hands any real estate or any interest in real estate encumbered or unencumbered, and may hire and become lessees of any property, easement or right, the use of which is, in their judgment, advantageous to real estate held hereunder." Appellants contend that this does not confer an unrestricted power to purchase land, but that the power to purchase as well as the power to become lessees of land is limited by the last clause in the provision just quoted. We do not so read this provision of the indenture, but our conclusion would not be different if the narrower interpretation were given.

However, when beneficiaries of an estate formed a couple of trusts and the trustees merely executed and extended the leases and collected and distributed the rents, the trusts were not business entities.[506] Another case holding that trusts were not business

[506] *Wyman Building Trust v. Commissioner*, 45 B.T.A. 155 (1941), *acq.*, 1941-2 C.B. 14, holding:

One important element in deciding whether a trust is taxable as a corporation is its form—does it resemble a corporation? *Morrissey v. Commissioner*, 296 U. S. 344; *Sears v. Hassett*, 111 Fed.(2d) 961. This trust does bear some resemblance to a corporation in form. But that circumstance is not necessarily determinative, "it must also have been created as a joint enterprise for the carrying on of a business and sharing its gains, as distinguished from the mere holding and conserving of particular property, with incidental powers, as in the traditional type of trusts." *Sears v. Hassett*, *supra*. These trusts were not intended or permitted to deal with other than a single piece of property. They could not deal with the property generally. Their only purpose was to provide a convenient authority for executing and extending the leases on behalf of a more cumbersome group of beneficial owners and for receiving and distributing the rent. There was no larger purpose to engage in business or to deal with the property in other ways. *Cf. Sears v. Hassett*, *supra*. The lessee paid all expenses, including taxes and repairs. There was no change in the lessee or the provisions of the leases. The only change in beneficiaries was caused by death. The trusts were for definite, short terms. Some of these circumstances may be fortuitous and of little or no significance, but the case is as strong for the taxpayer as some other recent ones. *Cf. Commissioner v. i denied*, 312 U.S. 704; *Lewis & Co. v. Commissioner*, 301 U. S. 385.

entities involved a little more management by the trustee, with some of the beneficiaries directing the trustees on behalf of the others:[507]

> At the time of creation of the respective trusts, two parcels of the real estate were managed by a real estate agency and the remaining properties were directly managed by the sons of decedent, who acted as agents for the other beneficiaries in the making of leases, supervising repairs, erecting new buildings, etc. There was a contemporaneous oral agreement between the parties to the written trusts that where the properties involved were managed by members of the family or beneficiaries, such persons would be considered agents of the beneficiaries of the trusts, and the properties have been so managed since the creation of the trusts. Leases have been negotiated, tenants secured, rentals fixed and repairs and improvements made by the members of the family in the management of the properties of the trusts. In some instances, buildings have been erected or the existing ones remodeled, the necessity for which was determined by members of the Gibbs family, contracts for the work executed by them and the necessary funds contributed by the beneficiaries.
>
> The trustee paid for insurance and taxes from the trust income whenever the lease did not require the lessee to do so, but the members of the family selected the company in which the insurance was placed and the amount to be carried.
>
> On the execution of the trust instruments, certificates of beneficial interest were issued to the several beneficiaries in proportion to their respective interests, some of which have been since transferred in trust for other members of the family. The trustee has at no time exercised control or management of any of the trust property, but has limited its activities to the holding of legal title to them, the payment of taxes and maintenance and insurance items upon order of a member of the Gibbs family. It has signed leases at the direction of members of the family, collected the rents, paid the bills and kept the necessary records. There have been no sales of any of the real estate in the trusts nor any additional purchased and no accumulations of funds by the trustee except for the payment of taxes.

> The *Sears* case, *supra*, is distinguishable. The court looked at the entire purpose and history of the Sears trust and saw that it had a broad purpose and extensive powers to deal with a number of properties to the best advantage of the beneficial owners for an indefinite time. Here the purpose and powers as set forth in the instruments were much more limited.

Lewis & Co .involved only one grantor, who assigned his interest in the trust to only one purchaser, who then died. *Commissioner v. Gibbs-Preyer Trusts* is the case described in fn. 507 and the accompanying text.

[507] *Commissioner v. Gibbs-Preyer Trusts Nos. 1 & 2*, 117 F.2d 619 (6th Cir. 1941), holding:

> In the present cases, the trustee did nothing of any consequence with respect to the management and conduct of the business, all of it being carried on by the cestuis que trustent. Article X of the trust instruments limited the duties of the trustee substantially to the receipt of rentals, keeping accounts and making distribution of net rentals to the cestuis que trustent.

The case from which the quote above was excerpted involved the IRS trying to tax the trust as a corporation. It did not address whether the owners had formed a partnership that then created a trust.

The following trust was treated as a business entity:[508]

> The heirs to a number of contiguous parcels of real estate established a real estate trust, *T*. *T* is to collect the income from the real estate and to distribute such income to the heirs.
>
> The real estate transferred to *T* is subject to a net lease, which provides that the lessee will pay all property taxes, betterment assessments, water rates, sewer and utility charges, and fire and general public liability insurance. The lessee is required to manage, maintain, and repair the property under the terms of the lease.
>
> The property transferred to *T* was allocated on its books in undivided fractional interests, corresponding to each heir's interest in the property contributed.
>
> All the income of *T* is required to be distributed quarterly. *T*'s governing instrument may be amended by the consent of all the beneficiaries, and *T* will terminate 30 years from the date of its creation, unless terminated earlier by the consent of all the beneficiaries.
>
> Upon an express determination by the trustees that it is necessary to conserve or protect *T*'s real estate, beneficiaries or members of their families may contribute to *T* interests in real estate adjacent or contiguous to the real estate held in trust by *T*, in which event such persons shall become additional beneficiaries.
>
> If necessary to conserve and protect the value of *T*'s real estate, the trustees of *T* have the power to accept from any source and retain real estate contiguous or adjacent to the trust's real estate. The trustees also have the power to sell any real estate of the trust, and may purchase any real estate adjacent or contiguous to the real estate originally contributed to *T*, including any tangible personal property located on such real estate. Funds derived from the sale of property held by *T* and not reinvested in real estate can only be invested in certificates of deposits, or obligations of federal or state governments.

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[508] Rev. Rul. 78-371, citing *Wyman* from fn 506 and *Sears* from fn. 505, holding:

> While the facts in the instant case are similar to the facts in *Wyman*, the trustees of *T* also have the power to purchase and sell contiguous or adjacent real estate, and to accept and retain contributions of contiguous or adjacent real estate from the beneficiaries or members of their families. The trustees have the further power to raze or erect any building or other structure and make any improvements they deem proper on the land originally donated to the trust or on any adjacent or contiguous land subsequently acquired by the trust. The trustees are also empowered to borrow money and to mortgage and lease the property. These additional powers taken together indicate that the trustees of *T* are empowered to do more than merely protect and conserve the trust's property. Thus, the arrangement, in the instant case, is similar to the trust ruled to be an association in the *Sears* case.

> The trustees are further empowered to borrow money, mortgage and lease property, raze or erect any building or other structure, and make any improvements they deem proper.

Shortly thereafter, the following trust was not held to be a business entity:[509]

> Individuals A, B, and C, who owned a commercial building and the land upon which it was situated as tenants in common, established a trust with a bank as trustee. Simultaneously, A, B, and C transferred the land and building to the trust and named themselves as beneficiaries. A, B, and C receive proportionate quarterly distributions of all net income of the trust.
>
> The trust agreement provides that the purpose of the trust is to empower the trustee to act on behalf of the beneficiaries as signatory of leasing agreements and management agreements, to hold title to the land and building and to the proceeds and income of the property, to distribute all trust income and to protect and conserve the property.
>
> The beneficiaries' interests in the trust are evidenced by certificates that are transferable only on the death of a beneficiary or by unanimous written agreement of the beneficiaries. In addition, after the initial contribution no additional contributions may be made to the trust.
>
> The beneficiaries must approve all agreements entered into by the trustee and they are personally liable for all debts of the trust. The trustee may determine whether to allow minor nonstructural alterations to the building and can institute legal or equitable action to enforce any provisions of a lease. The trust will terminate upon the sale of substantially all its assets or upon unanimous agreement of the beneficiaries.
>
> The beneficiaries directed the trustee to sign a lease of the property to X, a corporation, for 20 years with options for three six-year extensions. X is to pay all taxes, assessments, fees or other charges imposed on the property by federal, state or local authorities. In addition, X is to pay for all insurance, maintenance, repairs, and utilities relating to the property.
>
> The trustee as lessor prepared the building for X's use and can approve additional alterations by X only if the alterations protect and conserve the building or are required by law. The rent remains fixed for 20 years, but if the lease is renewed the rent will be recomputed based on the fair market value of the property. X has an option to purchase the property every tenth year during the

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[509] Rev. Rul. 79-77, citing Rev. Rul. 78-371 in fn. 508 and *Wyman* in fn. 506, held:

> This case is distinguishable from Rev. Rul. 78-371 in that the trustee is restricted to dealing with a single piece of property subject to a net lease. Further, the trustee has none of the powers described in Rev. Rul. 78-371. Thus, the arrangement is similar to the trust held not to be a corporation in the WYMAN case.
>
> HOLDING. The arrangement is classified as a trust for federal income tax purposes. Further, A, B, and C are the owners of the trust and are taxable on the income therefrom under subpart E of subchapter J, chapter 1 of the Code (sections 671-678).

> term of the initial lease for an amount equal to the greater of the property's cost to the owners or its fair market value.

When two investors formed trust to hold real estate to facilitate their estate planning as a form of ownership by which later transfers of beneficial interest to other members of their families would be permitted, the trustee's role was passive,[510] and the IRS attacked the trust when the investors has passed their interests to their beneficiaries, the trust was not a business entity because the beneficiaries were not associates.[511]

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[510] *Elm Street Realty Trust v. Commissioner*, 76 T.C. 803 (1981), described the trustee's Johnson's role and relationship with the grantors:

> Johnson's understanding with respect to the Elm Street Realty Trust was that it was to be a passive trust; his duties would be to collect the rent from the tenant, pay the mortgage and distribute the income. The lease was a net lease under which Risley bore all expenses in connection with the property. Moreover, the trust was a "simple" trust which did not allow for any accumulation of income.
>
> It was never suggested to Johnson that the trust purchase additional property. He had no duties with respect to the Elm Street property because they were all assumed by the lessee. He never had occasion to confer with any of the beneficiaries regarding the real estate nor did he ever see the trust real estate.
>
> The various discretionary powers given to the trustee in the declaration of trust were inserted by Johnson as the attorney who drafted the trust instrument, without any participation by Egan and Harvey. It was Johnson's practice to include such powers in trust instruments in order to deal with any problems that might result from a wide array of unforeseen circumstances (*e.g.*, fire, disaster, condemnations, etc.). Johnson never discussed the wording of these powers with Egan and Harvey.

[511] *Elm Street Realty Trust v. Commissioner*, 76 T.C. 803 (1981), described the beneficiaries' roles:

> Turning to the circumstances of the instant case in light of the above-mentioned considerations, we note that the beneficiaries played no role in petitioner's creation. Egan and Harvey transferred the Elm Street property to petitioner and were the original beneficiaries, but they soon thereafter assigned their interests pursuant to article Sixth of the declaration of trust. It also appears that the subsequent beneficiaries received their interests gratuitously.[4] We think it can be safely said that the individuals who were petitioner's beneficiaries during the years in issue played no active role either in the creation of petitioner or upon their subsequent entrance into a beneficial relationship with the trust.[5]
>
> [4] This fact can be reasonably inferred from the lack of consideration referred to in the assignment documents as well as the estate planning purpose which Egan and Harvey stated as being one of the main reasons they chose a trust form of ownership.
>
> [5] For example, beneficiaries' purchase of beneficial interests would tend to indicate the presence of associates, since the purchase signifies a voluntary and affirmative entrance into the enterprise. See *Second Carey Trust v. Helvering*, 126 F.2d 526 (D.C. Cir. 1942), *cert. denied* 317 U.S. 642 (1942).
>
> The interests of the beneficiaries in the trust were transferable only under certain restrictive provisions contained in article Sixth. That article generally prohibited a transfer of the beneficiaries' interests with the exception of testamentary transfers pursuant to the will of a beneficiary and transfers assented to by the trustee and all of the other beneficiaries. The requirement that all other beneficiaries agree to any transfer of a beneficial interest imposes a substantial limitation on free transferability (sec. 301.7701-2(e)(1), Proced. & Admin. Regs.), and thus significantly hinders the ability of the beneficiaries to voluntarily and unilaterally substitute others for themselves as associates.

If the beneficiaries are associates in a joint enterprise for the conduct of business for profit, then the trust might be characterized as a business entity, not only for tax purposes[512] but also under state partnership law.[513] A business trust, created by the beneficiaries simply as a device to carry on a profit-making business that normally would have been carried on through a corporation or partnership, might be treated as a business entity.[514]

> The beneficiaries' other powers under the trust instrument included the authority to appoint a successor trustee in the event of the trustee's death, inability to serve, or resignation; amend or modify the trust instrument if acknowledged in writing by the trustee and all of the other beneficiaries; and terminate the trust prior to the expiration of the stated 11-year period if all of the beneficiaries notified the trustee in writing, or if any 25-percent (or greater) interestholder notified the trustee, subject to the trustee's absolute discretion to refuse to terminate the trust.
>
> In our view, the ability of the beneficiaries to influence or otherwise participate in the trust's activities is limited in scope by virtue of the conditions attached to the exercise of the relevant powers — either concurrence by all of the beneficiaries or concurrence of the trustee in addition. Although petitioner possessed a business objective, the evidence concerning the trust's creation and its subsequent operations does not indicate that the beneficiaries affirmatively planned or entered into a joint effort for the conduct of a common enterprise. Similarly, the nature of the beneficiaries' interests, including the powers incident thereto, does not suggest that they could effect an unfettered, significant influence on petitioner. We thus conclude that petitioner's form did not afford a medium by which the beneficiaries could conduct income-producing activities through a quasi-corporate entity. The beneficiaries were not associates for purposes of section 7701(a)(3) and the regulations thereunder.

[512] Reg. § 301.7701-4(a) provides that generally a trust will be respected as a trust if its purpose is to "vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit."

[513] *Roby v. Colehour*, 25 N.E. 777, 778 (Ill. Supreme Ct. 1890).

[514] Reg. § 301.7701-4(b), which elaborates:

> … the fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership. The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under § 301.7701-2.

Rev. Rul. 88-79 treated as a business entity the following arrangement:

> Six individuals formed an organization, O, in Missouri, under the terms of an Agreement styled "Royalty Trust Agreement" (Agreement). O was formed for the purpose of buying, holding, and selling oil and gas royalty interests. The six individuals, referred to in the Agreement as the managers, contributed cash to O in exchange for certificates of beneficial interest. The managers of O collectively have substantial assets other than their interests in O. Certificates of beneficial interest were sold also to members of the general public pursuant to a public offering registered with the Securities and Exchange Commission. The agreement refers to these public investors as participants. The certificates of beneficial interest represent the right to share in the profits and losses of O and the right to a share of the assets of O upon its liquidation. The managers own 10 percent of the certificates of beneficial interest, and the participants own the remaining 90 percent.
>
> The Agreement provides that the investment activity of O is to be controlled and managed solely by the managers. The managers will determine the timing and amount

A trust that constitutes a pooling of assets that are actively managed is at risk for being treated as a business entity.[515] For example, the IRS ruled that a trust formed by a couple and their grandchildren would not qualify as a charitable remainder trust (or be taxed as any type of trust), because the grantors would be deemed associates who pooled their assets with an object to carry on business and divide the gains therefrom.[516] It also ruled that a trust and subtrusts to control the exploitation of the patents, which would distribute to the grantors the royalties received from licensing the patents (net of administration expenses and other required payments), was a partnership.[517]

Some trusts with multiple owners are disregarded for income tax purposes,[518] including unit investment trusts, which limit the trustee's role to a relatively passive one.[519] Rev. Rul. 2004-86 ruled that a Delaware statutory trust (DST)[520] owned by multiple investors who invested to make a profit was a unit investment trust that was a disregarded entity rather than a partnership. Rev. Rul. 2004-86 involved the following:

> On January 1, 2005, A, an individual, borrows money from BK, a bank, and signs a 10-year note bearing adequate stated interest, within the meaning of § 483. On January 1, 2005, A uses the proceeds of the loan to purchase Blackacre, rental real property. The note is secured by Blackacre and is nonrecourse to A.
>
> Immediately following A's purchase of Blackacre, A enters into a net lease with Z for a term of 10 years. Under the terms of the lease, Z is to pay all taxes, assessments, fees, or other charges imposed on Blackacre by federal, state, or local authorities. In addition, Z is to pay all insurance, maintenance, ordinary repairs, and utilities relating to Blackacre. Z may sublease Blackacre. Z's rent is a fixed amount that may be adjusted by a formula described in the lease agreement that is based upon a fixed rate or an objective index, such as an escalator clause based upon the Consumer Price Index, but adjustments to the rate or index are not within the control of any of the parties to the lease. Z's rent is not contingent on Z's ability to lease the property or on Z's gross sales or net profits derived from the property.

> of distributions from O to the certificate holders. Although the Agreement designates a commercial bank to serve as a trustee of O, the trustee does nothing more than hold legal title to the assets of O. The managers may replace the trustee with another bank at any time.
>
> ….
>
> Under the terms of the Agreement, O has associates and an objective to carry on business and divide the gains therefrom, and, therefore, O is not classified as a trust for tax purposes. Rather, it is classified as a partnership or as an association….

Rev. Rul. 98-37 obsoleted Rev. Rul. 88-79 in light of Reg. § 301.7701-4(a), but fn. 2302 indicates that Reg. § 301.7701-4(a) was not intended to change the principles of prior law.

[515] See generally Zaritsky, Lane & Danforth, "¶ 1.07 The Income Tax Meaning of 'Trust,'" *Federal Income Taxation of Estates and Trusts* (WG&L).

[516] Letter Ruling 9547004.

[517] Letter Ruling 200219017.

[518] See part II.D Special Purpose Trusts.

[519] See part II.D.4.a Investment Trusts.

[520] The DST Act provides much freedom to contractually set rules. See Swoyer, "Don't Let the Name Fool You: Delaware Statutory Trusts are Controlled by Contract," *Business Law Today* (12/2016) (saved as Thompson Coburn LLP document number 6488741), discussing *Grand Acquisition, LLC v. Passco Indian Springs DST*, 145 A.3d 990 (Del. Ch. 2016).

> Also on January 1, 2005, A forms DST, a Delaware statutory trust described in the Delaware Statutory Trust Act, Del. Code Ann. Title 12, §§ 3801-3824, to hold property for investment. A contributes Blackacre to DST. Upon contribution, DST assumes A's rights and obligations under the note with BK and the lease with Z. In accordance with the terms of the note, neither DST nor any of its beneficial owners are personally liable to BK on the note, which continues to be secured by Blackacre.
>
> The trust agreement provides that interests in DST are freely transferable. However, DST interests are not publicly traded on an established securities market. DST will terminate on the earlier of 10 years from the date of its creation or the disposition of Blackacre, but will not terminate on the bankruptcy, death, or incapacity of any owner or on the transfer of any right, title, or interest of the owners. The trust agreement further provides that interests in DST will be of a single class, representing undivided beneficial interests in the assets of DST.
>
> Under the trust agreement, the trustee is authorized to establish a reasonable reserve for expenses associated with holding Blackacre that may be payable out of trust funds. The trustee is required to distribute all available cash less reserves quarterly to each beneficial owner in proportion to their respective interests in DST. The trustee is required to invest cash received from Blackacre between each quarterly distribution and all cash held in reserve in short-term obligations of (or guaranteed by) the United States, or any agency or instrumentality thereof, and in certificates of deposit of any bank or trust company having a minimum stated surplus and capital. The trustee is permitted to invest only in obligations maturing prior to the next distribution date and is required to hold such obligations until maturity. In addition to the right to a quarterly distribution of cash, each beneficial owner has the right to an in-kind distribution of its proportionate share of trust property.
>
> The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law. The trust agreement further provides that the trustee may engage in ministerial activities to the extent required to maintain and operate DST under local law.

The Ruling pointed out:

> Under Delaware law, DST is an entity that is recognized as separate from its owners. Creditors of the beneficial owners of DST may not assert claims directly against Blackacre. DST may sue or be sued, and the property of DST is subject to attachment and execution as if it were a corporation. The beneficial owners of DST are entitled to the same limitation on personal liability because of actions of DST that is extended to stockholders of Delaware corporations. DST may merge or consolidate with or into one or more statutory entities or other business

entities. DST is formed for investment purposes. Thus, DST is an entity for federal tax purposes.

Whether DST or its trustee is an agent of DST's beneficial owners depends upon the arrangement between the parties. The beneficiaries of DST do not enter into an agency agreement with DST or its trustee. Further, neither DST nor its trustee acts as an agent for A, B, or C in dealings with third parties. Thus, neither DST nor its trustee is the agent of DST's beneficial owners. *Cf. Comm'r v. Bollinger*, 485 U.S. 340 (1988).

This situation is distinguishable from Rev. Rul. 92-105. First, in Rev. Rul. 92-105, the beneficiary retained the direct obligation to pay liabilities and taxes relating to the property. DST, in contrast, assumed A's obligations on the lease with Z and on the loan with BK, and Delaware law provides the beneficial owners of DST with the same limitation on personal liability extended to shareholders of Delaware corporations. Second, unlike A, the beneficiary in Rev. Rul. 92-105 retained the right to manage and control the trust property.

The Ruling the addressed the DST's status as an entity:

Because DST is an entity separate from its owner, DST is either a trust or a business entity for federal tax purposes. To determine whether DST is a trust or a business entity for federal tax purposes, it is necessary, under § 301.7701-4(c)(1), to determine whether there is a power under the trust agreement to vary the investment of the certificate holders.

Prior to, but on the same date as, the transfer of Blackacre to DST, A entered into a 10-year nonrecourse loan secured by Blackacre. A also entered into the 10-year net lease agreement with Z. A's rights and obligations under the loan and lease were assumed by DST. Because the duration of DST is 10 years (unless Blackacre is disposed of prior to that time), the financing and leasing arrangements related to Blackacre that were made prior to the inception of DST are fixed for the entire life of DST. Further, the trustee may only invest in short-term obligations that mature prior to the next distribution date and is required to hold these obligations until maturity. Because the trust agreement requires that any cash from Blackacre, and any cash earned on short-term obligations held by DST between distribution dates, be distributed quarterly, and because the disposition of Blackacre results in the termination of DST, no reinvestment of such monies is possible.

The trust agreement provides that the trustee's activities are limited to the collection and distribution of income. The trustee may not exchange Blackacre for other property, purchase assets other than the short-term investments described above, or accept additional contributions of assets (including money) to DST. The trustee may not renegotiate the terms of the debt used to acquire Blackacre and may not renegotiate the lease with Z or enter into leases with tenants other than Z, except in the case of Z's bankruptcy or insolvency. In addition, the trustee may make only minor non-structural modifications to Blackacre, unless otherwise required by law.

> This situation is distinguishable from Rev. Rul. 78-371, because DST's trustee has none of the powers described in Rev. Rul. 78-371, which evidence an intent to carry on a profit making business. Because all of the interests in DST are of a single class representing undivided beneficial interests in the assets of DST and DST's trustee has no power to vary the investment of the certificate holders to benefit from variations in the market, DST is an investment trust that will be classified as a trust under § 301.7701-4(c)(1).

Thus, when tenants in common lease the property on a triple-net lease to an entity that itself engages in an active rental business (a "master lease"), the tenants in common may be able to avoid partnership treatment. Ideally, the tenant under the master lease (that subleases to various tenants in its real estate business) would have ownership different than those who own the tenants in common, to avoid the master tenant being considered merely an extension of the tenants in common. However, Rev. Rul. 2004-86 did not specify who owned X, the master tenant, and whether the master tenant needs to have a different ownership structure is subject to debate.[521]

When using the master triple-net lease, however, note that the rental income will be subject to the 3.8% net investment income tax, because rental generally is passive and does not qualify for certain exceptions that may apply to rental that is an active trade or business.[522] The owners would also want to take steps to limit liability, either holding the real estate through a unit investment trust such as the DST described in Rev. Rul. 2004-86 or by each owner forming a separate LLC to hold that owner's undivided interest in the real estate. See Lipton, Donovan, and Kassab, "The Promise (and Perils) of Using Delaware Statutory Trusts in Real Estate Offerings," *Journal of Taxation* (June 2008).

II.D.2. Business Entity as Grantor of Trust

If a partnership or corporation makes a gratuitous transfer to a trust for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust.[523]

For example, if a partnership creates a trust to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the trust's grantor.[524]

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[521] Consider obtaining the recording to "Use of Delaware Statutory Trusts in Non-Syndicated Exchange and Drop-and-Swap Situations," American Bar Association Section of Taxation May 2016 meeting. Slides are at http://www.americanbar.org/content/dam/aba/events/taxation/taxiq/may16/taxiq-16may-seb-useofdelaware-foster-slides.pdf, and recordings may be purchased for $30 at http://www.dcprovidersonline.com/abatx.

[522] See part II.I.8.c Application of 3.8% Tax to Rental Income.

[523] Reg. § 1.671-2(e)(4). Jonathan Blattmachr's 2015 Heckerling presentation cites the following examples of split-interest trusts created by business entities:

> PLR 9205031 (not precedent) and PLR 8102093: CRT could be created by C corporation; PLR 9340043: CRT could be created by S corporation; PLR 9419021 and PLR 199952071: CRT could be created by partnership (or LLC treated as partnership)
> …
> PLR 9512002: S corporation could create charitable lead trust; PLR 8145101: C corporation could create charitable lead trust. (These were non-grantor trust CLATs)

However, if a partnership or a corporation creates a trust that is not for a business purpose of the entity but is for the personal purposes of one or more of the entity's owners, the gratuitous transfer will be treated as a constructive distribution to those owners under federal tax principles and the owners will be treated as the trust's grantors.[525] For example:

- If a corporation creates a trust that includes not only the corporation but also its shareholders as beneficiaries, the corporation shall be treated as having distributed property to those shareholders and those shareholders being consider to have contributed that property to the trust.[526]

- If a partnership creates a trust for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner and a subsequent gratuitous transfer by the partner to the trust.[527]

Beware that a corporation recognizes gain if it conveys substantially all of its assets to a tax-exempt entity.[528] Subject to that caution, an S corporation that is about to sell an asset that would incur built-in gain tax should consider contributing the asset to a charitable remainder trust if the sale will not generate unrelated business taxable income (UBTI).[529]

The ultimate parent entity of a multinational enterprise group that has annual revenue for the preceding annual accounting period of at least $850 million may be required to file Form 8975, annual country-by-country reporting. A grantor trust owned by a business entity is itself considered a business entity subject to these rules.[530]

II.D.3. Trust as Grantor of a Trust

When the trustee of a trust creates another trust, the original grantor is treated as the grantor of both trusts;[531] furthermore, the first trust is treated as the Code § 678 owner of the second trust if the first trust can revoke the second trust.[532] See also part II.J.9.b Trust Divisions.

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524 Reg. § 1.671-2(e)(4).

525 Reg. § 25.2511-1(h)(1), which controls gift tax treatment and is reproduced in fn. 4859 in part III.B.1.h Transfers in the Ordinary Course of Business– Reg. § 25.2512-8.

526 See fn. 3573 in part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

527 Reg. § 1.671-2(e)(4). Also, TAM 200733024 asserts a similar position (deemed distribution from corporation to shareholder for a trust that the corporation established for shareholder's family) before the regulation's effective date.

528 Reg. § 1.337(d)-4(a)(1).

529 See parts II.Q.6.d Unrelated Business Income and II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

530 Reg. § 1.6038-4(b)(2).

531 Reg. § 1.671-2(e)(5). T.D. 8831 discussed this rule in a parenthetical:

> These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.

532 Reg. § 1.671-2(e)(6), Example (8) provides:

> G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to

The beneficiary of a nongrantor trust can, through the exercise of a power of appointment, create a charitable remainder trust for a term of years where the original trust is the noncharitable beneficiary.[533]

II.D.4. Disregarding Multiple Owner Trust for Income Tax Purposes

II.D.4.a. Investment Trusts

II.D.4.a.i. Classifying an Investment Trust

An investment trust with a single class of ownership interests, representing undivided beneficial interests in the trust's assets, will be classified as a trust if the trust agreement does not authorize varying the investment of the certificate holders.[534]

> If the investment trust has multiple classes of ownership interests, but the trust agreement does not authorize varying the investment of the certificate holders, it will be classified as a trust if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose.[535] However, if an investment trust with multiple classes of ownership interests is not described in the preceding sentence, ordinarily it will be classified as a business entity.[536]

A power to sell trust assets does not constitute a power to vary the investment.[537]

> revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

533 Letter Ruling 9821029.

534 Reg. § 301.7701-4(c)(1), citing *Commissioner v. North American Bond Trust*, 122 F.2d 545 (2d Cir. 1941), cert. denied, 314 U.S. 701 (1942).

535 Reg. § 301.7701-4(c)(1).

536 Reg. § 301.7701-4(c)(1). If the timing of payments is sufficiently similar to that found in a preferred partnership, the trust effectively creates investment interests with respect to the trust's assets that differ significantly from direct investment in the assets and therefore is classified as a business entity. See Reg. § 301.7701-4(c)(2), contrasting Example (1)(classified as business entity) with Example (2) (classified as trust). If a trust holds publicly traded stock and creates classes of ownership interest in the trust, which effectively separate dividend rights from a portion of the right to appreciation in the stock's value, so that the investors, by transferring one of the certificates and retaining the other, can fulfill their varying investment objectives of seeking primarily either dividend income or capital appreciation from the trust's stock, the trust is classified as a business entity. Reg. § 301.7701-4(c)(2), Example (3). However, this prohibition against stripping dividends does not extend to bonds, because Code § 1286 already allows investors to strip bonds without using an investment trust. Reg. § 301.7701-4(c)(2), Example (4).

537 Rev. Rul. 78-149 (holding that the authority to reinvest sale proceeds, rather than the authority to sell, causes a trust to be taxable as a business entity). Letter Ruling 201226019 held that a voting trust to hold stock in an S corporation qualified as an investment trust; the trust could sell stock in limited circumstances, although the ruling did not address the issue of the ability vary investments and did not cite Rev. Rul. 78-149, perhaps because the trust would terminate in that event. For additional guidance, see Rev. Ruls. 2004-86, 89-124 (OK to deposit additional assets and issue units within 90 days after trust's formation if the contributed assets are substantially the

A trust does not qualify as an investment trust when it holds a partnership interest to enable information to be provided to investors under the Reg. § 1.671-5 widely held fixed investment trusts rather than have the LLC partnership issue schedule K-1s to investors.[538]

For more information, see Gray, “Investment Trusts, the Power to Vary, and Holding Partnership Interests,” *Journal of Taxation* (WG&L), May 2016.[539]

A land trust is more of an agency relationship than the buy-and-hold-or-sell-but-not-reinvest philosophy of an investment trust.[540]

II.D.4.a.ii. Tax Treatment of Investment Trusts

The beneficial owner is treated as a grantor under the grantor trust rules.[541] A person acquiring a beneficial owner’s entire interest in a fixed investment trust becomes a grantor with respect to that interest.[542]

A beneficial owner of an investment trust does not realize gain or loss upon exchanging the certificates for a proportionate share of each of the trust’s assets, other than cash.[543]

On the other hand, when a deemed owner sells its beneficial interest, the seller should be deemed to sell a proportionate share of each of the trust’s assets to the buyer.[544]

II.D.4.a.iii. Practical Applications of Investment Trusts

Voting trusts are equivalent to investment trusts and expressly qualify to hold stock in an S corporation.[545]

Consider a formula gift or sale of real estate. The formula gift would be made public through the recorder of deeds, causing loss of privacy and messy detail that would create uncertainty in dealing with lenders and future buyers. Instead, the donor transfers the real estate to a unit investment trust, a simple event in the chain of title. Then the donor makes a formula transfer of the investment certificates.

Sometimes partners (including LLC members treated as partners) disagree on whether to reinvest the proceeds from the sale of real estate. However, the partners are not

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same as the assets originally contributed), 86-92, and 75-192. A voting trust may participate in a Code § 1036 exchange of stock. Letter Ruling 200618004.

538 AM 2007-005.

539 Saved as Thompson Coburn LLP doc. no. 6392112.

540 See part II.D.6 Land Trusts.

541 Reg. § 1.671-2(e)(3). Because a beneficial owner of a unit investment trust is deemed to own the trust’s assets, the assets can be distributed to the beneficial owner tax-free. Rev. Rul. 90-7.

542 Reg. § 1.671-2(e)(6), Examples (2) and (5), the latter which is reproduced in fn. 4989 in part III.B.2.h.i Who Is the Grantor.

543 Rev. Rul. 90-7.

544 See TAM 200814026, reproduced in part in fn. 4917 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation. TAM 200814026 did not deal with unit investment trusts, but its reasoning should apply.

545 See part III.A.3.b.iv A Trust Created Primarily To Exercise The Voting Power Of Stock Transferred To It.

direct owners of the property, so they cannot separately choose to have a tax-deferred like-kind exchange[546] inside the partnership. Instead, the partnership needs to distribute the property to the partners who want to achieve tax-deferral, and the distributees need to establish an investment purpose, which might be challenging in that they very recently obtained the property and intend to sell it rather than hold it. If all of the daily financial arrangements have been decided, such as through a long-term triple-net lease, consider using an investment trust hold the real estate and provide limited liability. That allows the real estate to be securitized and the beneficial owners to obtain like-kind exchange treatment on the transfer of the trust's underlying assets.[547]

II.D.4.b. Liquidating Trusts

An organization will be considered a liquidating trust if both:[548]

- It is organized for the primary purpose of liquidating and distributing the assets transferred to it, and
- Its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose.

A liquidating trust is treated as a trust because it is formed with the objective of liquidating particular assets and not for the purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships.[549] However, if the liquidation is unreasonably prolonged or if business activities eventually become the trust's main focus, the trust will no longer be treated as a liquidating trust.[550] Arrangements to protect the interests of security holders during insolvency, bankruptcy, or corporate reorganization proceedings can begin as liquidating trusts but lose that status if later used to further the control or profitable operation of a going business on a permanent continuing basis.[551]

The IRS will rule on whether a liquidating trust is treated as such.[552]

II.D.4.c. Environmental Remediation Trusts

An environmental remediation trust receives a special classification as a trust if all of the following apply:[553]

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[546] Code § 1031.
[547] Rev. Rul. 2004-86, which is quoted extensively in part II.D.1 Trust as a Business Entity.
[548] Reg. § 301.7701-4(d).
[549] Reg. § 301.7701-4(d).
[550] Reg. § 301.7701-4(d).
[551] Reg. § 301.7701-4(d).
[552] Rev. Proc. 82-58 which specifies the conditions that must be present before the IRS will consider issuing advance rulings whether a liquidating trust is treated as such or as a business entity under Reg. § 301.7701-4, and Rev. Proc. 91-15 provides a checklist that must accompany all such requests. Rev. Rul. 72-137 discusses the treatment of liquidating trusts as grantor trusts. For grantor trusts generally, see part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.
[553] Reg. § 301.7701-4(e)(1).

- It is organized under state law as a trust; the primary purpose of the trust is collecting and disbursing amounts for environmental remediation of an existing waste site to resolve, satisfy, mitigate, address, or prevent the liability or potential liability of persons imposed by federal, state, or local environmental laws;[554]

- All contributors to the trust have (at the time of contribution and thereafter) actual or potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site; and

- The trust is not a qualified settlement fund.[555]

This classification is because its primary purpose is environmental remediation[556] of an existing waste site and not the carrying on of a profit-making business that normally would be conducted through business organizations classified as corporations or partnerships.[557]

If the remedial purpose is altered or business or investment activities dominate such that the declared remedial purpose is no longer controlling, the organization will no longer be classified as a trust.[558]

Each contributor to the trust is treated as the owner of the portion of the trust contributed by that person under the grantor trust rules, including treatment of that person as the owner of a portion of a trust applied in discharge of the grantor's legal obligation.[559] The trust needs to file a Form 1041 with a grantor information statement that includes certain specified items.[560]

II.D.5. Severing Trusts with Multiple Grantors

If a multiple grantor trust is not a business trust under part II.D.1 Trust as a Business Entity and is not described in part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes, generally one will need to separate it at some point.

The GST rules recognize the severance of such trusts.[561] Such a severance of a trust does not trigger gain or loss if an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust and any non-pro rata funding of the

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554 For purpose of this test, persons have potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for remediation of the existing waste site if there is authority under a federal, state, or local law that requires or could reasonably be expected to require such persons to satisfy all or a portion of the costs of the environmental remediation.
555 As defined in Reg. § 1.468B-1(a).
556 For purpose of this test, "environmental remediation" includes the costs of assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, and collecting amounts from persons liable or potentially liable for the costs of these activities. Reg. § 301.7701-4(e)(1).
557 Reg. § 301.7701-4(e)(1).
558 Reg. § 301.7701-4(e)(1).
559 Reg. § 301.7701-4(e)(2), referring to Code § 677 and Reg. § 1.677(a)-1(d).
560 Reg. § 301.7701-4(e)(2).
561 Reg. § 26.2654-1(a)(3).

separate trusts resulting from the severance, whether mandatory or in the trustee's discretion, is authorized by an applicable state statute or the governing instrument.[562]

II.D.6. Land Trusts

An interest in an Illinois land trust constitutes real property that may qualify for a nontaxable like-kind exchange[563] for other real property, so long as the arrangement involving the land trust is not treated as a business entity.[564] The following arrangement qualified for this treatment:

- The grantor created an Illinois land trust, under which he was the beneficiary. The trust's purpose was to hold title to Illinois real property that the grantor had held for investment purposes. The beneficiary's interest in the trust was characterized as personal property under state law.

- The beneficiary or any person designated by the beneficiary has the exclusive power to direct or control the trustee in dealing with the title to the property in the land trust.

- The beneficiary has the exclusive control of the management of the property and the exclusive right to the earnings and proceeds from the property.

- Any person dealing with the trustee would take any interest in the trust's property free and clear of the claims of the grantor/beneficiary.

- The trust paid the trustee an annual fee, and the trust agreement authorized the trustee execute deeds, mortgages, or otherwise deal with the legal title of the property at the beneficiary's direction.

- The beneficiary retained the exclusive control of the management, operation, renting, and selling of the land, together with the exclusive right to the earnings and proceeds from the land. The beneficiary was required to file all tax returns, pay all taxes, and satisfy any other liabilities with respect to the land.

- The beneficiary also retained the right to assign his interest in the Illinois land trust.

- The trust agreement precluded the trustee from disclosing the beneficiary's identity unless directed to do so by the beneficiary in writing.

[562] Reg. § 1.1001-1(h).
[563] Code § 1031.
[564] Rev. Rul. 92-105.

Although the ruling applies to Illinois land trusts, it recognized that other states' common law and statutes permitted similar arrangements, which would receive the same treatment if:[565]

- The trustee has title to real property;

- The beneficiary (or a designee of the beneficiary) has the exclusive right to direct or control the trustee in dealing with the title to the property; and

- The beneficiary has the exclusive control of the management of the property, the exclusive right to the earnings and proceeds from the property, and the obligation to pay any taxes and liabilities relating to the property.

Similarly, a *fideicomiso* or Mexican Land Trust arrangement ("MLT"), is disregarded as a trust, and the beneficiary is treated as the owner, for U.S. income tax purposes.[566] Because the Mexican Federal Constitution prohibits non-Mexican persons from directly holding title to residential real property in certain areas of Mexico, they hold such property through an MLT with a Mexican bank after obtaining a permit from the Mexican government.[567] The MLT qualifying for this treatment had the following characteristics:

- The beneficiary has the right to sell without permission from the trustee.

- The trustee must grant a security interest in the property to a third party, such as a mortgage lender, if the beneficiary so requests.

- The beneficiary is directly responsible for the payment of all liabilities relating to the property, including pay any Mexican real estate taxes directly to the Mexican taxing authority.

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[565] Rev Rul. 92-105. The ruling mentioned that other states, such as California, Florida, Hawaii, Indiana, North Dakota, and Virginia, then had statutorily or judicially sanction arrangements that are similar to the Illinois land trust arrangement described in the ruling.

[566] Rev. Rul. 2013-14. Shortly after the ruling was issued, the AICPA applauded the ruling, stating at http://www.aicpa.org/Advocacy/Tax/TrustEstateGift/DownloadableDocuments/Trust%20Advocacy%20Documents/aicpa_comments_on_Rev_Rul_2013-14_submitted.pdf:

> The holding in the revenue ruling means that many U.S. taxpayers finally have certainty on the U.S. tax treatment of such common MLTs, and will no longer need to incur the expense and burden associated with preparing and filing the Form 3520 and Form 3520-A foreign trust reporting forms on a protective basis.

However, the AICPA noted certain limitations:

> We realize that the ruling does not apply if the MLT owns any other property or is permitted or required to engage in any activity beyond holding legal title to the Mexican real property. Therefore, we will continue to review trust agreements to evaluate these points.

The AICPA's resource page on Foreign Trust Documents is at http://www.aicpa.org/Advocacy/Tax/TrustEstateGift/Pages/ForeignTrustAdvocacyDocuments.aspx.

[567] Rev. Rul. 2013-14. I have been told that Mexico has a capital gain tax and that it has a real estate transfer tax of up to 4.5%, so one needs to be careful to structure ownership correctly from inception.

- The beneficiary has the exclusive right to possess the property and to make any desired modifications, limited only by the need to obtain the proper licenses and permits in Mexico. If the property is occasionally leased, the beneficiary directly receives the rental income and reports the income on the beneficiary's U.S. federal income tax return.

- The trustee disclaims all responsibility for the property, including obtaining clear title and defending or maintaining the property.

- The trustee collects a nominal annual fee from the beneficiary.

- No other agreement or arrangement is in place between one or more of the beneficiary, trustee, or any third party that would cause the overall relationship to be classified as a partnership (or any other type of entity) for U.S. federal income tax purposes.

If qualification as a land trust is in doubt, consider a unit investment trust.[568]

II.D.7. Sham Trusts

The Tax Court looks to the following factors to determine whether a trust has economic substance:[569]

(1) whether the taxpayer's relationship to the transferred property differed materially before and after the trust's creation;

(2) whether the trust had an independent trustee;

(3) whether an economic interest passed to other trust beneficiaries; and

(4) whether the taxpayer respected restrictions imposed on the trust's operation as set forth in the trust documents or by the law of trusts.

II.E. Recommended Structure for Entities

II.E.1. Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities

Below is a comparison of annual federal and state income tax burdens when the owners are in the highest or in a modest tax bracket, based on Parts II.E.1.a Taxes Imposed on C Corporations and II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships.

The assumptions made in putting together the chart can be criticized, but hopefully reviewing them helps one understand the post-2017 paradigm.

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[568] See part II.D.4.a Investment Trust.

[569] *Close v. Commissioner*, T.C. Memo. 2014-25, citing *Markosian v. Commissioner*, 73 T.C. 1235, 1243-1244 (1980).

	Individual in Top Bracket	Individual in Modest Bracket
Distributing 100% of Corporate Net Income After Income Tax	47.3%	40.8%
Distributing 50% of Corporate Net Income After Income Tax	36.7%	33.4%
Distributing None of Corporate Net Income After Income Tax	26.0%	26.0%
S Corporation, Partnership, or Sole Proprietorship	34.6%-45.8%	27.4%-46.2%

Note, however, that distributing less than 100% of corporate net income after tax does not reflect the true tax cost, because additional tax will often be incurred when extracting the earnings later through a dividend or sale.

Also consider that the excess of pass-through income tax rates over corporate rates is at an all-time high.

A partnership or S corporation that does business in many states incurs extra state compliance obligations, because states often require withholding on nonresident owners, require all owners to file in all of those states, or require both.

For a start-up entity, consider that most businesses lose money initially, and some never get into the black. An LLC taxed as a sole proprietorship or partnership is a much better vehicle for deducting losses[570] than is an S corporation[571] or C corporation.[572] If one is enamored with corporate income taxation, one might start as an LLC and then contribute the LLC to a corporation when one becomes sufficiently profitable to save taxes.[573] The disadvantage of such an approach occurs when the owner is in a low tax bracket, so that losses provide little, if any, benefit; in that case, having the C corporation carry forward its losses to offset them against income that would otherwise have been taxed at a

[570] See part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.3.c.ii Basis Limitations for Partners in a Partnership.
[571] See part II.G.3.c.i Basis Limitations for S Corporation Owners Beyond Just Stock Basis.
[572] See parts II.G.3.b C Corporations: Losses Incurred by Business, Owner, or Employee and II.G.3.c.iii Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses.
[573] Although one could just "check the box" by filing Form 8832 or 2553, as the case may be, contributing an interest in the LLC sets one up for an ideal entity structure and avoids possible (remote) self-employment tax issues. See parts II.E Recommended Structure for Entities and II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, respectively. For entity conversion issues, see part II.P.3 Conversions.

higher rate – and relying on Code § 1244 for ordinary loss treatment if the business is unsuccessful[574] – might be of greater benefit.

Incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[575] However, C corporations provide better fringe benefits.[576]

II.E.1.a. Taxes Imposed on C Corporations

For taxable years beginning after December 31, 2017, all C corporations pay tax at a flat 21% rate, unless some industry-specific exclusions, such as those for insurance companies, apply.[577] However, if a C corporation receives a dividend from another corporation, only part of that dividend is taxed,[578] reducing the effective tax rate to 10.5% for dividends from unrelated companies or zero or 7.35% for dividends from affiliates.

In addition to taxes on annual operations, consider:

- Dividends to shareholders, which are distributions out of a corporation's current or accumulated earnings and profits, are subject to regular tax at capital gain rates[579] (if qualified dividends)[580] and the 3.8% tax on net investment income.[581]

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[574] See parts II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244 and II.J.11.b Code § 1244 Treatment Not Available for Trusts.

[575] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

[576] See part II.P.2 C Corporation Advantage Regarding Fringe Benefits.

[577] Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

[578] See fns. 10-14 in part II.A.1.a C Corporations Generally.

[579] Code §§ 1(h)(3), 1(h)(11)(A).

[580] Code § 1(h)(11)(B) provides the following paramters for "qualified dividend income":

(i) *In general*. The term "qualified dividend income" means dividends received during the taxable year from-
  (I) domestic corporations, and
  (II) qualified foreign corporations.
(ii) *Certain dividends excluded*. Such term shall not include-
  (I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
  (II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
  (III) any dividend described in section 404(k).
(iii) *Coordination with section 246(c)*. Such term shall not include any dividend on any share of stock-

- A corporation that does not pay dividends may become subject to the 20% accumulated earnings tax. See part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.

- A corporation that distributes property to its shareholders generally is subject to tax on the excess of value over basis (but cannot deduct a loss). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

Let's examine the effects of earning $100,000 taxable income inside the corporation and distributing various proportions of the net after-tax profits, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals. The individual in a top bracket is assumed taxed at a rate of 28.8%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 5% state income tax. The individual in a modest bracket is assumed taxed at a rate of 20%, consisting of 15% capital gain tax, no net investment income tax, and 5% state income tax.

(I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or

(II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

Elaborating on Code § 1(h)(11)(B)(i)(II), Code § 1(h)(11)(C) provides rules for qualified foreign corporations.

Code § 1(h)(11)(D) provides special rules:

(i) *Amounts taken into account as investment income*. Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B). [My note: This relates to income against which investment interest may be deducted. See part II.G.19.a Limitations on Deducting Business Interest Expense, which mentions in passing investment interest expense.]

(ii) *Extraordinary dividends*. If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) *Treatment of dividends from regulated investment companies and real estate investment trusts*. A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

[581] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

Distributing 100% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Income Taxes at 28.8% or 20%	-21,312	-14,800
Net Cash to Owner	$52,688	$59,200

Note that the tax rates above seem somewhat high – 47.312% or 40.8%, depending on whether the shareholder is in a high or modest bracket. The corporation might try paying more compensation to avoid double taxation, but compensation income is taxed at ordinary income rates, and the employer's and employee's share of FICA combines to add tax equal to 2.5%-13.3%.[582] So, add that tax to the employee's federal, state, and local income tax rate and compare to the above. Consider, however, that a corporation cannot deduct more than reasonable compensation - see part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment – and in 2017 the IRS has instructed its examiners how to prevent taxpayers from contesting the issue in Tax Court.[583]

Distributing 50% of Corporate Net Income After Income Tax	Individual in Top Bracket	Individual in Modest Bracket
Corporate Taxable Income	$100,000	$100,000
Federal and State Income Tax	-26,000	-26,000
Net Income after Income Tax	$74,000	$74,000
Distribution to Owner	$37,000	$37,000
Income Taxes at 28.8% or 20%	-10,656	-7,400
Net Cash to Owner	$26,344	$29,600
Corporate Cash Plus Shareholder Cash	$63,344	$66,600

[582] The tax hit is 2.9%-15.3%, as described in part II.E.1.b Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships, text accompanying fn 585-587. However, the employer's deduction for half of this amount at an assumed 26% rate lowers the effective rate to 2.5%-13.3%.
[583] See fns. 82-84 in part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax.

Distributing None of Corporate Net Income After Income Tax	
Corporate Taxable Income	$100,000
Federal and State Income Tax	-26,000
Net Income after Income Tax	$74,000

Many years ago, Congress incentivized corporations to declare dividends, through the imposition of two taxes:

- Personal holding company tax. A personal holding company is taxed on 20% of its undistributed personal holding company income. See part II.A.1.e Personal Holding Company Tax.

- Accumulated earnings tax. Generally, a C corporation that accumulates funds could be subject to the 20% accumulated earnings tax on its excess undistributed accumulated earnings and profits. The corporation needs to articulate specific reasons why its needs to reinvest its earnings. For details, see part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. This tax does not apply to personal holding companies (as used in the preceding bullet point). If the company not a personal holding company but is a mere holding or investment company, the tax kicks in if undistributed earnings exceed $125,000.[584]

Each of these taxes can be avoided by paying sufficient dividends. The corporation may manage these taxes by actual or deemed dividends; see the relevant tax for rules on the extent to which this is permitted and how to do it.

II.E.1.b. Taxes Imposed on S Corporations, Partnerships, and Sole Proprietorships

Generally, S corporations and partnerships do not pay entity-level income tax; instead, their owners pay tax on their distributive share of the entity's income. However, some state or local governments do impose an entity-level tax, which may be in addition to imposing income tax on the owners' distributive share of the entity's income.

Tax reform in 2017 introduced a deduction of up to 20% of business earnings. See part II.E.1.c Code § 199A Pass-Through Deduction Qualified Business Income.

An owner of a partnership or sole proprietorship also generally pays tax self-employment ("SE") tax on income from a trade or business, subject to various exceptions; see part II.L Self-Employment Tax (FICA). SE tax is 15.3% OASDI and Medicare taxes until the taxpayer reaches the taxable wage base ($128,400 in 2018),[585] then is 2.9% Medicare tax until it reaches 3.8%, when the supplemental Medicare tax (employee's

[584] See fn 3488 in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax.
[585] See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount.

portion) kicks in.[586] The employer's portion of SE tax, which is 7.65% up to the taxable wage base and 1.45% thereafter, is deductible in determining adjusted gross income (not as an itemized deduction).[587]

An owner of an S corporation or partnership may pay the 3.8% tax on net investment income ("NII"); see part II.I 3.8% Tax on Excess Net Investment Income (NII). SE income is excluded from NII.[588] The deduction for the employer's share of SE tax makes SE tax preferable to NII tax, except to the extent that the income would be below the taxable wage base.

To the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[589] or stock[590] increases. Generally, an owner can withdraw the earnings tax-free, merely reducing basis in the owner's partnership interest or stock. See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.7.b Redemptions or Distributions Involving S Corporations. However, an S corporation that distributes property triggers tax on the gain,[591] which gain is taxed at its shareholders' respective income tax rates and in many cases does not qualify for favorable capital gain rates.[592]

Let's examine the effects of earning $100,000 taxable income inside the entity, assuming the taxpayer lives in a state that imposes moderate (5%) income tax on corporations and individuals:

An individual in a top bracket might be taxed at a rate of 34.6%-45.8%, consisting of:

- 29.6%-37% ordinary income tax (depending on whether the Code § 199A 20% deduction is available)

- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and

- 5% state income tax.

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[586] See fns 2348-2350 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.

[587] Code § 164(f), "Deduction for one-half of self-employment taxes," provides:

(1) *In general*. In the case of an individual, in addition to the taxes described in subsection (a), there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 (other than the taxes imposed by section 1401(b)(2)) for such taxable year.

(2) *Deduction treated as attributable to trade or business*. For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.

[588] As to SE income being excluded from NII, see fn 1527 in part II.I.5 What is Net Investment Income Generally.

[589] Code § 705.

[590] Code § 1367.

[591] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[592] See parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

An individual in a modest bracket might be taxed at a rate of 27.4%-46.2%, consisting of:

- 22.4%-28% ordinary income tax (depending on whether the Code § 199A 20% deduction is available, and the wage limitations and restrictions on types of businesses do not apply to modest income taxpayers)
- zero-13.2% SE tax income tax (after considering the deduction for one-half of SE tax)
- 5% state income tax.

II.E.1.c. Code § 199A Pass-Through Deduction Qualified Business Income

Code § 199A provides a deduction for taxable years beginning after December 31, 2017 but not beginning after December 31, 2025.[593]

In the case of a partnership or S corporation, Code § 199A applies at the partner or shareholder level.[594] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[595]

Code § 199A does not address this issue as to whether the components of this calculation pass through separately on the K-1 that a nongrantor trust provides to a beneficiary. I believe that the IRS' position would be calculate at the nongrantor trust level, just as all other calculations are done. Code § 643(a) would include it in calculating DNI. Code § 199(d)(1)(B)(i), from the deduction for domestic production activities that involved W-2 limitations and was repealed when Code § 199A was enacted, mandated that the deduction for domestic production activities be calculated at the beneficiary level to the extent included in DNI, but Code § 199A does not. In my view, this shows that Congress knows how to vary the general rule that everything is calculated at the trust level, and Congress chose not to do so. Furthermore, Code § 199A(f)(1)(A) describes passing the items used in calculating the deduction through the partnerships and S corporations to their owners, and it does not provide anything regarding nongrantor trusts doing the same.

The IRS is to "prescribe such regulations as are necessary to carry out the purposes of" Code § 199A, including regulations:[596]

> (A) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and
>
> (B) for the application of this section in the case of tiered entities.

The rules described in the various subparts of this part II.E.1.c apply to pass-throughs, but similar rules apply to any "specified agricultural or horticultural cooperative."[597]

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[593] Code § 199A(i).
[594] Code § 199A(f)(1)(A)(i).
[595] Code § 199A(f)(1)(A) (flush language).
[596] Code § 199A(f)(4).

II.E.1.c.i. What Kind of Deduction; Maximum Impact of Deduction

II.E.1.c.i.(a). Summary of Impact of Deduction

The deduction is not allowed in computing adjusted gross income[598] but also is not an itemized deduction,[599] so it is in its own category of deduction.

The deduction applies for income tax but not for net investment income tax[600] or self-employment tax[601] purposes.[602]

When calculating alternative minimum taxable income under Code § 55, qualified business income is determined without regard to any adjustments under Code §§ 56-59.[603]

Although wage income is not qualified business income,[604] in computing withholding allowances and employee may take into account the estimated deduction under Code § 199A.[605]

With a top regular income tax bracket of 37%, the deduction's maximum relief is the equivalent of a 7.4% (20% of 37%) rate reduction, reducing the effective regular income tax rate to 29.6% (37% minus 7.4%).

However, the rate reduction may be thought of as being somewhere between zero and 7.4%, for the following reasons:

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597 Code § 199A(g) describes qualified entities and the related deduction. The Senate report said (note that the Conference Committee reduced the deduction from 23% to 20% and pushed up the effective date by one year):

> For taxable years beginning after December 31, 2018 but not after December 31, 2025, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of 23 percent of the cooperative's taxable income for the taxable year or 50 percent of the W-2 wages paid by the cooperative with respect to its trade or business. A specified agricultural or horticultural cooperative is an organization to which subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (c) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

598 Code § 62(a).

599 Code § 63(d)(3).

600 Net investment income tax, described in part II.I 3.8% Tax on Excess Net Investment Income (NII), is provided by Code § 1411, which is Chapter 2A.

601 Self-employment tax, described in part II.L Self-Employment Tax (FICA), is provided by Code §§ 1401-1403, which is Chapter 2.

602 Code § 199A(f)(3) provides:

> DEDUCTION LIMITED TO INCOME TAXES.—The deduction under subsection (a) shall only be allowed for purposes of this chapter.

Chapter 1 of Subtitle A of the Code includes Code §§ 1-1400U-3.

603 Code § 199A(f)(2).

604 See fn 621 In part II.E.1.c.ii Types of Income and Activities Eligible for Deduction.

605 Code § 3402(m)(1).

- Each trade or business the entity runs needs to be separately subjected to the limitations described below.

- Some income does not qualify for the deduction at all, although generally business activities qualify if the taxpayer's taxable income is below certain thresholds. See parts II.E.1.c.ii Types of Income and Activities Eligible for Deduction and II.E.1.c.v Liberalized Rules When Owner's Taxable Income Is Below Thresholds.

- An activity that does qualify may have its deduction limited if it has insufficient wages and not enough investment to make up for insufficient wages, although this limitation does not apply if the taxpayer's taxable income is below certain thresholds. See parts II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds and II.E.1.c.v Liberalized Rules When Owner's Taxable Income Is Below Thresholds.

- Deducting a net operating loss may in some situations cause the taxpayer to lose part or all of the benefit of the Code § 199A deduction.[606]

II.E.1.c.i.(b). Other Effects of Code § 199A Deduction

When determining how much Code § 172 net operating loss is applied, the Code § 199A deduction is disallowed.[607]

Claiming the Code § 199A deduction makes the taxpayer more susceptible to the penalty for understatement of income tax.[608]

The Code § 199A deduction does not reduce income when computing the percentages of income used in calculating the individual income tax charitable deduction.[609]

It does not reduce taxable income in computing the taxable income limitation for percentage depletion under Code § 613(a) or 613A(d)(1).

The Code § 199A deduction also has some interaction with the dividends-received deduction that I have not yet tried to analyze,[610] which is unexpected in that the dividends-received deduction applies only to corporations; presumably this applies to a specified agricultural or horticultural cooperative.[611]

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[606] See part II.E.1.c.i.(b) Other Effects of Code § 199A Deduction, fn. 607.
[607] Code § 172(d)(8).
[608] Code § 6662(d)(1)(C) provides:

> (C) SPECIAL RULE FOR TAXPAYERS CLAIMING SECTION 199A DEDUCTION.—In the case of any taxpayer who claims the deduction allowed under section 199A for the taxable year, subparagraph (A) shall be applied by substituting "5 percent" for "10 percent."

[609] Code § 170(b)(2)(D)(vi).
[610] Code § 246(b)(1).
[611] See fn 597.

II.E.1.c.ii. Types of Income and Activities Eligible for Deduction

QBI means "the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer."[612] It does not include any "qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income."[613] (Note that the Code § 199A separately takes into account qualified cooperative dividends in addition to QBI.)[614]

Whether a trade or business is a "qualified trade or business" is discussed further below. First, the question is how do we delineate what is a "trade or business" to which we apply these rules?

Neither the statute nor the legislative history explain what is a "trade or business." Here are some resources that may help:

- Part II.G.3.i.i.(a) "Trade or Business" Under Code § 162 would be the most important source.

- What is a "trade or business" is important regarding particular issues for the Code § 1411 3.8% tax on net investment income ("NII"), which is tied to the Code § 469 passive activity loss ("PAL") rules. When reviewing the resources below, keep in mind that (a) being passive tends to be bad for taxpayers in the context of the NII and PAL rules but is irrelevant for Code § 199A, and (b) real estate has special rules regarding its character as passive, which again is irrelevant for Code § 199A:

  - The government received and responded to comments on what is a "trade or business" when working on regulations for the net investment income See part:

    - II.I.8.a General Application of 3.8% Tax to Business Income, fns 1578-1587, and

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[612] Code § 199A(c)(1).

[613] Code § 199A(c)(1). Code § 199A(e)(3) provides:

> QUALIFIED REIT DIVIDEND.—The term "qualified REIT dividend" means any dividend from a real estate investment trust received during the taxable year which—
> (A) is not a capital gain dividend, as defined in section 857(b)(3), and
> (B) is not qualified dividend income, as defined in section 1(h)(11).

Code § 199A(e)(4) provides:

> QUALIFIED PUBLICLY TRADED PARTNERSHIP INCOME. The term "qualified publicly traded partnership income" means, with respect to any qualified trade or business of a taxpayer, the sum of—
> (A) the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) which is not treated as a corporation under section 7704(c), plus
> (B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

[614] See fns 630-632 in part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds.

        - II.I.8.c.iii Rental as a Trade or Business, fns 1641-1649.

    - In the PAL rules:

        - What is a trade or business has received some attention in the real estate professional exception, but most of that tends to be whether the trade or business qualifies as a real estate trade or business. Although I don't view those as particularly instructive as to what is a trade or business, here is the discussion so you can see for yourself: Part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.

        - Part II.K.1.f Royalty as a Trade or Business may have some application.

        - Because what is a "trade or business" is so driven by facts and circumstances and one needs to delineate among separate trades or businesses in applying Code § 199A, one wonders whether the government might provide some guidance. The PAL rules provide guidance that one might speculate the government might consider adopting, rather than creating a whole new set of rules. The PAL rules allow taxpayers to group activities, with a general grouping rule and a rule specific to real estate professionals. See parts II.K.1.b Grouping Activities and II.K.1.e.iii.(b) Aggregating Real Estate Activities for a Real Estate Professional. The net investment income tax rules were required to refer to the PAL rules, so they also adopted those grouping rules, but allowed taxpayers to regroup when first subject to the NII tax. See part II.I.8.a.ii Passive Activity Grouping Rules.

- Self-employment tax is imposed only on activity that is a trade or business. See parts:

    - II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, fns 2361-2364.

    - II.L.2.a.ii Rental Exception to SE Tax and II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax, keeping in mind that the rental exception excludes certain trades or businesses for self-employment tax purposes.

- A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.[615]

The last bullet point, focusing of accounting methods, might be a paradigm if the government does not base the separation of businesses on passive loss rules. Reg. § 1.446-1(d), "Taxpayer engaged in more than one business," provides:

> (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly

[615] Code § 446(d). Thus, a single member LLC that is a disregarded entity may use a different accounting method than its parent if the single member LLC engages in a separate trade or business; see CCA 201430013 (see fn 273 in part II.B Limited Liability Company (LLC)).

reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

In the case of a partnership or S corporation, each partner or shareholder shall take into account such person's allocable share of each qualified item of income, gain, deduction, and loss.[616] In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[617]

To be a qualified item of income, gain, deduction, and loss, the item must be a U.S.-source item[618] and "included or allowed in determining taxable income for the taxable year."[619]

Various items of investment income, including short- or long-term capital gains and losses, are not qualified items.[620]

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[616] Code § 199A(f)(1)(A)(ii).

[617] Code § 199A(f)(1)(A) (flush language).

[618] Code § 199A(c)(3)(A)(i) requires the item to be:

> effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting 'qualified trade or business (within the meaning of section 199A)' for 'nonresident alien individual or a foreign corporation' or for 'a foreign corporation' each place it appears)"

However, Code § 199A(f)(1)(C)(i) provides:

> IN GENERAL.—In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term "United States" shall include the Commonwealth of Puerto Rico.

[619] Code § 199A(c)(3)(A)(ii).

[620] Code § 199A(c)(3)(B) list those nonqualified items:

> (i) Any item of short-term capital gain, short- term capital loss, long-term capital gain, or long-term capital loss.

QBI does not include:[621]

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

The reasonable compensation exception means that wages paid to an owner-employee of an S corporation are not themselves QBI. However, those wages would increase the QBI-related deduction to the extent that the wage limitation is a concern.[622]

For details on the references in (B) and (C) to Code § 707, see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

"Qualified trade or business" means any trade or business other than:[623]

(A) a specified service trade or business, or

(B) the trade or business of performing services as an employee.

A "specified service trade or business" is any trade or business other than (A) certain businesses that do not qualify for the Code § 1202 exclusion from capital gain on the sale of C corporation stock, or (B) which involves the performance of services that

(ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G).

(iii) Any interest income other than interest income which is properly allocable to a trade or business.

(iv) Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1) (applied by substituting "qualified trade or business" for "controlled foreign corporation").

'(v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).

(vi) Any amount received from an annuity which is not received in connection with the trade or business.

(vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

[621] Code § 199A(c)(4). The Senate report makes it apparent that subparagraph (A) was aimed at reasonable compensation paid by an S corporation.

[622] See parts II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds, especially fns. 637-646, the impact of which may be reduced or eliminated under part II.E.1.c.v Liberalized Rules When Owner's Taxable Income Is Below Thresholds.

[623] Code § 199A(d)(1).

consist of investing and investment management, trading, or dealing in securities (as defined in Code § 475(c)(2)), partnership interests, or commodities (as defined in Code § 475(e)(2)).[624]

The Code § 1202 exclusion from capital gain on the sale of C corporation stock is described in part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation. The following businesses are among those not eligible for the Code § 1202 exclusion when looking at the definition of a "specified service trade or business": any trade or business involving the performance of services in the fields of health,[625] law, engineering, architecture, accounting, actuarial science, performing arts,[626] consulting,[627] athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.[628] However, Code § 199A(d)(2)(A) specifically excludes engineering and architecture from this blacklist, so that those professions do

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[624] Code § 199A(d)(2).

[625] Footnote 44 of the Senate report commented about the services in the field of health:

> A similar list of service trades or business is provided in section 448(d)(2)(A) and Treas. Reg. sec. 1.448-1T(e)(4)(i). For purposes of section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. See Treas. Reg. sec. 1.448-1T(e)(4)(ii).

[626] Footnote 45 of the Senate report commented about the services in the field of performing arts:

> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performance of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). See Treas. Reg. sec. 1.448-1T(e)(4)(iii).

[627] Footnote 46 of the Senate report commented about the services in the field of consulting:

> For purposes of the similar list of services in section 448, Treasury regulations provide that the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). See Treas. Reg. sec. 1.448-1T(e)(4)(iv).

[628] Code § 1202(e)(3)(A), which is discussed in part II.Q.7.j.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, fns. 3769-3770.

qualify for QBI treatment. Also, Code § 199A(d)(2)(A) specifically looks to the work of not only employees but also owners.

This blacklisting of professions is relaxed or does not apply if taxable income is below certain thresholds.[629] See part II.E.1.c.v Liberalized Rules When Owner's Taxable Income Is Below Thresholds.

II.E.1.c.iii. Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds

Taxpayers other than C corporations may deduct a portion of qualified business income ("QBI") and qualified cooperative dividends ("QCDs").[630] The deduction for QCDs[631] is not a focus of this document.[632] At any rate, the combined deduction for QBI and QCDs

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[629] Code § 199A(d)(3).

[630] Code § 199A(a).

[631] Code § 199A(e)(4) provides:

> QUALIFIED COOPERATIVE DIVIDEND.—The term 'qualified cooperative dividend' means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which—
> (A) is includible in gross income, and
> (B) is received from—
> (i) an organization or corporation described in section 501(c)(12) or 1381(a), or
> (ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T.

[632] Code § 199A(a)(2) provides a deduction of the lesser of:

> (A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or
> (B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The Senate report explained (footnotes omitted) (remember that the Conference Committee reduced the deduction from 23% to 20%):

> A deduction is allowed under the provision for 23 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the taxable year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend or a qualified dividend. A qualified cooperative dividend means a patronage dividend, per-unit retain allocation, qualified written notice of allocation, or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization, or a taxable or tax-exempt cooperative that is described in section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the Code in 1962. Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer), the sum of the (a) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (that are effectively connected with a U.S. trade or business and are included or allowed in determining taxable income for the taxable year and do not constitute excepted enumerated investment-type income, and not including the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) section 707(a) payments for services) from a publicly traded partnership not treated as a

cannot exceed the excess of the taxpayer's taxable income over the taxpayer's net capital gain.[633] "Net capital gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.[634]

The QBI-based deduction is the lesser of the taxpayer's combined QBI amount or 20% of the excess (if any) of (i) the taxpayer's taxable income over (ii) the sum of the taxpayer's net capital gain and aggregate QCDs.[635]

The QBI amount is (A) the sum of certain QBI-related amounts for each qualified trade or business the taxpayer carries on, plus (B) "20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year."[636]

The QBI-related amount with respect to any qualified trade or business is the lesser of (A) 20% of the taxpayer's QBI with respect to the qualified trade or business, or (B) the wage limitation.[637]

The wage limitation is the greater of:[638]

(i) 50 percent of the W–2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

In the case of a partnership or S corporation, each partner or shareholder is treated "as having W–2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W–2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary)."[639] A partner's or shareholder's allocable share of W–2 wages is determined in the same manner as the partner's or shareholder's allocable share of wage expenses.[640] A partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition of qualified property shall be determined in the same manner as the partner's or shareholder's allocable share of depreciation.[641]

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corporation, and (b) gain recognized by the taxpayer on disposition of its interest in the partnership that is treated as ordinary income (for example, by reason of section 751).

[633] Code § 199A(a) (flush language at the end).

[634] Code § 1222(11), which applies for purposes of subtitle A (Code §§ 1-1563). Code § 199A(a)(1)(B)(ii) refers to Code § 1(h) to define "net capital gain," but Code § 1(h) does not define the term.

[635] Code § 199A(a)(a)(B).

[636] Code § 199A(b)(1). Fn 613 defines "qualified REIT dividend" and "qualified publicly traded partnership income."

[637] Code § 199A(b)(2).

[638] Code § 199A(b)(2)(B).

[639] Code § 199A(f)(1)(A)(iii).

[640] Code § 199A(f)(1)(A) (flush language).

[641] Code § 199A(f)(1)(A) (flush language).

In the case of an S corporation, an allocable share is the shareholder's pro rata share of an item.[642]

For trusts and estate, rules similar to those that applied to the former Code § 199 deduction for domestic production activities apply.[643]

W-2 wages generally are wages subject to withholding and include elective deferral, such as Code § 401(k) and similar plans.[644] The wages must relate to QBI.[645] The wages must be "properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return."[646]

The IRS must explain how the QBI rules apply "in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year."[647]

As discussed above, part of the wage limitation test is an alternative calculation relating to qualified property.[648] "Qualified property" means, with respect to any QBI for a taxable year, tangible property of a character subject to the allowance for depreciation under Code § 167:[649]

> (i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,
>
> (ii) which is used at any point during the taxable year in the production of qualified business income, and
>
> (iii) the depreciable period for which has not ended before the close of the taxable year.

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[642] Code § 199A(f)(1)(A) (flush language).

[643] Code § 199A(f)(1)(B) provides:

> APPLICATION TO TRUSTS AND ESTATES.—Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages shall apply to the apportionment of W-2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

[644] Code § 199A(b)(4)(A) provides:

> IN GENERAL.—The term "W-2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

If a taxpayer has qualified business income from sources within the commonwealth of Puerto Rico and all that income is taxable under Code § 1 for the taxable year, then Code § 199A(f)(1)(C)(ii) provides that:

> the determination of W-2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.

[645] Code § 199A(b)(4)(B).

[646] Code § 199A(b)(4)(C).

[647] Code § 199A(b)(5).

[648] Code § 199A(b)(2)(B)(ii).

[649] Code § 199A(b)(6)(A).

The "depreciable period" means the period beginning on the date the taxpayer first placed the property in service and ending on the later of the tenth anniversary of being placed in service or the last day of the last full year in the applicable recovery period under Code § 168 (the current depreciation rules).[650]

Note that the test for qualified property refers to "unadjusted basis," so it does not take into account depreciation deductions or any other basis reductions, such as bonus depreciation deductions (but Code § 179 deductions appear to expense and not capitalize the property, giving it no unadjusted basis to the extent it is expensed).[651] The IRS must:[652]

(1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and

(2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

The wage limitation is relaxed or does not apply if taxable income is below certain thresholds.[653] See part II.E.1.c.v Liberalized Rules When Owner's Taxable Income Is Below Thresholds.

II.E.1.c.iv. Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction

If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, that amount is treated as a loss from a qualified trade or business in the succeeding taxable year.[654] The Senate's report states (note that the Conference Committee reduced the deduction from 23% to 20%):

> If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year. Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced (but not below zero) by 23 percent of any carryover qualified business loss. For example, Taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Taxpayer has qualified business income of $20,000 from qualified business A and qualified business income of $50,000

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[650] Code § 199A(b)(6)(B), which also provides that Code § 168(g), under which an extended depreciable life is required or permitted to be elected, does not apply in determining the property's depreciable life.
[651] See part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation.
[652] Code § 199A(h).
[653] Code § 199A(b)(3).
[654] Code § 199A(c)(2).

from qualified business B. To determine the deduction for Year 2, Taxpayer reduces the 23 percent deductible amount determined for the qualified business income of $70,000 from qualified businesses A and B by 23 percent of the $30,000 carryover qualified business loss.

II.E.1.c.v. Liberalized Rules When Owner's Taxable Income Is Below Thresholds

The wage limitation[655] and the restriction on type of business[656] are eased up or do not apply if the taxpayer's taxable income, computed without regard to the Code § 199A deduction,[657] is below the "threshold amount." The "threshold amount" is $315,000 for a joint return and $157,500 for any other return.[658] The "threshold amount" will be indexed for inflation in a manner similar to indexing the income tax brackets.[659]

If the wage limitation reduces the QBI-related amount (20% of QBI income)[660] with respect to any qualified trade or business, and the taxpayer's taxable income does not exceed the threshold amount by $100,000 for a joint return or $50,000 for other returns, then the reduction is pro-rated.[661] The reduction is multiplied by the excess over the threshold divided by $100,000 or $50,000, as applicable.[662]

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[655] See text accompanying fns. 637-653 in part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds.

[656] See text accompanying fns. 624-629 in part II.E.1.c.ii Types of Income and Activities Eligible for Deduction.

[657] Code § 199A(e)(1).

[658] Code § 199A(e)(2)(A).

[659] Code § 199A(e)(2)(B) provides:

> INFLATION ADJUSTMENT.—In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to—
>
> (i) such dollar amount, multiplied by
>
> (ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.
>
> The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

[660] See text accompanying fn. 637 in part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds.

[661] Code § 199A(b)(3)(B)(i), "Phase-in of limit for certain taxpayers," provides:

> *In general*. If-
>
> (I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and
>
> (II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,
>
> then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

[662] Code § 199A(b)(3)(B)(ii) and (iii) provide:

> (ii) *Amount of reduction*. The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as-

If certain types of specified service trade or business are excluded from being QBI, the taxpayer having taxable income below the threshold removes the exclusion, so that the trade or business qualifies for the deduction.[663] Those activities include any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.[664] If the taxpayer's taxable exceeds the threshold, the deduction is phased out using a $100,000 or $50,000 calculation similar to that described above:[665]

> only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W-2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W-2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

The "applicable percentage" is 100% minus the ratio of the excess taxable income to the $100,000 or $50,000 threshold.[666]

Let's work through an example:

Suppose for 2018 a married taxpayer filing jointly has taxable income of $355,000 before considering the Code § 199A deduction, has qualified business income of $100,000 from one trade or business, related W-2 wages are $30,000, and has qualified property with a $200,000 adjusted basis. The wage limit is the greater of:

(i) $15,000, being 50% of the $30,000 wages, or

(I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to

(II) $50,000 ($100,000 in the case of a joint return).

(iii) *Excess amount*. For purposes of clause (ii), the excess amount is the excess of-

(I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

(II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

[663] Code § 199A(d)(3).

[664] Code § 199(d)(3)(A)(i) provides, "any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A)," so one needs to go to Code § 199(d)(1)(A). See fns 625-628 in part II.E.1.c.ii Types of Income and Activities Eligible for Deduction.

[665] Code § 199A(d)(3)(A)(ii).

[666] Code § 199A(d)(3)(B) provides:

> *Applicable percentage*. For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of-
>
> (i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to
>
> (ii) $50,000 ($100,000 in the case of a joint return).

(ii) $12,500, being the sum of $7,500 (25% of the $30,000 wages) and $5,000 (2.5% of $200,000 qualify property).

Before applying the wage limit, 20% of qualified business income is $20,000, which is 20% of the $100,000 qualified business income.

The tentative wage reduction is $5,000, the excess of the $20,000 tentative deduction minus the $15,000 limit.

The $355,000 pre-Code § 199A taxable income of $355,000 is $40,000 over the $315,000 threshold. Therefore, 40% ($40,000 divided by $100,000) of the tentative wage reduction applies. The wage reduction is $2,000, which is the tentative wage reduction of $5,000 multiplied by 40%.

The Code § 199A deduction is $18,000, which is the $20,000 tentative qualified business income deduction minus the $2,000 wage reduction.

Suppose the business is a specified service trade or business. The applicable percentage is 60%, which is 100% minus the 40% ratio of the excess. Thus , everything above is multiplied by 60%:

- The tentative deduction is $12,000, which is 60% of $20,000.
- The wage limitation is $9,000, which is 60% of $15,000.
- The tentative wage reduction is $3,000, the excess of $12,000 over $9,000.
- The wage reduction is $1,200, which is 40% of $3,000.

Thus, the Code § 199A deduction is $10,800, which is $12,000 minus $1,200.

Note that the $10,800 Code § 199A deduction for a specified service trade or business is 60% of the $18,000 Code § 199A deduction if it were not a specified service trade or business. I'm not quite sure why the statute does not simply multiply the deduction by the applicable threshold. I think it's because a different calculation applies to losses carried from prior years; for how losses work, see part II.E.1.c.iv Effect of Losses from Qualified Trades or Businesses on the Code § 199A Deduction.

II.E.1.d. Partnerships Compared to S Corporations for Code § 199A Deduction

Suppose, before considering the owner's compensation, a business has $300,000 of qualified business income ("QBI"), reasonable compensation would be $200,000, distributions to the owner are at least $200,000, and the owner's taxable income is below the $315,000 threshold for married filing jointly.

The wage limitation would not apply. See part II.E.1.c.v Liberalized Rules When Owner's Taxable Income Is Below Thresholds.

If the business is an S corporation, then the $200,000 wages the S corporation pays its owner will reduce the QBI from $300,000 down to $100,000. If the taxpayer argues that the payments to the owner-employee were distributions and not wages, the IRS will have the upper hand in the dispute, because in 2017 the IRS figured out (and instructed its examiners) how to effectively keep taxpayers out of Tax Court on this issue[667] – meaning that taxpayers would have to pay the tax and sue for a refund.

II.E.1.e. Whether Real Estate Qualifies As a Trade or Business

To constitute qualified bsuienss income, the income must be from a trade or business.[668]

Whether real estate is a trade or business depends on the circumstances. The best discussion of the issue in this document is in part II.I.8.c.iii Rental as a Trade or Business, fns 1641-1649. Another discussion on what is a trade or business is in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162. These and other items are summarized near the beginning of part II.E.1.c.ii Types of Income and Activities Eligible for Deduction.

If all the taxpayer does is lease one property to one tenant on a triple net lease, consider changing the responsibilities. Instead of the tenant arranging for and paying for maintainence, have the landlord take care of that and obtain reimbursement from the tenant. Even the long-term rental of one property can constitute a trade or business.[669]

For futher thoughts on how to make real estate a trade or business, see my summary at the end of part II.I.8.c.iii Rental as a Trade or Business.

Note also what is required for real estate not to be passive income for purposes of restrictions on S corporations that used to be C corporations, described in part II.P.3.c.iii Excess Passive Investment Income. A triple net lease would not work for that test, but incurring expenses and having them reimbursed by the tenant would be.[670] Following these rules for S corporations does not directly address the "trade or business" issue, but if the IRS views it as nonpassive for one purpose (the S corporation test) then an examiner might have a positive view for other purposes (trade or business qualification).

II.E.1.f. Whether a High-Bracket Taxpayer Should Hold Long-Term Investments in a C Corporation

As mentioned earlier:

- Dividends a C corporation receives from another domestic C corporation are subjected to federal income tax of no more than 10.5%.[671]

- Taxable interest and capital gains are subjected to 21% federal income tax.[672]

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[667] See part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fns 82-83.
[668] See part II.E.1.c.ii Types of Income and Activities Eligible for Deduction, especially fn. 623.
[669] See part II.I.8.c.iii Rental as a Trade or Business, fn 1646.
[670] See fns 2861-2864.
[671] See part II.E.1.a Taxes Imposed on C Corporations, especially the text accompanying fn 578, referring to fns. 10-14 in part II.A.1.a C Corporations Generally.

Contrast this to a taxpayer in the highest tax bracket, who is subjected to federal income tax of:

- 23.8% on qualified dividends[673] and net long-term capital gains, considering the 20% top capital gain rate[674] and 3.8% net investment income tax.[675]

- 40.8% on taxable interest income, nonqualified dividends, and net short-term capital gains, considering the 37% top ordinary income tax rate[676] and 3.8% net investment income tax.[677]

- For any taxable year beginning after December 31, 2017 and before January 1, 2026, individuals cannot deduct investment management fees relating to managing their own marketable securities.[678] This disallowance does not apply to C corporations, because C corporation deductions are not itemized deductions.

However, the chart in part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, which also considers moderate state income tax, illustrates that the C corporation advantage quickly dissipates if the corporation makes distributions.

The personal holding company tax or accumulated earnings tax may essentially force a corporation to declare dividends – especially if the corporation accumulates more than $125,000 in earnings.[679]

Eventually, however, income will need to be distributed so that the owner actually benefits from the investment return, imposing dividend tax at that time and undermining – to some extent (small or large) the advantage of C corporation income tax savings. Another option, which can make this strategy much more tenable, is: the investor grows the assets at smaller income tax rates, increasing future annual income, then converts to an S corporation and distributes current income while leaving prior years' income in the

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672 Code § 11(a), (b). Code § 11(c) provides that corporate income tax does not apply to a corporation subject to a tax imposed by:

(1) section 594 (relating to mutual savings banks conducting life insurance business),
(2) subchapter L (sec. 801 and following, relating to insurance companies), or
(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts).

Code § 11(d), "Foreign corporations," provides:

> In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.

673 See part II.E.1.a Taxes Imposed on C Corporations, fns 579-580 and text accompanying them.

674 Code § 1(h)(1), with exceptions under Code § 1(h)(3)-(8) for depreciation recapture, collectibles and Code § 1202 gain taxed as a capital gain at 28%

675 See part II.I 3.8% Tax on Excess Net Investment Income (NII).

676 Code § 1(j), fo any taxable year beginning after December 31, 2017, and before January 1, 2026.

677 See part II.I 3.8% Tax on Excess Net Investment Income (NII).

678 Code § 67(g).

679 See text accompanying and preceding fn 584 in part II.E.1.a Taxes Imposed on C Corporations.

corporation to grow; see part II.E.2.c Converting a C Corporation to an S Corporation, which also includes warnings regarding investment mix after making the S election.

Harvesting the accumulated income by simply selling the C corporation does not produce good results. See part II.E.2 Comparing Exit Strategies from C Corporations and Pass-Through Entities.

Finally, if one decides to use a corporation to hold investments, consider what happens when one passes them to one's children or other various beneficiaries. A similar but perhaps more predictable termination concern applies to trusts. A corporation that invests in portfolio assets cannot divide without triggering income tax. One might consider creating a few corporations (in the case of a trust, one for each remainderman). These corporations then invest in a partnership, which can divide without triggering income tax. That way, each corporation can receive a mix of assets more along the lines of the beneficiary's preferences. For more details, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made), which describes the corporate division issue and a solution.

I cannot emphasize enough the need to consider an exit strategy. Political winds change over time, and it is very likely that at some point Congress will increase corporate taxes to bring them closer to individual rates. Beware getting into a structure that has costly exit steps and then being stuck there because of that high exit tax. Consider that the Tax Reform Act of 1986 taxed all income, including long-term capital gains, at a top rate of 28%, and the paradigm before 2017 tax reform was very different. The paradigm from 2017 tax reform will change, whether by creeping as the 1986 one did or by dramatic changes needed to reduce the exploding national debt or pay for Medicare or Social Security.

II.E.2. Comparing Exit Strategies from C Corporations and Pass-Through Entities

II.E.2.a. Transferring the Business

Part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis shows that, when doing a seller-financed sale of a business, such as to key employees, other owners, or family members, the value of a business attributable to goodwill can be transferred much more tax-efficiently when using a partnership compared to a C corporation or an S corporation. Part or all of these dynamics can be replicated in other transactions.

A shareholder's stock's basis does not increase as a result of a C corporation's reinvested income. However, part or all of the gain on the sale of original issue stock in a qualified corporation that runs a qualified business is excluded from income. See part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation, explaining Code § 1202.

However, to the extent that an owner's distributive share of a partnership's or S corporation's income is reinvested, the owner's basis in the partnership interest[680] or

[680] Code § 705.

stock[681] increases. Thus, the gain on sale usually is much lower when selling a partnership interest or S corporation stock than when selling C corporation stock.

S corporations and partnerships are ideal candidates for estate planning transfers using irrevocable grantor trusts. See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust. When the pass-through entity makes distributions to pay its owners' taxes, the irrevocable grantor trust that bought the stock or partnership interest uses those distributions to pay down the note owed to seller, and the seller uses this to pay taxes. Thus, tax distributions are used to build equity in the purchasing irrevocable grantor trust. Contrast this with C corporations, where the corporation pays taxes directly to the government, and any distributions are subject to double taxation. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, using the scenario of a C corporation distributing all of its earnings to its shareholders.

Also, gain on the sale of C corporation stock is subject to the 3.8% tax on net investment income.[682] Gain on the sale of an S corporation or partnership that conducts a trade or business may be largely excluded from that tax when the owner sufficiently participates.[683]

Furthermore, when an owner dies, the assets of a sole proprietorship (including an LLC owned by an individual that has not elected corporate taxation) or a partnership (including an LLC owned by more than one person that has not elected corporate taxation) can obtain a basis step-up (or down) when an owner dies, whereas the assets of a C corporation or an S corporation do not receive a new basis.[684]

Part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons describes more reasons why I tend to prefer partnerships over S corporations and S corporations over C corporations.

II.E.2.b. Converting from S Corporation to C Corporation

See part II.P.3.e Conversion from S Corporation to C Corporation for short-term planning. Ideas include:

- A conversion may be taxable, with the main issue being that an S corporation that was on the cash method that may be required to convert to the accrual method.

- Additional steps may be needed to preserve or distribute the S corporation's accumulated adjustment account (which generally lets S corporations distribute its reinvested taxable earnings later without taxing it shareholders – see part II.Q.7.b Redemptions or Distributions Involving S Corporations). Note that, if the corporation distributes a note before converting, interest income on the note will be taxable at its shareholders' full ordinary income rates and subject to net investment income tax, which together combine to impose a 40.8% federal tax rate,

[681] Code § 1367.
[682] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[683] See part II.I.8 Application of 3.8% Tax to Business Income.
[684] See part II.H.2 Basis Step-Up Issues.

whereas the corporation may receive (see part II.G.19.a Limitations on Deducting Business Interest Expense) a deduction at a 21% federal rate.

However, one always needs to consider what if that decision needs to be reversed when a new Congress changes the income tax paradigm. See parts II.P.3.c Conversion from C Corporation to S corporation and II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation.

II.E.2.c. Converting a C Corporation to an S Corporation

A C corporation that revoked its S election must wait 5 years to convert back to an S corporation. See part II.A.2.l Terminating S Election.

See part II.P.3.c Conversion from C Corporation to S corporation, including II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation. Issues discussed there include the following:

- Generally, an asset sold within 5 years after converting from a C corporation to an S corporation will be taxed at the entity level and again to the shareholders. See part II.P.3.c.ii Built-in Gain Tax on Former C Corporations under Code § 1374. Therefore, before converting, one might sell assets that are likely to sold within 5 years. If the taxpayer uses the cash receipts and disbursements method of accounting, consider switching to accrual before convertings, so that accoutns receiveable do not get hit with this tax.

- Although an S corporation that has accumulated earnings and profits from when it was a C corporation cannot have excess passive investment income, that issue is easily managed through the corporation's investment mix – if one considers the issue and plans for it. See part II.P.3.c.iii Excess Passive Investment Income, especially fns 2865-2868.

- Also, an S corporation that has accumulated earnings and profits from when it was a C corporation should not invest in tax-exempt investments, the income from which does not generate AAA and therefore may trigger a taxable dividend when distributed. See part II.P.3.c.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

- If the corporation maintains an inventory, converting from a C corporation to an S corporation may incur tax. See part II.P.3.c.i LIFO Recapture.

II.E.3. Recommended Structure for Start-Ups

The structure should start as a simple one and then, when the entity is making a lot money, would be transitioned to a more complex structure. For long-term reasons why an entity taxed as a sole proprietorship or partnership makes sense, see part II.E.5.a Strategic Income Tax Benefits of Recommended Structure.

Consider starting with an LLC. Start-up businesses often lose money initially, and an LLC taxed as a sole proprietorship or partnership facilitate loss deductions better than other entities[685] (although deducting start-up losses might not always generate the best result).[686] Also, often owners of closely-held businesses operate with a high degree of informality, and owners of corporations can get into trouble by taking money out without documenting compensation or documenting loans;[687] contrast that to an LLC that for income tax purposes is either disregarded entity or a partnership,[688] in which case distributions are either disregarded or generally nontaxable.[689]

A business with owners that work more than 100 but not more than 500 hours per year might want to move its real estate into the desired structure to avoid the 3.8% net investment income tax on the rental income (because the rental income and expense are disregarded for income tax purposes, being in the same umbrella as the operating business) or on the sale of the rental property. For example, a parent LLC might own an operating LLC and a real estate LLC. See parts II.I.8.c.i If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income, II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax, and II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

However, deducting start-up losses may not be desirable, because the owner is in a lower tax bracket now and expects not to be in a low tax bracket in the future. In that case, consider using an entity taxed as an S corporation, with the owners guaranteeing loans by third parties but not investing or lending a lot of money themselves. If that, too, generates more losses than desirable, then try a C corporation, which will just roll forward the losses. When using a C corporation or and S corporation, consider planning to qualify for the requirements of part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244. Beware, however, that using either kind of corporation can make getting into an ideal long-term structure more difficult, because one needs to avoid triggering taxation on a deemed distribution of assets. See

[685] See part II.G.3 Limitations on Losses.

[686] If the owner is in a lower bracket in start-up years than in later years, losses might best be deferred, if possible. A variation of this idea is in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good. If deferring losses is expected to be particularly beneficial, consider:

- If loans are bank-financed, an S corporation can easily ensure that its owners' distributive share of losses be suspended due to basis limitations until the S corporation becomes profitable. See part II.G.3.c.i.(a) Limitations on Using Debt to Deduct S Corporation Losses.
- A start-up C corporation's losses are simply carried forward and deducted against its later income. See Code § 172. In case the C corporation doesn't succeed, certain start-up documentation can generate ordinary loss (instead of capital loss) treatment when the stock becomes worthless. See part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244, subject to part II.J.11.b Code § 1244 Treatment Not Available for Trusts. The timing and documentation (including initial documentation in the case of a loan) of a worthless stock or bad debt deduction can be tricky. See part II.G.3.b C Corporations: Losses Incurred by Business, Owner, or Employee, especially fns. 811-812 (stock) and 814-816 (loans).

[687] Such payments are potentially taxable distributions to shareholders; see the text accompanying fns. 3437-3438 in part II.Q.7 Exiting From or Dividing a Corporation. The IRS attacks distributions from S corporations, asserting (often successfully) that they are disguised compensation (and perhaps assessing penalties as well); see part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fns. 77-78.

[688] See part II.B Limited Liability Company (LLC).

[689] See part II.Q.8.b.i Distribution of Property by a Partnership.

part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure. Often a trigger for moving a corporation into the structure is the desire to avoid capital gain tax on the seller-financed sale of the business, which often makes the costs of transition worthwhile if the business has significant goodwill. See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

When the business starts making money but only enough to pay owner compensation and equipment that is expensed immediately, no additional self-employment tax is due relative to if the entity were a corporation paying compensation to its owners. Furthermore, if the business is investing profits in equipment, etc., generous write-offs are available.[690] However, note that wages paid by an S corporation may provide a higher Code § 199A deduction relative to compensation paid to a partner, so consider this corporate advantage.[691]

Then, when the client is ready for the ideal entity (for example, when self-employment tax on reinvested earnings becomes a significant number), the client can simply assign the LLC to the limited partnership described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart; see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure. However, the client might express a preference in the long-run to use part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. If so, the client might want to start with that structure instead of starting with an LLC. If one starts with an entity taxed as an S or C corporation instead of an LLC, then the presence of non-compete agreements would make migration to a partnership structure less effective, because the value of the goodwill at the time of the migration would remain inside the corporation.

Suppose that one concludes that a C corporation would be ideal. Starting with an LLC taxed as a partnership and then converting to a C corporation the earlier of five years before a sale is anticipated or shortly before its gross assets reach $50 million might be the most tax-efficient approach.[692]

Whether or not one likes the above recommendations, consider asset protection with a business' net profits. An entity's creditors' claims take priority over distributions to owners. If an entity distributes to its owners any profits not needed to keep the entity fiscally responsible, generally those assets will not be subjected to the claims of the entity's future creditors. For tax purposes, investments are best kept outside the entity, particularly for a C or an S corporation,[693] but also, to a certain but more limited extent,

[690] See part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation.
[691] See part II.E.1.c Code § 199A Pass-Through Deduction Qualified Business Income, especially part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholdsand particularly fns 637-646.
[692] See part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially part II.Q.7.j.ii Limitation on Assets a Qualified Small Business May Hold, especially part II.Q.7.j.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S Corporation or a Partnership? (particularly the text accompanying fns. 3815-3821).
[693] Any distributions of appreciated assets trigger corporate-level income tax, whether paid by the corporation (C corporation) or shareholders (S corporation). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Note also that S corporations that

for a partnership.[694] The owners might consider loaning the distributions back to the entity, becoming creditors, rather than owners, to that extent. The owners might also consider forming an LLC taxed as a partnership to hold any distributions that they neither loan to the company nor keep for personal purposes, viewing the LLC as a source for funding future capital projects or exit strategies or perhaps for providing or securing a line of credit for the business;[695] however, S corporations might want to avoid any formal requirement in their governing documents that distributions be made to such an LLC.[696]

II.E.4. Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure

In part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, we learned that:

- To the extent that a C corporation reinvests profits, it is more tax-efficient from the perspective of annual income from operations.

- To the extent that it distrubutes profits, it is not more tax-efficient.

Given that pass-through entities tend to have superior exit strategies,[697] the portion of the business that distributes profits should be in a pass-through entity.

Consider forming a limited partnership owned by a C corporation and a pass-through entity, with ownership based on the desired long-term goal for distributions:

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have accumulated earnings and profits from prior periods as an S corporation might want to avoid investments that generate tax-free income; see part II.P.3.c.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

[694] See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). Such distributions have more potential to trigger tax than do distributions of other assets, but tax can be avoided with careful planning.

[695] If there is a risk that the corporation will have losses but the shareholders' basis will be insufficient to deduct those losses, then the LLC should loan the funds to its members who should then lend them to the corporation. See part II.G.3.c.i Basis Limitations for S Corporation Owners Beyond Just Stock Basis. Presumably, if the loan from the LLC to the corporation is already in place, the LLC could simply distribute the loan to its members. See fn. 831.

[696] A partnership is not an eligible shareholder of an S corporation; see part II.A.2.g Shareholders Eligible to Hold S Corporation Stock. Therefore, one might consider avoiding any distribution arrangements that might make a partnership appear to be a shareholder. However, distribution arrangements that are not baked into the governing documents do not count for determining whether a second class of stock exists (see part II.A.2.j.iii Disproportionate Distributions, and within that see fn. 214 for what constitutes governing documents and the effect, if any, given to certain arrangements), so presumably they would not count as creating a shareholder relationship. Although I have not seen anything directly on point, presumably an S corporation can contribute to a partnership in exchange for a partnership interest and then distribute that partnership interest to its shareholders; the parties would have substantial authority for not applying undesirable valuation discounts to that distribution – see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders for general rules, fn. 3694 for authority for no valuation discounts, and part II.Q.7.h.iii.(b) Nondeductible Loss to Corporation When It Distributes Property to Shareholders for why valuation discounts are undesirable.

[697] See part II.E.2.a Transferring the Business.

- This might be worked in with the general ideas of parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

- If the entity is already a C corporation or an S corporation, see part II.E.7 Migrating into Partnership Structure.

Before doing any of this, consider that investing in a partnership might make a C corporation ineligible for part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation. However, as described in part II.Q.7.j, not all businesses are eligible for the exclusion, and the exclusion applies only to stock originally issued to the owner (or to the person who gifted or bequeathed the stock).

II.E.5. Recommended Long-Term Structure for Pass-Throughs – Description and Reasons

II.E.5.a. Strategic Income Tax Benefits of Recommended Structure

To maximize basis step-up of assets used in a business[698] and promote tax-efficient exit strategies,[699] the main entity should be a partnership. A partnership often is a better exit vehicle than a C corporation, notwithstanding part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation;[700] if the exclusion of gain on sale of a C corporation is particularly compelling, consider instead starting as an LLC taxable as a partnership then later converting to a corporation.[701] However, corporate structure has some advantages:

[698] See parts II.H.2 Basis Step-Up Issues, II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, and II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

[699] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis, for how to save capital gain tax on the seller-financed sale of an interest in a business. Also compare part II.Q.7.f Corporate Division Into More Than One Corporation (including the cumbersome requirements of Code § 355 mentioned in parts II.Q.7.f.ii Code § 355 Requirements and II.Q.7.f.iii Active Business Requirement for Code § 355), with part II.Q.8 Exiting From or Dividing a Partnership (partnership divisions are generally tax-free, subject to certain rules about shifting unrealized gain in property whose value had been used to determine partnership percentage interests). Also, corporate redemptions might be recharacterized as distributions (see part II.Q.7.a.iii Redemption Taxed Either As Sale of Stock or Distribution; Which Is Better When) and lose installment sale treatment, whereas partnership redemptions are nontaxable until basis is fully recovered (see part II.Q.7.b.ii Redemptions or Distributions Involving S Corporations Compared with Partnerships).

[700] See parts II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill (California).

[701] See part II.Q.7.j.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S Corporation or a Partnership? (especially the text accompanying fns. 3815-3821).

- The partnership audit rules are becoming onerous and may artificially increase tax.[702] Even though S corporations generally are pass-throughs, Congress has not targeted them, and the IRS needs to consider the burdens of making adjustments at both the entity and shareholder level.[703]

- If the owners find a corporate buyer and can, on a tax-free basis, merge the business into the buyer and receive the buyer's stock, and they don't mind having low basis publicly-traded stock, then note that a tax-free merger or similar reorganization under Code § 368 is available only to corporations. Forming a corporation immediately before the sale might not work;[704] I am unsure whether checking-the-box to elect corporate treatment helps any.

- If the owners would like for a qualified retirement plan to own the business, then an S corporation owned by an ESOP would be the ideal structure;[705] on the other hand, an entity can start in the structure set forth below and then easily assign the interests in the operating LLCs to the S corporation general partner, in what generally would be a tax-free transaction.[706]

Also, incentive pay and deferred compensation can be more difficult in a corporate setting than in a partnership setting.[707]

Furthermore, a partnership often is a better vehicle for deducting start-up losses.[708]

II.E.5.b. Self-Employment Tax and State Income Tax Implications of Recommended Structure

To avoid self-employment tax, the entity should be a limited partnership, since an interest as a limited partner is not subject to self-employment (SE) tax.[709] However, in Tennessee, if one already has earnings that exceed the FICA/SE taxable wage base,[710] SE tax is actually good, because one is paying 2.9% or 3.8% SE tax, not worrying about the 3.8% net investment income tax,[711] and avoids paying the "Hall tax," a 6.5% excise tax on a limited liability entity's income;[712] using an LLC subject to SE tax allows one to

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702 See part II.G.18.c Audits of Partnership Returns.
703 See part II.G.18.b Audits of S Corporation Returns.
704 See part and II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations, especially fn. 2477.
705 See part II.G.20 Employee Stock Ownership Plans (ESOPs, which also explains that a partnership interest does not qualify as employer stock.
706 See parts II.M.2.c Contribution of Partnership Interest to Corporation and II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.
707 See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.
708 See part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.
709 See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
710 See parts II.L.2.a.i General Rules for Income Subject to Self-Employment Tax and II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 3079, the latter for rates.
711 SE income is not subject to the net investment income tax. See fn. 1527.
712 Tenn. Code § 67-4-2007 imposes a 6.5% excise tax on all persons, other than not-for-profit entities, doing business in Tennessee. "'Person' or 'taxpayer' means every corporation,

avoid the Hall tax by paying possibly unreasonably high compensation,[713] and such compensation strategies tend to prevent an S or a C corporation form accumulating the war chest it needs for a rainy day or to buy out an owner who retires or becomes uninsurable. One should involve a local tax expert regarding any state or local taxes on pass-through entities in the states in which the entity does business.[714]

II.E.5.c. Operating the Recommended Structure

To protect any real estate from business losses, maximize protection from creditors, and facilitate future restructuring of the business:

- Operations should be conducted in one or more LLCs, wholly owned by the limited partnership.

- Real estate should be held in one or more LLCs, wholly owned by the limited partnership. However, it would also be fine for the real estate to be held in a separate LLC outside of the limited partnership structure,[715] if the owner materially participates in the business.[716] Note that keeping the real estate inside the master LP umbrella would take the place of or facilitate grouping under the passive loss rules,[717] which might be more important in the case of a real estate professional, because grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[718]

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subchapter S corporation, limited liability company, professional limited liability company, registered limited liability partnership, professional registered limited liability partnership, limited partnership, cooperative, joint-stock association, business trust, regulated investment company, REIT, state-chartered or national bank, or state-chartered or federally chartered savings and loan association," Tenn. Code § 67-4-2004(38). Just to drive home the point for LLCs, Tenn. Code § 67-4-2105 expressly includes "any limited liability company regardless of how it is treated for federal income tax purposes." The tax does not apply to self-employment income. Tenn. Code § 67-4-2006(4)(B).

713 See fn. 28 for federal unreasonable compensation cases.

714 See part II.G.2 State Taxation.

715 The 2012 proposed regulations on the 3.8% tax on net investment income called into question the treatment of real estate rented to one's business. However, under the final regulations, any rental income considered nonpassive income under the self-charged rental rules would not be subject to the 3.8% tax. However, self-rental might not fully work, in that ownership of the real estate and the operating business might change over time. See parts II.I.8.c Application of 3.8% Tax to Rental Income. These issues can be addressed through special allocations and preferred returns inside the partnership structure.

716 The self-charged rental rules require that the landlord materially participate in the tenant's business (which the landlord must also own at least in part). See part II.I.8.c Application of 3.8% Tax to Rental Income and II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. If a business owner wants to rely on the more-than-100-hour significant participation rules rather than the material participation rules (which generally require more than 500 hours of work), then the business owner will not be able to rely on the self-rental exception and needs to keep the real estate inside the limited partnership umbrella so that the rent is disregarded for income tax purposes.

717 See part II.K.1.b.i Grouping Activities – General Rules, particularly fn. 2092.

718 See fns. 2176-2177.

- The real estate LLC(s) should lease the property to the operating LLC(s) for fair rental, which will be ignored for tax purposes but should allow the LLCs' respective assets to be segregated for purposes of protection from creditors.

The individuals involved in the business would own:

- An S corporation[719] that is a 1% general partnership, and

- In the aggregate, the remaining 99% interest as limited partners.

To respect the S corporation's role as a general partner and to prevent the 3.8% tax from applying to their distributive shares of the S corporation's 1% interest as a general partner, the individuals would be employees of the S corporation and receive reasonable compensation for the services they perform. The employment arrangement also keeps the individual owners from tainting their limited partnership interests. The individuals' participation would be attributed to both the corporation (if applicable) and themselves.[720]

On a daily basis, the operation is simple:

- The S corporation, as general partner of the limited partnership, controls each LLC subsidiary, because the limited partnership is the LLC's sole member.

- In this capacity, the S corporation appoints its owners as the LLC's managers (and can give them more traditional titles, such as president, chief financial officer, etc.) who sign documents on behalf of the LLC showing their capacity as the LLC's managers or other officers.

- Each LLC subsidiary pays the S corporation a management fee to the S corporation to pay for the cost of the services provided by the owners and any other employees leased to the LLC. To protect each LLC's separateness from the other LLCs (if the partnership has more than one LLC subsidiary), it would be best for each LLC to have its own employees and not simply use the S corporation as a central payroll master; however, this might not be practical, depending on how the business is run. An entity that is disregarded for income tax purposes is also disregarded for self-employment tax purposes, notwithstanding that it is treated as a separate entity for payroll tax purposes.[721]

[719] The entity being an LLC taxed as an S corporation would facilitate material participation of any trust that is or might eventually become an owner of the general partner. See part II.K.2.b Participation by an Estate or Nongrantor Trust. (Material participation is important to avoid the 3.8% tax on net investment income that might otherwise apply. See part II.I.8 Application of 3.8% Tax to Business Income.) If one is concerned that an LLC taxed as an S corporation might be subjected to self-employment tax because of some regulations that appear to be obsolete (see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election), using a statutory close corporation might be a safer approach. See text accompanying fn. 2290 within part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[720] See part II.K.1.c Limited Partnership with Corporate General Partner, particularly fn. 2154.
[721] See part II.B Limited Liability Company (LLC), fns. 279-280.

- Only the S corporation and limited partnership file federal income tax returns. No matter how many LLC subsidiaries the partnership owns, the partnership files one federal income return to report all of their activity. (These materials do not attempt to cover state income or other tax issues in any systematic way that would help with state issues here.)

The tiered structure comes into play more when quarterly distributions are made to pay taxes or otherwise provide investment return to the owners. The LLCs would distribute part or all of their profits to the limited partnership, which then makes appropriate distributions to the limited partners and the S corporation general partner.

II.E.5.d. Net Investment Income Tax and Passive Loss Rules Under Recommended Structure

If any individual participates no more than 500 hours per year, that person might be subjected to the 3.8% tax more readily as a limited partner than as the owner of an S corporation, because limited partners have fewer ways to satisfy the material participation test than do other owners of pass-through entities.[722] On the other hand, if one is concerned only about avoiding the 3.8% tax on net investment income and not about disallowing passive losses or credits,[723] then a limited partner who works for more than 100 hours generally would avoid the 3.8% tax.[724]

II.E.5.e. Estate Planning Aspects of Recommended Structure

II.E.5.e.i. Family Conflicts

When some family members are in the business and others outside the business, conflicts can develop. The insiders want to reinvest earnings to grow the business and would like compensation commensurate with the value they view they bring to the business, including incentive equity compensation. The outsiders want to distribute earnings for their own use and believe that they should share in the business' growth because that is part of the ownership legacy their parents left to them.

The first generation might want to put a long-term lease on real estate used in the business and bequeath the real estate to the outsiders. That allows the outsiders to have significant cash flow locked in for a while and allows more (or all) of the business to be bequeathed to the insiders.

The cleanest break would be for any LLCs holding real estate to be distributed from the limited partnership and then bequeathed. Generally, such a distribution would not generate any income tax.[725] To maximize income tax planning opportunities, all of the real estate LLCs might stay under one partnership umbrella.[726]

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[722] See part II.K.1.a.ii Material Participation.
[723] See part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[724] For more details, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[725] See part II.Q.8 Exiting From or Dividing a Partnership.
[726] See part II.Q.8.a Partnership as a Master Entity.

If insiders are pitted against insiders, generally a partnership structure is easier to divide than a corporate structure.[727]

II.E.5.e.ii. Estate Tax Deferral Using Recommended Structure

If long-term estate tax deferral is required,[728] deferring estate on a partnership interest involves more uncertainty than deferring estate on stock.[729]

II.E.5.e.iii. Grantor Trust Planning

When a business is sold, clients may wish to turn off grantor trust status[730] so that the income tax burden does not deplete their assets more than they are comfortable with.

For a grantor trust owning an S corporation, generally grantor trust status should be turned off before January 1 of the year of the sale if the grantor wishes to avoid all tax on the gain on sale. This concern is diminished or may not even exist for a partnership. See part III.B.2.j.i Changing Grantor Trust Status, especially the text accompanying fns. 5158-5160.

II.E.5.f. Recommended Structure with C Corporation

Becase 2017 tax reform caused C corporation annual income taxation to be quite attractive, one might the S corporation shown in the structure to instead be a C corporation, and give the corporation more than 1%.

See part II.E.4 Reaping C Corporation Annual Taxation Benefits Using Hybrid Structure.

II.E.5.g. Other Aspects of Recommended Structure

Parts II.E.7 Migrating into Partnership Structure discusses moving to the recommended structure. Consider not only it but also part II.E.9 Real Estate Drop Down into Preferred Limited Partnership for real estate, long-lived tangible personal property, or intangible assets. The latter might generate royalty income subject to the 3.8% tax on net investment income, but in the recommended structure royalties would be disregarded the same way rent would be.

If the client would prefer not to have an S corporation general partner, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary. Note, however, that a corporation transitioning into that structure (instead of retaining a preferred partnership interest) would pay tax; see parts II.P.3.b From Corporations to Partnerships and Sole Proprietorships and II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially parts II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property and II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

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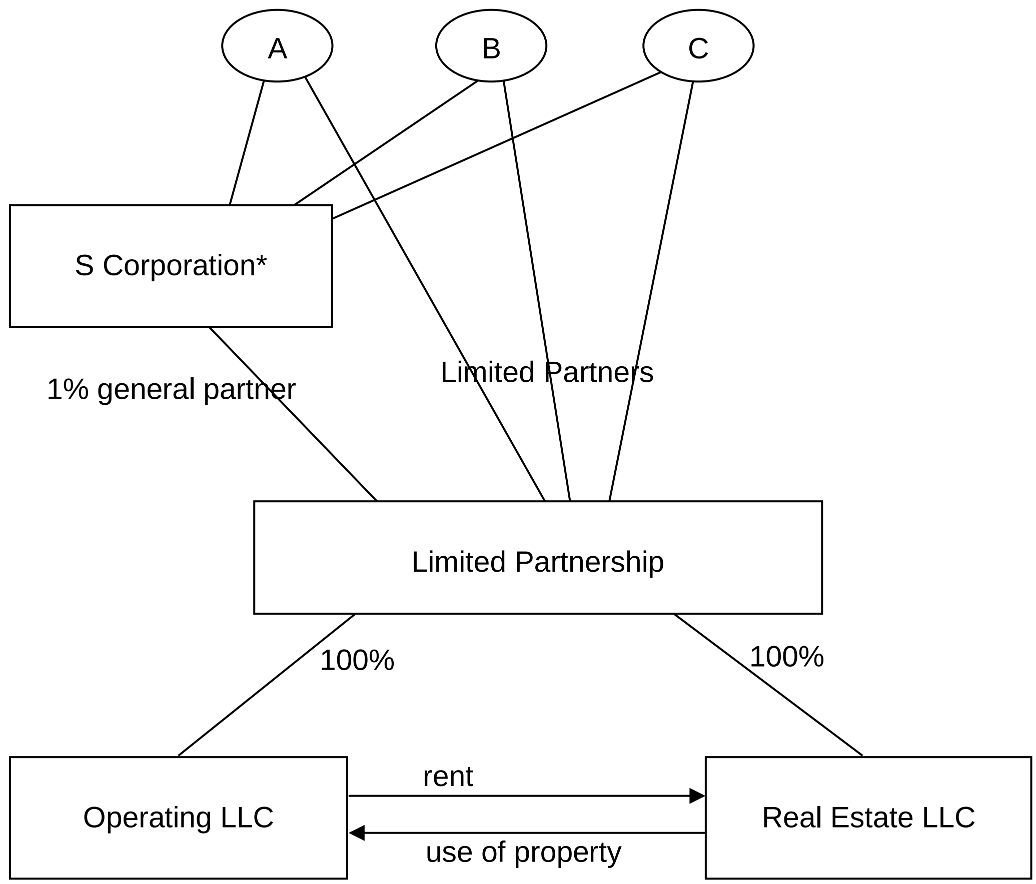
[727] See parts II.Q.7 Exiting From or Dividing a Corporation (especially part II.Q.7.f Corporate Division Into More Than One Corporation) and II.Q.8 Exiting From or Dividing a Partnership.
[728] See part III.B.5.d.ii Code § 6166 Deferral.
[729] See part III.B.5.d.ii.(b) Tiered Structures.
[730] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

II.E.6. Recommended Partnership Structure – Flowchart



* See part II.E.5.f. Recommended Structure with C Corporation.

If no real estate is ever held and the client balks at creating what the client perceives as too many entities, this structure could simply be a limited partnership without the LLCs. However, it would be much easier to start the operating business in its own LLC and later simply add other LLCs than it would be for the limited partnership to later transfer all of its business operations into a new LLC when real estate or a separate location or line of business is acquired.

II.E.7. Migrating into Partnership Structure

II.E.7.a. Overview of How to Migrate into Desired Structure

Moving an existing LLC, that is taxed as a partnership or as a disregarded entity, into this structure is relatively straightforward. The member or members form an S corporation. The S corporation contributes to a new limited partnership cash equal to 1/99 of the appraised value of the LLC's business, in exchange for a 1% interest as a general partner. The member or members contribute their interests in the LLC to the partnership in exchange.

Forming the S corporation and the limited partnership are not taxable events,[731] so long as the liabilities are not shifted (or reallocated) too much from the members of the LLC to the corporate general partner.[732] Any gain inherent in the contributed assets will be taxed to the original owners when those assets are sold.[733] The work-in-process, appreciated inventory, and accounts receivable would tend to be the assets to watch, and accounts receivable would not be a concern if the LLC's income was reported using the accrual method. Given that the S corporation would probably have been formed with a modest cash contribution and therefore would have not contributed such assets, the only gain likely to receive a special allocation would be those inherent in the LLC. Thus, the 99% owners would be allocated 100% of the gain on such assets. Presumably they would own the same proportion of the S corporation as they did of the LLC, so presumably they have the same economic interest in the partnership's income as they did before and this allocation of income is of no practical consequence, although this special allocation of income would need separate accounting on the partnership's annual return. This could be avoided by the members forming a limited partnership as general and limited partners[734] and then contributing their interests as general partners to the S corporation. If reallocation of liability becomes an issue, the original members can guarantee the debts to get the debts allocated to them.

These two transactions are illustrated in part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure, including parts II.E.7.b.i Using Cash Contribution to Fund New S Corporation and II.E.7.b.ii Using LLC to Fund New S Corporation.

This migration would be much more involved if the business is operated inside a corporation. Converting a corporation into a partnership would trigger gain.[735] Instead, generally the corporation would move its assets into an LLC and then contribute that LLC to the limited partnership.[736] The corporate partner would receive a preferred return on this invested capital (for which it receives a capital account)[737] and a 1% interest in

[731] See part II.M.1. Taxation on Formation of Entity: Comparison between Partnership and Corporation.

[732] If formed as described above, the concern would be that the reallocation of liabilities from a partner would be a deemed cash distribution that would generate gain if and to the extent that it exceeds the basis of that partner's partnership interest; see part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. If formed as described below, where the partners contribute to the S corporation their interests as general partner, then, in addition to the issue described above, a shareholder would have gain to the extent that the debt the corporation assumed exceeds the basis of the partnership interest the shareholder contributes to the corporation; see part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.

[733] See part II.P.1.a.i Allocations of Income in Partnerships.

[734] See part II.C.5 Converting from One Entity Taxed as a Partnership to Another.

[735] See part II.P.3.b From Corporations to Partnerships and Sole Proprietorships.

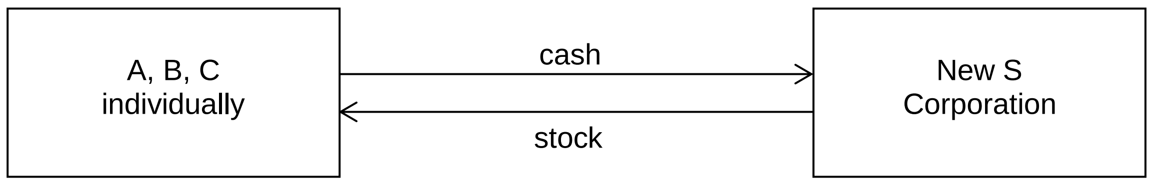
[736] The corporation would do this either gradually or in one fell swoop, as described in part II.E.7.c.i Corporation Forms New LLC, including parts II.E.7.c.i.(a) Direct Formation of LLC and II.E.7.c.i.(b) Use F Reorganization to Form LLC.

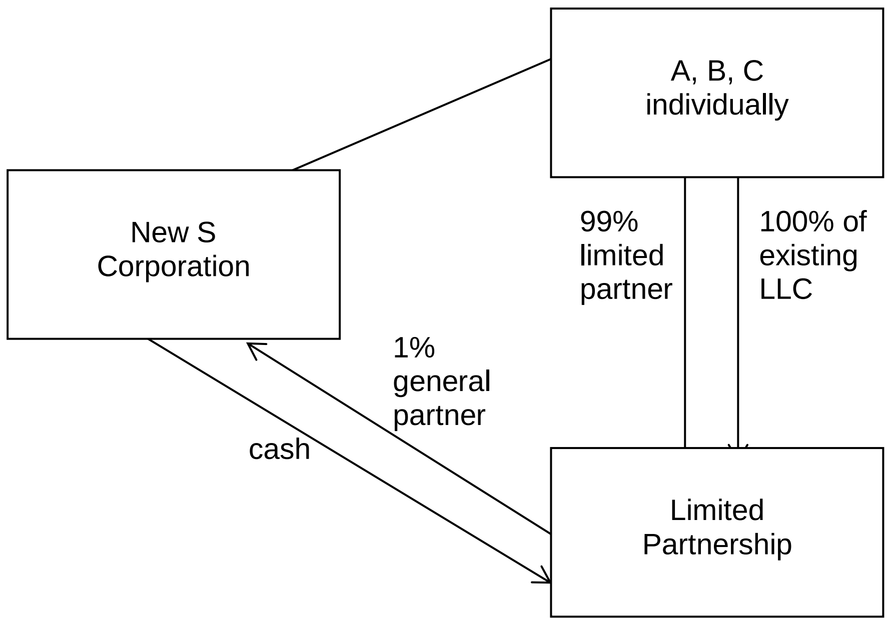
[737] The exchange for a capital account (not intended to be redeemed in any manner in the first several years) and preferred payments (made from operating cash flow) can easily be done in a nontaxable manner that prevents the disguised sale rules from applying. See part II.M.3 Buying into or Forming a Partnership, particularly part II.M.3.e Exception: Disguised Sale. If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members,

the residual profits as a general partner, and the individuals would receive 99% of the residual profits as limited partners.[738] The considerations about debt reallocation described above would also apply. In some cases a C corporation might retain certain assets, collect them in due course, and then make an S election. For more information on this conversion, see part II.Q.7.h.viii Value Freeze as Conservative Alternative.

II.E.7.b. Flowcharts: Migrating LLC into Preferred Structure

II.E.7.b.i. Using Cash Contribution to Fund New S Corporation

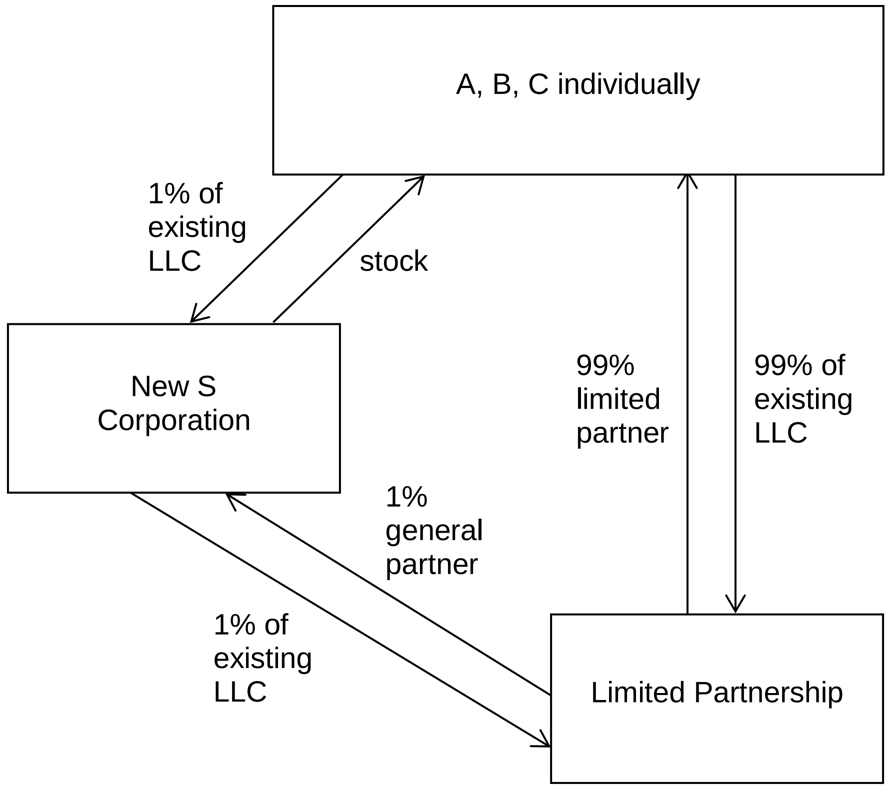




see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[738] As illustrated in part II.E.7.c.ii Moving New LLC into Preferred Structure.

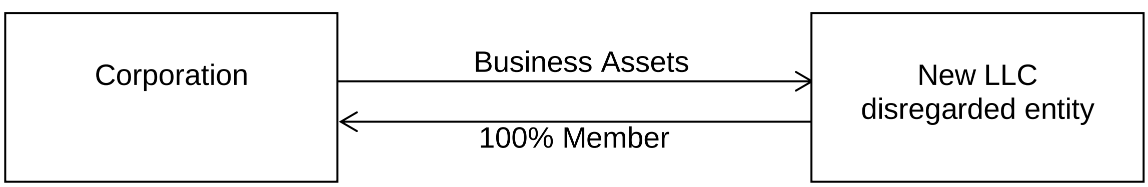
II.E.7.b.ii. Using LLC to Fund New S Corporation



II.E.7.c. Flowcharts: Migrating Existing Corporation into Preferred Structure

II.E.7.c.i. Corporation Forms New LLC

II.E.7.c.i.(a). Direct Formation of LLC



<u>Advantages</u>

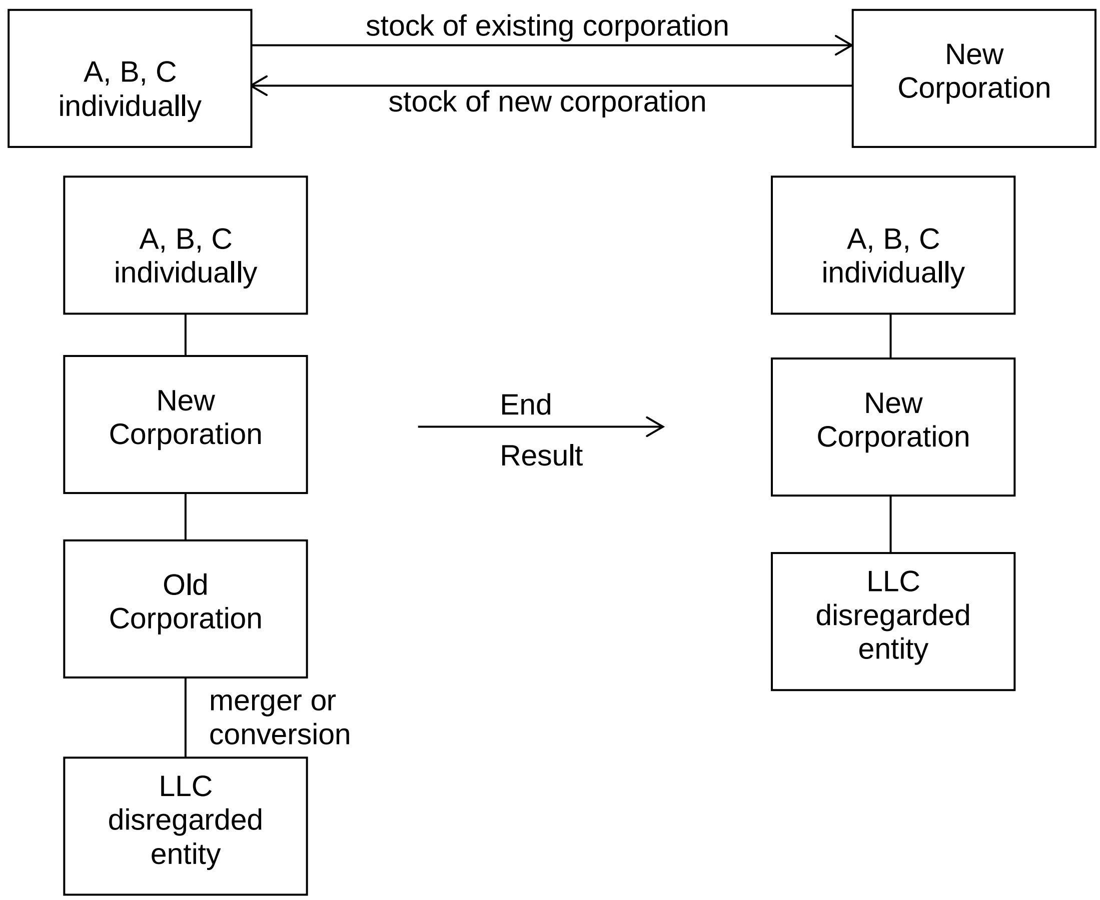
- Corporation can keep nonbusiness assets
- Corporation can keep business assets that would generate complications if transferred to the limited partnership structure and then had income recognition event
- New LLC can stay as a disregarded entity for a while as transition to new structure and get everyone used to working in LLC structure

Disadvantages

- Piecemeal transfer of assets

- Some assets not readily transferable

II.E.7.c.i.(b). Use F Reorganization to Form LLC



Advantage

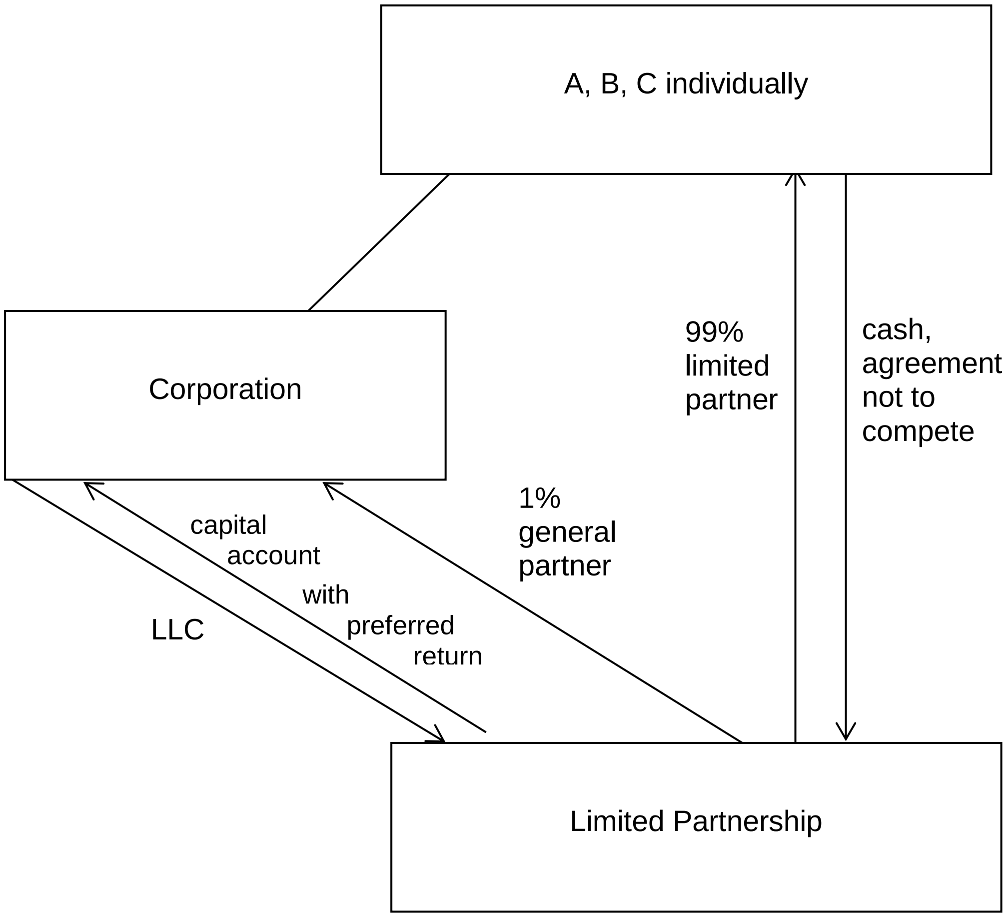
- Moves all assets in one fell swoop

Disadvantages

- No selectivity of retained assets
- Contribution of stock of old corporation to new corporation and merger or conversion of old corporation into new corporation need to be done at the same time
- If S Corporation involved, new corporation does new S election and old corporation does qualified subchapter S subsidiary election.

See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. For an S corporation, see also part II.A.2.h Qualified Subchapter S Subsidiary (QSub), especially fn. 172.

II.E.7.c.ii. Moving New LLC into Preferred Structure



II.E.7.c.iii. Migrating Gradually Over Time

A company might have its employees and intellectual property locked down so tightly that the migrations described in the preceding provisions of this part II.E.7 Migrating into Partnership Structure result in a large value and large preferred return that might be so large that they cause very significant estate tax issues that seem impossible to overcome. Consider:

- A corporation that needs to migrate to these structures to obtain income tax efficiencies.

- Any type of company that is subject to estate tax and difficult to move into a structure outside the estate tax system. For example, it might have too low a cash flow to make a GRAT or a sale to an irrevocable grantor trust be efficient.

In those cases, consider that, in today's economy and global environment, businesses need to reinvent themselves – sometime gradually, sometimes quickly – to keep up with or try to out-perform their competitors.

The company might reinvent itself over time through a sister company that is held in the business structure recommended in this part II.E Recommended Structure for Entities. For example, the senior generation makes gifts or loans to new trusts that establish this structure. The new trusts own the S corporation and limited partnership (or LLC, in the case of a state such as Tennessee).

For examples of new activities, see part III.B.1.a Business Opportunities.

Certain IRS responses to such movement and generally successful taxpayer responses are described in parts III.B.1.a.v Sending Business and III.B.1.a.vi Asset Transfers to Children or Their Businesses.

If the business being transitioned is a corporation, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.E.8. Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary

II.E.8.a. Description of Structure; Nontax Issues

The structure would be one of the following:

- Limited Liability Limited Partnership (LLLP). An LLLP is a limited partnership (LP) (a partnership consisting of one or more general partners (GPs) and one or more limited partners) that registers for limited liability protection for its GPs.

- LP with LLC Subsidiary. The LP parents functions as a holding company and does business through one or more LLC subsidiaries, the latter which are disregarded entities for most tax purposes.[739]

See parts II.C.11 Limited Partnership and II.C.12 Limited Liability Partnership Registration for General Partners in General or Limited Partnerships, the latter covering LLLPs as variations of LPs.

If one were to choose between the two structure, I would tend to favor the LP with LLC Subsidiary structure, because it facilitates opening separate branches or lines of businesses as separate LLCs without the initial business being comingled with the ownership of these new branches or lines of business. I also tend to favor it in Missouri, because in Missouri the lapse of an LLLP's registration cannot be cured, leaving the GPs exposed, whereas a Missouri LLC does not require annual registration and cannot have any lapse in liability protection. A disadvantage of the LP with LLC Subsidiary structure is that two registrations might be required in each state in which the company does business, contrasted with one registration per state for a LLLP. However, the latter might not be a disadvantage relative to the LP with LLC Subsidiary structure when separate branches or lines of businesses operate as separate LLCs.

The LP with LLC Subsidiary structure also permits the general partner's name to be kept confidential in most business dealings if the general partner is not active in the business, in that each LLC can be run by a manager who is not an owner.

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[739] See part II.B Limited Liability Company (LLC).

II.E.8.b. Tax Issues

Let's discuss FICA/ self-employment (SE) tax issues and passive loss issues.

According to the legislative history of the SE tax, a person who is not only a GP but also a limited partner is subjected to SE tax only with respect to the GP interest.[740] However, this is based on legislative history, and I am unaware of any cases or rulings applying this principle. Any compensation paid to a partner for services is subject to SE tax to the extent that the services are rendered in carrying out a trade or business,[741] whether or not the partner is a GP.[742] Presumably the IRS would seek to reclassify distributions to a limited partner as compensation for services rendered, in a manner similar to what it does in the S corporation arena.[743]

Although originally a limited partner lost liability protection by participating in the partnership's activities, that has not been the case for quite some time.[744] In the passive loss area, being a general partner has a different effect – it converts an interest as a

[740] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 2409 and accompanying text.

[741] See part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, especially the text accompanying fns. 2402-2404.

[742] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 2405 and accompanying text.

[743] See part II.L.1 FICA: Corporation, especially fn. 2337, and part II.L.5.a S Corporation Blocker Generally, especially fn. 2444.

[744] A prior version of Willis & Postlewaite, *Partnership Taxation*, ¶2.02. Requirements of Section 704(e), stated:

> As originally written, the Uniform Limited Partnership Act provided that "[a] limited partner shall not become liable as a general partner unless…he takes part in the control of the business." ULPA, § 7 (1916). The versions of the Revised Uniform Limited Partnership Act approved in 1976 and 1985 relaxed the control requirement by providing a safe harbor in the form of a lengthy list of activities deemed not to constitute participation in the control of the partnership and a limitation on a limited partner's liability for participation in activities not within the safe harbor to only those persons who transacted business with the limited partnership "reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." RULPA, § 303 (1985). Section 303 of the Uniform Limited Partnership Act approved in 2001 has eliminated the control requirement and provides that:
>
> > A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.
>
> RULPA, § 303 (2001). According to the commentary accompanying the act, this provision is intended to provide "a full, status-based liability shield for each limited partner" even when the limited partner participates in the management and control of the limited partnership. The purpose is to bring limited partners into parity with the members of a limited liability company, partners in a limited liability partnership, and corporate shareholders. It is unclear how this change in state partnership law might affect the application of federal tax law in the context of family partnerships. Nevertheless, if the limited partners are to have no role in the management of the partnership, the partnership agreement should expressly provide that the limited partners have no management power.

limited partner into an interest as a general partner when determining material participation.[745]

The idea that an interest as a limited partner has passive loss characteristics that differ from its SE tax characteristics might cause confusion in reporting and auditing. A Tax Court case includes language about the self-employment exclusion as applied to active limited partners that concerns a tax expert I highly respect,[746] and I would rather not tempt fate. Thus, I would generally prefer to place a client in the recommended structure with an S corporation general partner described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart. However, if the client resists that structure, the LLLP Alone and LP with LLC Subsidiary structures are alternatives to consider, after warning the client appropriately.

Also, if the business engages in domestic manufacturing, note that wages paid by a corporation would provide a small tax benefit relative to compensation paid to a partner.[747]

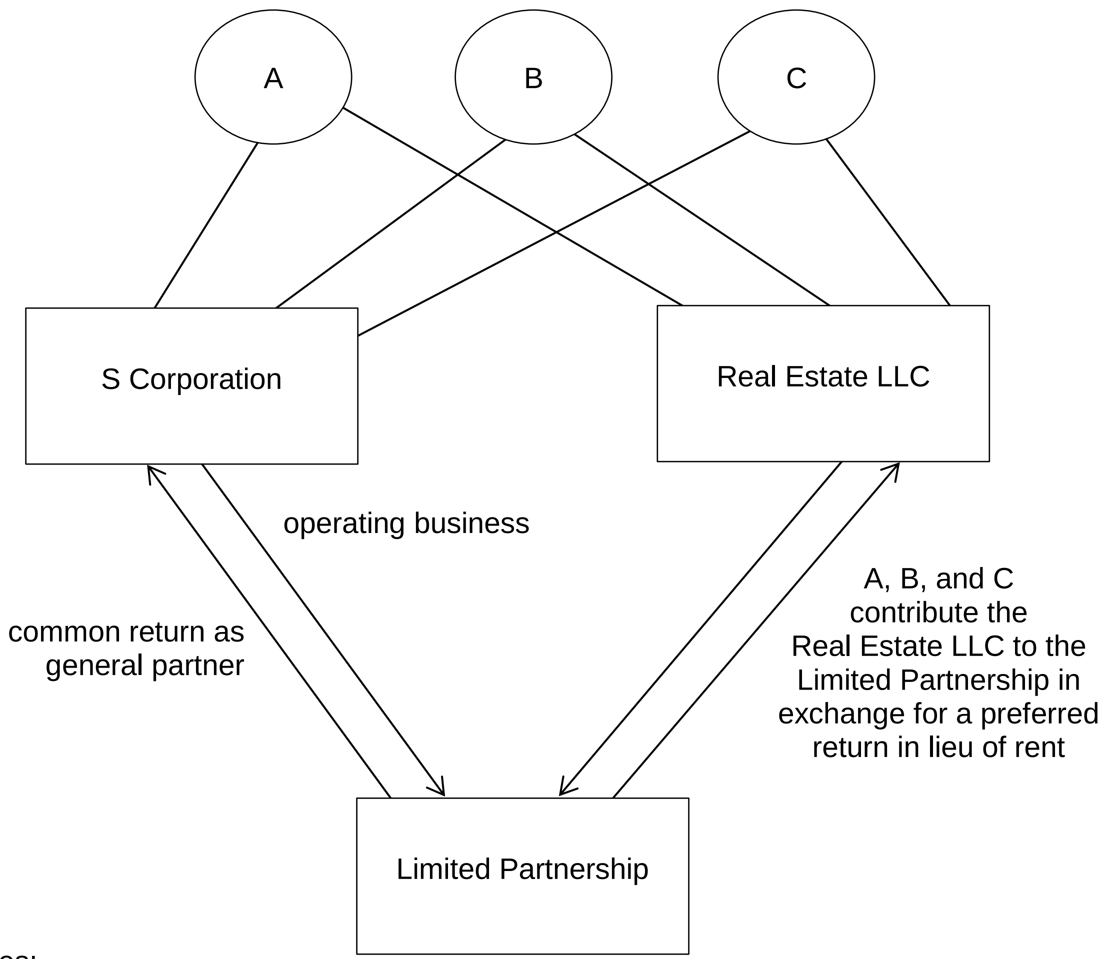
II.E.8.c. Migrating to LP with LLC Subsidiary Structure

Migrating from an LLC to an LP with LLC Subsidiary structure is much easier than migrating to my preferred recommended structure.[748]

The members of the LLC simply form the LP and then contribute their LLC interests to it. That transaction has no income tax consequences.[749] Both the LP and the LLC will continue to use LLC's tax ID – the LP because it has assumed the LLC's prior tax existence[750] and the LLC because it is a disregarded entity.[751] Presumably the LLC would need to obtain a new tax ID for payroll tax purposes, if it has its own payroll,[752] as well as for purposes of excise and certain other taxes.[753]

745 See part II.K.1.a.ii Material Participation, especially fn. 2057.
746 See fn. 2438, found in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
747 Note the W-2 limitation mentioned in part II.G.24 Code § 199 Deduction for Domestic Production Activities especially fn. 1270.
748 For the latter, see part II.E.7.b Flowcharts: Migrating LLC into Preferred Structure.
749 See part II.C.5 Converting from One Entity Taxed as a Partnership to Another.
750 See part II.C.5 Converting from One Entity Taxed as a Partnership to Another, especially fn. 403.
751 See part II.B Limited Liability Company (LLC), especially fn. 273.
752 See part II.B Limited Liability Company (LLC), especially fn. 279.
753 See part II.B Limited Liability Company (LLC), especially fn. 282-283.

II.E.9. Real Estate Drop Down into Preferred Limited Partnership



Notes:

- Assume A, B, and C are active in business (more than 500 hours) and receive reasonable compensation from the general partner for services rendered to the corporation, which is the general partner of the limited partnership.

- A, B, and C assign their interests in the LLC to the limited partnership, converting the LLC into a disregarded entity and making A, B, and C directly hold interests as a limited partner.

- Similarly, the S corporation might contribute its assets to a single member operating LLC that the limited partnership then owns, which would then rent the property from the Real Estate LLC. The rental payments would be disregarded for income tax purposes, and the properties would be separate for asset protection purposes.

- Even better would be for the S corporation also to hold a preferred interest preferred based on the value of its assets (and a small common interest) and for A, B and C to hold some or most of the common interests, maximizing the partnership component to obtain a basis step-up at death and minimize tax on a seller-financed sale of the business.

- This would not avoid self-employment tax on the limited partners if the long-ago proposed regulations defining limited partner for purposes of the self-employment tax were finalized.

For more details on this drop-down structure, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

II.E.10. What if Self-Employment Tax Rules Change Unfavorably?

If self-employment tax would apply to the limited partners and the parties would prefer to have the operating business inside an S corporation structure, then the limited partnership dissolves.

The limited partners take all of the real estate LLC(s) and an appropriate portion of the operating LLC(s), with the S corporation taking its fair share of the operating LLC(s).[754]

Next, the limited partners contribute all of their interest in the operating LLC(s) to the S corporation.[755]

The final structure is the S corporation holding one or more LLCs that are disregarded for tax purposes and the individuals owning a real estate LLC taxed as a partnership. As a matter of state law, all of the transactions listed above are done by assigning LLC interests rather than more burdensome transfers of operating assets.

II.F. Asset Protection Planning

The LLCs, Partnerships and Unincorporated Entities Committee of the American Bar Association's Business Law Section continues to expand its leadership regarding the issues described in this section. See http://apps.americanbar.org/dch/committee.cfm?com=CL590000.

II.F.1. Business Entities and Creditors Generally

This part II.F.1 discusses not only how entities can protect their owners from liability but also how the state law entity can affect the ability of an owner's creditors to disrupt business operations. State law defaults typically give a transferee of stock full voting and information rights, whereas state law defaults (as modified by certain federal laws) give a transferee of an interest in a partnership or LLC little or no voting rights and limited information rights. For the reasons described below, one might consider doing a tax-free conversion of a corporation to an LLC or a limited partnership taxed as a corporation.

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[754] If the business was started from scratch with only cash and labor, then generally this transaction will not be taxable. If a partner contributed any particular property within seven years of this dissolution, then it might be necessary for that partner to receive the LLC holding that property. For a general discussion of all of these ideas, see part II.Q.8 Exiting From or Dividing a Partnership.

[755] Code 351 precludes income taxation of this transaction.

Piercing the corporate veil – when a creditor of an entity can go after the entity's owner(s) - is a doctrine that can apply to any type of limited liability entity.[756]

"Reverse piercing" is the common name for when a creditor of an owner obtains an interest in a business entity and then tries to get to the entity's assets. Courts tend to be reluctant to disrupt business operations, when doing so would be unfair to the other owners of the business.

A "charging order" is an order for an entity to turn over to the creditors of a partner (or owner of an LLC or other unincorporated entity) that debtor's share of distributions. This remedy for a creditor of an owner of a partnership interest or interest in an LLC[757] might be more unattractive than a creditor's remedies of taking possession of stock (particularly voting stock) of a corporation:[758] if a creditor is able to foreclose on stock, the creditor obtains voting rights and other shareholder rights, whereas a creditor foreclosing on an interest in a partnership or LLC generally obtains only an assignee interest (the right to receive a pro rata share of any distributions but not to vote or in any other way obtain information about the entity's operations).[759] If the creditor forecloses, then the creditor becomes the owner and is taxed as such;[760] however, if the creditor

[756] For a general discussion of such issues and doctrines that go beyond equitable veil-piercing, see Donn, "Is the Liability of Limited Liability Entities Really Limited?" *ALI-ABA seminar on Choice of Business Entity* 2/13/2008. Elizabeth S. Miller, Professor of Law, Baylor University School of Law, summarizes recent developments in limited liability partnerships and LLCs at http://www.baylor.edu/law/faculty/index.php?id=75536. A trade creditor needs to prove not only that the entity was not run in a financially responsible way but also that the creditor made a reasonable inquiry into the debtor's financial position, by obtaining a credit report and perhaps a balance sheet. *On Command Video Corporation v. Roti*, 705 F.3d 267 (7th Cir. 2013). In selecting the law to apply, that court held that, under Illinois law, "veil-piercing claims are governed by the law of the state of the corporation whose veil is sought to be pierced." The court also accepted the parties' acceptance of applying corporate veil-piercing standards to an LLC.

[757] See Bishop, "LLC Charging Orders: A Jurisdictional and Governing Law Quagmire," *Business Entities* (May/June 2010), discussing reverse piercing and whether an LLC is a necessary party to a charging order action brought by a judgment creditor against a member (but not the LLC itself) and, if the LLC was formed in another state, which state law controls the limits of the charging order remedy. *New Times Media LLC v. Bay Guardian Co., Inc.* (U.S. District Court for Delaware Case No. 10-CV-72), rebuffed an attempt to have a California case be moved to Delaware to have a court sympathetic to Delaware's anti-reverse-piercing rules.

[758] See Forsberg, Spratt and Stein, "Conversion of Business Entities Into Limited Liability Companies: Asset Protection Issues Surrounding LLC Interests," American Bar Association Section of Real Property, Trust & Estate Law, 2009 Spring Symposia.

[759] See fn. 2697 for an assignee being admitted as a member.

[760] Rev. Rul. 77-137, the facts of which are brief enough to recite here:

> A, a limited partner in a limited partnership formed under the Uniform Limited Partnership Act of a state, assigned the limited partnership interest to B. The agreement of the partnership provides, in part, that assignees of limited partners may not become substituted limited partners in the partnership without the written consent of the general partners. However, it also provides that a limited partner may, without the consent of the general partners, assign irrevocably to another the right to share in the profits and losses of the partnership and to receive all distributions, including liquidating distributions, to which the limited partner would have been entitled had the assignment not been made. Under the terms of the assignment A, who was the nominal limited partner under local law, agreed to exercise any residual powers remaining in A solely in favor of and in the interest of B.

does not foreclose, generally the debtor will continue to be taxed as the owner,[761] and any cash the creditor receives from the charging order will constitute a payment by the debtor.[762]

Regarding interests in LLCs and partnerships, states vary on whether they make a charging order the exclusive remedy or allow creditors to foreclose on the LLC or partnership interest and possibly pursue aggressive reverse piercing strategies. Most states authorize charging orders but do not address whether charging orders are the exclusive remedy.[763] If the charging order is not enough to pay the creditor, a judge might then order the sale of the interest in the entity. Since third parties are unlikely to buy at the sale, the creditor would acquire the interest in the entity as an assignee. Rather than foreclosing and having the interest in the entity convert to that of an assignee, a judge might order a receiver to take control of the interest in the entity so that the receiver attempts to exercise the debtor's rights. In a nonbankruptcy case, the debtor objected to a charging order against his interests in two LLCs, the court issued a sweeping charging order against the LLCs that the court acknowledged were not parties to the case;[764] presumably the LLCs would need to fight the lack of jurisdiction.

> *Held*, even though the general partners did not give their consent to the assignment, since B, the assignee, acquired substantially all of the dominion and control over the limited partnership interest, for Federal income tax purposes B is treated as a substituted limited partner. Therefore, B must report the distributive share of partnership items of income, gain, loss, deduction, and credit attributable to the assigned interest on B's Federal income tax return in the same manner and in the same amounts that would be required if B was a substituted limited partner.

[761] See GCM 36960, which provided the basis for and explains the context of Rev. Rul. 77-137.

[762] Adkisson, Bishop, and Rutledge, "Recent Developments in Charging Orders," *Business Law Today* (Feb. 2013).

[763] Professor Carter G. Bishop has written extensively in the area, including "Fifty State Series: LLC Charging Order Statutes" (Suffolk University Law School Research Paper No. 10-03, written January 25, 2010 and updated March 1, 2016 (or later) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1542244), "Fifty State Series: LLC Charging Order Case Table" (Suffolk University Law School Research Paper No. 10-15, written 3/19/2010 and updated at http://papers.ssrn.com/abstract=1565595), and "Fifty State Series: LLC & Partnership Transfer Statutes" (Suffolk University Law School Research Paper No. 10-25, written 6/7/2010 and updated at http://papers.ssrn.com/abstract=1621694). For a complete set of his articles, see http://ssrn.com/author=55232. Another helpful resource is at http://www.internationalcounselor.com/chargingorder.htm. However, it has been suggested that choice of law for governing documents is overrated, because the law of the jurisdiction in which a foreclosure is attempted controls, rather than law of the state of formation. Adkisson, Bishop, and Rutledge, "Recent Developments in Charging Orders," *Business Law Today* (Feb. 2013).

[764] *Rockstone Capital, LLC v. Marketing Horizons*, LTD, 2013 WL 4046597 (Conn. Super., 7/17/2013) (unpublished), ordering:

> 1. The interests of the Defendant/Judgment Debtor, Ashton Edwards (the "Defendant"), in the Companies (as defined in the Motion for Charging Order) are charged with payment of the unsatisfied amount of the judgment debt herein and also with costs, attorneys fees and interest. Within 10 days of the entry of this Order, the Defendant is ordered to provide the complete name and current mailing address of the managing member of each of the Companies, Marketing Ventures Worldwide, LLC & Nonprofit Solutions, LLC.

In a bankruptcy case, courts vary on whether an LLC operating agreement is considered an "executory contract."[765]

Although for purposes of estate tax generally an intangible asset is considered located where the decedent was domiciled, for purposes of bankruptcy venue might lie there or might lie in another venue that facilitates the bankruptcy trustee's collection of the estate.[766] The bankruptcy trustee might take the bankruptcy debtors' interest as a

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2. The Companies are each directed to pay the Plaintiff present and future shares of any and all distributions, credits, drawings, or payments due to the Defendant until the judgment is satisfied in full, including attorneys fees, interest and costs.
3. Until said judgment is satisfied in full, including attorneys fees, interest and costs, the Companies shall make no loans, directly or indirectly, to or for the benefit of the Defendant or other partners or anyone else for the benefit of the Defendant without further Order of this Court.
4. Within twenty days of service of a copy of this Order upon any members of the Companies, the Companies shall supply the Plaintiff full, complete and accurate copies of the Companies' Operating Agreements including any and all amendments or modifications thereto; true, complete and accurate copies of any and all Federal and State income tax or informational income tax returns filed within the past two years; balance sheets and profit and loss statements for the past two years; and balance sheet and profit and loss statements for the past two years; and balance sheet and profit and loss statements for the most recent present period for which same have been computed. Further, upon twenty-day notice from the Plaintiff to the Companies, all books and records shall be produced for inspection, copying and examination in the Plaintiff's counsel's office.
5. Until said judgment is satisfied in full, including all costs and interest thereon, the Companies shall supply the Plaintiff, within thirty days of the close of the respective accounting period for which said data is or may be generated, all future statements reflecting cash position, balance sheet position, and profit and loss.

[765] *In re Denman*, 513 B.R. 720 (W.D. Tenn. 2014) (holding that an operating agreement was not in that case - and generally would not be - an executory contract, recognizing that several other courts disagree but suggesting that those other courts are wrong). The court also threw out an "ipso facto" clause that provided a bargain sale from a bankruptcy estate.

[766] *In re Blixseth*, 484 B.R. 360 (9th Cir. BAP Nev. 2012), holding that Nevada was an appropriate venue since its statutes governing the subject entities required any charging order or dissolution proceeding to be brought in a Nevada court. See "Jay Adkisson on Blixseth: Rags-to-Riches to," *Steve Leimberg's Asset Protection Planning Email Newsletter* - Archive Message #220. See also G. Rothschild, "Recent Developments in Asset Protection," *TM Memorandum* (BNA) (6/17/2013), summarizing *Weddell v. H2O, Inc.*, 128 Nev. Adv. Op. No. 9 (3/1/2012), as follows:

> The Supreme Court of Nevada reversed the district court's judgment relating to the scope of the charging order against Weddell's membership interests. The Supreme Court ruled that the charging order only divested Weddell of his economic opportunity to obtain profits and distributions from Granite, not his managerial rights.
>
> …
>
> This decision is in line with decisions in other charging order cases. It is noteworthy that this case was decided under the Nevada charging order laws prior to the revisions that were modified in the 2003 legislative session and did not include the substantial enhancements made in the 2011 legislative session. The 2011 legislative changes to Nevada's charging order laws specifically disallow the issuance of any equitable remedies. However, there were no provisions prohibiting the judge from issuing an equitable remedy to find a way around the exclusive remedy language. Therefore, in future litigation, members of Nevada LLCs will be even more protected than the degree of protection provided by pre-2011 laws.

member, as bankruptcy law supersedes the state's LLC statutory conversion of the debtors' interest into an assignee's interest.[767] Notably, the court did not follow prior cases that said that an LLC was not protected from its sole owner's bankruptcy simply because there was no third party member to protect. Rather, it held that the event of bankruptcy itself cannot strip the original owner of his or her pre-petition rights. Thus, a debtor needs to divest himself or herself of rights in an LLC (or a partnership) if and to the extent it is legitimate to do so before the filing the petition.

Generally, single member LLCs are not protected from foreclosure and reverse piercing, because no co-owner needs to be protected from the member's debts[768] (but be sure to have records sufficient to prove not owned solely by the person whose actions led to the reverse-piercing claim).[769] Otherwise, one can create something better than a self-settled spendthrift trust. However, Wyoming[770] and Nevada[771] provide such protection

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[767] *In re First Protection, Inc.*, 2010 WL 5059589 (9th Cir. BAP Ariz. 11/22/2010) (allowing the bankruptcy trustee to step into the debtor's shoes). See also *In re Blixseth*, 484 B.R. 360, (9th Cir. BAP Nev. 2012), which noted that, although a charging is the only remedy of a creditor to satisfy a judgment, the bankruptcy trustee steps into the debtor's shoes and may exercise all rights that the debtor had immediately before bankruptcy.

[768] See, e.g., *Olmstead vs. The Federal Trade Commission*, Supreme Court of Florida, 2010 WL 2158106 (June 24, 2010) (www.floridasupremecourt.org/decisions/2010/sc08-1009.pdf), followed by the 11th Cir. even though the FTC argued that the Supreme Court of Florida was wrong; *In re Modanlo*, 412 B.R. 715, 727 (Bankr. D. Md. 2006); *In re Albright*, 291 B.R. 538, 540 (D. Colo. 2003). In an unpublished opinion, the Montana Supreme Court upheld a trial court's imposition of a charging order, appointment of a receiver, and dissolution of an LLC that appeared to have been owned solely by the judgment debtor. *Jonas v. Jonas*, 2010 MT 240N, Supreme Court case number DA 10-0137 (11/9/2010).
The IRS can presumptively obtain a lien on the assets of a single member LLC (disregarded for tax purposes) when the member owes taxes. *Little Italy Oceanside Investments, LLC v. U.S.*, Case No. 14-cv-10217 (E.D. Mich. 8/14/2015). The case did not seem to turn on the LLC having only one member; rather, the LLC failed to contest the lien on its property before the property was sold, and the LLC did not have any remedies against the IRS after the property was sold when the IRS provided evidence that it timely mailed a notice of lien to the taxpayer. See also *Politte v. U.S.*, 104 A.F.T.R.2d 2009-6229 (S.D. Cal. 2009) (collecting from shareholders money the company loaned to them when the company owed the IRS), upheld through various procedural moves, ultimately by an unpublished opinion, 115 A.F.T.R.2d 2015-874 (9th Cir. 2015).
Furthermore, when a married couple, in the aggregate, owned all of an LLC and the couple filed for bankruptcy in a single consolidated case, the court allowed the bankruptcy trustee to take over the LLC. *In re First Protection, Inc.*, 2010 WL 5059589 (9th Cir. BAP Ariz. 11/22/2010).

[769] See *Sky Cable, LLC v. Coley*, Civ. Action No. 5:11cv00048, 2016 WL 3926492 (W.D. Va. 7/18/2016), applying Delaware law, all according to a summary prepared by Prof. Elizabeth S. Miller for an 4/7/2017 ABA Business Law Section meeting.

[770] Wyo. Stat. § 17-29-503(g), provides:

> This section provides the exclusive remedy by which a person seeking to enforce a judgment against a judgment debtor, including any judgment debtor who may be the sole member, dissociated member or transferee, may, in the capacity of the judgment creditor, satisfy the judgment from the judgment debtor's transferable interest or from the assets of the limited liability company. Other remedies, including foreclosure on the judgment debtor's limited liability interest and a court order for directions, accounts and inquiries that the judgment debtor might have made are not available to the judgment creditor attempting to satisfy a judgment out of the judgment debtor's interest in the limited liability company and may not be ordered by the court.

[771] NRS § 86.401.2(a) states that a charging order:

(which protection might be limited to cases outside a bankruptcy setting).[772] Another practitioner suggests having the managing member be an irrevocable grantor trust the client sets up for his children, with the client being the trustee and with the passive member being the client's revocable trust. Although this other strategy might help for asset protection, consider whether the client wants to be accountable to his children for how he manages the LLC on behalf of the trust. Sometimes lenders insist on placing collateral in a bankruptcy-remote LLC - an LLC that is treated as a disregarded entity but in which the lender has certain protections through an entity that is a member without an economic interest.[773]

Even if a creditor can foreclose on a single member LLC, the creditor might prefer to impose a charging order, so that the debtor can run its business and continue to generate cash flow to repay the creditor, without the creditor expending any effort. If the LLC's only income is from the debtor's services and the LLC distributes all of its net income, one court held that the charging order of the creditor (the U.S. government) was limited to the 25% statutory maximum for garnishing earnings under applicable state law.[774]

> Provides the exclusive remedy by which a judgment creditor of a member or an assignee of a member may satisfy a judgment out of the member's interest of the judgment debtor, whether the limited-liability company has one member or more than one member. No other remedy, including, without limitation, foreclosure on the member's interest or a court order for directions, accounts and inquiries that the debtor or member might have made, is available to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's interest in the limited-liability company, and no other remedy may be ordered by a court.

[772] See fn. 767.

[773] See fn. 304 and the accompanying text.

[774] *U.S. v. Alexander*, 2016 WL 2893406 (D. Ariz. 5/18/2016), holding:

> The United States is entitled to a charging order against Defendant's member interest in E-Logic. "The United States may enforce a judgment imposing a fine in accordance with the practices and procedures for the enforcement of a civil judgment under Federal law or State law." 18 U.S.C. § 3613(a); see also *United States v. Berger*, 574 F.3d 1202, 1204 (9th Cir. 2009). Under Arizona law, a court of competent jurisdiction "may charge the member's interest in the limited liability company with payment of the unsatisfied amount of the judgment plus interest." A.R.S. § 29-655(A). In such a case, "the judgment creditor has only the rights of an assignee of the member's interest." *Id.* An assignee of a member's interest is not entitled to participate in the LLC's management. A.R.S. § 29-732(A). Instead, an assignee "is only entitled to receive, to the extent assigned, the share of distributions, including distributions representing the return of contributions, and the allocation of profits and losses, to which the assignor would otherwise be entitled with respect to the assigned interest." *Id.* A charging order is the exclusive remedy by which a judgment creditor may satisfy a judgment out of a member's interest in a limited liability company. A.R.S. § 29-655(C). Here, Defendant is the sole member of E-Logic, LLC. The United States may charge Defendant's interest in E-Logic for Defendant's unpaid restitution plus interest. The United States, however, is not entitled to participate in E-Logic's management. Instead, the United States is only entitled to Defendant's share of ELogic's distributions.
>
> But the charging order is limited to the garnishment permitted by Arizona law. The fact that a charging order is entered, however, "does not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company." A.R.S. § 29-655(B). Arizona law limits garnishment to 25 percent of a garnishee's

To maximize asset protection planning, when drafting LLC operating agreements consider limiting any fiduciary duties a manager of an insolvent LLC might owe a lender.[775]

If the entity is already a corporation, consider an F reorganization to convert the corporation into a partnership or LLC taxed as a corporation; see part II.P.3.i. Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. If any such conversion causes transitory ownership, see part II.A.2.k.ii Disregarding Transitory Owners.

Note that some corporate statutes provide some protection against transfers to creditors, such as close corporation statutes, that allow a corporation to be managed largely like a partnership or LLC.[776] It might be possible to convert a regular corporation into a close corporation without creating a new entity. That can help an ongoing business but does not provide the protection of the dissolution without a merger following the sale of the business assets.

II.F.2. Asset Protection Benefits of Dissolving the Business Entity After Asset Sale

Subject to tax issues triggered on dissolution of an entity, consider the following approach when the corporation has sold all of its business assets:

> disposable earnings. A.R.S. § 33-1131(B). "Earnings" are defined broadly to include "compensation paid or payable for personal services, whether these payments are called wages, salary, commission, bonus or otherwise." A.R.S. § 12-1598(4). "Disposable earnings" is defined as the "amount remaining from the gross earnings for a pay period after the deductions required by state and federal law." A.R.S. § 12-1598(3). As the sole member of E-Logic, Defendant receives distributions equivalent to the LLC's annual income. These are provided as compensation for his personal services to E-Logic. These distributions qualify as earnings and are protected by the personal property exemption. The charging order therefore cannot deprive Defendant of more than 25 percent of his disposable earnings. [footnote omitted]

[775] Maloney and Carter, "Asserting Breach-of-fiduciary-duty Claims In the Context of Delaware LLCs," p. 36 of *ABI Journal* (September 2009). *CML V, LLC v. Bax*, C.A. No. 5373-VCL (Del. Ch. 11/3/2010) held that, absent a contractual agreement with the creditor or in the LLC's operating agreement, the members and managers of a Delaware LLC owed no fiduciary duties to creditors. Generally, managers of financially troubled Missouri limited liability companies do not owe a fiduciary duty to creditors of their troubled enterprises. See http://www.thompsoncoburn.com/insights/blogs/credit-report/post/2016-12-07/managers-of-insolvent-missouri-llcs-have-no-fiduciary-duty-to-creditors, discussing *Imperial Zinc Corp. v. Engineered Products Industries, L.L.C.*, No. 4:14-CV-1015-AGF, 2016 WL 812695 (E.D. Mo. Mar. 2, 2016); *Imperial Zinc Corp. v. Engineered Products Industries, L.L.C.*, No. 4:16-CV-551-RWS, 2016 WL 6611129 (E.D. Mo. Nov. 9, 2016).

[776] See fn. 2290 for a discussion of changing the normal rules for corporate governance that might also help with control issues, including links to a survey of all states. My understanding is that Nevada has enacted some sort of charging order protection for corporations with up to 75 shareholders. See, *e.g.*, Missouri's close corporation statutes, at RSMo § 351.750 et seq. Chapter 351 is at www.moga.mo.gov/STATUTES/C351.HTM. RSMo § 351.770.2(1) (www.moga.mo.gov/statutes/C300-399/3510000770.HTM) might block a creditor that is not an eligible shareholder of an S corporation from acquiring shares in an S corporation, although perhaps the creditor could assign its claim to an eligible shareholder.

Form a single member LLC owned by the corporation, transfer all of corporation's assets into the LLC, dissolve and liquidate the corporation (distributing the LLC to the shareholders), and have the LLC elect (as of the date of liquidation) the same corporate status the corporation had. The corporation's dissolution will start the statute of limitations for making claims relating to the corporation's business (or other) operations; thus, the sale proceeds will be subjected to claims for only a limited time period.

Even if the buyer assumes the business' liabilities and agrees to indemnify the corporation, the corporation is relying on the buyer to always be able to satisfy its indemnification obligation; the suggested dissolution approach removes that risk once the dissolution statute of limitations has passed. Contrast that to a merger, in which the claims are never cut off, because the old entity is deemed for state law purposes merely to continue in a new form.

II.F.3. Limited Partnerships and LLCs as Control Vehicles

In a limited partnership, the general partner runs the entity, and the limited partners have no rights to vote, except perhaps on major structural decisions such as liquidation. Giving an interest as a limited partner is a way of transferring property without transferring control of that property.

Similarly, LLC operating agreements can provide for members with or without voting rights.

These can provide the asset protection benefits mentioned above, as well as preventing the limited partner or nonvoting member from having undesirable control. When a trust distributes outright to a beneficiary who the trustee deems not ready to receive large liquid sums, the trustee might consider forming a limited partnership or LLC and distributing limited partner or nonvoting member interests to the beneficiary. Before doing that, however, the trustee should consider that the beneficiaries might very well contest that action.[777]

II.F.4. Taxing Authorities Piercing Corporate Veil

A partner who has control over payroll tax withholdings generally is personally liable for paying those to the taxing authority. New York makes any member or partner responsible for unpaid sales tax, even if the partner does not have any control over the collection and remittance of that tax;[778] the statute providing that result does not impose liability on a shareholder who has no control over business.[779]

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[777] *Schumacher v. Schumacher*, 303 S.W.3d 170 (Mo. App. W.D. 2010), holding that the forming the entity was not a per se violation of fiduciary duties and the trustees could present defenses. Based on my search done 1/1/2011, it appears that the trustees lost on remand and are appealing again, which is docketed as WD73012.

[778] Banoff and Lipton, "Personal Liability of LLC Members and Limited Partners for New York Sales/Use Tax," in their "Shop Talk" column, *Journal of Taxation* (WG&L) (Feb. 2015). The case they described was affirmed; see *In the Matter of the Petitions of Eugene Boissiere and Jason Krystal*, 2015 WL 4713238 (N.Y. Tax. App. Trib.). Thank you to Allan G. Donn of Willcox & Savage, P.C. for bringing this to my attention.

[779] The *Boissiere/Krystal* case cited in fn. 778 quoted the relevant statute:

II.F.5. Tax Liens

See part III.B.5.d.iv Federal Estate Tax Liens, including reference to an article about the effect of a beneficiary's tax liens on a trust,[780] as well as rules piercing tenancy by the entirety and community property.[781]

II.F.6. Asset Protection for IRAs

Although IRAs enjoy certain protection from creditors (particularly in the bankruptcy arena), note that they can lose that protection by directly or indirectly engaging in transactions that cause them to lose their status as IRAs.[782]

II.G. Income Tax Operating Issues

The IRS portal, "Tax Information For Businesses," was found at https://www.irs.gov/Businesses on April 6, 2016.

Part II.Q.1 General Principles of Exiting from or Dividing a Business illustrates that selling the goodwill component of a business is much more tax efficient by a partnership than by a corporation and that an S corporation is more efficient that a C corporation. Estate planning considerations tend to generate a similar conclusion. However, current taxation of undistributed income from business operations tends to work in the reverse. A high income, passive investor in a partnership or S corporation might be subject to a higher short-term tax rate than a shareholder in a C corporation; see part II.I 3.8% Tax on Excess Net Investment Income. Also, a general partner (or LLC equivalent) faces additional FICA tax on undistributed business income, an issue that does not apply to a shareholder of an S or C corporation; see part II.L Self-Employment Tax (FICA) for a discussion of this issue and how to plan around it.

II.G.1. IRS Resources

II.G.1.a. Applicable Federal Rate (AFR)

See http://apps.irs.gov/app/picklist/list/federalRates.html for the current month's rates and a complete history from January 2000.

II.G.1.b. Internal Revenue Manual

See http://www.irs.gov/irm/index.html.

"also include[s] any officer, director or employee of a corporation ..., any employee of a partnership, any employee or manager of a limited liability company ... who as such officer, director, employee or manager is under a duty to act for such corporation, partnership, limited liability company ... in complying with any requirement of this article; *and any member of a partnership or limited liability company*" (emphasis added).

780 See fn. 5418.

781 See fn. 5428.

782 See part II.G.21 IRA as Business Owner, especially fn. 1261.

II.G.1.c. How and When to Obtain or Change an Employer Identification Number (EIN)

EIN resources include:

- https://www.irs.gov/businesses/small-businesses-self-employed/employer-id-numbers-eins (general EIN webpage)

- https://www.irs.gov/businesses/small-businesses-self-employed/do-you-need-a-new-ein (whether to get a new tax ID)

- https://www.irs.gov/pub/irs-pdf/p1635.pdf (summary of whether to get a new tax ID and an explanation of various terms used and requirements for completing Form SS-4).

See also part III.B.2.e.ii Tax ID Issues When the Deemed Owner of a Grantor Trust Dies. I am uncertain about the effect of decanting[783] on a tax ID.[784]

II.G.1.d. IRS Audit Techniques Guides (ATGs)

See https://www.irs.gov/businesses/small-businesses-self-employed/audit-techniques-guides-atgs, explaining industry-specific examination techniques and common and unique industry issues, business practices and terminology, as well as providing guidance on the examination of income, interview techniques and evaluation of evidence.

II.G.1.e. IRS Valuation Resources

See http://www.irs.gov/Businesses/Valuation-of-Assets.[785]

II.G.2. State Taxation

States impose franchise tax and other taxes, some of which vary according to the type of entity. This includes differences between general partnerships, limited partnerships, and LLCs.[786] For an example of when self-employment tax can avoid a larger state tax, see the text accompanying fn. 712.

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783 See part II.J.4.i Modifying Trust to Make More Income Tax Efficient.

784 ACTEC comments on decanting (http://www.actec.org/resources/comments-on-transfers-by-a-trustee) proposed a revenue ruling saying no new tax ID but do not cite authority for that conclusion. However, they mentioned that Letter Ruling 200607015 treated a decanted trust as a continuation of the original trust. On the other hand, they also referred to Letter Ruling 200736002, which involved a trust division and also treated the division as being a continuation and not a distribution, but the three successor trusts were treated as different trusts from each other. So I don't know how much to read into whether being considered a continuation trust would require a tax ID.

785 Critiques include Grossman, "Dissecting the IRS Job Aid On S corporation Tax-Affecting," *Valuation Strategies* (WG&L) (Sept./Oct. 2015).

786 See, *e.g.*, Ely, Thistle, and Rhyne, "State Tax Treatment of LLCs and LLPs: Update for 2014," *Journal of Multistate Taxation and Incentives* (5/2014). Other resources include not only various

Illinois imposes an income tax, called the "replacement tax," on partnerships, S corporations and C corporations.[787] LLCs that are treated as disregarded entities do not appear to be subject to this tax.[788]

II.G.3. Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner

As described further below in this part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, a loan to an S corporation or a partnership or a guarantee of a third party loan to a partnership can generate current deductions of losses that the loan finances, whereas a loan to a C corporation or a loan guarantee to an S or C corporation does not.

Furthermore, a worthless loan to a C corporation is difficult to deduct and might or might not qualify for ordinary loss treatment, and such a deduction might be subject to a 7-year statute of limitations rather than a 3-year statute of limitations (as would a deduction for worthless stock).

II.G.3.a. Loans to Businesses or Business Associates

II.G.3.a.i. Loans to Businesses – Whether AFR Is Required

Generally, loans between corporations and shareholders are subject to the Code § 7872 rules governing below-market loans.[789]

However, loans between partners and partnerships are subject to those rules only if one of the principal purposes of the interest arrangements of which is the avoidance of any Federal tax.[790]

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state tax treatises, such as Hellerstein & Hellerstein, *State Taxation*, and Fenwick, McLoughlin, Salmon, Smith, Tilley, Wood, *State Taxation of Pass-Through Entities and Their Owners*, but also magazines, such the *Journal of Business Entities*. Before starting new operations, one might explore state and local tax incentives.

[787] 35 ILCS 5/201(c).

[788] Illinois taxes LLCs as corporations or partnerships if they are classified as such for federal income tax purposes. 35 ILCS 5/1501(a)(4), (16); IL Admin. Code § 100.9750(b), (d)(1). IL Admin. Code § 100.9750(b)(1)(A) provides that a corporation and its federally disregarded subsidiary are taxed as a single corporation.

[789] Code § 7872(c)(1)(C).

[790] Whitmire, Nelson, McKee, et al, "¶3.08. Partner and Member Loans," *Structuring & Drafting Partnership Agreements: Including LLC Agreements*, conclude:

> If no interest is charged on partner-to-partnership loans, or if interest is charged at less than the applicable "federal rate," interest may be imputed under § 7872 if (1) the loan is determined to be a "tax avoidance loan" under § 7872(c)(1)(D) or (2) the loan is an "other below-market loan" described in regulations promulgated under § 7872(c)(1)(E). At present, no regulations have been proposed that would generally treat garden-variety partner-to-partnership loans as below-market loans or tax-avoidance loans.

Code § 2701 provides a backstop in a family partnership. See part III.B.7.c.i.(b) CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer.

II.G.3.a.ii. Bad Debt Loss – Must be Bona Fide Debt

Only a bona fide debt qualifies for purposes of Code § 166.[791] The debt must arise from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."[792] For this purpose, an accrual method taxpayer's account receivable is deemed to be an enforceable obligation to the extent that the income such debt represents has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.[793] Conversely, worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income are not deductible under Code § 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.[794]

A gift or contribution to capital is not a debt for purposes of Code § 166.[795] See part II.G.19 Debt vs. Equity.

Not being due yet does not prevent a Code § 166 deduction.[796]

II.G.3.a.iii. Character of Bad Debt

Where any nonbusiness debt held by a noncorporate taxpayer becomes worthless within the taxable year, the resulting loss is a short-term capital loss;[797] note that reporting a

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[791] Reg. § 1.166-1(c).

[792] Reg. § 1.166-1(c). *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> A bona fide debt is a debt that arises from "a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." *Kean v. Commissioner*, 91 T.C. 575, 594 (1988); sec. 1.166-1(c), Income Tax Regs. A gift or contribution to capital is not considered a "debt" for purposes of section 166. *Kean*, 91 T.C. at 594. Whether a purported loan is a bona fide debt for tax purposes is determined from the facts and circumstances of each case. See *A.R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970); *Gross v. Commissioner*, 401 F.2d 600, 603 (9th Cir. 1968), *aff'g* T.C. Memo. 1967-31; *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).

Rutter held that advances not documented with promissory notes were equity, not debt. See fn. 1219 in part II.G.19 Debt vs. Equity.

[793] Reg. § 1.166-1(c), which continues:

> For example, a debt arising out of gambling receivables that are unenforceable under state or local law, which an accrual method taxpayer includes in income under section 61, is an enforceable obligation for purposes of this paragraph.

[794] Reg. § 1.166-1(e).

[795] Reg. § 1.166-1(c). *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> Advances made by an investor to a closely held or controlled corporation may properly be characterized, not as a bona fide loan, but as a capital contribution. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Shaw v. Commissioner*, T.C. Memo. 2013-170, 106 T.C.M. (CCH) 54, 56, *aff'd*, 623 F. App'x 467 (9th Cir. 2015). In general, advances made to an insolvent debtor are not debts for tax purposes but are characterized as capital contributions or gifts. See *Dixie Dairies Corp.*, 74 T.C. at 497; *Davis v. Commissioner*, 69 T.C. 814, 835-836 (1978). For an advance to constitute a bona fide loan, the purported creditor must expect that the amount will be repaid. See *CMA Consol., Inc. v. Commissioner*, T.C. Memo. 2005-16, 89 T.C.M. (CCH) 701, 724.

[796] Reg. § 1.166-1(c).

large short-term capital loss might stand out, given that the IRS now matches proceeds and basis on sale and the basis would not match any report to the IRS by a broker. "Nonbusiness debt" means a debt other than:[798]

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

When part or all of a debt, which is not a security[799] and is not a nonbusiness debt, becomes worthless, the taxpayer holding the debt can deduct the worthless portion,[800] if

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[797] Code § 166(d)(1). Capital losses are deductible only against the sum of capital gains plus $3,000. Short-term capital gains are taxed using ordinary income tax rates, so short-term capital losses from bad debts have the most benefit for taxpayers with short-term capital gains.

[798] Code § 166(d)(1).

[799] Code § 166(e) provides, "This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C)."

[800] Code § 166(a), which allows a taxpayer to deduct a debt that is worthless in whole or in part, with Reg. § 1.166-3(a)(2)(iii) providing:

> Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off.

Rutter v. Commissioner, T.C. Memo. 2017-174, elaborated:

> The Commissioner's disallowance of a deduction under section 166(a)(2) will be sustained so long as he exercises his discretion reasonably. *Brimberry v. Commissioner*, 588 F.2d 975, 977 (5th Cir. 1979), *aff'g* T.C. Memo. 1976-209; *Portland Mfg. Co. v. Commissioner*, 56 T.C. 58, 72 (1971), *aff'd* on other grounds, 35 A.F.T.R.2d (RIA) 75-1439, 75-1 U.S. Tax Cas. (CCH) para. 9449 (9th Cir. 1975). His exercise of discretion will not be set aside unless it is arbitrary and unreasonable. *Ark. Best Corp. & Subs. v. Commissioner*, 800 F.2d 215, 221 (8th Cir. 1986), *aff'g* in part, *rev'g* in part 83 T.C. 640 (1984), *aff'd* on other grounds, 485 U.S. 212 (1988).
>
> Petitioner has not made the showing that the statute and the regulations require. First, he has not established to the Commissioner's satisfaction, or ours, the amount of the debt that was worthless at year-end 2009. Sec. 1.166-3(a)(2)(iii), Income Tax Regs. The $8.55 million number he chose for the writedown (reduced from the $10 million "placeholder" figure Mr. Bardoff had used initially) appears to have been selected because it approximated the income petitioner realized earlier in 2009 from another of his startup companies. He made no effort to tie this writedown to IM's actual financial condition or ability to repay.
>
> Second, petitioner did not show that any portion of his advances became worthless during 2009. He appears to have had a reasonable hope of recovering on his investments; that is presumably why he continued to advance another $37.75 million to IM during 2010-2013. See *Crown*, 77 T.C. 582, 598 (1981); *Flood v. Commissioner*, T.C. Memo. 2001-39, 81 T.C.M. (CCH) 1175, 1180 ("A debt becomes worthless in the tax year in which a creditor, using sound business judgment, abandons all reasonable hope of recovery[.]"); sec. 1.166-2(a), Income Tax Regs. Conversely, if any portion of the debt was worthless, petitioner did not show that it became worthless in 2009 rather than in some earlier year. See *Hirsch v. Commissioner*, 124 F.2d 24, 31 (9th Cir. 1941) ("A taxpayer should not be permitted to close his eyes to the obvious, and to carry accounts on his books as good when in fact they are worthless, and then deduct them in a year subsequent to the one in which he must be presumed to have ascertained their

the taxpayer charges off the loan.[801] Nonbusiness bad debts must be wholly worthless to be deductible;[802] the debtor's filing of bankruptcy does not show that the debt is wholly worthless if the creditor files a claim.[803]

When a manager of venture capital funds loaned money to a business associate who provided leads on companies in which the venture capital funds might invest, with the expectation that the lender would receive carried interests in the venture capital fund, the loan was made in the trade or business of managing venture capital funds.[804] Key is

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> worthlessness." (citing *Avery v. Commissioner*, 22 F.2d 6, 7-8 (5th Cir. 1927))), *aff'g* 42 B.T.A. 566 (1940).

After reviewing the parties' contentions and testimony, the court concluded:

> In sum, the IRS did not abuse its discretion in determining that petitioner was not entitled to a deduction of $8.55 million for a partially worthless debt for 2009. Even if petitioner established that his advances were debt and that this debt was a business debt, he did not meet the requirements for deducting a partially worthless debt under section 166(a)(2) and section 1.166-3(a)(2)(iii), Income Tax Regs.[7]
>
> [7] Given our disposition, we need not address respondent's contention that petitioner's deduction should be disallowed because the documents implementing the writedown were executed in February or March 2010 and backdated to 2009.

[801] LAFA 20153501F argued that the taxpayer created a reserve rather than charging off the debt:

> The purpose of the charge-off requirement is to perpetuate evidence of a taxpayer's election to abandon part of the debt as an asset. *Findley v. Commissioner*, 25 T.C. 311, 319 (1955), *aff'd per curium*, 236 F.2d 959 (3d Cir. 1956) (emphasis added). An increase in a general reserve account does not constitute the required charge off. *International Proprietaries. Inc. v. Commissioner*, 18 T.C. 133 (1952). The taxpayer's intent to abandon the charged-off portion of the debt must be reflected in its books and records. *Id.*

[802] Reg. § 1.166-5(a)(2). *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

> To give rise to a deduction under section 166(a)(1), a debt must have become wholly worthless during the tax year. Sec. 1.166-3(b), Income Tax Regs.; see *Bodzy v. Commissioner*, 321 F.2d 331, 335 (5th Cir. 1963), *aff'g* in part, *rev'g* in part T.C. Memo. 1962-40. In the case of a partially worthless debt, section 166(a)(2) provides that, "[w]hen satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction." "Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off." Sec. 1.166-3(a)(2)(iii), Income Tax Regs.

[803] *Bunch v. Commissioner*, TC Memo. 2014-177, held:

> Even if we were to accept that the proof of claim established the amount of petitioners' loss, the document does not establish that petitioners had no hope of recovery in 2006. On the contrary, it tends to establish the reverse: By filing a proof of claim in Mortgage Co.'s bankruptcy, petitioners took the requisite step to secure a place in the order of distribution from the bankruptcy estate and thereby increased their odds of recovering at least some of the loaned funds.

[804] *Dagres v. Commissioner*, 136 T.C. 263 (2003). This case involved a number of factors when taking a bad debt deduction, such that it is worth reproducing the heart of the court's analysis:

> …We have held that the General Partner L.L.C.s' activity was not mere investment but was the trade or business of managing venture capital funds. Consequently, it follows that Mr. Dagres was in that trade or business.
>
> However, as we have noted, Mr. Dagres was also an investor (i.e., of his portion of 1 percent of the Venture Fund L.P.'s capital), and if his loan to Mr. Schrader was proximately related to his investment interest, then the resulting bad debt was not a

whether the lender merely expects a normal investor's return (not a trade or business)[805] or is "flipping" businesses.[806]

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business bad debt. Moreover, Mr. Dagres was also a salaried employee of BMC and was therefore in the trade or business of being an employee. If his loan to Mr. Schrader was proximately related to his employment, rather than to the venture capital business, then the deduction of the resulting bad debt loss is severely limited. See *supra* part II.A. We must therefore determine to which of these activities--his investment, his employment, or his venture capital management--the loan was proximately related.

In *United States v. Generes*, 405 U.S. at 103, the Supreme Court indicated that when determining whether a bad debt has a proximate relation to a taxpayer's trade or business and therefore qualifies as a business bad debt, the question to ask is whether the "dominant motivation" for the loan was business; a merely "significant motivation" is insufficient to show a proximate relation. In *Generes*, the Supreme Court held that the dominant motivation for the taxpayer's lending money to his company was not the business motive of protecting his modest salary; rather, in addition to protecting his son-in-law's livelihood, he was motivated to protect his sizable investment in the company. *Id.* at 106. Accordingly, non-business motives prompted the loan, and therefore the loss was not a business bad debt.

In this case, however, Mr. Dagres's compensation for his work as a manager of the Venture Fund L.P.s--*i.e.*, his share of the 20-percent profits interest and the 2-percent management fee--exceeded by twenty-fold his share of the return on the 1-percent investment. Moreover, although his salary from BMC (i.e., his share of the management fees) was significant in absolute terms (nearly $11 million in five years, of which he received almost $2.6 million in the year of the loan), his carry was clearly dominant ($43 million of capital gains in those same five years, of which $40 million was carry received in the year of the loan). He lent $5 million to Mr. Schrader to protect and enhance what he considered a valuable source of leads on promising companies in which, as Member Manager of General Partner L.L.C.s, he could invest the money of the Venture Fund L.P.s, help manage those companies, and earn substantial income in the form of carry. Mr. Dagres's carry significantly exceeded both his salary and his return on his own investment. We are satisfied that venture capital motives and not employment or investment motives were the primary motivation for his loan. It is that venture capital business motive that characterizes the subsequent bad debt loss.

[805] *Rutter v. Commissioner*, T.C. Memo. 2017-174, elaborated:

… we have held that a taxpayer is not in the business of being a "promoter" where he is entitled to no compensation other than a normal investor's return. See, *e.g.*, *Dagres*, 136 T.C. at 281-282 (noting that a promoter "receives not just a return on his own investment but compensation attributable to his services"); *Deely v. Commissioner*, 73 T.C. 1081, 1095-1096 (1980) (stating that, "in order for a promoter to be engaged in a trade or business for tax purposes he must do so for `compensation other than the normal investor's return'" (quoting *Millsap v. Commissioner*, 46 T.C. 751, 756 (1966), *aff'd*, 387 F.2d 420 (8th Cir. 1968))); *Ackerman v. Commissioner*, T.C. Memo. 2009-80, 97 T.C.M. (CCH) 1392, 1414 (finding no trade or business as "promoter" where taxpayer did not receive fees or commissions for providing advisory services). Here, petitioner received no fees, commissions, or other compensation for his services. He expected to receive the return that equity investors normally hope for, namely, long-term gain upon appreciation or sale of IM's assets.

[806] *Rutter v. Commissioner*, T.C. Memo. 2017-174, suggested:

A taxpayer may be able to show that he is engaged in business as a "promoter" or "trader" if he establishes that his goal is to earn profits by "flipping" assets, *i.e.*, making quick and profitable sales of real estate, securities, or other property. See, *e.g.*, *Assaderaghi v. Commissioner*, T.C. Memo. 2014-33. Central to these holdings is that the

If a loss is not connected with a trade or business, generally it must be incurred in any transaction entered into for profit.[807] That standard requires that the taxpayer's "primary reason for investing … was to make an economic profit, or in other words, a profit without consideration to any tax benefit flowing from the [investment]."[808] See also part II.G.3.i.i Limitations on Deductions Attributable to Activities Not Engaged in for Profit.

For deducting loans to corporations, see part II.G.3.b C Corporations, particularly fns. 814-816.

II.G.3.a.iv. Extension of Statute of Limitations for Deduction for Bad Debt or Worthless Securities

Code § 6511(d) provides a 7-year statute of limitations of certain deductions for bad debt or worthless securities rather than the normal 3-year statute of limitations.

II.G.3.a.v. Tax Effect of Loan to S Corporation or Partnership

Loans to S corporations or partnerships can allow the owner who is a lender to deduct losses against the owner's basis in the loan; this generally generates ordinary losses and, to the extent of those losses, that one does not need to worry about whether writing off that part of the loan would be a business bad debt or a nonbusiness bad debt. See part II.G.3.c Basis Limitations for Deducting Partnership and S Corporation Losses.

However, a loan to a partnership can backfire if the loan is not repaid until the partnership is rescued by an angel investor's infusing capital. In that case, the lending partner would contribute the loan to the partnership in exchange for a partnership interest. Unfortunately, often the founder will receive only pennies on the dollar for the founder's original investment (capital and debt):

- To the extent that the amount of debt contributed to the partnership exceeds the value of the partnership interest that the lending partner received in exchange for that debt, the partnership will have cancellation of indebtedness (COD) income.[809]

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taxpayer aimed for profit from frequent short-term sales, not from patient long-term investment. "It is the early resale which makes the profits income received directly for services, for the longer an interest is held, the more profit becomes attributable to the successful operation of the corporate business." *Deely*, 73 T.C. at 1093-1094; see *Millsap*, 46 T.C. at 756-757.

[807] Code § 165(c)(2). Code § 165(c)(3) also allows a taxpayer to deduct nonbusiness losses that "arise from fire, storm, shipwreck, or other casualty, or from theft."

[808] *McElroy v. Commissioner*, T.C. Memo. 2014-163, citing:

> *See Fox v. Commissioner*, 82 T.C. 1001, 1018-1027 (1984); *see also Friedman v. Commissioner*, 869 F.2d 785, 789-790 (4th Cir. 1989), *aff'g Glass v. Commissioner*, 87 T.C. 1087 (1986); *cf. Surloff v. Commissioner*, 81 T.C. 210, 233 (1983) (noting that an intent to make a profit for purposes of section 162 requires an intent to make an economic profit, independent of tax savings).

See also part II.G.16 Economic Substance for the possibility of penalties for tax-motivated transactions not entered into for either profit or a Congressionally approved tax benefit (such as a tax credit).

[809] Code § 108(e)(8); Reg. § 1.108-8 (subsection (c) has a specific example, but the example involved a creditor who was not also a partner). If and to the extent that the value of the

Generally, partnership agreements require income to be allocated to a partner to the extent that the partner deducted losses against the debt. Therefore, the lending partner would be allocated all of this COD income; this allocation essentially is a recapture of the lending partner's prior losses and gives the lending partner basis in the partnership interest.

- If, instead of lending money to the partnership, the partner had contributed the money, the partner would have avoided this COD income. Providing a priority return of capital might be adequate to let that partner be repaid. If enough money is at stake to justify the complexity, consider providing a preferred partnership interest instead of a loan.[810] Realistically, the only way the loan would be repaid would be if the partnership makes money. Furthermore, a preferred return could be high enough to provide reward commensurate with risk. If the preferred return needs to be eliminated in an angel investor rescue, the restructuring would generate any adverse consequences.

II.G.3.b. C Corporations: Losses Incurred by Business, Owner, or Employee

C corporations are taxed on their own operations. C corporations that have losses carry them back or forward to other years; C shareholders generally may not take current deductions for a decrease in the value of their stock unless the stock becomes worthless.[811] A taxpayer who tried to deduct his C corporation's losses, claiming that the

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partnership interest issued in exchange for the debt is attributable to accrued interest, the lender partner is taxed on that interest. Reg. § 1.721-1(d)(2).

[810] The preferred partnership interest must not be a substitute for debt. The fact that the partner already has a regular partnership interest should help significantly; *see, e.g.*, parts II.G.19, Debt vs. Equity and III.B.7.c.viii Creative Bonus Arrangements (discussing when a financial interest might rise to the level of being a partner). The interest component should not be based on fixed or variable interest rates, because then it looks like a loan under Code § 707(a). Instead, it would be a preference on cash flow and structured so as not to be a guaranteed payment; *see* Reg. § 1.707-1(c).

[811] *Bilthouse v. U.S.*, 553 F.3d 513 (7th Cir. 2009), held:

> The worthlessness of a stock as of a particular year is a factual inquiry, varying according to the circumstances of each case. *Boehm v. Comm'r*, 326 U.S. 287, 293 (1945); see *United States v. Davenport*, 412 F. Supp. 2d 1201, 1207 (W.D. Okla. 2005). Although section 165(g) does not define "worthless," most courts consider both the liquidating value and the potential value of the company to determine the year of worthlessness. See *Morton v. Comm'r*, 38 B.T.A. 1270, 1278 (B.T.A. 1938), aff'd 112 F.2d 320 (7th Cir. 1940) (worthlessness of stock depends on current liquidating value and potential value); see also *Delk v. Comm'r*, 113 F.3d 984, 986 (9th Cir. 1997); *Figgie Int'l, Inc. v. Comm'r*., 807 F.2d 59, 62 (6th Cir. 1986).

Continuing to earn substantial revenue suggests that the corporation might not be worthless. *In Re: Carpenter*, 118 A.F.T.R.2d 2016-XXXX (Bankruptcy. Ct. MT 9/15/2016) held that stock became worthless when the corporation ceased operations and its creditor seized its assets. The court applied the following:

> The tax court set forth a test for determining whether stock is worthless:
>
> > The ultimate value of stock, and conversely its worthlessness, will depend not only on its current liquidating value, but also on what value it may acquire in the future through foreseeable operations of the corporation. Both factors of value must be wiped out before we can definitely fix the loss. If the assets of the corporation exceed its liabilities, the stock has liquidating value. If its assets are less than its liabilities but there is a reasonable hope and expectation that the assets will exceed

he incurred the losses and the C corporation was merely his agent, was penalized for taking that position.[812]

A founding shareholder might be able to take an ordinary loss of up to $50,000 ($100,000 for joint returns) on the sale of stock under Code § 1244.[813]

A shareholder who loans money to a C corporation that cannot repay the loan might be stuck deducting the loan as a nonbusiness bad debt, which is deducted as a short term capital loss (deductible each year against only capital gains plus up to $3,000 of other income) rather than an ordinary loss;[814] alternatively, if the primary purpose of the debt is

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> the liabilities of the corporation in the future, its stock, while having no liquidating value, has potential value and can not be said to be worthless. The loss of potential value, if that exists, can be established ordinarily with satisfaction only by some "identifiable event" in the corporation's life which puts an end to such hope and expectation.

Morton v. Comm'r, 38 B.T.A. 1270, 1278–1279 (1938), *aff'd* 112 F.2d 320 (7th Cir. 1940). The Ninth Circuit more recently echoed this test:

> Securities may not be considered worthless, even when they have no liquidating value, if there is a reasonable hope and expectation that they will become valuable in the future. *Lawson v. Commissioner*, 42 B.T.A. 1103, 1108, 1940 WL 144 (1940). But, "such hope and expectation may be foreclosed by the happening of certain events such as the bankruptcy, cessation from doing business, or liquidation of the corporation, or the appointment of a receiver...." *Morton v. Commissioner*, 38 B.T.A. 1270, 1278, 1938 WL 165 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940). To establish worthlessness, the taxpayer "must show a relevant identifiable event ... which clearly evidences destruction of both the potential and liquidating values of the stock." *Austin Co. v. Commissioner*, 71 T.C. 955, 970, 1979 WL 3593 (1979). The burden of establishing worthlessness is on the taxpayer. *Figgie Int'l Inc. v. Commissioner*, 807 F.2d 59, 62 (6th Cir. 1986).

Delk v. C.I.R., 113 F.3d 984, 986 (9th Cir. 1997). *See also Textron, Inc . v. U.S.*, 418 F.Supp. 39, 44-47 (D. RI 1976) (requiring that the stock be wholly worthless and that the "deduction for a worthless security be claimed for the year in which said security becomes worthless without the benefit of hindsight").

812 *Barnhart Ranch, Co. v. Commissioner*, T.C. Memo. 2016-170.

813 See part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation. A trust or estate is not eligible for this treatment. Part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

814 *Haury v. Commissioner*, T.C. Memo 2012-215. Advances that were not documented as loans were treated as equity in *Ramig v. Commissioner*, 110 A.F.T.R.2d 2012-6450 (9th Cir. 2012), an "unpublished" opinion affirming an unpublished Tax Court opinion. Same result in *Herrera v. Commissioner*, T.C. Memo. 2012-308 (imposing accuracy-related penalty), which focused on lack of consistent documentation, the lack of interest payments, and the lack of a Form 1099 reporting cancellation of indebtedness income, and which cited 13 factors from the Fifth Circuit, the weight to each of which varies by case:

> (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a fixed maturity date; (3) the source of payments; (4) the right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement."

to preserve the shareholder's job and therefore would be bad debt, presumably the deduction would be an employee business expense, deductible as a miscellaneous itemized deduction; miscellaneous itemized deductions are allowable for regular income tax purposes only to the extent that they exceed 2% of the taxpayer's adjusted gross income and are not deductible at all for alternative minimum tax purposes.[815] The shareholder must prove that the debt was bona fide and then became worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment.[816]

For a very brief overview of the principles of this part II.G.3.b, see *Aleamoni v. Commissioner*, T.C. Summ. Op. 2016-21.

II.G.3.c. Basis Limitations for Deducting Partnership and S Corporation Losses

Owners generally may deduct losses to the extent of the owners' basis in their S stock[817] or partnership interest.[818] Instructions to Form 1040, Schedule E provide:

The Fifth Circuit affirmed, at 112 A.F.T.R.2d 2013-6858 (11/11/2013), commenting:

> … the Treasury Regulations provide that a guaranty payment only qualifies for a bad debt deduction if "[t]here was an enforceable legal duty upon the taxpayer to make the payment." Treas. Reg. § 1.166–9(d)(2). Voluntary payments do not qualify. See id. § 1.166–1(c) ("A gift ... shall not be considered a debt for purposes of section 166."); *see also Piggy Bank Stations, Inc. v. Comm'r*, 755 F.2d 450, 452–53 (5th Cir. 1985).

[815] See part II.G.3.a Loans to Businesses or Business Associates, especially fn. 804.

[816] *Shaw v. Commissioner*, T.C. Memo 2013-170 (taxpayer failed to prove that the advance was a bona fide loan and not a capital contribution and also failed to prove worthless; 20% accuracy-related penalty imposed), *aff'd* 116 A.F.T.R.2d ¶ 2015-5471 (9th Cir. 2015); *Alpert v. Commissioner*, TC. Memo. 2014-70 (similar result outside a corporate setting).

[817] See Code § 1366(d) and Rev. Rul. 2008-16, discussing losses generally and specifically how charitable contributions interact with these limitations. If the shareholder later transfers stock without having been able to use the losses, the losses are permanently disallowed. Reg. § 1.1366-2(a)(5).

T.D. 9682 (2014), finalizing regulations using debt to deduct losses as described in part II.G.3.c.i.(a) Limitations on Using Debt to Deduct S Corporation Losses, commented on stock basis:

> The preamble to the proposed regulations requested comments regarding the basis treatment when an S corporation shareholder or a partner contributes the shareholder's or partner's own note to an S corporation or a partnership. An S corporation shareholder does not increase his basis in the stock of his S corporation under section 1366(d)(1)(A) from a contribution of his own note. See Rev. Rul. 81-187 (1981-2 CB 167) (holding that a shareholder who (i) merely executed and transferred the shareholder's demand note to the shareholder's wholly owned S corporation, and (ii) made no payment on the note until the following year had a zero basis in the note until the following year when the shareholder made a payment on the note). The preamble to the proposed regulations described as one potential model § 1.704-1(b)(2)(iv)(d)(2), which provides that a partner's capital account is increased with respect to non-readily tradable partner notes only (i) when there is a taxable disposition of such note by the partnership, or (ii) when the partner makes principal payments on such note. One commentator recommended consideration of, and consistency with, § 1.166-9(c) (regarding contributions of debt to capital). Another commentator noted that courts have applied the "actual economic outlay" standard to determine when shareholders increase their bases in their

- When deducting losses on Schedule E, Part II, taxpayers need to attach basis computations to prove their losses.

- When losses suspended future year basis increases, taxpayers should separately state those losses and write "PYA" by them.

Code § 1367(a) provides the general rules for calculating basis in S corporation stock (Code § 1366 being items in the K-1 the corporation issues the shareholder):

> (1) *Increases in basis*. The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:
>
> (A) the items of income described in subparagraph (A) of section 1366(a)(1),
>
> (B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and
>
> (C) the excess of the deductions for depletion over the basis of the property subject to depletion.
>
> (2) *Decreases in basis*. The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:
>
> (A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,
>
> (B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),
>
> (C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),
>
> (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account,[819] and

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> S corporation stock. See, for example, *Maguire v. Commissioner*, T.C. Memo. 2012-160. This commentator requested that the final regulations provide that actual economic outlay does not apply to determinations of a shareholder's stock basis under section 1366(d)(1)(A). To expedite finalization of the proposed regulations, the scope of these final regulations is limited to basis of indebtedness. The Treasury Department and the IRS continue to study issues relating to stock basis and may address these issues in future guidance.

[818] See Code § 704(d). See also Collins, "Charitable Gifts of Partnership Interests and Partnership Property," ACTEC Business Planning Committee (Summer 2008).

[819] Reg. § 1.1367-1(c)(2) provides:

> *Noncapital, nondeductible expenses*. For purposes of section 1367(a)(2)(D), expenses of the corporation not deductible in computing its taxable income and not properly

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B) .

The decrease under subparagraph (B) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property.

"The shareholder bears the burden of establishing his basis in an S corporation."[820]

The extent to which they may use debt in addition to this is described below.

II.G.3.c.i. Basis Limitations for S Corporation Owners Beyond Just Stock Basis

II.G.3.c.i.(a). Limitations on Using Debt to Deduct S Corporation Losses

Owners of S corporations generally may not deduct losses financed by the corporation's debt except to the extent that the shareholders are the lenders;[821] instead of

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> chargeable to a capital account (noncapital, nondeductible expenses) are only those items for which no loss or deduction is allowable and do not include items the deduction for which is deferred to a later taxable year. Examples of noncapital, nondeductible expenses include (but are not limited to) the following: illegal bribes, kickbacks, and other payments not deductible under section 162(c); fines and penalties not deductible under section 162(f); expenses and interest relating to tax-exempt income under section 265; losses for which the deduction is disallowed under section 267(a)(1); the portion of meals and entertainment expenses disallowed under section 274; and the two-thirds portion of treble damages paid for violating antitrust laws not deductible under section 162. For basis adjustments necessary to coordinate sections 1367 and 362(e)(2), see § 1.362-4(f)(ii).

Among loss disallowances that lose basis under Code § 267 is part II.Q.7.h.iii.(b) Nondeductible Loss to Corporation When It Distributes Property to Shareholders.

[820] *Hall v. Commissioner*, T.C. Memo. 2014-171, citing *Broz v. Commissioner*, 137 T.C. 46, 60 (2011), *aff'd* 727 F.3d 621 (6th Cir. 2013). The taxpayers asked for trouble and got it:

> [The CPA firm] did not prepare a basis schedule for Mr. Hall's basis in Ophthalmic Associates. Instead, [the CPA firm's forensic accountant] testified that he analyzed gross receipts to estimate Mr. Hall's basis. Mr. Hall and Mrs. Hall did not offer into evidence the purported analysis used by [the CPA] to estimate Mr. Hall's basis. Instead, Mr. Hall and Mrs. Hall offered into evidence monthly bank statements for Ophthalmic Associates for January 2005 and December 2006. We note that Mr. Hall and Mrs. Hall did not share these bank statements with respondent before trial pursuant to the Court's pretrial order. Mrs. Hall testified that during the weekend before trial she realized that two of the deposits were actually loans made to Ophthalmic Associates. Mr. Hall and Mrs. Hall did not provide sufficient evidence for us to find that these amounts were loans. We are not required to accept Mr. Hall and Mrs. Hall's self-serving testimony. See *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986). We find that petitioners have failed to prove that Mr. Hall and Mrs. Hall had a basis in Ophthalmic Associates in an amount greater than respondent determined.

[821] Code § 1366(d)(1)(B) allows deductions against:

guaranteeing a corporation's bank loan,[822] S corporation shareholders should borrow and then loan the proceeds to the corporation to deduct the loss.[823]

To cut down on controversy in this area,[824] regulations focus on whether the corporation's debt to the shareholder is bona fide[825] and intend to override the "actual

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> the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

Code § 1367(c)(2) provides:

> (A) *Reduction of basis*. If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.
>
> (B) *Restoration of basis*. If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

Reg. § 1.1366-2(a)(2)(i) provides:

> *In general*. The term basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis (as defined in § 1.1011-1 and as specifically provided in section 1367(b)(2)) in any bona fide indebtedness of the S corporation that runs directly to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general Federal tax principles and depends upon all of the facts and circumstances.

822 Reg. § 1.1366-2(a)(2)(ii) provides:

> *Special rule for guarantees*. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in any similar capacity relating to a loan. When a shareholder makes a payment on bona fide indebtedness of the S corporation for which the shareholder has acted as guarantor or in a similar capacity, then the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment.

823 Reg. § 1.1366-2(a)(2)(iii), Examples (2) (shareholder borrowed from another S corporation she owned and loaned the proceeds to the loss corporation) and (4) (no basis in loan for guarantee, but guarantor received basis in indebtedness when she made payments to the bank because the corporation no longer could).

824 Starr, "How to Obtain Debt Basis in an S Corporation? Use Bona Fide Indebtedness, Say Proposed Rules, Journal of Taxation," *Journal of Taxation* (obtained from the *Journal*'s preview service; probably published November 2012). The author of this article suggests that the Proposed Regulations adopted the recommendations of the American Bar Association's Section of Taxation (the "Tax Section"), http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/072610comments.authcheckdam.pdf, in which the author participated. The Tax Section's comments on the Proposed Regulations are at http://www.americanbar.org/content/dam/aba/administrative/taxation/091712comments2.authcheckdam.pdf (9/17/2012). T.D. 9682 (7/23/2014) adopted the proposed regulations with very few changes. Reg. § 1.1366-5(b) allows taxpayers to rely on Reg. § 1.1366-2(a)(2) with respect to indebtedness between an S corporation and its shareholder that resulted from any transaction that occurred in a year for which the period of limitations on the assessment of tax has not expired before July 23, 2014.

economic outlay" doctrine that had been developed.[826] The preamble to the Proposed Regulations explained:[827]

> The key requirement of these proposed regulations is that purported indebtedness of the S corporation to a shareholder must be bona fide indebtedness to the shareholder. These proposed regulations do not attempt to provide a different standard for purposes of section 1366 as to what constitutes bona fide indebtedness. Rather, general Federal tax principles — many of which have developed outside of section 1366 — determine whether indebtedness is bona fide.

Final Regulations retained this rule, without any changes.[828]

Reg. § 1.1366-2(a)(2) preempts case law, which provided unpredictable results. See *Russell v. Commissioner*, T.C. Memo. 2008-246 (shareholders co-signing loans made by others did not provides basis; also, adjusting journal entries regarding loans were not respected because timing was suspicious), *aff'd per curiam United Energy Corporation v. Commissioner*, 106 AFTR.2d 2010-6056 (8th Cir. 2010). On the other hand, the fact that a loan made directly to the shareholder was repaid by the corporation did not mean that the corporation was deemed to have borrowed the money. *Gleason v. Commissioner*, T.C. Memo. 2006-191. If a creditor obtains a judgment against a shareholder who guaranteed a loan to the corporation, the shareholder is not deemed to have made a loan to the corporation until the shareholder actually makes a payment to the creditor. *Montgomery v. Commissioner*, T.C. Memo. 2013-151.

[825] See part II.G.19 Debt vs. Equity for various cases determining whether debt was bona fide.

[826] The preamble to the proposed regulations, REG-1342042-07, explained:

> The frequency of disputes between S corporation shareholders and the government regarding whether certain loan transactions involving multiple parties, including back-to-back loan transactions, create shareholder basis of indebtedness demonstrates the complexity of and uncertainty about this issue for both shareholders and the government. The Treasury Department and the IRS propose these regulations to clarify the requirements for increasing basis of indebtedness and to assist S corporation shareholders in determining with greater certainty whether their particular arrangement creates basis of indebtedness. These proposed regulations require that loan transactions represent bona fide indebtedness of the S corporation to the shareholder in order to increase basis of indebtedness; therefore, an S corporation shareholder need not otherwise satisfy the "actual economic outlay" doctrine for purposes of section 1366(d)(1)(B).

The IRS had attacked loans that seem too circular. See, e.g. TAM 200619021, which was upheld in *Kerzner v. Commissioner*, T.C. Memo. 2009-76 (S corp. paid rent to partnership owned by its shareholders, partnership then loaned rent to its partners, who then loaned the same money to the S corp.). The preamble to the Proposed Regulations summarized these cases, some of which are cited in the *Kerzner* case as well. See Example 4 of the regulations, discussed in fn. 831, for comments on the circular flow of funds and the *Kerzner* case.

[827] The preamble cites the following cases as examples:

> *Knetsch v. U.S.*, 364 U.S. 361 (1960) (disallowing interest deductions for lack of actual indebtedness); *Geftman v. Comm'r*, 154 F.3d 61, 68-75 (3d Cir. 1998) (based on the objective attributes and the economic realities of the transaction, holding that the transaction at issue was not a bona fide debt); *Estate of Mixon v. U.S.*, 464 F.2d 394, 402 (5th Cir. 1972) (discussion of factors indicative that debt is bona fide); *Litton Business Systems, Inc. v. Comm'r*, 61 T.C. 367, 376-77 (1973).

The article at footnote 824 discusses the approaches recommended by the AICPA and the Section of Taxation of the American Bar Association took regarding what is bona fide debt.

[828] T.D. 9682 (2014) included commented on the actual economic outlay test:

The Regulations provide some helpful examples:

- A shareholder who lends money to an S corporation has basis of indebtedness, even if the shareholder's wholly-owned disregarded (for income tax purposes) LLC makes the loan.[829] Query whether the at-risk rules might limit the loss.

- If a shareholder borrows money from one S corporation he wholly owns and lends it to another S corporation, the loan to the S corporation gives the shareholder basis of indebtedness.[830]

- If one S corporation borrows from another S corporation and the lending corporation distributes the loan to the person who is the sole shareholder of both corporations, the distribution of the loan gives the shareholder basis of indebtedness.[831] Until the

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> Courts developed the actual economic outlay standard, which requires that shareholders be made "poorer in a material sense" to increase their bases of indebtedness. Some courts concluded that an S corporation shareholder was not poorer in a material sense if the shareholder borrowed funds from a related entity and then lent those funds to his S corporation. See, for example, *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004), *aff'g*, T.C. Memo. 2002-172. Instead of applying the actual economic outlay standard, the proposed regulations provided that shareholders receive basis of indebtedness if it is bona fide indebtedness of the S corporation to the shareholder.
>
> One commentator suggested that language be added to the regulations providing that actual economic outlay is no longer the standard used to determine whether a shareholder obtains basis of indebtedness. After considering this comment, the Treasury Department and the IRS believe that the proposed regulations clearly articulate the standard for determining basis of indebtedness of an S corporation to its shareholder, and further discussion of the actual economic outlay test in the regulations is unnecessary. Accordingly, the final regulations adopt the rule in the proposed regulations without change.
>
> With respect to guarantees, however, the final regulations retain the economic outlay standard by adopting the rule in the proposed regulations that S corporation shareholders may increase their basis of indebtedness only to the extent they actually perform under a guarantee. The final regulations make some minor changes to clarify the treatment of guarantees, including changing the heading to reiterate that the rule for guarantees is distinguished from the general rule adopting a bona fide indebtedness standard and moving the guarantee example after the examples illustrating the general rule consistent with the order of the regulations.

[829] Reg. § 1.1366-2(a)(2)(iii), Example 1.

[830] Reg. § 1.1366-2(a)(2)(iii), Example 2.

[831] Reg. § 1.1366-2(a)(2)(iii), Example 3. Make sure that the distribution of the loans is well documented contemporaneously, as did not happen in *Broz v. Commissioner*, 137 T.C. 46 (2011), *aff'd* 727 F.3d 621 (6th Cir. 2013). T.D. 9682, adopting final regulations, commented on Example 4:

> The Treasury Department and the IRS recognize that there are numerous ways, including certain circular cash flows, in which an S corporation can become indebted to its shareholder. The proposed regulations included Example 4 as an example of a loan originating between two related entities that is restructured to be from the S corporation to the shareholder to show that the debt need not originate between the S corporation and its shareholder, provided that the resulting debt running between the S corporation and the shareholder is bona fide. The Treasury Department and the IRS are aware, however, of cases involving circular flow of funds that do not result in bona fide indebtedness. See, for example, *Oren v. Commissioner*, 357 F.3d at 859 (purported

loan is distributed, however, the owner of the lending S corporation cannot receive basis for the loan, according to a case that applied to a taxable year before the Regulations applied.[832]

- If a shareholder makes payment with respect to a loan guarantee, the payment gives the shareholder basis of indebtedness.[833]

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loans, although meeting all the proper formalities, lacked substance); *Kerzner v. Commissioner*, T.C. Memo. 2009-76, at 5 (transaction lacked substance because money wound up right where it started and shareholder was merely a conduit through which the money flowed). Whether a restructuring results in bona fide indebtedness depends on the facts and circumstances. Because the Treasury Department and the IRS believe that the examples in the proposed regulations adequately illustrate that a restructuring of a debt that did not originate between the shareholder and the S corporation may result in basis of indebtedness as long as the resulting debt is bona fide, these final regulations do not contain additional examples.

[832] *Messina v. Commissioner*, T.C. Memo. 2017-213, rejecting taxpayers' arguments that the lending S corporation be treated as a mere agent for its owners rather than being respected as an entity. The court rejected the taxpayers' assertion that *Commissioner v. Bollinger*, 485 U.S. 340 (1988), or *Lee v. Commissioner*, T.C. Memo. 1976-265, allowed taxpayers to disregard the form of the transaction they chose.

[833] Reg. § 1.1366-2(a)(2)(iii), Example 4. For a taxable year before the regulation was effective, see *Franklin v. Commissioner*, T.C. Memo. 2016-207, describing when an S corporation's creditor, ARCO, seized property of the taxpayer who owned the S corporation:

> On the basis of his testimony, applying a preponderance-of-the-evidence standard, we find that, in 2007, ACRO seized and sold petitioner's property and applied the proceeds, $496,000, to FDI's indebtedness to it pursuant to petitioner's obligation as a guarantor. That gave rise to an indebtedness from FDI to petitioner in an equal amount. See *Putnam v. Commissioner*, 352 U.S. 82, 85 (1946) ("The familiar rule is that, instanter upon the payment by the guarantor of the debt, the debtor's obligation to the creditor becomes an obligation to the guarantor[.]"); *Perry v. Commissioner*, 47 T.C. 159, 164 (1966), *aff'd*, 392 F.2d 458 (8th Cir. 1968). Petitioner's basis in that indebtedness increased the limitation on the amount of FDI's losses and deductions that he could take into account. See sec. 1366(d)(1)(B); see also Rev. Rul. 70-50, 1970-1 C.B. 178 (1970) ("Payment by a shareholder-guarantor of a loan made by a bank to an electing small business corporation is treated as an indebtedness of the corporation to the shareholder for purposes of computing his portion of a net operating loss.").[7] That is not so with respect to the remaining $500,000 that petitioner claims he guaranteed. As we said in *Raynor v. Commissioner*, 50 T.C. 762, 770-771 (1968): "No form of indirect borrowing, be it guaranty, surety, accommodation, comaking or otherwise, gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay part or all of the obligation." See also *Borg v. Commissioner*, 50 T.C. 257 (1968). Petitioner may, therefore, deduct the $343,939 passthrough loss from FDI that he reported on his 2007 Form 1040.
>
> [7] Although entitled to consideration, revenue rulings do not have the force of law. *Dixon v. United States*, 381 U.S. 68, 73 (1965); see, *e.g.*, *Murray v. Commissioner*, T.C. Memo. 2012-213, 2012 WL 3030366, at *2 n.3.

For a taxable year before the regulation was effective, *Phillips v. Commissioner*, TC Memo 2017-61, held that judgments against a shareholder did not constitute an "economic outlay" (fn. 826) until the shareholder paid on a guarantee.

For a taxable year before the regulation was effective, the sole owner of an S corporation that liquidated failed to prove that he had assumed the debt when the loan continued to show the corporation as the borrower. *Tinsley v. Commissioner*, T.C. Summary Opinion 2017-9. Although

When the shareholder is named as a co-borrower but really is just a guarantor, the shareholder is not deemed to have borrowed the money and loaned it to the corporation.[834]

II.G.3.c.i.(b). Consequences of Using Shareholder Debt to Deduct S Corporation Losses

When losses are deducted against the basis in a loan, the shareholder's basis in the loan is less than the principal, generally causing income recognition when principal payments are made.[835]

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common sense suggests that the sole owner had assumed the debt because presumably the business was operated as a sole proprietorship, the taxpayer did not prove the form of business post-liquidation and bizarrely kept the loan in the liquidated corporation's name when it was renewed after liquidation; presumably the lender did not care about that detail because he personally guaranteed the loan, and payments were made (with the owner not proving who was making post-liquidation payments on the loan).

[834] *Hargis v. Commissioner*, T.C. Memo. 2016-232, applied the old economic outlay test (fn. 826), but the analysis seems consistent with the bona fide loan requirement under Reg. § 1.1366-2 (fn. 827). *Hargis* stated:

> …. Petitioners ask us to view petitioner's comaking and guaranty arrangements constructively as back-to-back loans from the lenders to petitioner and from petitioner to the operating companies.
>
> The "substance over form" argument advanced by petitioners here has been mostly rejected by this Court in past cases…..
>
> In the case at hand none of the proceeds of the loan agreements entered into by petitioner and his operating companies were ever advanced to petitioner individually….
>
> None of the notes petitioner signed as coborrower or guarantor were collateralized by petitioner's own property….
>
> Lastly, petitioners provided no convincing evidence that any of the lenders looked to petitioner as the primary obligor on the loans received by the operating companies….
>
> Because the form of the transactions shows the indebtedness existed directly between the operating companies and the lenders, and because petitioners have not shown that the substance of those transactions should be viewed differently from their form, we conclude that petitioner's role as comaker or guarantor of the operating companies' notes did not entitle him to claim basis in the indebtedness of the operating companies under section 1366(d)(1).

[835] When losses are deducted against the loan's basis, with under Code § 1367(b)(2)(A) making the loan's basis less than the principal that is owed, refinancing by repaying the loan from the shareholders to the corporation might cause a creditor-shareholder to recognize income. Any net increase (the amount by which the shareholder's pro rata share of the items described in Code § 1367(a)(1), relating to income items and excess deduction for depletion, exceed the items described in Code § 1367(a)(2), relating to losses, deductions, noncapital, nondeductible expenses, certain oil and gas depletion deductions, and certain distributions) in any subsequent taxable year of the corporation is applied to restore that reduction. Reg. § 1.1367-2(c)(1), interpreting Code § 1367(b)(2)(B). Some taxpayers argued that Code § 118(a) excludes contributions to capital from income, and therefore such contributions constituted tax-exempt income that increased basis in the loan; the Tax Court and Second Circuit held that such contributions are not tax-exempt income because they are not income at all. *Nathel v. Commissioner*, 131 T.C. 262 (2008), *aff'd* 615 F.3d 83 (2nd Cir. 2010).

Special rules apply to "open account" debt - shareholder advances not evidenced by separate written instruments and repayments on the advances, the aggregate outstanding principal of which does not exceed $25,000 of indebtedness of the S corporation to the shareholder at the

When the corporation's later income gives the shareholder basis, the loan's basis is restored before the stock's basis increases.[836]

When the debt to the shareholder is evidenced by a note or other written instrument held at least one year, the debt is a capital asset and repayment will result in long-term capital gain.[837] However, if the debt is not evidenced by a written instrument (*e.g.*, open account debt), the income upon repayment will be ordinary income;[838] open account debt also risks being recharacterized as a contribution to capital, the repayment of which might be recharacterized as a distribution that might then be recharacterized as disguised compensation.[839] Unless a taxpayer objectively substantiates both the

close of the S corporation's taxable year. Reg. § 1.1367-2(a)(2), (d)(2), (e) (Exs. 7 & 8). See Bailey, "Managing S corporation Open Account Debt," *Practical Tax Strategies* (11/2013).

[836] Code § 1367(b)(2)(B).

[837] Rev. Rul. 64-162.

[838] Rev. Rul. 68-537.

[839] *Glass Blocks Unlimited v. Commissioner*, T.C. Memo. 2013-180, upheld the IRS determination of wages, resulting in payroll taxes and penalties on what the taxpayer claimed to be repayment of open account debt. In testing for contribution to capital vs. loan treatment, the court held that:

> factors include: (1) the names given to the documents that would be evidence of the purported loans; (2) the presence or absence of a fixed maturity date; (3) the likely source of repayment; (4) the right to enforce payments; (5) participation in management as a result of the advances; (6) subordination of the purported loans to the loans of the corporation's creditors; (7) the intent of the parties; (8) the capitalization of the corporation; (9) the ability of the corporation to obtain financing from outside sources; (10) thinness of capital structure in relation to debt; (11) use to which the funds were put; (12) the failure of the corporation to repay; and (13) the risk involved in making the transfers. *Calumet Indus., Inc. v. Commissioner*, 95 T.C. 257, 285 (1990).

But for the court's view that the taxpayer was lying (testified in court that he worked 20 hours per week when he told the IRS examiner that he worked full time and all evidence supported his statements to the IRS), the situation appeared sympathetic. The company barely broke even, and the relatively modest payments to the shareholder-employee that were recharacterized as wages were much larger than his K-1 income. The taxpayer would have paid lower employment taxes if the entity had been taxed as sole proprietorship.

On the other hand, after citing the same 13 factors, *Scott Singer Installations, Inc. v. Commissioner*, TC Memo 2016-161, *acq.* 2017-15 I.R.B. 1072 (see fn. 840 for the limited scope of acquiescence and hostility toward the court's decision), held:

> No single factor is controlling. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. at 493. However, the ultimate question is whether there was a genuine intention to create a debt, with a reasonable expectation of repayment, and whether that intention comported with the economic reality of creating a debtor-creditor relationship. *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973).
>
> Transfers to closely held corporations by controlling shareholders are subject to heightened scrutiny, however, and the labels attached to such transfers by the controlling shareholder through bookkeeping entries or testimony have limited significance unless these labels are supported by other objective evidence. *E.g.*, *Boatner v. Commissioner*, T.C. Memo. 1997-379, 1997 WL 473162, at *3, *aff'd without published opinion*, 164 F.3d 629 (9th Cir. 1998).
>
> Rather than analyze every factor on the debt-equity checklists, we confine our discussion to those points we find most pertinent. In our analysis we look at the relative financial status of petitioner at the time the advances were made; the financial status of petitioner at the time the advances were repaid; the relationship between Mr. Singer and petitioner; the method by which the advances were repaid; the consistency with which the advances

existence of a loan and that payments made were in repayment of that loan, the IRS will assert that the payment of personal expenses by an S corporation on behalf of its corporate officer/employee constitute wages subject to Federal employment taxes.[840]

> were repaid; and the way the advances were accounted for on petitioner's financial statements and tax returns. After looking at all these criteria in the light of the other factors traditionally distinguishing debt from equity, particularly the intent factor, we believe Mr. Singer intended his advances to be loans and we find that his intention was reasonable for a substantial portion of the advances. Consequently, we also find that petitioner's repayments of those loans are valid as such and should not be characterized as wages subject to employment taxes.

With the same result – no wage income - *Goldsmith v. Commissioner*, T.C. Memo. 2017-020, followed *Scott Singer*, pointing out (emphasis in original):

> There's no rule that an S corporation *has* to pay its sole shareholder a wage, especially when it's bleeding money the way G&A did. The real question is one of fact—were the payments a return of capital, repayments of loans, or wages? See *Scott Singer Installations, Inc., v. Commissioner*, T.C. Memo. 2016-161.

[840] A.O.D. 2017-04 (4/17/2017), taking the position in the text above and strongly criticizing *Scott Singer Installations, Inc. v. Commissioner*, TC Memo 2016-161, *acq.* 2017-15 I.R.B. 1072 (see fn. 839):

> The critical factor in determining the appropriate tax treatment is whether the payments are remuneration (i.e., compensation) for services provided to the employer. The Service disagrees with the Court's reasoning, which failed to properly address the critical issue of whether the payments made by Taxpayer to creditors on behalf of Mr. Singer were compensation for his services and thus wages under the applicable statutory and regulatory provisions. The Service's position is that the Court incorrectly decided that no portion of the payment of personal expenses by Taxpayer on behalf of Mr. Singer should be characterized as wages subject to Federal employment taxes. Whether advances made to a corporation by a shareholder-officer are characterized as loans rather than capital contributions does not control whether a payment made by the corporation to the shareholder-officer is compensation for services and therefore properly characterized as wages. The Court failed to acknowledge that, similar to debt repayments, wages are also paid in a recurring nature and may be paid even if a business is operating at a loss.
>
> In focusing on the intention to create a debtor-creditor relationship and whether Mr. Singer had a reasonable expectation of repayment of the advances, the Court failed to analyze or even cite the relevant statutory or regulatory provisions governing the definition of wages for Federal employment tax purposes. Nor did the Court review its own substantial body of case law that repeatedly rejects taxpayers' attempted characterizations of payments to officers who perform substantial services as something other than compensation for services. The Court failed to analyze why precedents concerning officer compensation were not applicable. See *Veterinary Surgical Consultants PC v. Commissioner*, 117 T.C. 141 (2001) (stating that "the characterization of the payment to [president] as a distribution of net income is but a subterfuge for reality;" and holding the payments constituted remuneration for services performed by the [president] and were subject to employment taxes). See *also Glass Blocks Unlimited v. Commissioner*, T.C. Memo 2013-180 (holding that "[a]n employer cannot avoid Federal employment taxes by characterizing payments to its employee, sole officer and shareholder as something other than wages where such payments represent remuneration for services rendered"). See *Smith v. Commissioner*, T.C. Memo. 1995-410 (finding that payments of personal living expenses made by a wholly owned corporation on behalf of its president/employee and sole shareholder, who received no salary in the year at issue, are properly characterized as wages when they represent remuneration for employment).

II.G.3.c.ii. Basis Limitations for Partners in a Partnership

Generally, partners may deduct losses only to the extent of basis.[841] Not all deductions are subject to these rules,[842] but the those deductions would reduce basis[843] and therefore can cause their deductions to be suspended.[844]

> Several circuit courts have also rejected arguments that officers who perform *substantial services received something other than compensation for those services. See Joseph M. Grey Accountant, P.C. v. Commissioner*, 119 T.C. 121 (2002), *aff'd* 93 Fed. Appx. 473 (3rd Cir. 2004) (holding that money taken from corporate account by the sole shareholder and president of the corporation to pay for his needs as they arose was wages subject to employment taxes); *Joly v. Commissioner*, 211 F.3d 1269 (6th Cir. 2000) (holding that distributions to controlling shareholders were wages despite an express written agreement that any excess distributions would be treated as loans); *Joseph Radtke S.C. v. United States*, 895 F.2d 1196, 1197 (7th Cir. 1990) (holding that dividends paid by the corporation to the only significant employee, who otherwise received no salary for his substantial services, were in fact wages subject to employment taxes because the payments "were clearly remuneration for services performed"); *David E. Watson, P.C. v United States*, 668 F.3d 1008 (8th Cir. 2012) (holding that the proper legal analysis was whether the payments at issue were made as remuneration for services performed; rejecting the argument that taxpayer intent controls when characterizing payments and finding dividend distributions should properly be characterized as wages, despite repeated assertions by the taxpayer that there is no statute, regulation, or rule requiring an employer to pay minimum compensation); *Spicer Accounting, Inc. v. U.S.*, 918 F.2d 90, 93 (9th Cir. 1990) (holding that the only stockholder of an S corporation, who "donated" his services and withdrew earnings in the form of dividends, actually received wages; stating that regardless of how an employer chooses to characterize payments made to employees, "the true analysis is whether the payments are for remuneration for services rendered").
>
> While none of the courts in the cases cited above found the existence of a debtor-creditor relationship, the applicable employment tax regulations defining the scope of wages as all remuneration for employment does not cease to apply even if such debtor-creditor relationship is present. As previously noted, the regulations expressly provide that an employer's characterization of the payment is irrelevant. Accordingly, when a corporation makes any payment of personal expenses to or on behalf of a shareholder-officer, the question must be asked - is the payment being made as remuneration for services? If so, then the payment is wages. While the Service may recognize a payment from a corporation to its shareholder-officer who is also an employee as a loan repayment, the taxpayer must provide objective evidence that both substantiates that a bona fide loan exists between the parties and substantiates that the payment from the taxpayer to the employee was specifically in repayment of that loan and is separate from compensation paid to the employee for the performance of services for the taxpayer.

See also https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-employees-shareholders-and-corporate-officers (last visited 9/2/2017).

[841] Reg. § 1.704-1(d)(2) provides:

> In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be increased under section 705(a)(1) and decreased under section 705(a)(2), except for losses of the taxable year and losses previously disallowed. If the partner's distributive share of the aggregate of items of loss specified in section 702(a)(1), (2), (3), (8), and (9) exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under section 704(d) must be allocated to his distributive share of each such loss. This

Partners generally may deduct losses financed by certain obligations (including bank loans to the partnership) to the extent permitted by the Code § 465 at-risk rules. Although loan guaranties can cause debt to be allocated to the guarantor instead of to other partners, contributing the partner's own promissory note to a partnership does not constitute such a guarantee.[845] For a discussion of the Code § 465 at-risk rules, as well as the Code § 752 treatment of certain nonrecourse or other liabilities, see part II.G.3.g At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

Among liabilities that create basis are "debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps."[846] However, an obligation counts:[847]

> allocation shall be determined by taking the proportion that each loss bears to the total of all such losses. For purposes of the preceding sentence, the total losses for the taxable year shall be the sum of his distributive share of losses for the current year and his losses disallowed and carried forward from prior years.

[842] Reg. § 1.704-1(d)(2), reproduced in fn. 841, implicitly does not suspend the following deductions under Code § 702(a):

> (4) charitable contributions (as defined in section 170(c)),
> (5) dividends with respect to which section 1(h)(11) or part VIII of subchapter B applies,
> (6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,
> (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary…

Confirming this interpretation, see fn. 859 in part II.G.3.d.ii Basis Limitations on Deducting Charitable Contributions Made by an S Corporation or a Partnership.

[843] Code § 705(a)(2)(B). See also fn. 860 in part II.G.3.d.ii Basis Limitations on Deducting Charitable Contributions Made by an S Corporation or a Partnership.

[844] The first sentence of Reg. § 1.704-1(d)(2), reproduced in fn. 841, provides that "In computing the adjusted basis of a partner's interest for the purpose of ascertaining the extent to which a partner's distributive share of partnership loss shall be allowed as a deduction for the taxable year, the basis shall first be … decreased under section 705(a)(2)…."

[845] *VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182. The court's analysis of not obtaining basis for contributing the notes is described in fn. 2495. In discussing the loan issue, the court reasoned:

> VisionMonitor argues that the notes in this case, like the assumption of debt in *Gefen*, were necessary to persuade a third party to kick in more funding to a cash-strapped partnership. But unlike the partner in Gefen, neither Mantor nor Smith were guaranteeing a preexisting partnership debt to a third party. And they did not directly assume any of VisionMonitor's outside liabilities—these notes are their liability to VisionMonitor, not an assumption or guaranty of VisionMonitor's debt to a third party. Mantor did sign a resolution in 2007 that included a promise "to provide *** personal credit to the company vendors *** to ensure continued uninterrupted operations"—but there's no evidence that either he or Smith ever actually provided that credit. And there's also no evidence that Mantor or Smith were personally obliged under the VisionMonitor partnership agreement to contribute a fixed amount for a specific, preexisting partnership liability.

[846] Reg. § 1.752-1(a)(4)(ii). Letter Ruling 201608005 gave the owners of partnership P basis for certain obligations owed to O under construction contract guarantees:

> Before P is entitled to receive payments under the contracts and, explicitly, to receive the Notice to Proceed payments, P is required to provide certain guarantees and also to

only if, when, and to the extent that incurring the obligation-

(A) Creates or increases the basis of any of the obligor's assets (including cash);

(B) Gives rise to an immediate deduction to the obligor; or

(C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

For more information, see part II.C.3 Allocating Liabilities (Including Debt).

In a partnership setting, generally no income is recognized on the repayment of a debt until distributions (including deemed distributions when the partner's share of partnership debt is reduced) exceed basis.[848]

> deliver to O irrevocable standby letters of credit. The letters of credit secure P's obligations to perform under the contracts and cover O's damages in the event of non-performance or default by P. The amount of the letters of credit securing P's obligations roughly corresponds to the amount of the Notice to Proceed payments.
>
> The contracts provide that if P fails to prosecute the work in a diligent and efficient manner, or if P abandons the project or repudiates any of its obligations, a default occurs. In that event, O is entitled to several remedies, including seeking specific performance (that is, obtaining judicial enforcement requiring to make good on its obligation to perform the work) and recovery from P of costs, damages, losses, and expenses (that is, requiring P to make good on its obligation to cover O's damages in the event of nonperformance). Specifically, the contracts allow O to draw-down directly against the letters of credit in the event of a default by P.

The Letter Ruling discussed certain authority:

> Revenue Ruling 95-26, 1995-1 C.B. 131, concludes that a partnership's obligation to deliver securities in a short sale transaction constitutes a section 752 liability under a definition of partnership liability similar to the definition quoted above. The Revenue Ruling reasons that a short sale creates such a liability inasmuch as: (1) a short sale creates an obligation to return the borrowed securities, citing *Deputy v. Du Pont*, 308 U.S. 488, 497-98 (1940), 1940-1 C.B. 118; and (2) the partnership's basis in its assets is increased by the amount of cash received on the sale of the borrowed securities. Therefore, the Revenue Ruling concludes that the partners' bases in their partnership interests are increased under section 722 to reflect their shares of the partnership's liability under section 752. In *Salina Partnership LP v. Commissioner*, T.C. Memo 2000-352, the Tax Court examined the policy underlying section 752 and the analysis of Revenue Ruling 95-26 and held that a partnership's obligation to close its short sale by replacing borrowed securities represented a partnership liability within the meaning of section 752.

The Letter Ruling held:

> Based solely on the facts submitted and the representations made, we conclude that P's obligations under the contracts to proceed with performing work and to incur costs in performing the work, and the corresponding obligations to satisfy O's remedies in the event P were to default or suspend work, constitute liabilities under section 752 upon and to the extent P receives the Notice to Proceed payments but has not yet reported the related income.

[847] Reg. § 1.752-1(a)(4)(i).

[848] Code §§ 752(a), (b) and 731(a)(1). For a scathing critique of proposed regulations under Code § 752, see Lipton, "Proposed Regulations on Debt Allocations: Controversial, and

If a partner loans money to the partnership that is a start-up venture and it is possible that the partnership might need a capital infusion by another party in which the debt is converted to equity, the later capital infusion might trigger ordinary income taxation.[849] One might consider using preferred equity instead of loaning the money to the partnership.

II.G.3.c.iii. Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses

Thus, partnership and S corporations are better for deducting losses against debt than C corporations, because they permit ordinary loss treatment for any portion of the debt not repaid. For partnerships and S corporations, the deduction comes not when the note is worthless but rather every year as the owner's distributive share of the entity's income or loss. Contrast this against needing to prove the C corporation's inability to pay the debt and the additional restrictions imposed on the nature of the loss – partnership and S corporation deducting in calculating adjusted gross income (the most valuable way to deduct anything) compared to a C corporation shareholder's short-term capital loss or miscellaneous itemized deduction.

Rutter v. Commissioner, T.C. Memo. 2017-174, is a good example of this. The taxpayer, a "world-renowned scientist in the field of biotechnology," struck it rich. Then he poured tens of millions of dollars into a new losing business, hoping to replicate his earlier success. First, he used documented loans, which he later converted to preferred stock. Eventually he made advances to the business that were not documented by loans and that never paid interest. The Tax Court held that the advances constituted equity, and even if it might be reversed on that issue the advances would have been nonbusiness bad debts, deductible as capital losses when wholly worthless. If the entity had been taxed as a partnership and his investment structured as a partnership interest, his advances could have generated annually deductible losses.

If one exits from a C corporation that has lost money, see part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

II.G.3.d. Limitations on Deducting Charitable Contributions

II.G.3.d.i. Charitable Deduction vs. Business Expense

Deductions for charitable contributions made by C corporations are limited to 10% of their taxable income,[850] whereas such contributions made by S corporations and

Deservedly So," *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014); Schneider and O'Connor, "The IRS Did What to the Partnership Debt Allocation and Disguised Sale Rules?!?" *TM Real Estate Journal* (BNA), Vol. 30 No. 8 (8/6/2014).

[849] See part II.G.3.a.v Tax Effect of Loan to S Corporation or Partnership, especially the text accompanying fns. 809-810.

[850] Code § 170(b)(2)(A). For a very helpful chart, see Wittenbach, Milani, and Riegel, "Charting The Interactions Of The Charitable Contribution Deduction For Corporations," *Taxation of Exempts* (WG&L) May/Jun 2017, which is saved as Thompson Coburn doc. no. 6568468 (chart in PDF embedded at bottom of first page).

partnerships are deducted at the owner level, subject to limitations due to basis,[851] percentage (20%-50%) of modified adjusted gross income if the taxpayer is an individual[852] or if the taxpayer is a fiduciary with unrelated business taxable income,[853] and certain reductions of itemized deductions (for individuals).[854] Additional limitations apply to contributions of ordinary income and capital gain property.[855]

Transfers of property to a Code § 170(c) organization bearing a direct relationship to the taxpayer's trade or business that are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses[856] rather than as charitable contributions.[857]

A taxpayer that promises to donate a portion of its sales or profits to organizations that it specifies may deduct those donations as business expenses so long as the expenditure is not expressly precluded from being deducted (the latter including lobbying expenses).[858]

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[851] See part II.G.3.d.ii Basis Limitations on Deducting Charitable Contributions Made by an S Corporation or a Partnership.

[852] Code § 170(b)(1).

[853] See parts II.Q.6.d Unrelated Business Income and II.Q.7.c S Corporations Owned by a Trust Benefitting Charity, especially part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. As described in that part (including Code §§ 681 and 512(e)), the focus is on S corporations because all S corporation K-1 income received by a nongrantor trust deducting charitable contributions is per se unrelated business income, but partnerships can generate unrelated business income, too. Trusts without unrelated business income can deduct all of their charitable contributions, if and to the extent paid from gross income. Code § 642(c)(1). However, Code § 642(c) does not apply to an ESBT. See fn 4529 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview.

[854] Code § 68.

[855] Code § 170(e).

[856] Reg. § 1.162-15(a)(1) provides that any amounts characterized as Code § 170 charitable contributions are not deductible as Code § 162 business expenses. Rul. 84-110 amplifies Rev. Rul. 73-113 (fn. 857) by providing that expenditures of serving as a public official are Code § 162 business expenses, even if not engaged in for profit (in the ruling, the expenses were much more than the annual income), because Code § 7701(a)(26) eliminates the profit motive as a requirement for being in the business of serving as a public official.

[857] Reg. § 1.170A-1(c)(5); Rev. Rul. 73-113, which provides, "Whether a particular transfer was made with a reasonable expectation of a financial return, commensurate with the amount of the transfer, is a question of fact."

[858] CCA 201543013, which discussed the customers' charitable intent:

> Here, it does not appear that Taxpayer's customers have a right to a share of the amounts in Program X. The [promise to make certain donations] does not by itself appear to give the customers control over these funds such that Taxpayer is the agent of the customer or is acting as a mere conduit for the dispersal of these funds.
>
> You have indicated that factual development of this issue is ongoing. If you wish to pursue the agency theory, we suggest that you develop the facts consistent with the criteria set out in *National Carbide v. Commissioner*, 336 U.S. 422 (1949) and *Commissioner v. Bollinger*, 485 U.S. 340 (1988). If you wish to pursue a conduit theory, you may want to review *Seven-Up Co. v. Commissioner*, 14 T.C. 965 (1950) *acq. in result*, 1974-2 C.B. 1. It does not appear from the facts supplied so far that the funds in Program X belong to and are donated by Taxpayer's customers.

II.G.3.d.ii. Basis Limitations on Deducting Charitable Contributions Made by an S Corporation or a Partnership

A partner may deduct charitable contributions without regard to the partner's basis.[859] The basis of the partner's interest in the partnership is decreased (but not below zero) by the partner's share of the partnership's basis in the property contributed.[860]

Until recently, the full fair market value of the contribution reduced basis, and triggering the regular basis limitations under part II.G.3.c.i Basis Limitations for S Corporation Owners. However, for contributions made in tax years beginning after December 21, 200,5[861] appreciation does not reduce basis and therefore is not subject to these basis limitations.[862]

Trusts that are partners or S corporation shareholders may see their charitable contributions reduced due to certain rules relating to unrelated business income (which rules apply to all S corporation K-1 income even if the S corporation does not engage in a trade or business and does not have any debt-financed income). See part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity (some of which applies to partnerships, even though the focus is S corporations). Although generally a trust cannot deduct contributions unless the trust agreement authorizes contributions to be made, trust deductions of partnership contributions are not so limited.[863]

II.G.3.e. Expenses Incurred by Owner-Officer

Under Code § 162(a), an S corporation shareholder could deduct losses arising from lawsuits against him personally relating to that person managing the business.[864]

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[859] Letter Ruling 8405084; see fns. 841-842 in part II.G.3.c.ii Basis Limitations for Partners in a Partnership. See discussion in McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 11.05[1][b] "Exclusion of Charitable Contributions From the Limitation."

[860] Rev. Rul. 96-11; see Code § 705(a)(2)(B).

[861] P.L. 109-280, section 1203(a).

[862] Code § 1366(d)(4), 1367(a)(2).

[863] Rev. Rul. 2004-5, which is discussed in fn. 3534, which is found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Note that charitable contributions by trusts are more beneficial for net investment income tax purposes than charitable contributions by individuals. See fn. 1561.

[864] Letter Ruling 201548011, which discussed the origin of the claim doctrine and mentioned:

> Generally, amounts paid in settlement of lawsuits are currently deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. See, *e.g.*, *Federation Bank & Trust Co. v. Commissioner*, 27 T.C. 960, 973 (1957), *aff'd*, 256 F.2d 764 (2d Cir. 1958), *acq.*, 1969-2 C.B. xxiv (allowing petitioner to deduct amounts paid in settlement of legal proceedings charging petitioner with mismanagement in the liquidation of assets); *Butler v. Commissioner*, 17 T.C. 675, 679-81 (1951), *acq.*, 1952-1 C.B. 1 (settlement payment arising from shareholder suit for damages against principal officer for mismanagement of corporate affairs held deductible as an ordinary and necessary business expense directly connected to and proximately resulting from his business activity); Rev. Rul. 79-208, 1979-2 C.B. 79 (permitting taxpayer to deduct payments to settle lawsuit and obtain a release from breach of contract claims under a franchise agreement).

II.G.3.f. Passive Loss Limitations

See part II.K Passive Loss Rules for limitations on deductions and credits under the Code § 469 passive loss rules.

Although these limitations are significant, they are temporary, except when an individual dies or a trust terminates.[865] More important than the timing of losses is the application of the passive loss rules in determining whether income is subject to the 3.8% tax on net investment income, which is why the detailed discussion is moved to the part describing that tax.[866]

II.G.3.g. At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities)

An individual (as well as certain personal holding companies) may not deduct a loss to the extent not "at risk" with respect to the activity that generated the loss.[867]

Partners generally may deduct losses financed by bank loans to the partnership to the extent permitted by these rules.[868]

AM 2014-003 addressed LLC Member guarantees of LLC debt and "qualified nonrecourse financing," taking the following positions:[869]

> Similarly, amounts paid for legal expenses in connection with litigation are allowed as business expenses where such litigation is directly connected to, or proximately results from, the conduct of a taxpayer's business. See, *e.g.*, *Howard v. Commissioner*, 22 B.T.A. 375, 378 (1931), *acq.*, 1945 C.B. 4 (holding that legal fees incurred by taxpayer to settle a shareholder's claim of misrepresentation in the conduct of business are deductible as business expenses); *D'Angelo v. Commissioner*, T.C. Memo. 2003-295 (petitioner entitled to a section 162 deduction for legal fees paid in defending suits alleging breach of fiduciary duty, mismanagement, and breach of contract in his capacity as an officer, partner, and shareholder of entities in which he had an ownership interest).
>
> In Rev. Rul. 80-211, 1980-2 C.B. 57, the taxpayer was sued civilly for breach of contract and fraud relating to the ordinary conduct of its trade or business. A judgment was rendered that included punitive damages. The ruling allowed the taxpayer to deduct amounts paid as punitive damages under section 162(a) as an ordinary and necessary business expense because the acts that gave rise to the civil suit were performed in the ordinary course of the taxpayer's business.

865 See part II.K.2.d Effect of Death of an Individual or Termination of Trust .

866 See part II.I.8 Application of 3.8% Tax to Business Income.

867 Code § 465.

868 See Code § 465(b)(6), treating certain nonrecourse real estate loans as at-risk to partner. Also, compare Prop. Reg. § 1.465-24(a)(2) (which would treat partners as at-risk for loan guarantees) with Prop. Reg. § 1.465-24(a)(3) (contrary rule for S corporations). If a grantor trust borrows on a recourse basis but the lender's only recourse is against the trust's assets, its grantor is "at risk" for purposes of Code § 465(b) only to the extent of the trust's assets. Rev. Rul. 78-175.

869 AM 2014-003, authored by Curt G. Wilson, Associate Chief Counsel (Passthroughs & Special Industries) and sent to Division Counsel (Large Business & International) to the attention of a Senior Level Counsel (Domestic). In addition to the comments made below, the memo commented:

- When a member of an LLC classified as a partnership or disregarded entity for federal tax purposes guarantees the LLC's debt, the member is at risk with respect to the amount of the guaranteed debt, without regard to whether such member waives any right to subrogation, reimbursement, or indemnification from the LLC, but only to the extent that the member has no right of contribution or reimbursement from persons other than the LLC, the member is not otherwise protected against loss within the meaning of Code § 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law.[870]

> This memorandum does not address the effect of a member guarantee of qualified nonrecourse financing in the context of a single member LLC taxed as a disregarded entity for federal tax purposes, because the member's at-risk amount generally will not be affected by the guarantee. As the sole owner of an LLC with qualified nonrecourse financing, the single member is at risk prior to guaranteeing the debt because the debt is qualified nonrecourse financing. After guaranteeing the debt, the debt no longer meets the definition of qualified nonrecourse financing, but as the guarantor, the single member is still at risk to the extent of the amount guaranteed and to the extent the single member is not otherwise protected against loss.

In addition to being concerned about using a disregarded entity LLC to avoid the at-risk rules, the IRS is also leery of using a QSST to avoid the at-risk rules. A QSST is a trust owning stock in an S corporation, which trust is taxed as a grantor trust deemed owned by the beneficiary; see part III.A.3.e.i QSSTs. CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note; see part III.A.3.e.vi QSST . The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability.

[870] Reasoning:

> In the case of an LLC, all members have limited liability with respect to LLC debt. In the absence of any co-guarantors or other similar arrangement, an LLC member who guarantees LLC debt becomes personally liable for the guaranteed debt and is in a position akin to the general partners in the example in Prop. [Reg.] § 1.465-24(a)(2)(ii) who had personally assumed the partnership's debt and who had no right of reimbursement for their $12,500 share. If called upon to pay under the guarantee, the guaranteeing member may seek recourse only against the LLC's assets, if any. As in the case of a general partner, a right to subrogation, reimbursement, or indemnification from the LLC (and only the LLC) does not protect the guaranteeing LLC member against loss within the meaning of § 465(b)(4).

Moreno v. U.S., 113 A.F.T.R.2d 2014-2149 (D. La. 5/19/2014), agreed with this principle and rebuffed government arguments looking to the individual guarantor's net worth or the practical matter of how the guaranty would be satisfied, instead counting only a legal right to contribution as reducing the amount at risk. *Moreno* said:

> With respect to rights of contribution and reimbursement, where a member of a limited liability company guarantees a liability of the limited liability company, he or she is at risk, except to the extent he or she has a right of contribution or reimbursement from the other guarantors. See e.g. IRS Field Service Advisory 2000-25-018 (June 23, 2000), 2000 WL 33116072 (each member of a limited liability company "who has guaranteed a liability of the limited liability company is at-risk, except to the extent the member has a right of reimbursement against the remaining members"); IRS Chief Counsel Advisory 20130828 (February 22, 2013), 2013 WL 653295 ("an LLC member is at risk with respect to LLC debt guaranteed by the member (where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes), but only to the extent that the member has no right of contribution or reimbursement from the other guarantors..."; taxpayer is not at risk "for those amounts" for which he has a right of contribution against co-sureties); Susan Kalinka, *Limited Liability Companies and Partnerships: A Guide to*

- When a member of an LLC classified as a partnership for federal tax purposes guarantees qualified nonrecourse financing of the LLC, the member's amount at risk is increased by the amount guaranteed, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from persons other than the LLC, the guaranteeing member is not otherwise protected against loss within the meaning of Code § 465(b)(4), and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

- When a member of an LLC guarantees qualified nonrecourse financing of the LLC, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under Code § 465(b)(6)(B) if the guarantee is bona fide and enforceable by creditors of the LLC under local law, and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guarantor members of the LLC.[871]

Business and Tax Planning, 9A LACIVL § 6.7 (3d ed.) (2012) (a member of an LLC who guarantees an obligation of the LLC will assume personal liability for the LLC's obligation, and that member should be entitled to include in his or her at risk amount the portion of the guaranteed liability for which the member may not seek reimbursement); S. Rep. 94-938, 49, 1976 U.S.C.C.A.N. 3438, 3485 ("a taxpayer's capital is not "at risk" in the business ... to the extent he is protected against economic loss of all or part of such capital by reason of an ... arrangement for compensation or reimbursement to him of any loss which he may suffer"). Here, all parties acknowledge that if either Dynamic or Moreno were to pay Aerodynamic's obligation, the paying entity would have right of contribution against the other for half the amount it paid, pursuant to La. Civ. Code arts. 3055 and 3056. Under such circumstances, the IRS has determined a guarantor is at risk for fifty percent of the amount guaranteed.

[871] Reasoning:

As a general rule, LLC members may not include liabilities of the LLC in their at-risk amounts unless the members are personally liable for the debt as provided by § 465(b)(2)(A). Further, under § 465(b)(4), taxpayers are not at risk with respect to amounts protected against loss through nonrecourse financing. Section 465(b)(6)(A) creates an exception to these rules when a nonrecourse liability meets the definition of qualified nonrecourse financing. Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment. When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover that amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for that debt, that debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1). Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, that debt also fails to satisfy the requirement in § 1.465-27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.

Because that debt is no longer qualified nonrecourse financing, the nonguaranteeing members of the LLC who previously included that portion of the qualified nonrecourse financing in their amount at risk and who have not guaranteed any portion of that debt may no longer include that amount of the debt in determining their amount at risk. Any reduction that causes an LLC member's at-risk amount to fall below zero will trigger recapture of losses under § 465(e). The at-risk amount of the LLC member that guarantees LLC debt is increased, but only to the extent such debt was not previously

The IRS has addressed whether a guarantor of debt of an LLC treated as either a partnership or a disregarded entity for federal tax purposes be at "risk" with respect to the guaranteed debt if the guarantor does not completely waive his rights of subrogation and reimbursement from the LLC with respect to that guaranteed debt. The IRS applied the following requirements (assuming certain exceptions[872] do not already apply):[873]

- The taxpayer must be personally liable for the debt,[874] and

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> taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from persons other than the LLC, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and the guarantee is bona fide and enforceable by creditors of the LLC under local law.
>
> The Field Office noted that non-guaranteeing LLC members may assert that a guarantee of qualified nonrecourse financing by another LLC member does not increase the guarantor's amount at risk and, therefore, should not reduce the at-risk amount of the non-guaranteeing members with respect to that financing. As discussed above, we do not adopt that reading of Prop. [Reg.] § 1.465-6(d). Even if it did apply in this situation, it would not aid the non-guaranteeing members because the financing would still cease to be qualified nonrecourse financing under Section 465(b)(6)(B). Section 465(b)(6)(B)(iii) defines qualified nonrecourse financing as financing for which no person is personally liable. Because a guarantor becomes personally liable for the amount guaranteed, any liability previously treated as qualified nonrecourse financing no longer meets the definition of qualified nonrecourse financing once it is guaranteed (whether or not the guarantor is at risk). As a result, the non-guaranteeing members may no longer avail themselves of the exception in § 465(b)(6)(A) to include any portion of the guaranteed liability in their at-risk amounts regardless of the impact of the guarantee on the guarantor's amount at risk. Whether Prop. [Reg.] § 1.465-6(d) applies to a guarantor of LLC debt is an inquiry that does not affect the analysis of whether a guaranteed liability constitutes qualified nonrecourse financing.

872 Code § 465(b)(2)(B).

873 CCA 201308028. The IRS noted:

> It should be noted that the conclusions contained within this advice may be viewed as contrary to Prop. Treas. Reg. § 1.465-6(d) (1979), which provides that if a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guaranty shall not increase the taxpayer's amount at risk. Prop. Reg. § 1.465-6(d) further provides that if the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor. However, Prop. Reg. § 1.465-6(d) was promulgated before the development of LLCs under various state laws, and at a time when entities treated as partnerships for federal tax purposes were usually state law general partnerships and limited partnerships.
>
> ….[W]e conclude that an LLC member is at risk with respect to LLC debt guaranteed by the member (where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes), but only to the extent that the member has no right of contribution or reimbursement from other guarantors and is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts. Therefore, we conclude that Prop. Reg. § 1.465-6(d) is generally not applicable to situations involving bona fide guarantees of LLC debt by one or more members of the LLC that is enforceable by creditors of the LLC under local law, where the LLC is treated as either a partnership or a disregarded entity for federal tax purposes.

874 Based on whether the taxpayer is ultimately liable for repayment as the payor of last resort in the worst case scenario.

- The taxpayer is not otherwise protected from loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements.[875]

The IRS took the position that the mere fact that a taxpayer may be entitled to subrogation, reimbursement, or indemnification from an LLC (and only the LLC) under local law when payment is made on the guarantee does not mean that the taxpayer is "protected against loss." The IRS also stated that, to the extent that co-guarantors protect the taxpayer from loss under the economic realities existing at the end of a taxable year, to the taxpayer is not at risk for that year.

CCA 201606027[876] addressed LLC Member guarantees of LLC debt and "qualified nonrecourse financing," taking the following positions regarding certain provisions that can trigger personal liability made the loans recourse (sometimes referred to as "bad boy guarantees"):

1. If a partner guarantees an obligation of the partnership and the guarantee is sufficient to cause the guaranteeing partner to bear the economic risk of loss for that obligation within the meaning of § 1.752-2(b)(1) of the Income Tax Regulations, the guaranteed debt is properly treated as recourse financing for purposes of applying the basis allocation rules of § 752. For this purpose, certain contingencies such as the partnership admitting in writing that it is insolvent or unable to pay its debts when due, its voluntary bankruptcy, or its acquiescence in an involuntary bankruptcy, after taking into account all the facts and circumstances, are not so remote a possibility that it is unlikely the obligation will ever be discharged within the meaning § 1.752-2(b)(4) that would cause the obligation to be disregarded under § 1.752-2(b)(3).[877]

[875] The IRS said that the majority view bases its determination on the "economic realities" present at the end of the taxable year and that the minority viewed bases its determination on whether the taxpayer is payor of last resort in a worst case scenario. The IRS concluded that the majority view is correct. If a taxpayer is insulated from loss with respect to a borrowed amount, based upon the facts and circumstances existing at the end of the taxable year, then the taxpayer is not at risk. However, if at some future time the taxpayer demonstrates that the taxpayer cannot recover under the loss limitation arrangement, the taxpayer will become at risk at that time.

[876] Authored by James A. Quinn, Senior Counsel, Branch 3, Office of Associate Chief Counsel, (Passthroughs & Special Industries), to William D. Richard, Attorney (Seattle, Group 1) (Small Business/Self-Employed), October 23, 2015.

[877] In support of this conclusion, the CCA reasoned:

> As a threshold matter, a bona fide guarantee that is enforceable by the lender under local law generally will be sufficient to cause the guaranteeing partner to be treated as bearing the economic risk of loss for the guaranteed partnership liability for purposes of § 1.752-2(a). For purposes of § 1.752-2, we believe it is reasonable to assume that a third-party lender will take all permissible affirmative steps to enforce its rights under a guarantee if the primary obligor defaults or threatens to default on its obligations. In this case, we view the "conditions" listed in section 1(b) of the First Guarantee as circumstances under which the lender may enforce the guarantee to collect the entire outstanding balance on the loan, beyond an actual default by X on its obligations. As such, we do not believe these "conditions" are properly viewed as conditions precedent that must occur before Y is entitled to seek repayment from C under the guarantee.[2] In addition, we believe it is reasonable to assume that one or more of these conditions, more likely than not, would be met upon a constructive liquidation of X under § 1.752-2(b)(1). Accordingly, we

2. Where the partnership's sole business activity includes acquiring existing hotels, renovating them, installing personal property appropriate to improve the properties' utility as hotels, and holding and maintaining the premises, but does not include the hotels' day-to-day operations, the partnership is engaged in an "activity of holding real property" within the meaning of § 465(b)(6)(A).

3. When an individual partner guarantees a partnership obligation, the amount of the guaranteed debt no longer meets the definition of "qualified nonrecourse financing" under § 465(b)(6)(B), and the amount of the guaranteed debt will no longer be includible in the at-risk amount of the other non-guaranteeing partners, if the guarantee is bona fide and enforceable by creditors of the partnership under local law.[878]

> believe that these "conditions" do not fall within the definition of "contingencies" as intended by § 1.752-2(b)(4).
>
> > [2] According to the submission, it appears the taxpayer may assert that the various events listed in section 1(b) of the First Guarantee, upon the occurrence of which the First Guarantee will become immediately due and payable for the entire outstanding balance of the loan, are the only events under which the First Guarantee will become due and payable. It appears to us that a failure of X to repay the loan, by itself, likely would be sufficient to trigger the First Guarantee, as evidenced by the first sentence of section 1 of the First Guarantee. Assuming, arguendo, that the taxpayer's assertion is correct, we nevertheless believe that the likelihood that X or any other co-borrower will ever meet any one of these conditions, in the aggregate, is not so remote a possibility that would cause the obligation to be considered "likely to never be discharged" within the meaning of § 1.752-2(b)(4).
>
> For these reasons, we conclude that, for the purposes of §§ 704(d) and 752, and § 1.752-2(a), the promissory notes described above are recourse partnership liabilities allocable to the guaranteeing partner (C), and not to either A or B.

For regulations under Code § 752 that were changed in October 2016, see part II.C.3 Allocating Liabilities (Including Debt).

[878] After quoting from the statute and Reg. § 1.465-27(b), the CCA explained the at-risk rules as follows:

> Generally, a limited partner, in a limited partnership organized under state law, who guarantees partnership debt is not at risk with respect to the guaranteed debt, because the limited partner has a right to seek reimbursement from the partnership and the general partner for any amounts that the limited partner is called upon to pay under the guarantee. The limited partner is "protected against loss" within the meaning of § 465(b)(4) unless or until the limited partner has no remaining rights against the partnership or general partner for reimbursement of any amounts paid by the limited partner. To the extent that a general partner does not have a right of contribution or reimbursement under local law against any other partner for the debts of the partnership, the general partner is at risk for such debts under § 465(b)(2). The general partner's right to subrogation, reimbursement, or indemnification from the partnership's assets (and only the partnership's assets) does not protect the general partner against loss within the meaning of § 465(b)(4).
>
> In the case of an LLC, all members have limited liability with respect to LLC debt. In the absence of any co-guarantors or other similar arrangement, an LLC member who guarantees LLC debt becomes personally liable for the guaranteed debt and more closely resembles a general partner with respect to the guaranteed debt. If called upon to pay under the guarantee, the guaranteeing member may seek recourse only against the

LLC's assets, if any. As in the case of a general partner, a right to subrogation, reimbursement, or indemnification from the LLC (and only the LLC) does not protect the guaranteeing LLC member against loss within the meaning of § 465(b)(4). Therefore, in the case of an LLC treated as a partnership or disregarded entity for federal tax purposes, we conclude that an LLC member is at risk with respect to LLC debt guaranteed by such member, but only to the extent that:

(1) the guaranteeing member has no right of contribution or reimbursement from other guarantors,

(2) the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and

(3) the guarantee is bona fide and enforceable by creditors of the LLC under local law.

As a general rule, LLC members may not include liabilities of the LLC in their at-risk amounts unless the members are personally liable for the debt as provided by § 465(b)(2)(A). Further, under § 465(b)(4), taxpayers are not at risk with respect to amounts protected against loss through nonrecourse financing. Section 465(b)(6)(A) creates an exception to these rules when a liability meets the definition of qualified nonrecourse financing. Under § 465(b)(6)(B)(iii), a liability is qualified nonrecourse financing only if no person is personally liable for repayment. When a member of an LLC treated as a partnership for federal tax purposes guarantees LLC qualified nonrecourse financing, the member becomes personally liable for that debt because the lender may seek to recover the amount of the debt from the personal assets of the guarantor. Because the guarantor is personally liable for the debt, the debt is no longer qualified nonrecourse financing as defined in § 465(b)(6)(B) and § 1.465-27(b)(1). Further, because the creditor may proceed against the property of the LLC securing the debt, or against any other property of the guarantor member, the debt also fails to satisfy the requirement in § 1.465-27(b)(2)(i) that qualified nonrecourse financing must be secured only by real property used in the activity of holding real property.

It should be noted that this conclusion generally will not be affected by a determination that the guarantee is a "contingent" liability within the meaning of § 1.752- 2(b)(4). Instead, the question is simply whether the guarantee is sufficient to cause the guarantor to be considered personally liable for repayment of the debt, based on all the facts and circumstances, within the meaning of § 465(b)(6)(B)(iii). In this case, we believe the First Guarantee is sufficient for this purpose.

When the debt is no longer qualified nonrecourse financing due to a guarantee of that debt, the non-guaranteeing members of the LLC who previously included a portion of the qualified nonrecourse financing in their amount at risk and who have not guaranteed any portion of the debt may no longer include any amount of the debt in determining their amount at risk. Any reduction that causes an LLC member's at-risk amount to fall below zero will trigger recapture of losses under § 465(e). The at-risk amount of the LLC member that guarantees LLC debt is increased, but only to the extent such debt was not previously taken into account by that member, the guaranteeing member has no right of contribution or reimbursement from other guarantors, the guaranteeing member is not otherwise protected against loss within the meaning of § 465(b)(4) with respect to the guaranteed amounts, and the guarantee is bona fide and enforceable by creditors of the LLC under local law.

In this case, we conclude that, for the purposes of § 465(b)(6)(B)(iii) and § 1.465-27(b)(1)(iii), the First Guarantee described above is sufficient to cause the guaranteeing partner, C, to be considered personally liable for the guaranteed debt obligations of X. Accordingly, the guaranteed debt obligations of X will no longer qualify as "Qualified Non-Recourse Financing" within the meaning of § 465(b)(6)(B) and § 1.465-27. A and B, as non-guaranteeing members of X, will not be considered at-risk with respect to any such amounts as a consequence of the First Guarantee.

4. To the extent the guaranteeing partner has the right under the partnership operating agreement to call for the non-guaranteeing partners to make capital contributions and, if they fail to do so, treat ratable portions of the payment as loans to those partners, adjust their fractional interests in the partnership, or enter into a subsequent allocation agreement under which the risk of the guarantee would be shared among the partners, this right generally will not be sufficient to make the non-guaranteeing partners personally liable with respect to the guaranteed obligation for the purposes of §§ 752 and 465.[879]

[879] The CCA first discussed some cases:

In *Pritchett v. Comm'r*, 85 T.C. 581 (1985), *rev'd and remanded*, 827 F.2d 644 (9th Cir. 1987), the taxpayers were limited partners in an oil and gas drilling operation, and they claimed deductions for losses in excess of their cash contributions to the partnership. The taxpayers argued that under the partnership agreement, they were "at risk" for partnership liabilities held by a drilling company that was responsible for developing the oil and gas fields. Under the contract the creditor would receive a portion of profits from the drilling operation. While general partners were the only parties personally liable, under the partnership agreement the general partners were given the right to call on the limited partners to make a capital contribution if the notes issued by the partnership remained unpaid upon their maturity date. The Service argued that the liability was contingent and that the taxpayers were only at risk once general partners called upon them to make a contribution. The Tax Court agreed with this analysis. Upon appeal, the Ninth Circuit held that the contractual obligations of the limited partners under the partnership agreement made them ultimately responsible for the debt. While the Commissioner argued that the liability was contingent simply because the general partners could elect to not make the cash calls, the Ninth Circuit did not agree. The Ninth Circuit determined that the cash calls were mandatory under the partnership agreements and that "economic reality" dictated that the general partners would make the calls.

In *Melvin v. Comm'r*, 88 T.C. 63 (1987), *aff'd*, 894 F.2d 1072 (9th Cir. 1990), the general partnership in which the taxpayer was a partner invested in a limited partnership. In payment for its limited partnership interest, the general partnership paid $35,000 cash and agreed to make additional capital contributions of $70,000. The obligation to make the additional capital contributions was evidenced by a $70,000 recourse promissory note. The taxpayer's share of the note was $50,000. The limited partnership obtained a $3,500,000 recourse loan from a bank and pledged partnership assets to the bank, including the $70,000 note along with other limited partner notes, as security. These notes were subsequently physically transferred to the bank. The court concluded that the taxpayer was at risk on the $3,500,000 loan to the extent of his pro rata share thereof. In reaching it conclusion the court reasoned that "a partner will be regarded as personally liable within the meaning of § 465(b)(2)(A) if he has the ultimate liability to repay the debt obligation of the partnership in the event funds from the partnership's assets are not available for that purpose. The relevant question is who, if anyone, will ultimately be obligated to pay the partnership's recourse obligations if the partnership is unable to do so. It is not relevant that the partnership MAY be able to do so. The scenario that controls is the worst-case scenario, not the best case." *Melvin*, 88 T.C. at 75 (citations omitted).

We believe that *Pritchett* and *Melvin* stand for the proposition that the relevant inquiries when dealing with guarantees of partnership debt, for purposes of § 465, are whether the guarantee causes the guaranteeing partner to become the "payor of last resort in a worst case scenario" for the partnership debt, given the "economic realities" of the particular situation, and whether the guarantor possesses any "mandatory" rights to contribution, reimbursement, or subordination with respect to any other parties, as a result or consequence of paying on the guarantee, that would cause these other parties to be considered the "payors of last resort in a worst case scenario" with respect to that debt.

The CCA concluded:

> It appears that the taxpayer interprets X's Operating Agreement as giving an enforceable right to require A and B to make additional contributions to X, in addition to the specific remedies provided in paragraphs (i) and (ii) of section 7.5(e) of the Operating Agreement. As noted above, we do not agree with this interpretation of the Operating Agreement. Nevertheless, even if the taxpayer's interpretation of the Operating Agreement is ultimately determined to be correct, we still conclude that the taxpayer is not allocated basis under § 752 and is not at risk under § 465 with respect to the guaranteed debt.
>
> We reach this conclusion because we view the requirement for A and B to make additional capital contributions to X as a contingent liability within the meaning of § 1.752-2(b)(4). Because C may choose alternate remedies that would not cause A or B to be viewed as bearing the ultimate economic risk of loss for the guaranteed debt of X, we believe these alternate remedies are properly viewed as contingencies that make it unlikely that any payment obligations of A or B would ever be discharged. In addition, we believe these remedies may also be viewed as future events that cause the payment obligations of A and B to be "not determinable with reasonable certainty" and cause the obligations to be ignored until A and B are actually required to make payments to X, for purposes of § 1.752-2(b)(4).[3]
>
> [3] We believe that one or more arguments may also be made under § 1.752-2(j) in this case, depending on further factual development.
>
> In addition, for purposes of § 465, even if we view C as having an enforceable right to require A and B to make additional contributions to X in addition to the other remedies available in section 7.5(e) of X's Operating Agreement, we believe that the facts of this case would continue to be distinguishable from those in *Pritchett*. In this case, C has been provided with alternate remedies under section 7.5(e) of X's Operating Agreement if A and B choose not to make additional contributions to X under this provision. As a result, it appears that the requirement for A and B to make additional contributions under this provision is not a "mandatory" requirement, since C may elect to use these alternate remedies rather than have X enforce the Operating Agreement under the default provision of section 7.7. Therefore, it does not appear that "economic reality" would dictate that X or C must enforce the Operating Agreement under section 7.7 in a court proceeding against A and B in such circumstances. Accordingly, we conclude that A and B are not "payors of last resort in a worst case scenario", as discussed in *Pritchett* and *Melvin*, and therefore A and B are not currently at risk with respect to the guaranteed debt of X for purposes of § 465.
>
> We would further note that, to the extent that C may elect to use the remedy described in section 7.5(e)(i) of X's Operating Agreement, in which C may treat the amount of a Guaranty Contribution that a defaulting member failed to contribute as a loan to the defaulting member, such "loan" would appear to be subject to the related-party rule of § 465(b)(3)(A). Under the remedy of section 7.5(e)(i), A and B would be viewed as borrowing money from C with respect to the activity of X, at a time when C also possesses an ownership interest in the activity. Accordingly, A and B would not be considered at risk with respect to such amounts pursuant to § 465(b)(3)(A) under this scenario.
>
> Of course, if a payment obligation does arise in the future which requires A and B to make a payment to X, A and B would properly be viewed as making contributions to X at that time, for purposes of §§ 722, 704(d) and 465(b)(1)(A).
>
> In conclusion, because A and B do not have a mandatory obligation to make additional capital contributions to the [sic] X, regardless of which interpretation of X's Operating Agreement is ultimately determined to be correct, A and B do not bear the ultimate economic risk of loss for purposes of § 752, and A and B are not the payors of last resort in a worst case scenario for purposes of § 465.

The May 2016 meeting of the American Bar Association's Section on Taxation included the following unofficial comments by the IRS:[880] The real estate tax community loudly protested CCA 201606027. The provisions that the CCA asserted turned the debt into recourse debt were typical provisions in nonrecourse arrangements. The CCA was mainly concerned with the seventh condition listed, triggered if the insolvency was admitted. Given that the lender required financial statements, the lender could force such an admission, making the loan essentially recourse. In fact, one state trial court had stated that the financial statements showing liabilities in excess of assets constituted such as admission. However, the appellate court pointed out that the lender's request for a formal admission of insolvency were repeatedly rejected, and the court reversed, saying that insolvency was never admitted and the financial statements did not constitute such an admission.[881]

In light of that case, AM 2016-001[882] addresses the treatment under Code §§ 752 (allocation of liabilities) and 465 (at-risk rules of guarantee) of a partnership nonrecourse liability when the guarantee is conditioned on certain "nonrecourse carve-out" events, backing away from CCA 201606027. It concluded:

1. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, the guarantee will not cause the obligation to fail to qualify as a nonrecourse liability of the partnership under section 752 and regulations promulgated thereunder until such time as one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law.[883]

For changes to regulations under Code § 752 in October 2016, see part II.C.3 Allocating Liabilities (Including Debt).

[880] Recording ABATX1659.

[881] *Zwirn*, fn. 883.

[882] From Curt G. Wilson, Associate Chief Counsel (Passthroughs and Special Industries) (written by William Kostak), to Division Counsel (Small Business/Self-Employed), attn: Samuel Berman, Special Counsel, March 31, 2016.

[883] The memorandum reviewed Code § 752(a), Reg. §§ 1.752-1(a), 1.752-2(a), 1.752-2(b)(1), 1.752-2(b)(3) and 1.752-2(b)(4), and *D.B. Zwirn Special Opportunities Fund, L.P. v. SCC Acquisitions, Inc.*, 902 N.Y.S.2d 93, 95 (App. Div. 2010), the latter which it characterized as a lender unsuccessfully enforcing a guarantee to be triggered by a "nonrecourse carve-out" event. In October 2016, the regulations under Code § 752 changed; see part II.C.3 Allocating Liabilities (Including Debt). In arriving at the conclusion to which this footnote is appended, the memorandum reasoned:

> We think that the approach to interpreting the "nonrecourse carve-out" event relating to written admissions of insolvency that the court followed in *D.B. Zwirn* is appropriate not just for that type of carve-out, but for other typical carve-outs as well. In the commercial real estate finance industry, "nonrecourse carve-out" provisions are not intended to allow the lender to require an involuntary action by the borrower or guarantor, or to place borrowers or guarantors in circumstances that would require them to involuntarily commit a "bad act." Rather, the fundamental business purpose behind such carve-outs and the intent of the parties to such agreements is to prevent actions by the borrower or guarantor that could make recovery on the debt, or acquisition of the security underlying the debt upon default, more difficult. The "nonrecourse carve-out" provisions should be interpreted consistent with that purpose and intent in mind. Consequently, because it is

2. If a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the occurrence of certain "nonrecourse carve-out" events described below, the guarantee will not cause the obligation to fail to qualify as qualified nonrecourse financing for purposes of section 465(b)(6) and the regulations promulgated thereunder until such time as one of those events actually occurs and causes the guarantor to become personally liable for the partnership debt under local law.[884]

At the ABA meeting, practitioner pointed out that the conditions in the CCA were only 7 out of about 20-30 triggers commonly found in nonrecourse financing and asked for guidance. The government spokesman unofficially provided the following bottom line: If the contingency that triggers the personal liability is within the control of the borrower or person who would be liable, then the loan is nonrecourse. On the other hand, if the lender controlled the triggers, then the loan is recourse. Court cases imposing recourse liability where the lender could force a trigger's occurrence would affect the government's view of that trigger. He also mentioned that the IRS does not revoke CCAs, so the CCA stands for that taxpayer, but AM 2016-001 represents the government's current thoroughly vetted position on triggers and is unlikely to change absent such court cases.

II.G.3.h. Be Sure to Use Suspended Losses as Soon as They Become Available

Finally, if one's losses are suspended due to basis limitations, be sure to deduct them as soon as basis becomes sufficient. Failure to do so causes the losses to become

> not in the economic interest of the borrower or the guarantor to commit the bad acts described in the typical "nonrecourse carveout" provisions, it is unlikely that the contingency (the bad act) will occur and the contingent payment obligation should be disregarded under § 1.752-2(b)(4). Therefore, unless the facts and circumstances indicate otherwise, a typical "nonrecourse carve-out" provision that allows the borrower or the guarantor to avoid committing the enumerated bad act will not cause an otherwise nonrecourse liability to be treated as recourse for purposes of section 752 and § 1.752-2(a) until such time as the contingency actually occurs.

[884] The memorandum reviewed Code §§ 465(c)(3), 465(b)(2)(A), 465(b)(4), and 465(b)(6) and Reg. §§ 1.465-27(b)(4), (5). In arriving at the conclusion to which this footnote is appended, the memorandum reasoned:

> Therefore, for the same reasons discussed above with respect to liability under section 752, we conclude that if a partner's guarantee of a partnership's nonrecourse obligation is conditioned on the "nonrecourse carve-out" events enumerated above, the guarantee does not cause the guarantor to be treated as personally liable for the repayment of the partnership's liability, because the likelihood of any of the "nonrecourse carve-out" events occurring is such that the guarantor is effectively protected against loss until such time as one or more of the events actually occurs. Accordingly, we conclude that such guarantee will not cause the nonrecourse financing to fail to qualify as qualified nonrecourse financing under section 465(b)(6) and the regulations thereunder if such financing otherwise meets those requirements.

unusable when the statute of limitations, for the year in which they should have been taken, has run.[885]

II.G.3.i. Business Deductions and Losses

II.G.3.i.i. Limitations on Deductions Attributable to Activities Not Engaged in for Profit

This part II.G.3.i.i discusses what is a "trade or business" under Code § 162, expenses from which generally would be deductible.[886] Then it discusses what are activities for the production of income under Code § 212, expenses from which generally would be deductible.[887] Because both provisions require a profit motive, it then discusses what Code § 183 says about profit motive.[888]

II.G.3.i.i.(a). "Trade or Business" Under Code § 162

Subject to the various limitations provided in the preceding parts of part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner and subject to other limitations on what can be deducted, Code § 162(a) allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," even if the business sustains a loss.[889]

Higgins v. Commissioner, 312 U.S. 212 (1941), held:[890]

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[885] *Barnes v. Commissioner*, T.C. Memo 2012-80, *aff'd* 712 F.3d 581 (D.C. Cir. 2013) (imposing penalties on taxpayer for deducting 2003 S corporation losses against basis that had been used by previously suspended losses that taxpayer had failed to deduct in 1997).

[886] See part II.G.3.i.i.(a) "Trade or Business" Under Code § 162.

[887] See part II.G.3.i.i.(b) Requirements for Deduction Under Code § 212.

[888] See part II.G.3.i.i.(c) Hobby Loss Benefits of Code § 183.

[889] Reg. § 1.162-1(a) provides:

> Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162.... The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business.

[890] *Higgins* dealt with the predecessor to Code § 162. Rev. Rul. 75-525 views the case as controlling in interpreting Code § 162. See fn. 2367 in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax. *Commissioner v. Groetzinger*, 408 U.S. 23 (1987), commented on *Higgins* [footnote omitted]:

> The opinion, therefore,—although devoid of analysis and not setting forth what elements, if any, in addition to profit motive and regularity, were required to render an activity a trade or business—must stand for the propositions that full-time market activity in managing and preserving one's own estate is not embraced within the phrase "carrying on a business," and that salaries and other expenses incident to the operation are not deductible as having been paid or incurred in a trade or business.

After additional commentary on the case, *Groetzinger* continued:

> Less than three months later, the Court considered the issue of the deductibility, as business expenses, of estate and trust fees. In unanimous opinions issued the same day and written by Justice Black, the Court ruled that the efforts of an estate or trust in asset conservation and maintenance did not constitute a trade or business. *City Bank Farmers*

> To determine whether the activities of a taxpayer are "carrying on a business" requires an examination of the facts in each case…. The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board.

Commissioner v. Groetzinger, 408 U.S. 23 (1987), discussed various cases (footnotes in the quote below are mine):

> From these observations and decisions, we conclude (1) that, to be sure, the statutory words are broad and comprehensive (*Flint*);[891] (2) that, however, expenses incident to caring for one's own investments, even though that endeavor is full-time, are not deductible as paid or incurred in carrying on a trade or business (*Higgins*; *City Bank*; *Pyne*);[892] (3) that the opposite conclusion may follow for an active trader (*Snyder*)[893]…. One also must acknowledge that *Higgins*, with its stress on examining the facts in each case, affords no readily helpful standard, in the usual sense, with which to decide the present case and others similar to it. The Court's cases, thus, give us results, but little general guidance.

Pointing out that the cases provide little guidance, *Groetzinger* said they provided "some helpful indicators" and reasoned:

> If a taxpayer, as Groetzinger is stipulated to have done in 1978, devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness (if there be much of that in the income tax law) demand that his

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> *Trust Co. v. Helvering*, 313 U.S. 121 (1941); *United States v. Pyne*, 313 U.S. 127 (1941). The *Higgins* case was deemed to be relevant and controlling.

[891] *Groetzinger* referred to *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), about which *Groetzinger* commented:

> It said: " 'Business' is a very comprehensive term and embraces everything about which a person can be employed." 220 U.S., at 171. It embraced the *Bouvier Dictionary* definition: "That which occupies the time, attention and labor of men for the purpose of a livelihood or profit." *Ibid*. See also *Helvering v. Horst*, 311 U.S. 112, 1181 (1940). And Justice Frankfurter has observed that "we assume that Congress uses common words in their popular meaning, as used in the common speech of men." Frankfurter, Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 536 (1947).

[892] See fn. 890 for the Court's discussion of these cases.

[893] *Groetzinger* commented:

> *Snyder v. Commissioner*, 295 U.S. 134 (1935), had to do with margin trading and capital gains, and held, in that context, that an investor, seeking merely to increase his holdings, was not engaged in a trade or business. Justice Brandeis, in his opinion for the Court, noted that the Board of Tax Appeals theretofore had ruled that a taxpayer who devoted the major portion of his time to transactions on the stock exchange for the purpose of making a livelihood could treat losses incurred as having been sustained in the course of a trade or business. He went on to observe that no facts were adduced in Snyder to show that the taxpayer "might properly be characterized as a 'trader on an exchange who makes a living in buying and selling securities.' " *Id.*, at 139. These observations, thus, are dicta, but, by their use, the Court appears to have drawn a distinction between an active trader and an investor.

activity be regarded as a trade or business just as any other readily accepted activity, such as being a retail store proprietor or, to come closer categorically, as being a casino operator or as being an active trader on the exchanges.

It is argued, however, that a full-time gambler is not offering goods or his services…. One might well feel that a full-time gambler ought to qualify as much as a full-time trader,[12] as Justice Brandeis in Snyder implied and as courts have held.[13] The Commissioner, indeed, accepts the trader result. Tr. Of Oral Arg. 17. In any event, while the offering of goods and services usually would qualify the activity as a trade or business, this factor, it seems to us, is not an absolute prerequisite.

[12] "It takes a buyer to make a seller and it takes an opposing gambler to make a bet." Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 763 (1986).

[13] *Levin v. United States*, 597 F.2d 760, 765 (Ct. Cl. 1979); *Commissioner v. Nubar*, 185 F.2d 584, 588 (CA4 1950), *cert. denied*, 341 U.S. 925 (1961); *Fuld v. Commissioner*, 139 F.2d 465, 468-469 (CA2 1943). See also *Moller v. United States*, 721 F.2d 810 (CA Fed. 1983), *cert. denied*, 467 U.S. 1251 (1984); *Purvis v. Commissioner*, 580 F.2d 1332, 1334 (CA9 1976).

After specifically rejecting the idea that offering goods or services is a prerequisite for engaging in a "trade or business," *Groetzinger* concluded (highlighting added):

Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with ... business or trade," on the other. See Revenue Act of 1916, § 5(a) Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business." *Whipple v. Commissioner*, 373 U.S. 193, 197 (1963). We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

It is suggested that we should defer to the position taken by the Commissioner and by the Solicitor General, but, in the absence of guidance, for over several decades now, through the medium of definitive statutes or regulations, we see little reason to do so. We would defer, instead, to the Code's normal focus on what we regard as a common-sense concept of what is a trade or business. Otherwise, as here, in the context of a minimum tax, it is not too extreme to say that the taxpayer is being taxed on his gambling losses,[15] a result distinctly out of line with the Code's focus on income.

We do not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned. Respondent Groetzinger satisfied that test in 1978. Constant and large-scale effort on his part was made. Skill was required and was applied. He

> did what he did for a livelihood, though with a less than successful result. This was not a hobby or a passing fancy or an occasional bet for amusement.
>
> We therefore adhere to the general position of the *Higgins* Court, taken 45 years ago, that resolution of this issue "requires an examination of the facts in each case." 312 U.S., at 217. This may be thought by some to be a less-than-satisfactory solution, for facts vary. See Boyle, What is a Trade or Business?, 39 Tax Lawyer 737, 767 (1986); Note, The Business of Betting: Proposals for Reforming the Taxation of Business Gamblers, 38 Tax Lawyer 759 (1985); Lopez, Defining "Trade of Business" under the Internal Revenue Code: A Survey of Relevant Cases, 11 Fla. St. L. Rev. 949 (1984). *Cf.* Comment, Continuing Vitality of the "Goods or Services" Test, 15 U. Balt. L. Rev. 108 (1985). But the difficulty rests in the Code's wide utilization in various contexts of the term "trade or business," in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we feel, at this late date, the ultimate responsibility rests. *Cf*. *Flood v. Kuhn*, 407 U.S. 258, 269-285 (1972).[16]
>
> [15] "The more he lost, the more minimum tax he has to pay." Boyle, 39 Tax Lawyer, at 754. The Commissioner concedes that application of the goods-or-services-test here "visits somewhat harsh consequences" on taxpayer Groetzinger, Brief for Petitioner 36, and "points to ... perhaps unfortunate draftsmanship." *Ibid*. See also Reply Brief for Petitioner 11.
>
> [16] It is possible, of course, that our conclusion here may subject the gambler to self-employment tax, see §§ 1401-1403 of the Code, and therefore may not be an unmixed blessing for him. Federal taxes, however, rest where Congress has placed them.

Let's look at the requirement that "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision) (footnote reproducing Code § 162(a) omitted below), seems to impose a higher standard:

> It is well settled, that in order to constitute the carrying on of a trade or business under section 162(a), the activity must "be entered into, in good faith, with the dominant hope and intent of realizing a profit, i.e., taxable income, therefrom." *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963), *affg*. a Memorandum Opinion of this Court. See also *Hager v. Commissioner*, 76 T.C. 759, 784 (1981); *Golanty v. Commissioner*, 72 T.C. 411, 425 (1979), *affd*. without published opinion 647 F.2d 170 (9th Cir. 1981).

However, *Brannen* was decided before *Groetzinger* and *Groetzinger* is a higher court), so *Groetzinger* would control.

Brannen suggests that the regulations reproduced in part II.G.3.i.i.(c) Hobby Loss Benefits of Code § 183 are a good summary of the cases on this issue; see fn. 904 in that part. However, no inference is to be drawn from the provisions of Code § 183 and the regulations thereunder that any activity of a C corporation is or is not a business or engaged in for profit.[894]

Losses for 12 years, when the taxpayer was 65 years of age when starting the activity, did not disqualify the activity, in which he engaged full time, from constituting a business.[895]

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[894] Reg. § 1.183-1(a).

[895] *Ellsworth v. Commissioner*, T.C. Memo. 1962-32, allowed the taxpayer to deduct losses. The taxpayer's testimony and corroborating expert testimony held persuade the court:

> Petitioner testified that he would not have reentered the breeding of dairy cattle in 1948 unless he "felt sure" he could make a profit, although, based on his past experience in breeding livestock, he realized that initial losses were inevitable since it would require about 10 to 15 years to develop superior strains in his Sybil cattle so that they would have substantial commercial value. Petitioner also ascribed his continuous losses from his farm enterprise in part to various causes such as climatic conditions, adverse effects on breeding establishments of artificial insemination, and economic depressions in the milk industry. Notwithstanding these latter factors, which were beyond his control, petitioner had more than a vain hope that a profit would result from his venture in the near future which would justify his expenditures.
>
> The record shows that petitioner's operation was conducted on an efficient, economical and sound scientific basis when compared to other breeding establishments; that the blood lines of his herd have been constantly improving; and that the prospects of making a profit from the sale of his cattle are considerably improved. Petitioner's expectation of realizing a profit in the very near future was corroborated by three experts in the breeding of livestock who testified, in general, as to the potential profit represented by petitioner's foundation herd, particularly in the "bull stud" market for use in artificial insemination establishments. J.F. Cavanaugh testified that petitioner's cattle "have arrived at a point where we think they would sell to good advantage." Likewise, Parodneck, another expert, testified that an individual who had a breeding herd during the taxable years involved, had "a reasonable expectancy of making a profit." We found their testimony in this respect convincing.

Although he had independent sources of income, he worked hard to minimize losses and set himself up for potential future profits:

> Admittedly, petitioner possessed an independent income and was not dependent on the success of the farm for a livelihood. He also may well have had pleasure from residing in a country home, but these facts alone do not negate his intent to operate the farm for profit. *Wilson v. Eisner*, 282 Fed. 38 (C.A. 2, 1922); *DuPont v: United States*, 28 F.Supp. 122, 124 (D. Delaware, 1939) (C.A. 2). Nor is such intent vitiated by the fact that petitioner received an annual income from dividends sufficient to offset substantial losses from his farm enterprise. No evidence was adduced that petitioner was indifferent to whether there was a loss or gain, or that the farm was an incident to the social or domestic aspects of his life. A substantial income from sources other than farming, or substantial sources of capital, was necessary as a basis for embarking on the farming project because of anticipated losses in the earlier years.
>
> We have no doubt upon the record that petitioner devoted himself assiduously to the economical operation of the farm with the reasonable hope of substantial future profits from the breeding operation. We further note that petitioner took affirmative steps to minimize losses derived in1958 by reducing his herd, terminating his lease of a neighboring farm and reducing his working area further by renting some of his acreage. We are satisfied that all of his activities at the farm were influenced by the ambition to produce a valuable strain of dairy livestock which would be commercially acceptable.

An individual who earns a living working 40 hours per week may also have a trade or business working another 30 hours per week, even if the other activity has not yet produced a product.[896]

When a taxpayer invests in a partnership, the partnership's profit motive is determinative.[897]

> That petitioner was about 65 years of age in 1948 when he commenced his selective breeding enterprise and would be 75 or 80 before he could make a profit, in our opinion, is not determinative of the issue. More significant, we believe, is the fact that he gave such attention to the farm as is usually given to a business enterprise. Apart from his annual vacation, petitioner devoted virtually all of his personal attention to supervising the farm operations, including a staff of several full time employees who assisted him. Petitioner, whose average working day on the farm was in excess of eight hours, performed all of the functions of a farm manager. During the taxable years involved, detailed records were kept of daily milk production, of statistics relating to the breeding activities of his livestock, and of income and expenses attributable to the operation of the farm. The farm was a well equipped establishment and was operated in a businesslike manner. We find, on the whole picture, that the farm operation was not carried on for the purpose of display, social diversion, or for the gratification of a personal whim. *Samuel Riker, Jr., Executor*, 6 B.T.A. 890, 893 (1927).

The court concluded:

> Considering all of the evidence we hold that petitioner carried on his farm activities, and particularly his breeding operations, on a commercial basis with the reasonable hope of making it profitable and not for his recreation, pleasure or other personal reason. Accordingly, the expenses in question are deductible under section 162(a), *supra*.

[896] *Snyder v. U.S.*, 674 F.2d 1359 (10th Cir. 1982), stated that the taxpayer's profit motive is only significant under Code § 162 insofar as it affords a means of *distinguishing* between an enterprise carried on in good faith as a "trade or business" and an enterprise merely carried on as a hobby. It pointed out:

> A taxpayer is clearly not engaged in a trade or business if his predominant purpose is recreation or a hobby. See, *e.g.*, *Carkhuff v. Commissioner*, 425 F.2d 1400, 1404 (6th Cir. 1970); *Schley v. Commissioner*, 375 F.2d 747, 750 (2d Cir. 1967). On the other hand, an author may be in a trade or business within the meaning of section 162 if he "participated in that endeavor with a good faith expectation of making a profit." *Stern v. United States*, No. 70-782-HP (C.D. Cal. Mar. 26, 1971), 71-1 U.S. Tax. Cas. (CCH) ¶ 9375. The business need not yield an immediate profit. *Id*.

It also pointed out that it is more difficult to prove a business when activity is not the taxpayer's principal means of livelihood and is of a sporting or recreational nature, citing *Imbesi v. Commissioner*, 361 F.2d 640, 645 (3d Cir. 1966). It held:

> On remand, if the trial court finds taxpayer was primarily motivated by profit, the court must then determine whether taxpayer devoted sufficient time over a substantial enough period to be in a trade or business under section 162. If the trial court finds that taxpayer was not engaged in a trade or business in the relevant years, it must then determine whether the expenses were deductible under section 212 as ordinary and necessary expenses for the production of income.

[897] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), stated:

> In order for a partnership to be entitled to a deduction for expenses attributable to a trade or business in computing its taxable income (or loss) under section 703(a), it must be established that the partnership engaged in the activity with the primary purpose and intent[14] of making a profit. *Hirsch v. Commissioner*, *supra* at 736; *Golanty v. Commissioner*, *supra* at 425; *Hager v. Commissioner*, *supra* at 784. Britton Properties need not have a reasonable expectation of profit, but the partnership must have the intent

II.G.3.i.i.(b). Requirements for Deduction Under Code § 212

Subject to the various limitations provided in the preceding parts of part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner and subject to other limitations on what can be deducted, Code § 212 allows an individual to deduct:

> all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

However, the activity need not produce a profit for the deductions to be allowable under Code § 212.[898]

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and objective of realizing a profit.[15] *Hirsch v. Commissioner*, *supra*; *Hager v. Commissioner*, *supra*; *Jasionowski v. Commissioner*, 66 T.C. 312, 321 (1976); *Bessenyey v. Commissioner*, 45 T.C. 261, 274 (1965), *affd*. 379 F.2d 252 (2d Cir. 1967).

[14] While it may at first appear difficult to ascribe an "intent" to an entity such as the limited partnership herein, we have previously held that "It is the intent of the partnership and not that of any specific partner which is determinative in characterizing the income for purposes of taxation." *Podell v. Commissioner*, 55 T.C. 429, 433 (1970). See also *Miller v. Commissioner*, 70 T.C. 448, 456 (1978), where we looked to the "partnership's motives." In this same context, the taxpayer in *Estate of Freeland v. Commissioner*, 393 F.2d 573, 584 (9th Cir. 1968), *affg*. a Memorandum Opinion of this Court, argued that as a limited partner, the intent of the operating partners in the partnership should not be attributed to her. In rejecting this contention, the Second Circuit stated that while the limited partnership may have been an "investment" to her, the intent of the partnership controlled in determining whether the land owned by the partnership was property described in sec. 1221(1).

[15] We recognize that the standard we have used was recently reviewed in *Dreicer v. Commissioner*, 665 F.2d 1292 (D.C. Cir. 1982), *revg. and remanding* a Memorandum Opinion of this Court. In *Dreicer*, the Circuit Court, after a review of the legislative history, concluded that the applicable standard is not whether the taxpayer had "a bona fide expectation" of profit but, rather, whether he engaged in the activity with the "objective" of making a profit. The Court correctly stated that sec. 1.183-2(a), Income Tax Regs., provides that the facts must indicate that the taxpayer entered into the activity with "the objective of making a profit." The difference in the standard of "objective of making a profit" and a "bona fide expectation" of making a profit might be merely one of semantics. In any event, the Circuit Court in the *Dreicer* case recognized, as this Court has in many cases, that an activity is not engaged in for profit if the taxpayer does not have the "objective" or "intent" of making a profit, and that the "objective" or "intent" of the taxpayer is a question of fact to be decided in each case from all the evidence of record.

[898] Reg. § 1.212-1(b) provides:

> The term "income" for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds,

On the other hand, Reg. § 1.212-1(c) provides that:

> In the case of taxable years beginning before January 1, 1970, expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

II.G.3.i.i.(c). Hobby Loss Benefits of Code § 183

Code § 183(a) provides:

> *General rule*. In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

Code § 183 also applies to deductions passing through a partnership.[899]

> the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

[899] Rev. Rul. 77-320 concluded:

> *Held*, section 183 of the Code applies to the activities of a partnership, and the provisions of section 183 are applied at the partnership level and reflected in the partners' distributive shares.

See *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), quoted in fn. 920. But the Fifth Circuit may have a different view, having stated in *Copeland v. Commissioner*, 290 F.3d 326 (2002) (but correctly pointing out how Code § 183 is sometimes incorrectly referred to as disallowing deductions):

Where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity.[900] Income and deductions would be allocated between activities.[901]

Code § 183(c) provides:[902]

The Tax Court's wording to the contrary notwithstanding, however, the deductions were not actually disallowed under I.R.C. § 183, but under I.R.C. §§ 162 and 174, neither of which are limited — as is § 183 — to activities engaged in by individuals and S corporations, to the exclusion of partnerships.[26] I.R.C. § 183 provided the *Krause* court with only the factors for analysis, not statutory authority to allow or disallow deductions themselves. To say that the deductions are disallowed "under section 183" impermissibly conflates the I.R.C. sections in question and thereby glosses over this crucial distinction.

[26] Even the Commissioner recognizes this limitation in his appellate brief when he states (emphasis ours): "The regulations under § 183 list a number of factors relevant to the determination of profit motive, and those factors have frequently been applied by the courts in determining whether a profit motive exists for all sorts of entities, including partnerships and corporations, *to which the limitations on deductibility of § 183 do not apply*."

[900] Reg. § 1.183-1(d)(1), which provides further:

In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

[901] Reg. § 1.183-1(d)(2) provides:

Rules for allocation of expenses. If the taxpayer is engaged in more than one activity, an item of deduction or income may be allocated between two or more of these activities. Where property is used in several activities, and one or more of such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

[902] Reg. § 1.183-1(a) reinforces this predicate by including:

Whether an activity is engaged in for profit is determined under section 162 and section 212(1) and (2) except insofar as section 183(d) creates a presumption that the activity is engaged in for profit.

> *Activity not engaged in for profit defined*. For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Thus, Code § 183 "is not a disallowance provision, but rather an allowance provision which operates only when the taxpayer's expenses are not allowable as deductions under section 162(a) or 212(1) and (2)," and "the profit motive analysis must be resolved *before* turning to section 183."[903] However, courts often conflate Code §§ 162 and 183 and jump directly to whether a profit motive exists under Code § 183, presumably because a finding of profit motive under Code § 183 means that one does not need to consider a profit motive under Code § 162.

Code § 183(d) presumes an activity is engaged in for profit if it is profitable for a particular number of years. If the presumption does not apply, then Reg. § 1.183-2(b) kicks in (footnotes in the long quote below are mine, elaborating on each factor):[904]

> *Relevant factors*. In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:
>
> (1) *Manner in which the taxpayer carries on the activity*. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of

[903] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision) (emphasis in original), quoted in fn. 920. However, courts often fail to consider Code § 162 before turning to a Code § 183 analysis; for example, *Boneparte v. Commissioner*, T.C. Memo. 2017-193, correctly contrasted the consequences of being a professional gambler with being a casual gambler and dove right into Code § 183 with even mentioning Code § 162 (but the taxpayer, who was a toll bridge operator, prepared his own returns and represented himself in Tax Court, so the lack of rigor is not surprising).

[904] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), held that:

> since the regulation is not unreasonable and plainly inconsistent as it deals with a specific issue raised in section 183 which requires a determination before that section is applicable, it should be given full force and effect. See *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948). In addition, since many of the statements in the regulation, including the relevant factors listed, were derived from case law decided prior to the enactment of section 183, it is clear that the standards used in determining whether a profit motive exists for purposes of section 162 or 212 have remained the same. See *Jasionowski v. Commissioner*, *supra* at 321-322; *Benz v. Commissioner*, 63 T.C. 375, 383 (1974).

new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.[905]

(2) *The expertise of the taxpayer or his advisors*. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.[906]

(3) *The time and effort expended by the taxpayer in carrying on the activity*. The fact that the taxpayer devotes much of his personal time and effort to carrying

[905] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hendricks v. CIR*, 32 F3d 94, 98 (4th Cir. 1994) (physician's farm sustained losses in 20 of 21 years of operation; lack of profit motive evidenced by taxpayer's knowledge "of steps he might have taken, but failed to take, to improve the farm's profitability"); *Holmes v. CIR*, 74 TCM (CCH) 494 (1997) (farm found not to be carried on for profit because, among other things, taxpayers failed to keep records in businesslike way; negligence penalty sustained; extensive analysis); *Elliott v. CIR*, 90 TC 960, 973 (1988), *aff'd* without opinion, 899 F2d 18 (9th Cir. 1990) (Amway distributors not engaged in business for profit where they "made some small modifications in their routine social life [on entering the business], kept cursory notes about their activities, and claimed deductions for the cost of nearly everything they owned or did"; negligence penalty imposed); *Allen v. CIR*, 72 TC 28 (1979) (taxpayers operated ski lodge in businesslike manner, experimenting with different modes of operating it in hope of making profit); *Lyon v. CIR*, 36 TCM (CCH) 979 (1977) (failure to maintain records and unbusinesslike approach; activity not "engaged in for profit"); Lee, *supra* note 8, at 397–407. Compare *Rozzano v. CIR*, 94 TCM (CCH) 29 (2007) (holding horse farm was run for profit, notwithstanding large losses annually for eight years, largely because operation was carried on in business-like manner).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974).

[906] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *DeMattia v. CIR*, 75 TCM (CCH) 1903, 1906 (1998) (retired dentist's sponsorship of son's professional golf career not conducted in businesslike manner; no "goals or financial conditions," no prior investigation of profit potential, and no separate records); *Taras v. CIR*, 74 TCM (CCH) 1388, 1395 (1997) ("Petitioners initiated their activity [horse racing] without developing a business plan commensurate with that which would be expected from someone who was motivated primarily by a profit objective"); *Lucid v. CIR*, 73 TCM (CCH) 2892 (1997) (no profit motive for business of selling yachts; no business plan or training or experience in business; negligence penalty sustained); *Benz v. CIR*, 63 TC 375 (1974) (taxpayer was "relative novice"; breeding activity was hobby); Lee, *supra* note 8, at 407–412. *Taras* has been affirmed by an unpublished opinion, 187 F3d 627 (3d Cir. 1999) .

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974).

on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.[907]

(4) *Expectation that assets used in activity may appreciate in value*. The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of § 1.183-1 for definition of an activity in this connection.[908]

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[907] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hawkins v. CIR*, 38 TCM (CCH) 469 (1979) (publication of book of poetry not for profit; no evidence of continuous or repeated activity in literary field or intent to write with substantial regularity); Lee, *supra* note 8, at 412–416. But see *Cornfeld v. CIR*, 797 F2d 1049, 1052 (DC Cir. 1986) ("to have an honest profit objective a taxpayer need not run the business himself or have expertise in it; it suffices that he engage those who do"); *Nickerson v. CIR*, 700 F2d 402, 407 (7th Cir. 1983) (taxpayer engaged in farming for profit even though he had another full-time job and spent only spare time on farm; taxpayer's efforts were "prodigious" and farm did not provide recreation); *Perry v. CIR*, 74 TCM (CCH) 616 (1997) (taxpayers' horse breeding operation was for profit, even though taxpayers were both employed full-time in other jobs, because they had knowledge and experience needed for success).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974).

[908] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Bolaris v. CIR*, 776 F2d 1428 (9th Cir. 1985) (depreciation and operating expense deductions allowed for former principal residence that was rented pending sale; profit motive can exist even if gain on sale qualifies for nonrecognition); *Thompson v. US*, 90-1 USTC ¶ 50,043 (D. Conn. 1989) (in determining whether horse breeding operation was carried on for profit, jury could consider possibility of appreciation in value of land used in operation); *Dickson v. CIR*, 47 TCM (CCH) 509 (1983) (expectation of profit from appreciation in value of sailboat was major factor in finding boat chartering activity was for profit); Lee, *supra* note 8, at 416–418. But see *Jasionowski v. CIR*, 66 TC 312 (1976) (taxpayer's expectation of capital gains upon eventual sale of property not sufficient to supply profit motive for current lease of the property).

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974). Another footnote in Bittker & Lokken says:

> See *Landry v. CIR*, 86 TC 1284, 1306 (1986) (rejecting IRS's argument that § 183 applies where, notwithstanding conceded expectation of profit in the long run, intention to profit during the taxable year was lacking; § 183 inapplicable if taxpayer "intended to make a profit within a reasonable time"); *Lemmen v. CIR*, 77 TC 1326 (1981) (*acq.*) (expectation of profit from herd of breeding cattle over long range established).

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities*. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.[909]

(6) *The taxpayer's history of income or losses with respect to the activity*. A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.[910]

(7) *The amount of occasional profits, if any, which are earned*. The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover an opportunity to earn a substantial ultimate

[909] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), cites Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 418-420 (1974).

[910] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Taras v. CIR*, 74 TCM (CCH) 1388, 1395 (1997) ("Throughout all the years of continuous losses, petitioners did not materially alter their mode of operation"); *Allen v. CIR*, 72 TC 28 (1979) (ski lodge's losses explained by market saturation, low snowfall, and gasoline shortages); Lee, *supra* note 8, at 420–428; infra ¶ 22.5.5 (presumption arising from two successful years). Taras has been affirmed by an unpublished opinion, 99-1 USTC ¶ 50,489 (3d Cir. 1999). But see *Rabinowitz v. CIR*, 90 TCM (CCH) 113, 121 (2005) (finding charter aircraft business was carried on for profit, notwithstanding 12 successive years of losses, because taxpayers "used their considerable business skills to attempt to make the business profitable" and losses for later periods resulted from unforeseen factors); *Burrus v. CIR*, 86 TCM (CCH) 429, 439 (2003) (finding "actual and honest intent to profit from" cattle raising, even though activity generated losses exceeding revenues for all of six years before court and four succeeding years; "such losses are consistent with a startup period inherent in herd building and therefore do not necessarily indicate a lack of profit motive").

The citation to Lee is to Lee, "A Blend of Old Wines in a New Wineskin: Section 183 and Beyond," 29 Tax L. Rev. 347 (1974).

profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.[911]

(8) *The financial status of the taxpayer*. The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.[912]

(9) *Elements of personal pleasure or recreation*. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.[913]

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[911] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), cites Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347, 428-431 (1974).

[912] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Hendricks v. CIR*, 32 F3d 94 (4th Cir. 1994) (physician's substantial income from medical practice was evidence that farm, which consistently operated at loss, was not for profit); *Jasionowski v. CIR*, 66 TC 312 (1976) (taxpayer's substantial income from other sources and other rental experience indicated that lease under which substantial losses, as distinguished from usual start-up losses, would be incurred for several years was not for profit); *Hurd v. CIR*, 37 TCM (CCH) 499 (1978) (substantial outside income enabled taxpayers to absorb large losses from ranch; held, not for profit); Lee, *supra* note 8, at 431–436. Compare *Ranciato v. CIR*, 52 F3d 23, 26 (2d Cir. 1995) (Tax Court's finding of lack of profit motive reversed because court failed to consider all relevant factors, including that taxpayer was "a solid middle-class wage earner, not an individual of wealth whose unprofitable extracurricular activities would suggest an effort to shelter unrelated income through deliberate losses").

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974).

[913] A footnote in Bittker & Lokken, ¶ 22.5. Activities Not Engaged in for Profit, *Federal Taxation of Income, Estates, and Gifts* (WG&L), provides:

> See *Allen v. CIR*, 72 TC 28 (1979) (taxpayers never used ski lodge for personal recreation); Lee, *supra* note 8, at 436–444. See *McCarthy v. CIR*, 79 TCM (CCH) 1912,

Reg. § 1.183-2(c) provides:

> *Example (1)*. The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.
>
> *Example (2)*. The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amount of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.
>
> *Example (3)*. The taxpayer, very successful in the business of retailing soft drinks, raise dogs and horses. He began raising a particular breed of dog many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the "prestige" tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

1916 (2000) ("motorcross racing activity was inherently recreational and was conducted as an activity to be shared by father and son").

The citation to Lee is to Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 Tax L. Rev. 347 (1974).

Example (4). The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time-to-time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting, crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

Example (5). A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The changes, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his oil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Example (6). C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to "market" his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

If a taxpayer conducts business through many entities and also conducts related business outside of those entities, the Court of Claims has held that the taxpayer may establish a "unified business enterprise" that supports finding that the outside related business has the requisite profit motive.[914] CCA 201747006, by Brad Poston, asserts that the Court of Claims' decision undermines the separateness of S corporations from their owners and should not be followed.[915] I do not view that to be the case; I view the "unified business enterprise" theory as merely helping establish motive. However, expect the IRS to strongly challenge the "unified business enterprise," as it did successfully in a taxpayer's very weak case decided in 2016.[916]

Code § 183(b) allows:

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(References above and below to "this chapter" or "chapter 1" are to Code §§ 1-1400U-3.)

Reg. § 1.183-1(b)(1) elaborates on allowing deductions:

> *Manner and extent*. If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent:
>
> (i) Amounts allowable as deductions during the taxable year under chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any

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914 *Morton v. United States*, 98 Fed. Cl. 596 (2011). The court did not seem aware that regulations addressed how to find a profit motive under Code § 183.

915 The CCA opens with:

> In conference calls on 7/20/17 and 8/28/17, we discussed with your office the holding of *Peter Morton v. U.S.*, 98 Fed. Cl. 596 (2011), and its effect of excluding wholly-owned or majority owned S corporations from precedent set by *Moline Properties v. Commissioner*, 63 S.Ct. 1132 (1943). Based upon the authorities and analysis below, we conclude the Service should reject the *Morton* holding and continue to assert that *Moline Properties* is applicable to S corporations, regardless of degree of ownership.

Of course, both *Moline* and another case the CCA cited, *Deputy v. DuPont*, 308 U.S. 488 (1940), long predate the idea of an S election. However, the CCA is quite correct that one cannot simply disregard an S corporation; for example, see parts II.G.23 Taxing Entity or Individual Performing Services and II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

916 *Steinberger v. Commissioner*, T.C. Memo. 2016-104, rejecting a doctor's alleged business use of an airplane to travel in his business when his flying the airplane did not save the doctor any significant time over driving.

limitations or exceptions with respect to the allowability of such amounts. For example, the allowability-of-interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d).

(ii) Amounts otherwise allowable as deductions during the taxable year under chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.

(iii) Amounts otherwise allowable as deductions for the taxable year under chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.

Special rules apply to basis adjustments for deductions allowed under Reg. § 1.183-1(b)(1)(iii).[917]

Code § 183(b)(2) and Reg. § 1.183-1(b)(1)(ii) provide a benefit to individuals that is not available to C corporations – deducting expenses that would be business expenses if the activity had been engaged in for profit. On the other hand, all expenses under Code § 183(b)(1) and Reg. § 1.183-1(b)(1)(i) would have been allowable to a corporation anyway, and all expenses allowable to an individual under Code § 183(b) and Reg. § 1.183-1(b)(1) would be subject to the limitations described in part II.G.3.i.ii Itemized Deductions, which might very well eliminate their benefit.

[917] Reg. § 1.183-1(b)(2), "Rule for deductions involving basis adjustments," provides:

(i) *In general*. If deductions are allowed under subparagraph (1)(iii) of this paragraph, and such deductions are allowed with respect to more than one asset, the deduction allowed with respect to each asset shall be determined separately in accordance with the computation set forth in subdivision (ii) of this subparagraph.

(ii) *Basis adjustment fraction*. The deduction allowed under subparagraph (1)(iii) of this paragraph is computed by multiplying the amount which would have been allowed, had the activity been engaged in for profit, as a deduction with respect to each particular asset which involves a basis adjustment, by the basis adjustment fraction—

(a) The numerator of which is the total of deductions allowable under subparagraph (1)(iii) of this paragraph, and

(b) The denominator of which is the total of deductions which involve basis adjustments which would have been allowed with respect to the activity had the activity been engaged in for profit. The amount resulting from this computation is the deduction allowed under subparagraph (1)(iii) of this paragraph with respect to the particular asset. The basis of such asset is adjusted only to the extent of such deduction.

Comparing the choice between C corporation and an individual (including through a partnership or S corporation):

- Both require the same profit motive to qualify under Code § 162 as a threshold inquiry.

- Code § 183 provides an additional chance for an individual to prove profit motive, which opportunity is not available to a C corporation. Whether this additional opportunity makes a difference depends on the facts and circumstances.

- Would being an entity make a difference? When testing business purpose, one would test the entity's intent[918] rather than the individual's. When looking at an individual's business purpose, one would compare that activity to the individual's other activities. An individual who is establishing a side business may consider interposing an entity that is not disregarded between the business and the individual, so that profit motive can be tested solely by reference to the entity's activities. My sense is that C corporations are tested for profit motive only when using a side deal to shelter income from their core activity and that they are not scrutinized for profit motive for their core activity; however, Code § 162 does not draw such a distinction, so one cannot rely on that distinction as a matter of law.

- If a profit motive cannot be established:

  - Code § 183(b)(1) and Reg. § 1.183-1(b)(1)(i) allows individuals to deduct whatever they could have deducted absent a profit motive, and C corporations have the same benefit. However, limitations on using itemized deductions may prevent these deduction from generating a tax benefit, whereas a C corporation does not have the same limits.

  - Code § 183(b)(2) and Reg. § 1.183-1(b)(1)(ii) provide a benefit to individuals that is not available to C corporations – deducting expenses that would be business expenses if the activity had been engaged in for profit. However, limitations on using itemized deductions may prevent these deduction from generating a tax benefit.

In applying Code § 183, gross income derived from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity.[919]

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918 For testing a partnership's intent, see fn. 897 in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162; note that adding a service partner might complicate funding any losses. For testing an S corporation's intent, see fn. 921; I have not looked to see the rule for Code § 162 absent Code § 183.

919 Reg. § 1.183-1(e), which further provides:

> Such gross income shall include, for instance, capital gains, and rents received for the use of property which is held in connection with the activity. The taxpayer may determine gross income from any activity by subtracting the cost of goods sold from the gross receipts so long as he consistently does so and follows generally accepted methods of accounting in determining such gross income.

In the case of a partnership, Code § 183(b) is applied at the partnership level and can be a helpful relief valve.[920] Also, Code § 183 is applied at the corporate level in determining the allowable deductions of an S corporation.[921]

II.G.3.i.ii. Itemized Deductions; Deductions Disallowed for Purposes of the Alternative Minimum Tax

For "itemized deductions," various limitations apply for regular tax and for alternative minimum tax. "Itemized deductions" are those not allowed in determining an adjusted gross income.[922]

Deductions allowed in determining adjusted gross income that might be business expenses or incurred for the production of income include the following:

- "Deductions … attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee."[923]

- Certain deductions that are reimbursed by an employer or are incurred by certain performing artists, governmental officials, elementary and secondary school teachers, or military reservists.[924]

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[920] *Brannen v. Commissioner*, 78 T.C. 471 (1982) (reviewed decision), held:

> Since the partnership is not entitled to any deductions under section 162, the activity of the partnership constitutes one "not engaged in for profit" as defined in section 183(c). We therefore turn to section 183 to determine the amount, if any, of deductions which are otherwise allowable under section 183(b). We are again faced with the question of whether the allowance provision, section 183(b), is to be applied at the partnership or partner level. For the many reasons stated above, we conclude that section 183(b) should be applied at the partnership level. See sec. 703(a); sec. 1.703-1(a), Income Tax Regs.; *Hager v. Commissioner*, *supra* at 788. Accordingly, as the partnership did not report any deductions in 1975 which are otherwise allowed without regard to whether the activity is engaged in for profit, the partnership is entitled to the deductions claimed, without inclusion in basis of the nonrecourse note in the amount of $1,400,000, but only to the extent of the gross income derived from the activity in 1975 in the amount of $679. Sec. 183(b)(2). The result of applying section 183(b)(2) is that the partnership in 1975 had income of zero; that is, it had no profit and it had no loss. Therefore, petitioner had no distributive share of income or loss from Britton Properties.[17]
>
> [17] Since petitioner's pro rata share of the partnership's income of $679 was included by respondent in his 1975 income, the result of our holding is that respondent erred in increasing petitioner's income, as reported, by $34 of partnership income but did not err in disallowing petitioner's claimed partnership loss of $15,751.

[921] Reg. § 1.183-1(f).

[922] Code § 63(b).

[923] Code § 62(a)(1). This includes unreimbursed business expenses as a partner. *Cristo v. Commissioner*, T.C. Memo. 2017-239 (managing member who owned 95% of an LLC.) It also includes expenses incurred by an individual taxpayer in preparing that portion of the taxpayer's return that relates to the taxpayer's business as a sole proprietor (such as profit or loss from business (Schedule C), income or loss from rentals or royalties (Part I of Schedule E, Supplemental Income and Loss), or farm income and expenses (Schedule F)), and expenses incurred in resolving asserted tax deficiencies relating to the taxpayer's business as a sole proprietor. Rev. Rul. 92-29.

- Losses from the sale or exchange of property under Code §§ 161-199.[925]

- The deductions allowed by Code §§ 161-199, by Code § 212, and by Code § 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.[926]

- In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by Code § 167 and the deduction allowed by Code § 611 (depletion).[927]

- Certain contributions to qualified retirement plans[928] or IRAs.[929]\

Code § 63(b), (e)(1) disallows an individual's itemized deductions if the individual takes the "standard deduction."

Code § 68 reduces itemized deductions by 3% of the excess of adjusted gross income over certain thresholds.

Code § 67(a) reduces an individual's "miscellaneous itemized deductions" by 3% of the excess of adjusted gross income, and Code § 67(b) defines "miscellaneous itemized deductions" as itemized deductions other than:

(1) the deduction under section 163 (relating to interest),

(2) the deduction under section 164 (relating to taxes),

(3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

(4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),

(5) the deduction under section 213 (relating to medical, dental, etc., expenses),

(6) any deduction allowable for impairment-related work expenses,

(7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),

(8) any deduction allowable in connection with personal property used in a short sale,

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924 Code § 62(a)(2).
925 Code § 62(a)(3).
926 Code § 62(a)(4).
927 Code § 62(a)(5).
928 Code § 62(a)(6), referring to the Code § 404 deduction allowed to self-employed individuals under Code § 401(c)(1).
929 Code § 62(a)(7), referring to Code § 219 IRA deductions.

(9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

(10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),

(11) the deduction under section 171 (relating to deduction for amortizable bond premium), and

(12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

Code § 164(b)(6) limits deductions for state taxes to $10,000 ($5,000 for married filing separately), but it does not apply this limit to property taxes attributable to Code § 212 trade or business (which generally would be rental real estate, if it is a trade or business).[930]

Among the items AMT disallows for noncorporate taxpayers are deductions for the following under Code § 56(b)(1)(A):

(i) for any miscellaneous itemized deduction (as defined in section 67(b)), or

(ii) for any taxes described in paragraph (1), (2), or (3) of section 164(a) or clause (ii) of section 164(b)(5)(A).

II.G.4. Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation

II.G.4.a. Code 179 Expense

Subject to certain limitations, a taxpayer may expense (instead of capitalizing)[931] $1,000,000[932] or so[933] of qualifying property each year.

Generally, qualifying property includes certain tangible property[934] or certain computer software,[935] which is Code § 1245 property[936] and is acquired by purchase for use in the active conduct of a trade or business.[937]

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930 For more details about my comment on real es business, see part II.E.1.e Whether Real Estate Qualifies As a Trade or Business.
931 Code § 179(a).
932 Code § 179(b)(1).
933 Code § 179(b)(6) provides for post-2018 increases for inflation.
934 To which Code § 168 applies.
935 As defined in Code § 197(e)(3)(B) and which is described in Code § 197(e)(3)(A)(i) and to which Code § 167 applies.
936 As defined in Code § 1245(a)(3).
937 Code § 179(d)(1), which also expressly excludes property described in Code § 50(b) (other than Code § 50(b)(2)). Generally, Code § 50(b) refers to property used (1) predominantly outside the United States, (2) predominantly to furnish lodging or in connection with the furnishing of lodging, (3) by certain tax-exempt organizations, or (4) by governmental units or foreign persons or entities.

However, a nongrantor trust cannot take Code § 179 expense,[938] which is a little awkward when it holds S corporation stock.[939]

Special rules apply to changes in interests in partnerships.[940]

Although Code § 179 expensing may be attractive, its limitations make one want to look first to bonus depreciation. Furthermore, if the taxpayer is not a C corporation and is seeking to obtain the Code § 199A deduction for qualified business activites and needs the basis of qualified property to meet the wage limitation test,[941] then expensing under Code § 179 is problematic because the property's cost is not capitalized. This makes bonus depreciation more attractive than Code § 179.

II.G.4.b. Bonus Depreciation

Code § 168(k) bonus depreciation had been a nice complement to Code § 179 depreciation, but 2017 tax reform has made it perhaps the first choice for many taxpayers.

Bonus depreciation is a component of depreciation that provides an up-front deduction of part of qualified property and applies regular depreciation for the remaining adjusted basis in the property.[942]

First, we will look at how powerful it is, then we'll see what property qualifies.

Code § 168(k)(6) provides bonus depreciation for qualified property as follows:

> (A) *In general*. Except as otherwise provided in this paragraph, the term "applicable percentage" means-
>
> (i) in the case of property placed in service after September 27, 2017, and before January 1, 2023, 100 percent,
>
> (ii) in the case of property placed in service after December 31, 2022, and before January 1, 2024, 80 percent,
>
> (iii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 60 percent,

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938 See part II.J.11.a.i Code § 179 Disallowance for Nongrantor Trust.

939 See part II.P.1.a.ii Allocations of Income in S corporations.

940 See part III.B.2.j.iii.(e) Allocation of Specific Items, especially fn. 5255.

941 See part II.E.1.c Code § 199A Pass-Through Deduction Qualified Business Income, especially part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds and fns 638 and 648-653 within that part.

942 Code § 168(k)(1) provides:

> *Additional allowance*. In the case of any qualified property—
>
> (A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property, and
>
> (B) the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

(iv) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 20 percent.

(B) *Rule for property with longer 20 production periods*. In the case of property described in subparagraph (B) or (C) of paragraph (2),[943] the term "applicable percentage" means-

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2024, 100 percent,

(ii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 80 percent,

(iii) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 60 percent,

---

[943] This is my footnote and not the statute's. Code § 168(k)(2)(B), (C) provide:

(B) Certain property having longer production periods treated as qualified propety.

(i) *In general*. The term "qualified property" includes any property if such property-

(I) meets the requirements of clauses (i) and (ii) of subparagraph (A),

(II) is placed in service by the taxpayer before January 1, 2028,

(III) is acquired by the taxpayer (or acquired pursuant to a written contract entered into) before January 1, 2027,

(IV) has a recovery period of at least 10 years or is transportation property,

(V) is subject to section 263A, and

(VI) meets the requirements of clause (iii) of section 263A(f)(1)(B) (determined as if such clause also applies to property which has a long useful life (within the meaning of section 263A(f))).

(ii) *Only pre-January 1, 2027 basis eligible for additional allowance*. In the case of property which is qualified property solely by reason of clause (i) , paragraph (1) shall apply only to the extent of the adjusted basis thereof attributable to manufacture, construction, or production before January 1, 2027.

(iii) Transportation property. For purposes of this subparagraph, the term "transportation property" means tangible personal property used in the trade or business of transporting persons or property.

(iv) *Application of subparagraph*. This subparagraph shall not apply to any property which is described in subparagraph (C).

(C) *Certain aircraft*. The term "qualified property" includes property-

(i) which meets the requirements of subparagraph (A)(ii) and subclauses (II) and (III) of subparagraph (B)(i),

(ii) which is an aircraft which is not a transportation property (as defined in subparagraph (B)(iii)) other than for agricultural or firefighting purposes,

(iii) which is purchased and on which such purchaser, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of-

(I) 10 percent of the cost, or

(II) $100,000, and

(iv) which has-

(I) an estimated production period exceeding 4 months, and

(II) a cost exceeding $200,000.

(iv) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 40 percent, and

(v) in the case of property placed in service after December 31, 2026, and before January 1, 2028, 20 percent.

(C) *Rule for plants bearing fruits and nuts*. In the case of a specified plant described in paragraph (5), the term 'applicable percentage means-

(i) in the case of a plant which is planted or grafted after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of a plant which is planted or grafted after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of a plant which is planted or grafted after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of a plant which is planted or grafted after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of a plant which is planted or grafted after December 31, 2025, and before January 1, 2027, 20 percent.

Code § 168(k)(2)(A) defines "qualified property" to be property:

(i)

(I) to which this section applies which has a recovery period of 20 years or less,

(II) which is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to this subsection,

(III) which is water utility property, or

(IV) which is a qualified film or television production (as defined in subsection (d) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection, or

(V) which is a qualified live theatrical production (as defined in subsection (e) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection,

(ii) the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of clause (ii) of subparagraph (E),[944] and

(iii) which is placed in service by the taxpayer before January 1, 2027.

"Qualified property" does not include[945] certain property used in the energy industry[946] or property that is financed by floor plan financing indebtedness that received a special business interest deduction.[947]

A taxpayer may elect out of Code § 168(k) bonus depreciation.[948] If the taxpayer places property in service the first taxable year ending after September 27, 2017, the taxpayer may elect to use 50% as the applicable percentage.[949]

II.G.4.c. Cost Segregation Studies to Accelerate Depreciation

It is not uncommon for taxpayers to separate a building's cost into tangible property with a shorter useful life and the building with a longer life.

Note that doing so would shorten the period during which the property's unadjusted basis may be used to to satisfy certain limits on the Code § 199A deduction for qualified business income.[950]

Query whether that should even be a factor for a deduction that is scheduled to expire after December 31, 2025.[951]

---

[944] This footnote is not in the statute. Code § 168(k)(2)(E)(ii) provides:

> *Acquisition requirements*. An acquisition of property meets the requirements of this clause if-
>
> (I) such property was not used by the taxpayer at any time prior to such acquisition, and
>
> (II) the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of section 179(d).

[945] Code § 168(k)(9).

[946] Code § 168(k)(9)(A) refers to "any property which is primarily used in a trade or business described in clause (iv) of section 163(j)(7)(A)." See text accompanying fn 1195 in part II.G.19.a Limitations on Deducting Business Interest Expense.

[947] Code § 168(k)(9)(B) refers to "any property used in a trade or business that has had floor plan financing indebtedness (as defined in paragraph (9) of section 163(j)), if the floor plan financing interest related to such indebtedness was taken into account under paragraph (1)(C) of such section." See text accompanying fns 1205-1207 in part II.G.19.a Limitations on Deducting Business Interest Expense.

[948] Code § 168(k)(7).

[949] Code § 168(k)(10).

[950] See part II.E.1.c Code § 199A Pass-Through Deduction Qualified Business Income, especially part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds and fns 638 and 648-653 within that part.

[951] Code § 199A(i), discussed in part II.E.1.c Code § 199A Pass-Through Deduction Qualified Business Income.

II.G.5. Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business

II.G.5.a. Code § 1231 Property

The net gain for a year recognized on the sale or exchange of depreciable property used in the trade or business[952] (referred to as section 1231 gain) constitutes long-term capital gain[953] to the extent that the taxpayer has not previously deducted losses from the sale of that type of property (five-year lookback).[954] This special treatment is needed because capital assets do not include "property, used in [the taxpayer's] trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in [the taxpayer's] trade or business."[955] However, when a taxpayer attempted to buy land to improve for use in a trade or business and the land purchase did not work out, but the taxpayer profited on the ensuing litigation, the profit was long-term capital gain according to the Eleventh Circuit,[956] overturning the Tax Court's finding of ordinary income.[957]

Generally, the property must be held for more than one year, be used in the trade or business, and be either real property or property depreciable under Code § 167;[958] presumably it includes property receiving a new basis under Code § 1014[959] without regard to how long the person receiving the property from the decedent actually holds the property.[960] It also must be held for use in such a trade or business; if it is held primarily with an intent to sell, with rental only merely a way to make the best use before sale, then the property's sale generates ordinary income as property held for sale to customers and Code § 1231 does not apply.[961]

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[952] Code § 1231(a)(3)(A)(i).

[953] Code § 1231(a)(1).

[954] Code § 1231(c)(1) provides:

> The net section 1231 gain for any taxable year shall be treated as ordinary income to the extent such gain does not exceed the non-recaptured net section 1231 losses.

Code § 1231(c)(2) provides:

> *Non-recaptured net section 1231 losses*. For purposes of this subsection , the term "non-recaptured net section 1231 losses" means the excess of—
>
> (A) the aggregate amount of the net section 1231 losses for the 5 most recent preceding taxable years, over
>
> (B) the portion of such losses taken into account under paragraph (1) for such preceding taxable years.

[955] Code § 1221(a)(2). Although such assets are not capital assets, they can receive a basis step-up at death. See part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured, especially fn. 3177.

[956] *Long v. Commissioner*, 114 A.F.T.R.2d 2014-6657.

[957] *Long v. Commissioner*, T.C. Memo. 2013-233.

[958] Code § 1231(c)(1). See Code § 1231(c)(2), (3), and (4) for additional qualifying assets. Gain a tenant recognizes when a landlord pays the tenant to terminate the lease may be taxed under Code § 1231; see part II.Q.1.b Leasing, especially fn. 3028.

[959] See part II.H.2 Basis Step-Up Issues.

[960] Code § 1223(9).

[961] *Fargo v. Commissioner*, T.C. Memo. 2015-96 held:

> We recognize that the La Jolla property was used as a rental property and GDLP and all related entities maintained their offices on the property. However, using the La Jolla

An "amortizable section 197 intangible," such as purchased goodwill, generally qualifies for Code § 1231 treatment if used in a trade or business and held for more than one year and not sold to a controlled entity.[962]

However, Code § 1231 property does not include inventory and certain other assets.[963]

Also subject to this rule is any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of either property used in the trade or business, or any capital asset which is held not only for more than one year but also in connection with a trade or business or a transaction entered into for profit.[964]

Note, however, that generally depreciation recapture on personal property is taxed as ordinary income,[965] and depreciation recapture on most real estate is taxed at a higher capital gain rate.[966]

> property as rental property was not GDLP's primary purpose of holding it. We held in *Cottle v. Commissioner*, 89 T.C. 467 (1987), that section 1231 capital gain treatment was applicable to a rental property subsequently sold to liquidate the investment. That is not the case here. GDLP was making its best use of the La Jolla property as office and rental space while never abandoning its primary intention, selling it.

[962] Reg. § 1.197-2(g)(8), which also makes goodwill subject to the ordinary income treatment described in part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

[963] Code § 1231(c)(1) excludes:

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,
(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,
(C) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221(a) , [and]
(D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section 1221(a).

[964] Code § 1231(a)(3)(A)(ii).

[965] Code § 1245(a)(1), recognizing such depreciation recapture as ordinary income; see part II.G.5.b Code § 1245 Property. The last sentence provides that this rule trumps Code § 1231:

> Such gain shall be recognized notwithstanding any other provision of this subtitle.

Reg. § 1.1245-1(e)(1) follows this rule.

[966] Code §§ 1(h)(1)(E) (25% rate applied to unrecaptured section 1250 gain), 1(h)(6) (definition of "unrecaptured section 1250 gain"). Citing S. Rept. No. 105-174 (P.L. 105-206), p. 149, *Federal Tax Coordinator Analysis* (RIA) ¶ I-5110.8 summarized the portion subject to this tax:

> …unrecaptured section 1250 gain means the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if the Code Sec. 1250 real property deprecation recapture rules applied to all depreciation (rather than only to depreciation in excess of straight-line depreciation) from property held for the long-term holding period. The unrecaptured section 1250 depreciation is reduced (but not below zero) by the excess (if any) of the amount of losses taken into account in

Also, although generally Code § 1231 gain is taxed as capital gain, Code § 1231 losses are deducted as ordinary losses.[967] To prevent taxpayers from playing games with the timing of sales of Code § 1231 property, net Code § 1231 gain is treated as ordinary income to the extent of prior Code § 1231 ordinary losses, with rules coordinating gain and loss on a cumulative basis.[968]

II.G.5.b. Code § 1245 Property

Code § 1245(a) imposes ordinary income taxation on depreciation and amortization of personal or certain other property that is disposed of, overriding various nonrecognition provisions.[969] Unless an exception or limitation under Code § 1245(b) applies (see fns. 987-992), gain under Code § 1245(a)(1) is recognized notwithstanding any contrary nonrecognition provision or income characterizing provision.[970] Because Code § 1245 overrides Code § 1231 (relating to property used in the trade or business),[971] the gain recognized under Code § 1245(a)(1) upon a disposition will be treated as ordinary income and only the remaining gain, if any, from the disposition may be considered as gain from the sale or exchange of a capital asset if Code § 1231 applies.[972] The nonrecognition provisions of subtitle A of the Code that Code § 1245 overrides include without limitation Code §§ 267(d), 311(a), 336, 337, 501(a), 512(b)(5)[973] and 1039,[974] but the override is limited with respect to Code §§ 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1071, and 1081(b)(1) and (d)(1)(A).[975] Although Reg. § 1.1245-6(d) appears to allow Code § 1245 property to be deferred under the installment method, it expressly subjects itself to Code § 453, and Code § 453(i) recaptures immediate recapture of Code § 1245(a) ordinary income before deferring the rest.[976] Code § 1245

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computing "28% rate gain" over the amount of gains taken into account in computing "28% rate gain".

However, part of real estate might be treated as personal property and therefore taxed at an even higher rate. Notice 2013-59.

[967] Code § 1231(a)(2).

[968] Code § 1231(c)(1).

[969] Code § 1245(a)(1), (d) (the latter overriding "any other provision of this subtitle." Reg. § 1.1245-6(a) starts by saying, "The provisions of section 1245 apply notwithstanding any other provision of subtitle A of the Code."

[970] Reg. § 1.1245-6(a).

[971] See part II.G.5.a Code § 1231 Property.

[972] Reg. § 1.1245-6(a), continuing, "See example (2) of paragraph (b)(2) of § 1.1245-1."

[973] Code § 512(b)(5) is the exclusion of capital gain from taxation under part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship; see fns. 3344-3351 of that part.

[974] Reg. § 1.1245-6(b).

[975] Reg. § 1.1245-6(b), referring to Code § 1245(b); see fn. 991.

[976] Code § 453(i), "Recognition of recapture income in year of disposition," provides:

(1) *In general*. In the case of any installment sale of property to which subsection (a) applies—
  (A) notwithstanding subsection (a), any recapture income shall be recognized in the year of the disposition, and
  (B) any gain in excess of the recapture income shall be taken into account under the installment method.

(2) *Recapture income*. For purposes of paragraph (1), the term "recapture income" means, with respect to any installment sale, the aggregate amount which would be treated as ordinary income under section 1245 or 1250 (or so much of section 751 as

does not subject to tax "any income which is exempt under section 115 (relating to income of states, etc.), 892 (relating to income of foreign governments), or 894 (relating to income exempt under treaties)."[977] Code § 1245 does not prevent gain recognition under other Code provisions.[978]

Property to which Code § 1245 applies is "any property which is or has been property of a character subject to the allowance for depreciation provided in section 167" and is one of the following:[979]

(A) personal property,[980]

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—[981]

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relates to section 1245 or 1250) for the taxable year of the disposition if all payments to be received were received in the taxable year of disposition.

For Code § 751, see part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

977 Reg. § 1.1245-6(e).

978 Reg. § 1.1245-6(f) provides:

> Treatment of gain not recognized under section 1245. Section 1245 does not prevent gain which is not recognized under section 1245 from being considered as gain under another provision of the Code, such as, for example, section 311(c) (relating to liability in excess of basis), section 341(f) (relating to collapsible corporations), section 357(c) (relating to liabilities in excess of basis), section 1238 (relating to amortization in excess of depreciation), or section 1239 (relating to gain from sale of depreciable property between certain related persons) . Thus, for example, if section 1245 property, which has an adjusted basis of $1,000 and a recomputed basis of $1,500, is sold for $1,750 in a transaction to which section 1239 applies, $500 of the gain would be recognized under section 1245(a)(1) and the remaining $250 of the gain would be treated as ordinary income under section 1239.

979 Code § 1245(a)(3).

980 Reg. § 1.1245-3(b) define "personal property" to mean:

> (1) Tangible personal property (as defined in paragraph (c) of § 1.48-1, relating to the definition of "section 38 property" for purposes of the investment credit), and
> (2) Intangible personal property.

981 Reg. § 1.1245-3(c) elaborates:

> (1) The term "property described in section 1245(a)(3)(B)" means tangible property of the requisite depreciable character other than personal property (and other than a building and its structural components), but only if there are adjustments reflected in the adjusted basis of the property (within the meaning of paragraph (a)(2) of § 1.1245-2) for a period during which such property (or other property)—
> (i) Was used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or
> (ii) Constituted a research or storage facility used in connection with any of the foregoing activities.
> Thus, even though during the period immediately preceding its disposition the property is not used as an integral part of an activity specified in subdivision (i) of this subparagraph and does not constitute a facility specified in subdivision (ii) of this

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,

(ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state),

(C) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 179B, 179C, 179D, 179E, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194[,]

(D) a single purpose agricultural or horticultural structure (as defined in section 168(i)(13)),

(E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum, or

(F) any railroad grading or tunnel bore (as defined in section 168(e)(4)).

Code § 1245 property includes livestock[982] and certain elevators and escalators.[983] Code § 1245 property also includes leaseholds of various Code § 1245 property.[984]

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subparagraph, such property is nevertheless property described in section 1245(a)(3)(B) if, for example, there are adjustments reflected in the adjusted basis of the property for a period during which the property was used as an integral part of manufacturing by the taxpayer or another taxpayer, or for a period during which other property (which was involuntarily converted into, or exchanged in a like kind exchange for, the property) was so used by the taxpayer or another taxpayer. For rules applicable to involuntary conversions and like kind exchanges, see paragraph (d)(3) of § 1.1245-4.

(2) The language used in subparagraph (1)(i) and (ii) of this paragraph shall have the same meaning as when used in paragraph (a) of § 1.48-1, and the terms "building" and "structural components" shall have the meanings assigned to those terms in paragraph (e) of § 1.48-1.

[982] Reg. § 1.1245-3(a)(4), which continues:

but only with respect to taxable years beginning after December 31, 1969. For purposes of section 1245, the term "livestock" includes horses, cattle, hogs, sheep, goats, and mink and other fur-bearing animals, irrespective of the use to which they are put or the purpose for which they are held.

[983] Reg. § 1.1245-3(a)(1)(iii).

[984] Reg. § 1.1245-3(a)(2), which provides:

If property is section 1245 property under a subdivision of subparagraph (1) of this paragraph, a leasehold of such property is also section 1245 property under such subdivision. Thus, for example, if A owns personal property which is section 1245

The facts and circumstances of each disposition are considered in determining what is the appropriate item of Code § 1245 property.[985] Special rules apply to multiple asset accounts.[986]

However, Code § 1245(a) does not apply to:

- A "disposition by gift."[987]
- A "transfer at death," except with respect to IRD assets.[988]
- Certain substituted basis transfers involving business entities under Code § 332, 351,[989] 361, 721,[990] or 731.[991]

> property under subparagraph (1)(i) of this paragraph, and if A leases the personal property to B, B's leasehold is also section 1245 property under such provision. For a further example, if C owns and leases to D for a single lump-sum payment of $100,000 property consisting of land and a fully equipped factory building thereon, and if 40 per cent of the fair market value of such property is properly allocable to section 1245 property, then 40 percent of D's leasehold is also section 1245 property. A leasehold of land is not section 1245 property.

Reg. § 1.1245-3(a)(1)(i), cited in the second sentence above, cross-references Reg. § 1.1245-3(b), which is reproduced in fn. 980.

[985] Reg. § [1.1245-1(a)(4), which further provides:

> A taxpayer may treat any number of units of section 1245 property in any particular depreciation account (as defined in § 1.167(a)-7) as one item of section 1245 property as long as it is reasonably clear, from the best estimates obtainable on the basis of all the facts and circumstances, that the amount of gain to which section 1245(a)(1) applies is not less than the total of the gain under section 1245(a)(1) which would be computed separately for each unit. Thus, for example, if 50 units of section 1245 property X, 25 units of section 1245 property Y, and other property are accounted for in one depreciation account, and if each such unit is sold at a gain in one transaction in which the total gain realized on the sale exceeds the sum of the adjustments reflected in the adjusted basis (as defined in paragraph (a)(2) of §1.1245-2) of each such unit on account of depreciation allowed or allowable for periods after December 31, 1961, all 75 units may be treated as one item of section 1245 property. If, however, 5 such units of section 1245 property Y were sold at a loss, then only 70 of such units (50 of X plus the 20 of Y sold at a gain) may be treated as one item of section 1245 property.

[986] Reg. § 1.1245-6(c) provides:

> *Normal retirement of asset in multiple asset account*. Section 1245(a)(1) does not require recognition of gain upon normal retirements of section 1245 property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e)(2) of § 1.167(a)-8 (relating to accounting treatment of asset retirements), does not require recognition of such gain.

[987] Code § 1245(b)(1).

[988] Code § 1245(b)(2). Code § 691 sets for the rules for IRD (income in respect of a decedent) assets, generally referring to property with income or gain realized and locked-in before death. See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[989] See part II.M.2 Buying into or Forming a Corporation.

[990] See part II.M.3 Buying into or Forming a Partnership.

[991] Code § 1245(b)(3) provides:

> If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 721,

- Like kind exchanges; involuntary conversions, etc., to the extent no gain is recognized and replacement property qualified.[992]

"Disposition" includes a sale in a sale-and-leaseback transaction and a transfer upon the foreclosure of a security interest but does not include a mere transfer of title to a creditor upon creation of a security interest or to a debtor upon termination of a security interest.[993]

Code § 1245 property distributed from a partnership generally retains its Code § 1245 characteristics.[994] Also, even though property may not be depreciable in the taxpayer's hands, such property may nevertheless be Code § 1245 property if the taxpayer's basis for the property is determined by reference to its basis in the hands of a prior owner of the property and such property was depreciable in the prior owner's hands, or if the taxpayer's basis for the property is determined by reference to the basis of other property that was depreciable in the taxpayer's hands, or if the taxpayer's basis for the property is determined under Code § 1022 and such property was depreciable in the decedent's hands.[995]

> or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). Except as provided in paragraph (6) , this paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

Regarding Code § 731, see part II.Q.8.b.i Distribution of Property by a Partnership.

[992] Code § 1245(b)(4) provides:

> If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033 , then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the sum of-
>
> (A) the amount of gain recognized on such disposition (determined without regard to this section), plus
>
> (B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

[993] Reg. § 1.1245-1(a)(3), which further provides:

> Thus, for example, a disposition occurs upon a sale of property pursuant to a conditional sales contract even though the seller retains legal title to the property for purposes of security but a disposition does not occur when the seller ultimately gives up his security interest following payment by the purchaser.

[994] Code § 1245(b)(5), "Property distributed by a partnership to a partner," provides:

> (A) *In general*. For purposes of this section, the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.
>
> (B) *Adjustments added back*. In the case of any property described in subparagraph (A) , for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be-
>
> (i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by
>
> (ii) the amount of such gain to which section 751(b) applied.

[995] Reg. § 1.1245-3(3), which continues:

All amortizable Code § 197 intangibles are treated as one asset, except for loss assets.[996]

Special rules apply to transfers to tax-exempt organization where property will be used in unrelated business[997] and to transfer of timber.[998]

Regulations should and do provide for adjustments to the basis of property to reflect gain recognized under Code § 1245(a).[999]

II.G.6. Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A Limitation on that Strategy

Except for a small allowance for individuals,[1000] capital losses are deductible only against capital gain.[1001] In addition to limiting the amount of loss that any taxpayer can take, for individuals (including owners of S corporations and partnerships) this rule causes such

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> Thus, for example, if a father uses an automobile in his trade or business during a period after December 31, 1961, and then gives the automobile to his son as a gift for the son's personal use, the automobile is section 1245 property in the hands of the son.

[996] Code § 1245(b)(8), "Disposition of amortizable section 197 intangibles, provides:

> (A) *In general*. If a taxpayer disposes of more than 1 amortizable section 197 intangible (as defined in section 197(c)) in a transaction or a series of related transactions, all such amortizable 197 intangibles shall be treated as 1 section 1245 property for purposes of this section.
>
> (B) *Exception*. Subparagraph (A) shall not apply to any amortizable section 197 intangible (as so defined) with respect to which the adjusted basis exceeds the fair market value.

[997] Code § 1245(b)(6) provides:

> (A) *In general*. The second sentence of paragraph (3) shall not apply to a disposition of section 1245 property to an organization described in section 511(a)(2) or 511(b)(2) if, immediately after such disposition, such organization uses such property in an unrelated trade or business (as defined in section 513).
>
> (B) *Later change in use*. If any property with respect to the disposition of which gain is not recognized by reason of subparagraph (A) ceases to be used in an unrelated trade or business of the organization acquiring such property, such organization shall be treated for purposes of this section as having disposed of such property on the date of such cessation.

Fn. 991 reproduces Code § 1245(b)(3). The point of Code § 1245(b)(6) is to limit Code §1245(a) recapture when property is transferred to certain exempt organizations for use in their exempt functions.

Reg. § 1.1245-6(b) provides:

> For limitation on amount of adjustments reflected in adjusted basis of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (a)(8) of § 1.1245-2.

[998] Code § 1245(b)(7) provides:

> In determining, under subsection (a)(2) , the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, the taxpayer shall not take into account adjustments under section 194 to the extent such adjustments are attributable to the amortizable basis of the taxpayer acquired before the 10th taxable year preceding the taxable year in which gain with respect to the property is recognized.

[999] Code § 1245(c). Reg. § 1.1245-6(a) cross-references Reg. § 1.1245-5 for the effect on basis.

[1000] $1,500 for married filing separately and $3,000 for all other individuals. Code § 1211(b)(1).

[1001] Code § 1211.

losses to offset favorably taxed capital gain,[1002] which is not as beneficial as offsetting highly taxed ordinary income. This part II.G.6 explains that abandoning a capital asset generates an ordinary loss, which is more favorable than selling a capital asset for a capital loss, so much so that a taxpayer turned its back on $20 million cash to generate an ordinary loss deduction worth much more than that.[1003]

Generally, a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, is a Code § 165(a) deduction for the taxable year in which the loss is actually sustained.[1004] The IRS views abandonment for purposes of claiming an ordinary loss as requiring "(1) an intention to abandon the asset, and (2) an affirmative act of abandonment."[1005] If a partnership interest subject to liabilities is abandoned, the partnership interest is treated as having being sold for the liabilities rather than abandoned.[1006]

[1002] Code § 1(h).

[1003] See fns. 1013-1014.

[1004] Reg. § 1.165-2(a).

[1005] CCA 200637032, citing:

> A.*J. Industries, Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); Rev. Rul. 93-80; Rev. Rul. 2004-58, 2004-1 C.B. 1043. *See also Echols v. Commissioner*, 935 F.2d 703, 706-08 (5th Cir. 1991) (finding both an intent to abandon and an affirmative act of abandonment when taxpayers called a partnership meeting at which they tendered their partnership interest to another partner, or anyone else, "gratis," and announced that they would contribute no further funds to the partnership), *reh'g denied*, 950 F.2d 209 (5th Cir. 1991).

Rev. Rul. 2004-58 explains what the IRS views as insufficient affirmative acts to constitute abandonment.

[1006] Rev. Rul. 93-80, Situation 1. *Watts v. Commissioner*, T.C. Memo. 2017-114, held:

> Subject to the prohibition on sales or exchanges giving rise to ordinary abandonment losses, partnership interests may be abandoned. *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), *rev'g and remanding* 93 T.C. 553 (1989); *Citron v. Commissioner*, 97 T.C. at 213.
>
> When a partner is relieved of his or her share of partnership liabilities, the partner is deemed to receive a distribution of cash. Sec. 752(b). Section 731(a) requires distributions to partners to be treated as payments arising from the sale or exchange of a partnership interest. Secs. 752(b), 731(a); *Citron v. Commissioner*, 97 T.C. at 214-215 n.11. Thus, ordinary abandonment losses may arise only in a narrow circumstance where the partner: (1) was not personally liable for the partnership's recourse debts or (2) was limited in liability and otherwise not exposed to any economic risk of loss for the partnership's nonrecourse liabilities. See sec. 752(b), (d); sec. 1.752-3, Income Tax Regs.; see also *Commissioner v. Tufts*, 461 U.S. 300 (1983).
>
> Respondent determined petitioners' disposal of their Partnership interests did not fall within these narrow exceptions. Accordingly, respondent recharacterized petitioners' losses from ordinary abandonment losses to capital losses on the sale or exchange of the interests.
>
> In contesting this determination, petitioners were tasked with the burden of proving respondent's determination incorrect. Petitioners have not met this burden. Petitioners presented no documentary or testimonial evidence to establish their eligibility for an abandonment loss deduction. Petitioners failed to prove their individual shares of any Partnership liabilities, capital restoration obligations, or lack thereof, in the light of

Code § 1234A was enacted to reduce opportunities to use abandonment to deduct what otherwise would have been a capital loss (although not necessarily in the example above), [1007] but the relevant committee report focused on futures contracts. [1008]

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documentary evidence suggesting otherwise. Additionally, petitioners did not offer any evidence or analysis as to how their actions constituted an intentional and overt manifestation of abandoning their Partnership interests.

[1007] The Senate Finance Committee Report on P.L. 97-34 (ERTA 1981) explained:

Treatment of Gain or Loss From Certain Terminations

Present Law.—The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions have interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss.[1] This interpretation has been applied even to dispositions which are economically equivalent to a sale or exchange of a capital asset. If a taxpayer can choose the manner of disposing of a capital asset, he may sell or exchange it, if it has appreciated in value, to realize capital gains. However, a transaction in which a taxpayer has suffered an economic loss may be terminated in a manner which produces a fully deductible ordinary loss, even though the loss in substance is the equivalent of a loss from the disposition of a capital asset.

[1] See *Leh v. Comm'r*, 260 F2d 489 (9th Cir., 1952) and *Comm'r v. Pittston Co.*, 252 F2d 344 (2d Cir., 1958), *cert. denied*, 357 U.S. 919 (1958).

Reasons for Change.—The committee believes that the change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gains. These transactions already cause significant losses to the Treasury.

Some taxpayers and tax shelter promoters have attempted to exploit court decisions holding that ordinary income or loss results from certain dispositions of property whose sale or exchange would produce capital gain or loss. These decisions rely on the definition of capital gains and losses in section 1222 which requires that there be a sale or exchange of a capital asset.

As a result of these interpretations, losses from the termination, cancellation, lapse, abandonment and other dispositions of property, which are not sales or exchanges of the property, are reported as fully deductible ordinary losses instead of as capital losses, whose deductibility is restricted. However, if such property increases in value, it is sold or exchanged so that capital gains, long-term when the holding period requirements are met, are reported.

[1008] The Senate Finance Committee Report on P.L. 97-34 (ERTA 1981) explained:

Some of the more common of these tax-oriented ordinary loss and capital gain transactions involve cancellations of forward contracts for currency or securities.

The committee considers this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the contract. For example, a taxpayer may simultaneously enter into a contract to buy German marks for future delivery and a contract to sell German marks for future delivery with very little risk. If the price of German marks thereafter declines, the taxpayer will assign his contract to sell marks to a bank or other institution for a gain equivalent to the excess of the contract price over the lower market price and cancel his obligation to buy marks by payment of an amount in settlement of his obligation to the other party to the contract. The taxpayer will treat the sale proceeds as capital gain and will treat the amount paid to terminate his obligation to buy as an ordinary loss.

Explanation of Provision.—In order to insure that gains and losses from transactions economically equivalent to the sale or exchange of a capital asset obtain similar treatment, the bill adds a new section 1234A to the Code providing that gains or losses

Code § 1234A taxes as a capital gain or loss the "cancellation, lapse, expiration, or other termination" of (1) certain rights or obligations[1009] "with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer," or a qualified straddle[1010] "which is a capital asset in the hands of the taxpayer." The right to a Code § 1231 asset[1011] does not qualify for Code § 1234A treatment, notwithstanding that the underlying asset's sale would have triggered long-term capital gain treatment.[1012]

When a taxpayer abandoned stock to obtain an ordinary loss rather than sell the stock for $20 million and have a capital loss, the Tax Court held that Code § 1234A applied to make the loss a capital loss,[1013] but the Fifth Circuit allowed an ordinary loss.[1014] The

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> attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property which is, or which would be if acquired, a capital asset in the hands of the taxpayer shall be treated as gains or losses from the sale of a capital asset. Property subject to this rule is any personal property (other than stock) of a type which is actively traded (sec. 1092(d)(1)).

[1009] Other than a "securities futures contract," as defined in Code § 1234B. Code § 1234B(c) provides the following definition (brackets quoted from RIA Checkpoint) and then authorizes certain regulations:

> For purposes of this section, the term "securities futures contract" means any security future (as defined in section 3(a)(55)(A) of the Securities Exchange Act of 1934, as in effect on the date of the enactment [12/21/2000] of this section).

[1010] A "section 1256 contract," which § 1256(b) provides includes any "regulated futures contract," "foreign currency contract," "nonequity option," " dealer equity option," or "dealer securities futures contract" but under Code § 1256(b)(2) does not include:

> (A) any securities futures contract or option on such a contract unless such contract or option is a dealer securities futures contract, or
> (B) any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.

[1011] A Code § 1231 asset is not a capital asset. See part II.G.5.a Code § 1231 Property.

[1012] *CRI-Leslie, LLC v. Commissioner*, 147 T.C. No. 8 (2016).

[1013] *Pilgrim's Pride Corp. v. Commissioner*, 141 T.C. 533 (2013). The official Tax Court Summary is:

> P is the successor in interest to G. G was contractually obligated to purchase, and in 1999 did purchase, securities from S and T for $98.6 million. The securities were capital assets of G. In 2004 S offered to redeem the securities for $20 million. G's board of directors decided to abandon the securities for no consideration because a $98.6 million ordinary loss would produce tax savings greater than the $20 million offered by S. On June 24, 2004, G voluntarily surrendered the securities to S and T for no consideration. On its Federal income tax return for the tax year ending June 30, 2004, G reported a $98.6 million ordinary abandonment loss deduction under I.R.C. sec. 165(a) pursuant to sec 1.165-2(a), Income Tax Regs.
>
> An abandonment loss cannot be claimed on a sale or exchange of property. Sec. 1.165-2(b), Income Tax Regs. Pursuant to I.R.C. sec. 165(f) losses from sales or exchanges of capital assets are subject to the limitations on capital losses under I.R.C. secs. 1211 and 1212. I.R.C. sec. 1234A requires gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right with respect to property that is (or on acquisition would be) a capital asset in the hands of a taxpayer to be treated as gain or loss from the sale of a capital asset.
>
> *Held*: the securities are intangible property comprising rights that G had in the management, profits, and assets of S and T. Those rights were terminated when G surrendered the securities.

Tax Court's decision seems consistent with the motivation for Code § 1234A, but the Fifth Circuit followed the statute's actual language.

When a contract right, commonly referred to as "phantom stock," passed to the employee's surviving spouse, who then contributed it to a partnership, the contribution to the partnership triggered taxation as income in respect of a decedent,[1015] converting the contract right to a capital asset in the partnership's hands; when the former employer paid on the contract, Code § 1234A applied to the proceeds.[1016] The contract right was a capital asset because it was not excluded from the definition of capital asset.[1017]

> *Held*, further, the $98.6 million loss on the surrender of the securities is attributable to the termination of G's rights with respect to the securities, which are capital assets, and pursuant to I.R.C. sec. 1234A the loss is treated as a loss from the sale or exchange of capital assets.
>
> *Held*, further, G is not entitled to an ordinary loss deduction for abandonment, because the loss is treated as a loss from the sale or exchange of capital assets pursuant to I.R.C. sec. 1234A. See sec. 1.165-2(b), Income Tax Regs.
>
> *Held*, further, pursuant to I.R.C. sec. 165(f), P's losses from the surrender of the securities, deemed to be a sale or exchange under I.R.C. sec. 1234A, are subject to the limitations on capital losses under I.R.C. secs. 1211 and 1212.

1014 *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015). The court held that Code § 1234A(1) did not apply:

> The primary question in this case is whether § 1234A(1) applies to a taxpayer's abandonment of a capital asset. The answer is no. By its plain terms, § 1234A(1) applies to the termination of rights or obligations with respect to capital assets (*e.g.* derivative or contractual rights to buy or sell capital assets). It does not apply to the termination of ownership of the capital asset itself. Applied to the facts of this case, Pilgrim's Pride abandoned the Securities, not a "right or obligation ... with respect to" the Securities. 26 U.S.C. § 1234A(1).
>
> [The court then explained why the IRS' position would have made Code § 1234A(2) meaningless.]
>
> For the foregoing reasons, we hold that 26 U.S.C. § 1234A(1) does not apply to Pilgrim's Pride's abandonment loss.[8]
>
> [8] Two administrative actions lend further support to Pilgrim's Pride's position. In Revenue Ruling 93-80, the IRS held that a taxpayer is allowed an ordinary loss on the abandonment of a partnership interest, even if the abandoned partnership interest is a capital asset. This Ruling directly contradicts the Commissioner's position in this case. Although the Commissioner asserts that Revenue Ruling 93-80 was superseded by a 1997 amendment to the statute at issue here, this begs the question presented in this case and is odd considering that the IRS never has formally revoked the Ruling and has relied on the Ruling since the statutory amendment.

1015 Code § 691(a)(2). See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

1016 *Hurford Investments No 2, Ltd. v. Commissioner*, Docket No. 23017-11 (4/17/2017), https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=7090068. This case related to the surviving spouse's estate in *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278, which is cited in fn. 4840 in part III.B.1.g.i Private Annuities: Estate Planning Implications. The surviving spouse failed to report the contribution to the partnership on her income tax return, and it was too late to assess her return. T.C. Memo. 2008-278 held that the contract right was included in her estate directly, so the partnership received a basis step-up to its value on her estate tax return; normally, the partnership would have needed to make a Code § 754 election, as described in part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

1017 *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1016, held:

Furthermore, the substitute-for-ordinary-income doctrine did not apply.[1018] Finally, the employer's paying the contract was a qualifying ""cancellation, lapse, expiration, or other termination."[1019]

Section 1221. Section 1221 defines the term "capital asset." It's a very broad section, and defines the term as all property that isn't specifically excluded by one of a list of exceptions. I.R.C. § 1221(a); 26 C.F.R. § 1.1221-1(a). Importantly, the character of property can change depending on who holds it. A car dealership's cars, for example, are inventory to the dealership, so the cars would fall into the category of non-capital assets in the hands of a car dealer. But a car becomes a capital asset in the hands of the usual car buyer because it no longer fits one of the non-capital asset definitions in section 1221. *See*, *e.g.*, *David Taylor Enters., Inc. v. Commissioner*, 89 T.C.M. (CCH) 1369 (2005). The same holds true in more complicated cases, such as inventory of a sole proprietorship which become capital assets in the hands of the business owner's estate. *Estate of Ferber v. Commissioner*, 22 T.C. 261 (1954); see also *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584, 650 n. 48 (1995) (noting that the character of property for one company may be different for a successor company). HI-2's interest in the phantom stock doesn't fit into one of the exceptions listed in section 1221,[2] so it seems it's a capital asset.

[2] The phantom stock is not (a) stock in trade (*i.e.*, dealer property), (b) depreciable property used in a trade or business, (c) a copyright or other similar item, (d) an account or note receivable acquired in the ordinary course of business, (e) a U.S. Government publication, (e) a commodities derivative financial instrument, (f) a hedging transaction, or (g) supplies used or consumed in the ordinary course of business. I.R.C. § 1221(a).

[1018] *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1016, held:

But caselaw throws another exception at us that we must consider – the substitute-for-ordinary-income doctrine. Sometimes something must be taxed as ordinary income even if it doesn't fit one of the exceptions specifically listed in section 1221. The classic example of this doctrine is the sale of a winning lottery ticket. Lump-sum payments or annuity payments for winning the lottery are taxed as ordinary income. But what if a taxpayer sells his right to future annuity payments? The IRS always argues that a sale of such property doesn't produce a capital gain. *See*, *e.g.*, *Davis v. Commissioner*, 119 T.C. 1, 5-6 (2002). The courts agree. We noted in *Davis* that the Supreme Court said "[w]hile a capital asset is defined . . . as 'property held by the taxpayer,' it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset." *Id.* At 7 (quoting *Commissioner v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960)). Should the phantom stock receive similar treatment? If Gary had lived to see the liquidation of the phantom account it would've been deferred compensation, and taxed as ordinary income. Why should that change now?

The reason is that HI-2 isn't Gary Hurford and the phantom stock isn't the same as a winning lottery ticket. We've already said the character of property can change when it's transferred to another party, so the character in the hands of Gary or Thelma shouldn't automatically be applied to HI-2. In *Davis* we said that "[i]t is well established that the purpose for capital-gains treatment is 'to afford capital gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.'" 119 T.C. at 7 n. 9 (quoting *Gillette Motor Transp.*, 364 U.S. at 134). The winning lottery ticket doesn't fit this description because it represents the right to guaranteed future payments of a set amount. The phantom stock, on the other hand, could increase or decrease in value over time, similar to ordinary stock. Once HI-2 acquired it, its value was inextricably linked to the value of Hunt Oil, which was far from set in stone. Unlike Gary, HI-2 couldn't do anything to affect its value, but rather simply held it and hoped it

TAM 200427025 asserted that Code § 1234A did not apply to the termination of a long-term power purchase agreement.

Code § 1234A, by its own terms, does not apply to "the retirement of any debt instrument (whether or not through a trust or other participation agreement)."

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would appreciate in value. This distinguishing characteristic is enough for us to conclude that it is a capital asset of HI-2's.

[1019] *Hurford Investments No 2, Ltd. v. Commissioner*, fn. 1016, discussed the issue:

> Winning capital-asset status is only half the battle for HI-2. To receive capital-gains rates, the income must be from a "sale or exchange" of that capital asset. I.R.C. § 1222. "The touchstone for sale or exchange treatment is consideration. If in return for assets any consideration is received, even if nominal in amount, the transaction will be classified as a sale or exchange." *LaRue v. Commissioner*, 90 T.C. 465, 483 (1988). The Commissioner argues that even if we find the phantom stock is a capital asset, HI-2 never sold or exchanged it. Instead, Hunt Oil simply fulfilled a contractual obligation. The Commissioner points us to *Pounds v. United States*, 372 F.2d 342 (5th Cir. 1967).

After discussing *Pounds*, the court noted:

> HI-2 doesn't dispute that under *Pounds* it would have a big problem. HI-2 argues instead that Founds has been superseded by a new Code section – section 1234A. Section 1234A says that "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is . . . a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset." If a transaction meets the definition in section 1234A, it counts as capital gain or loss from a sale.
>
> HI-2 argues that when its right to participate in the phantom-stock plan ended in 2006 and Hunt Oil paid out the value of the phantom account, HI-2's interest in the phantom stock was cancelled, lapsed, expired, or was otherwise terminated. HI-2 thinks this means that there was a sale or exchange in 2006, so it should receive capital-gains treatment under section 1234A. This motion is thus affected by the Fifth Circuit's decision in *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015), *rev'g* 141 T.C. 533 (2013).

The court then reviewed the Fifth Circuit's decision in *Pilgrim's Pride*:

> It held that section 1234A(1) applies only to the termination of rights or obligations to buy or sell capital assets, not the termination of their ownership. *Pilgrim 's Pride*, 779 F.3d at 315. So, a contractual right to buy or sell a capital asset would fall into section 1234A(1) under the Fifth Circuit's interpretation. The Fifth Circuit tells us that if there's no sale or exchange and there's no termination of a right or obligation to buy or sell, then there can't be capital-gains treatment. *Id.*
>
> So which category are we dealing with here--the termination of a right to buy or sell or the termination of ownership? Remember that both parties to the phantom-stock arrangement had the right to liquidate the account at any time. When Hunt Oil liquidated the phantom stock and distributed the proceeds, it ended HI-2's right to sell the phantom stock when it chose. We think that means there was a termination of a right to buy or sell a capital asset, and not an abandonment of property, under the Fifth Circuit's interpretation of 1234A(1). HI-2 still owned the rights to the phantom stock or, after the liquidation, to the cash proceeds. We therefore conclude that the transaction was a sale or exchange of a right to sell a capital asset under section 1234A(1) and HI-2 is entitled to capital-gains treatment.

Code § 1234A has reportedly been used to obtain capital gain treatment on the surrender of a life insurance policy.[1020]

Code § 1234A has attracted attention in the merger and acquisition arena.[1021]

II.G.7. Tax Distributions from Partnerships and S Corporation

S corporations and partnerships generally do not pay income tax.[1022] Instead, their income is taxed to their owners, whether or not their owners receive distributions. Accordingly, it is not uncommon for their organizational documents to mandate distributions to pay income tax.[1023]

Sometimes entities pay their owners' taxes directly, as a matter of convenience, treating payments to taxing authorities as distributions to the owners followed by the owners making payments of those taxes. Requiring this payment to taxing authorities might help ensure that these payments continue if the entity later files for bankruptcy.[1024] The IRS must honor this designation of payments.[1025]

1020 See fn. 3157, found in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy).

1021 For more about Code § 1234A, see Schnee and Seago, "The Application of Section 1234A: Explanation, Revision or Expansion?" *Journal of Taxation* (4/2017), also citing *Alderson v. U.S.*, 686 F.3d 791 (9th Cir. 2012); *Patrick v. Commissioner*, 142 T.C. 124 (2014); Letter Rulings 200823012 and 201123044, FAA 20163701F; and ILM 201642035. The article concluded:

> Recently, IRS rulings and cases have considered the application of Section 1234A. They appear to have expanded its scope to include M&A transactions but limit the definition of capital assets to those that would be treated as capital based on the historic cases and rulings. This includes applying Section 1221 exactly as enacted to the extent it lists assets as non-capital assets except if the court-created narrow definitional approach applies. The application of Section 1234A to M&A transactions is very significant since corporations pay ordinary income tax on capital gains but have limited deductions for capital losses.

A panel (including governmental) at the American Bar Association Section of Taxation's January (Midyear) 2017 meeting discussed these issues, including the observation that CCA 201642035 included a footnote disagreeing with the conclusion of Letter Ruling 200823012 that a termination fee was ordinary income. Slides are saved as Thompson Coburn doc. 6555254. Panelists suggested that regulations under Code § 263(a) capitalized expenditures investigating a possible acquisition as a general intangible asset under *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992), without identifying the intangible asset or dealing with its later being rolled into a stock purchase or being abandoned; they said that Treasury had intended to address those issues later but never got around to it.

1022 However, S corporations that had been C corporations might pay a tax on any built-in gain (excess of value over tax basis) if property that survived the conversion is sold within 10 years after the conversion. See part II.P.3.c.ii Built-in Gain Tax.

1023 For clients who want to spend time and money on a sophisticated tax distribution clause, consider some of the ideas in Schneider and O'Connor, "A Partnership Tax Distribution Menu: Just Say No to Phantom Income," *Business Entities*, Vol. 15, No. 1, at page 4 (January/February 2013).

1024 *In re Kenrob Information Tech. Solutions, Inc.*, No. 09-19660-RGM (Bankr. E.D. Va. 7/10/12). However, *In re DBSI, Inc.*, 561 B.R. 97 (D. Idaho 2016) (https://goo.gl/eCva3u), distinguished the affirmative act of making an S election in *Kenrob* from the members' decision in *DBSI* not to elect

II.G.8. Distributing Profits in Excess of Tax Distributions

Generally, a business owner should withdraw as much as possible from the business so long as the business is funded in a responsible way. The idea is to expose enough to those with claims against the entity to avoid "piercing the corporate veil" (which applies to LLCs and other unincorporated limited liability entities), while not exposing any more than necessary.[1026]

Generally, any equity in an entity is exposed to the entity's creditors. If an owner loans money to an entity, that loan would compete with all other claims against the entity. Although a creditor might ask a court to use "piercing the corporate veil" theories to provide less protection to the owner who is a creditor than the protection granted other creditors, presumably an owner who withdraws money and then loans it to the company would be in a better position than an owner who simply leaves his money in the company.

S corporation owners also have tax motivations to withdraw funds and reinvest them separately. If an S corporation buys long-term investments and later decides to distribute them, the distribution would be a deemed sale[1027] – unlike a partnership, which generally can distribute assets that the partnership bought without triggering a taxable

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taxation as a C corporation. The *DBSI* opinion did not mention whether the members affirmatively agreed not to be taxed as a C corporation in exchange for an agreement to make tax distributions; however, the operating agreement required tax distributions "if the cash position of the Company [was] sufficient to allow a distribution." The court also criticized the tax distributions being made to the IRS when they were required to made to the members; that view is nonsense, in that the members received credit from the IRS for payments made on their behalf.

[1025] *Dixon v. Commissioner*, 141 T.C. 173 (2013) (a reviewed opinion, holding that the individual taxpayers received credit as of the date of payment and not as withholding). Action on Decision 2014-001 recommended nonacquiescence, reasoning:

> The Service disagrees with the Tax Court that employment tax payments that were not withheld at the source may be designated by an employer to a specific employee's income tax liability. Pursuant to sections 3402 and 31(a), an employee may only get a credit for income taxes withheld at the source. If the income tax is not withheld at the source, a later payment by the employer of its liability for the tax it should have withheld will not result in a credit to the employee. In the absence of a statutory credit, the Dixons cannot rely on the rule allowing designation of partial voluntary payments. *See* Rev. Proc. 2002-26. Such rule only permits a taxpayer to designate a payment toward its own tax liabilities, such as where an employer designates a payment of employment taxes toward the trust fund portion of its employment tax liability. *See Wood v. United States*, 808 F.2d 411, 416 (5th Cir. 1987). Here, Tryco could not designate that its employment tax payments be applied to the income taxes of the Dixons because such income taxes were owed by the Dixons, and not Tryco.
>
> Accordingly, the Service will not follow the holding in *Dixon* that an employer can designate payments of its employment taxes to income taxes of specific employees, and effectively override the statutory limitations in the availability of a credit under section 31(a). We have, however, declined to pursue appeal of this case because due to its unique facts, Dixon has limited precedential effect.

If the taxpayer does not instruct the bank that accepts direct deposits but does not instruct the IRS, the taxpayer has not designated the payment. *Valteau, Harris, Koenig and Mayer v. Commissioner*, T.C. Memo. 2014-144.

[1026] See part II.F Asset Protection Planning.

[1027] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

event.[1028] The owners of an S corporation might consider taking their distributions and forming an LLC taxed as a partnership, which would then be available to guarantee the S corporation's loans, own property leased to the S corporation, fund cross-purchases, start new businesses, etc. Although the LLC's operating agreement might require them to make contributions of such distributions from the S corporation, they should avoid any agreement that the IRS might argue would constitute part of the S corporation's governing documents; this is necessary to avoid an IRS argument that the LLC is essentially an owner of some S corporation stock, because a partnership is not an eligible shareholder.

If a shareholder or the LLC described above loans money to the S corporation, what would be an appropriate interest rate? My gut reaction would be the prime rate or whatever the company pays on its line of credit. Consider, however, that any interest income generated would be subject to the net investment income (NII) tax,[1029] whereas any interest deductions generated will not reduce NII if the shareholders sufficiently participate in the business and therefore business operations do not generate NII.[1030] Therefore, to minimize taxes, one might consider charging only the applicable federal rate (AFR), which might very well be short-term, which generally is the lowest AFR. Be sure to fully document the loan, not only to prove it bona fide but also because that can have the best tax results when an S corporation is involved.[1031]

II.G.9. Personal Service Corporations

A C corporation that is a "qualified personal service corporation" is taxed at the highest marginal corporate income tax rate.[1032] A "qualified personal service corporation" is any corporation that satisfies both of these tests:[1033]

- substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

- substantially all of the stock of which (by value) is held directly or indirectly by employees performing services for such corporation in connection with the activities involving a field described above, retired employees who had performed such services for such corporation, the estate of any individual described above, or any other person who acquired such stock by reason of the death of an individual described above within two years after that individual's death.

Commissioned salesmen frequently describe themselves as consultants, but they are treated as salesmen and not consultants for purposes of this rule.[1034]

[1028] See part II.Q.8.b.i Distribution of Property by a Partnership.
[1029] See part II.I.5 What is Net Investment Income Generally.
[1030] See part II.I.8 Application of 3.8% Tax to Business Income, especially parts II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax and II.I.8.g Structuring Businesses in Response to 3.8% Tax.
[1031] See part II.G.3.c.i.(b) Consequences of Using Shareholder Debt to Deduct S Corporation Losses, especially the text accompanying fns. 837-839.
[1032] Code § 11(b)(2).
[1033] Code § 448(d)(2).

These types of entities are one of the few types of C corporations with more than $25 million of annual gross receipts that can use the cash receipts and disbursements method of accounting.[1035]

Generally, they also are required to file income tax returns using a calendar year.[1036]

II.G.10. Planning for C Corporation Using the Lowest Corporate Brackets and Is Owned by Taxpayer with Modest Wealth

Taxpayers in the lowest tax bracket do not pay federal income tax on qualified dividends.

Consider paying dividends when the shareholders are in the lowest tax bracket to reduce earnings and profits without incurring federal income tax.

If the corporation is not a personal service corporation[1037] for tax years beginning before January 1, 2018 or is any C corporation for tax years after that, reconsider a strategy of paying as much reasonable compensation as necessary to zero out the corporation's taxable income. Instead, consider having the corporation pay tax to the extent it is in a low bracket and pay nontaxable dividends to the shareholder.[1038] Make sure, however, that the employee-shareholder's compensation is not unreasonably low.[1039]

Note, however, that the corporation <u>and</u> shareholder may be subject to state or local income tax, which may reduce the efficacy of this idea.

[1034] Reg. § 1.448-1T(e)(4)(iv), particularly clause (A) and Example (1) of clause (B).

[1035] Code § 448(b)(2). See part II.P.3.e Conversion from S Corporation to C Corporation, fns 2926-2929.

[1036] Code § 444(i)(1). Note, however, that "personal service corporation" is defined differently for these purposes. Code § 444(i)(2).

[1037] See part II.G.9 Personal Service Corporations.

[1038] For how to try to get cash out of C corporations annually, see Zupanc, "Getting Cash out of a Closely Held Corporation," 92 *Practical Tax Strategies* 65 (Feb. 2014), which concluded:

> The exact amount of net tax savings or costs depends on the amount of the shareholder's (and spouse's if married filing jointly) earnings, AGI, modified AGI, taxable income, net investment income, the phase-out effect on exemptions and itemized deductions, and AMT, as well as the marginal rate of the C corporation. One general rule is that rental income from a C corporation with a corresponding deduction is usually the most advantageous choice as compared to salaries and qualified dividends for all (Alice, Basu, Claudia, and Dafir) but the highest marginal rate shareholders or when the C corporation has a 15% marginal rate. A second general rule is that the highest marginal rate shareholders (Eugenie) who are subject to the 3.8% net investment surtax will find salaries the most advantageous means to shift income, except when that C corporation is in the 15% bracket. A third general rule is that salaries are the second choice for tax-advantaged transfers to shareholders unless the C corporation is in the 15% marginal rate or the shareholder is in the 0% marginal rate for qualified dividends, which makes qualified dividends the best second choice.

I have not carefully read the article, and one should certainly use healthy skepticism, given that at the beginning of the Overview the author incorrectly referred to Code § 1411 as a Medicare contribution tax.

[1039] See part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fn. 77.

When taxpayers pay tax on qualified dividends, see part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities, especially part II.E.1.a Taxes Imposed on C Corporations.

II.G.11. Loans from Entity to Employee

The IRS has attempted to recast a forgivable loan to an employee as a payment of compensation for future services, with the portion not forgiven deemed to be a liquidated damages clause for failure to complete the term of service.[1040]

II.G.12. Future Development of Real Estate

Gain[1041] on the sale of real estate is taxed as:

- Capital gain, to the extent it is held for investment,
- Ordinary income, if the seller is a dealer or subdivided the property, or
- Capital gain, to the extent it was used in the business and is not described above.

A taxpayer who holds real estate for investment (and is not a dealer)[1042] but then decides to develop it should, before preparing development plans,[1043] consider selling it to the

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[1040] TAM 200040004.

[1041] For an excellent overview of expenditures that affect the adjusted basis of real estate, see Tucker and Langlieb, "Tax Planning for Real Estate Ownership (With a Focus on Choice of Entity)," *TM Real Estate Journal*, January 5, 2011, Vol. 27 No. 01.

[1042] Tucker and Langlieb, fn. 1041, point out:

> The "dealer" in real estate will encounter difficulties in segregating investment real estate from real estate held for sale. *See, e.g., Tibbals v. U.S.*, 362 F.2d 266 (Ct. Cl. 1966), and *Black v. Comr.*, 45 B.T.A. 204 (1941). *But see Cary v. Comr.*, 32 T.C.M. 913 (1973), *Adam v. Comr.*, 60 T.C. 996 (1973), and *Ridgewood Land Co. Inc. v. Comr.*, 31 T.C.M. 39 (1972), *aff'd* 477 F.2d 135 (5th Cir. 1973).

However, *Gardner v. Commissioner*, T.C. Memo. 2011-137, allowed a dealer to obtain capital gain treatment when he persuaded the Tax Court judge that he intended to hold the property and rent it. The property had been subdivided, but he had to build a road on it to give interior properties access to the nearby street.

Note, however, that the taxpayer had to litigate the issue. *Pool v. Commissioner*, T.C. Memo. 2014-3, held:

> This Court and the Court of Appeals for the Ninth Circuit have identified several relevant factors for evaluating whether a taxpayer held certain properties primarily for sale to customers in the ordinary course of business. Such factors include: (1) the nature of the acquisition of the property; (2) the frequency and continuity of sales over an extended period; (3) the nature and the extent of the taxpayer's business, (4) the activity of the seller about the property; and (5) the extent and substantiality of the transactions. *Id.* at 462; *see Pritchett v. Commissioner*, 63 T.C. 149, 162-163 (1974). We must decide each case upon its particular facts, and the presence of any one or more of these factors may or may not be determinative of a particular case. *Austin v. Commissioner*, 263 F.2d at 462.

Fargo v. Commissioner, T.C. Memo. 2015-96 held:

> Whether a taxpayer held specified property primarily for sale to customers in the ordinary course of business is a question of fact. *Rockwell v. Commissioner*, 512 F.2d 882, 884

taxpayer's wholly-owned S corporation to lock in capital gain treatment on the pre-development appreciation;[1044] however, any S corporation that holds real estate should have that (together with any ancillary cash) as its only property.[1045] A sale to a controlled partnership would be taxed as ordinary income, because the partnership's plan to act as a developer would taint the transaction.[1046] Although generally a corporation (whether S or C) is a poor choice to hold real estate, this property is intended to be developed and sold quickly, so it really will just turn into an corporation holding cash, which can then be liquidated if an S corporation.[1047]

> (9th Cir. 1975), *aff'g* T.C. Memo. 1972-133. The term "primarily" for purposes of section 1221(a)(1) means "of first importance" or "principally". See *Malat v. Riddell*, 383 U.S. 569, 572 (1966). This Court has identified several factors for evaluating whether a taxpayer held certain properties primarily for sale to customers in the ordinary course of business, including: (1) the purpose for which the property was initially acquired; (2) the purpose for which the property was subsequently held; (3) the extent to which improvements, if any, were made to the property by the taxpayer; (4) the frequency, number, and continuity of sales; (5) the extent and nature of the transactions involved; (6) the ordinary business of the taxpayer; (7) the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property; (8) the listing of property with brokers; and (9) the purpose for which the property was held at the time of sale. *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278, 1284 (1970). We must decide each case upon its particular facts, and the presence of any one or more of these factors may or may not be determinative of a particular case. *Redwood Empire Sav. & Loan Ass'n v. Commissioner*, 628 F.2d 516, 517 (9th Cir. 1980), *aff'g* 68 T.C. 960 (1977).

For more cases, see ¶ I-6313, Income from real estate sales relative to other income as a factor in determining whether a taxpayer is a dealer in real estate, *Federal Tax Coordinator 2d*. See also Bittker, ¶ 31.04[6] Special Rules Relating to Real Estate, *McMahon & Zelenak: Federal Income Taxation of Individuals* (WG&L), describing when sales of real estate generate capital gain or ordinary income, including references to Code §§ 1221(a)(2), 1231, 1237 (certain activities not considered development that converts property to inventory), 1239, and 1250.

When real estate is used in a business, see part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business; within that part, if property is bought for use in a trade or business but in never placed in service, see text accompanying fns. 956-957.

[1043] Once the taxpayer makes plans to develop, the taxpayer might face an uphill battle in proving otherwise. See *Fargo v. Commissioner*, T.C. Memo. 2015-96.

[1044] Eustice & Kuntz, ¶2.04. Situations in Which Subchapter S Is (or Is Not) Useful - ¶ 2.04[8] Real Estate Developed for Sale, *Federal Income Taxation of S corporations* (WG&L). However, they point out that, in *Little v. Commissioner*, T.C. Memo. 1993-281, *aff'd* 106 F.3d 1445 (9th Cir. 1997), the taxpayer argued unsuccessfully that he held investment property while his S corporation held dealer property. The *Little* case involved a taxpayer who already was a dealer in real estate, so a taxpayer who clearly is not already a dealer should be able to distinguish the case. That case would tend to cause more problems when a taxpayer holds a number of real estate properties and sells to a thinly capitalized S corporation.

[1045] To maximize basis step-up possibilities, each separate real estate property should be held in its own S corporation. See part II.H.8.a Depreciable Real Estate in an S Corporation. Dividing on a tax-free basis corporations that hold real estate can be challenging. See part II.Q.7.f Corporate Division.

[1046] McKee, Nelson & Whitmire, ¶14.04. Special Rules for Transactions Between Partnerships and Partners or Related Persons, *Federal Taxation of Partnerships & Partners* (WG&L), interpreting Code § 707(b)(2)(A).

[1047] For the recommendation to liquidate, see part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

The sale of the investment property might be using an installment note to defer capital gain until the real estate is sold.[1048]

See also part II.G.25 Real Estate Dealer vs. Investor.

II.G.13. Planning for Upcoming Sale That Is Not Imminent – Using an Installment Sale Now to Defer Tax on Upcoming Sale

If the sale is more than two years down the road, an installment sale might help fix the basis. See part II.Q.3 Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future, which deals with selling an interest in a business but also applies to other transactions.

Also consider using a partnership to shift basis to the property to be sold. See part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.

Consider contributing the property to a charitable remainder trust, if the property would not generate unrelated business taxable income on the sale. See part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax, analysis from which has uses beyond just the built-in gain tax setting.

II.G.14. Limitations on the Use of Installment Sales

Any depreciation recapture taxable as ordinary income under Code § 1245 or 1250 is not eligible for installment deferral, although that disallowance does not taint the rest of the gain; this includes such ordinary income taxed under Code § 751; see part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.[1049]

Generally, deferral does not apply to any installment obligation arising out of a sale of stock or securities traded on an established securities market or, to the extent provided in regulations, property (other than stock or securities) of a kind regularly traded on an established market (although there might be a way around that rule).[1050]

Generally, if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, the deferred gain is

1048 The gain would be accelerated when the real estate is sold. Code § 453(e).

1049 Code § 453(i) provides that any recapture income shall be recognized in the year of the disposition and that any gain in excess of the recapture income shall be taken into account under the installment method. as used here, “recapture income” means the amount that would be treated as ordinary income under Code §§ 1245 or 1250 (including indirectly through Code § 751) for the taxable year of the disposition and as if all payments to be received were received in the taxable year of disposition.

1050 Code § 453(k)(2), which further provides, “The Secretary may provide for the application of this subsection in whole or in part for transactions in which the rules of this subsection otherwise would be avoided through the use of related parties, pass-thru entities, or intermediaries.” For opportunities that remain in light of no regulations having been promulgated, see part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 4133.

accelerated.[1051] Installment notes transferred outright (not in trust) to a spouse or pursuant to a divorce are not accelerated.[1052] Various business formations and liquidations might escape gain recognition.[1053]

Special rules apply to installment notes includible in the holder's gross estate.[1054] Specifically bequeathing an installment note to the obligor accelerates income to the estate, and the bequest is not a distribution triggering the income distribution deduction[1055] (although other distributions might); however, such a bequest does not necessarily constitute a step transaction indicating an intention to forgive the note.[1056]

Transfers to[1057] or from[1058] nongrantor trusts trigger acceleration. Also, if any person disposes of property to a related person (the "first disposition"), and the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (the "second disposition"), then the amount realized with

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[1051] Code § 453B.
[1052] Code § 453B(g), referring to Code § 1041(a).
[1053] Reg. § 1.453-9(c). Cross-references include Code §§ 332, 337, 351, 361, 721, and 731, with exceptions for hot assets, depreciation recapture, etc. I have not researched the effect of any apparent conflict with Code § 453B. In a Code § 351 transaction, the contributing shareholder recognizes gain based on the value of stock received in exchange for the obligation, but any excess amount on the installment note is deferred. Rev. Rul. 73-423, which would be integrated into regulations under Prop. Reg. § 1.453B-1(c).
[1054] Code § 691(a)(4), (5). A transfer at death does not accelerate gain until the note is cancelled or distributed. ¶ 108.13.3 Obligations Held at Death, Bittker & Lokken, *Federal Taxation of Income, Estates, and Gifts* (WG&L), citing S. Rep. No. 1000, 96th Cong., 2d Sess., reprinted in 1980-2 C.B. 494, 508, which provides as follows:

> The bill provides that any previously unreported gain from an installment sale will be recognized by a deceased seller's estate if the obligation is transferred or transmitted by bequest, devise, or inheritance to the obligor or is cancelled by the executor. In the absence of some act of cancelling the obligation by distribution or notation which results in cancellation under the Uniform Commercial Code or other local law, the disposition will be considered to occur no later than the time the period of administration of the estate is concluded.
>
> If the cancellation occurs at the death of the holder of the obligation, the cancellation is to be treated as a transfer by the estate of the decedent. However, if the obligation were held by a person other than the decedent, such as a trust, the cancellation will be treated as a transfer immediately after the decedent's death by that person.
>
> If the decedent and the obligor were related persons (within the meaning of new Code section 453(f)(1)), the fair market value of the obligation for disposition purposes is not to be treated as less than its face amount.

For purposes of this provision, if an installment obligation becomes unenforceable, it will be treated as if it were cancelled.
[1055] Letter Ruling 9108027.
[1056] In the *Estate of Morrissette v. Commissioner*, the Tax Court brushed aside the IRS' step transaction argument when the temporary conservator for a 94-year-old entered into a generational split-dollar agreement and amended her estate plan to bequeath the interest in the split-dollar arrangement to the other party to the agreement. This was an economic benefit transaction and not a loan transaction, so it is not directly on point to my comment about bequeathing the note. The case is discussed in fns. 3214-3216 in part II.Q.4.f.ii.(b) Treatment of Split-Dollar Arrangement under Reg. § 1.61-22.
[1057] Rev. Rul. 67-167.
[1058] Rev. Rul. 55-159.

respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.[1059]

Given the many uncertainties of what might happen to trigger acceleration, consider transferring property to a partnership before selling it. The first two years of payments after forming the partnership might be interest-only, to avoid triggering the disguised sale rules.[1060] See also part II.Q.3 Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future. However, if the partnership later distributes the note to the obligor who is a partner, that distribution will constitute a payment of the note.[1061]

Large installment sales are subject to a charge for tax deferral.[1062]

Whereas this discussion suggests a partnership itself making an installment sale, part II.Q.8.e.ii.(c) discusses the Availability of Installment Sale Deferral for Sales of Partnership Interests.

II.G.15. Like-Kind Exchanges

As described below, Code § 1031 disallows gain or loss on the exchange of certain property. Confirm with the client that the property has a gain; generally one does not want to defer a loss.

Code § 1031(a)(1) provides:

> No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Code § 1031(a)(2) excludes the following property from that favorable treatment:

(A) stock in trade or other property held primarily for sale,

(B) stocks, bonds, or notes,

(C) other securities or evidences of indebtedness or interest,

(D) interests in a partnership,

(E) certificates of trust or beneficial interests, or

(F) choses in action.

Personal property is "of like kind" as follows:

[1059] Code 453(e).
[1060] See part II.M.3.e Exception: Disguised Sale.
[1061] Reg. § 1.731-1(c)(2).
[1062] Code § 453A.

- Depreciable tangible personal property is exchanged for property of a like kind or like class.[1063] "Like class" means either[1064] within the same General Asset Class[1065] or within the same Product Class.[1066]

- Whether intangible personal property is of a like kind to other intangible personal property generally depends on:[1067]

  - the nature or character of the rights involved (for example, patent or a copyright), and

  - the nature or character of the underlying property to which the intangible personal property relates.

As to the latter:

- Goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.[1068]

- A copyright on a novel is of like kind with a copyright on a different novel, but a copyright on a novel is not of like kind with a copyright on a song.[1069]

- Manufacturing and distribution are two distinct business activities and the rights to each would not, absent some close connection between these activities, be of a like kind; however, the close economic and unique historical connection between the manufacturing and the distribution of a particular product would make them of like kind as two aspects of a single business activity if the rights to manufacturing and distribution are contained within the same integrated agreement and any differences among the product that are relevant to manufacturing or distribution are differences in grade or quality, and not differences in nature or character.[1070] Similarly, distribution contracts were of like kind when distributed in a substantially similar manner to a largely common set of customers who resell them to end customers who, in turn, use each of the products for a substantially similar purpose, because any differences among the product relevant to distribution were differences in grade or quality, and not differences in nature or character, despite having different brand

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[1063] Reg. § 1.1031(a)-2(b)(1).
[1064] Reg. § 1.1031(a)-2(b)(1).
[1065] Reg. § 1.1031(a)-2(b)(2) describes when and how a general asset class consists of depreciable tangible personal property described in certain asset classes in Rev. Proc. 87-56.
[1066] Reg. § 1.1031(a)-2(b)(3) describes when and how a product class consists of depreciable tangible personal property that is described in the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002 (NAICS Manual), as periodically updated.
[1067] Reg. § 1.1031(a)-2(c)(1).
[1068] Reg. § 1.1031(a)-2(c)(2).
[1069] Reg. § 1.1031(a)-2(c)(3).
[1070] Letter Ruling 201531009.

names, appearances, ingredients, packaging, manufacturing processes, and marketing strategies.[1071]

A fee title may be exchanged for a 30-year leasehold.[1072] The tenant's renewal options count toward the 30 years.[1073] Regarding a lease with less than 30 years remaining, the transfer of a lease and leasehold improvements in a building in return for the leaseback of a portion of the building and money was a like-kind exchange.[1074] A leasehold interest

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[1071] Letter Ruling 201532021.

[1072] Reg. § 1.1031(a)-1(c), "Examples of exchanges of property of a 'like kind,'" provides {indenting added]:

> No gain or loss is recognized if
>
> (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or
>
> (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or
>
> (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

Letter Ruling 8453034 is an example of a fee interest for leasehold interests involving motels.

[1073] Rev. Rul. 78-72, reasoning:

> In *Century Electric Co. v. Commissioner*, 15 T.C. 581, 591 (1950), *aff'd* 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), the Tax Court of the United States, indicated that, for like kind exchange purposes, optional renewal periods are included in determining the length of a lease.
>
> In *R & J Furniture Co. v. Commissioner*, 20 T.C. 857, 865 (1953), *acq.*, 1954-1 C.B. 6, which involved a lease with an initial term of 5 years and ten renewal options of 5 years each, the Tax Court of the United States stated that the lease was property of a like kind and the equivalent of a fee interest in real estate under the regulations since the taxpayers had the right to possess, occupy, and use the leased property for a total of 55 years.
>
> In the instant situation, A's lease runs for an initial period of 25 years plus three optional 10-year renewal periods under the same rental terms. Thus, A has the right to possess, occupy, and use the leased property for a total of 55 years.

[1074] Rev. Rul. 76-301 reasoned:

> An exchange is considered to occur for the purposes of section 1031 of the Code if the transfers of the like kind property are reciprocal. Rev. Rul. 61-119, 1961-1 C.B. 395. Moreover, the reciprocal transfer of interests in like kind property is an exchange for the purposes of section 1031 even though the interests are in the same property. See *Century Electric Co. v. Commissioner*, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952), where a loss sustained on the sale of business property by a taxpayer was disallowed where it immediately leased back the same property under a long-term lease

The ruling concluded:

> … the assignment of the leasehold interest in the building in the instant case in return for an identical leasehold interest in a portion of the building qualifies as an exchange of property for like kind property and money subject to section 1031(c) of the Code.
>
> The fact that the transaction results in the disposition of the portion of the property used in one of the taxpayer's two businesses is not significant for the purposes of section 1031 of the Code. Section 1.1031(a)-1(a) of the regulations. Rather, the significant factor for the purposes of section 1031 is that the taxpayer's investment is still tied up in the same

in real property with 21 years remaining was not like-kind to fee interests in real property.[1075]

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kind of property. See H. R. Rep. No. 704, 73d Cong., 2d Sess. 13 (1934), 1939-1 (Part 2) C.B. 554, 564.

Accordingly, the loss of 200x dollars realized by X in the exchange of X's leasehold interest and improvements in the building in return for an identical leasehold interest in a portion of the building and money may not be recognized under the provisions of section 1031(a) and (c) of the Code.

[1075] *VIP's Industries, Inc. v. Commissioner*, T.C. Memo. 2013-157, explained:

Petitioner contends that its leasehold interest in the Eugene property was of like kind to the fee interests in the Bridgeport and Salem properties because (1) section 1.1031(a)-1(c), Income Tax Regs., does not exclude all exchanges of leasehold interests in real property with terms of less than 30 years for fee interests in real property from receiving like-kind exchange treatment but rather provides a safe harbor for exchanges of leaseholds with terms of 30 years or more for fee interests in real property; and (2) its leasehold interest in the Eugene property was of sufficient length to be considered of like kind to the fee interests in the Bridgeport and Salem properties.

Petitioner exchanged its leasehold interest in the Eugene property with a remaining term of 21 years and 4 months for fee interests in the Bridgeport and Salem properties. We previously have held that leasehold interests with similar or even longer terms than the one at issue here are not equivalent to fee interests. In *May Dep't Stores Co. v. Commissioner*, 16 T.C. at 556, we held that a 20-year leasehold was not equivalent to a fee interest. In *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. at 48, we held that a leasehold interest with a term of 1 year and an option to renew for a term of 24 years was not equivalent to a fee interest, and we have held that options to renew are included in determining whether a leasehold interest is equivalent to a fee interest. See *Peabody Natural Res. Co. v. Commissioner*, 126 T.C. at 275; *Century Elec. Co. v. Commissioner*, 15 T.C. 581, 591-592 (1950), *aff'd*, 192 F.2d 155 (8th Cir. 1951).[5]

[5] Petitioner contends that *May Dep't Stores Co. v. Commissioner*, 16 T.C. 547 (1951), and *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. 41 (1950), are distinguishable because they concern sale-leaseback transactions that may have been designed to achieve improper tax avoidance. However, these cases cannot be explained as targeting improper tax avoidance because they allowed, rather than disallowed, the respective taxpayers' claimed losses.

Petitioner further contends that *May Dep't Stores* and *Standard Envelope* are distinguishable because the respective taxpayers intended for sec. 1031 not to apply and for their losses to be recognized. However, this contention also fails because the "[t]he rules of *** [sec.] 1031 apply automatically; they are not elective." *Koch v. Commissioner*, 71 T.C. 54, 64 (1978).

Petitioner's leasehold interest in the Eugene property with a term of 21 years and 4 months remaining is closer in nature to the leasehold interests that we characterized as not equivalent to a fee interest, see *May Dep't Stores Co. v. Commissioner*, 16 T.C. at 556; *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. at 48, than to the 30-year leasehold interest that section 1.1031(a)-1(c), Income Tax Regs., recognizes as the equivalent of a fee interest. Applying our precedent, we therefore conclude that petitioner's leasehold interest was not of like kind to a fee interest under section 1031.[6]

[6] In reaching this conclusion we note that a short-term real property interest is not of like kind with a long-term real property interest irrespective of whether the short-term real property interest is a real property interest under State law. See *Peabody Natural Res. Co. v. Commissioner*, 126 T.C. 261, 275 n.11 (2006) (citing *Smalley v. Commissioner*, 116 T.C. 450, 464 n.11 (2001)).

The "held for productive use in a trade or business or for investment" requirement is based on facts and circumstances and encourages taxpayers to hold property for long enough before and after the exchange to establish that purpose. If over 50% of the use of property is for personal purposes, the IRS asserts that the property was not held for productive use in a trade or business of for investment.[1076] Personal use of property can disqualify it as being held for investment.[1077] Rev. Proc. 2008-16 provides a safe harbor for limited personal use[1078] referring to the vacation home rules.[1079] The vacation home

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> Because we decide this case in accordance with our existing precedent, we need not decide whether section 1.1031(a)-1(c), Income Tax Regs., mechanically excludes all exchanges of leaseholds with terms of less than 30 years for fee interests from receiving like-kind exchange treatment. Compare *Peabody Natural Res. Co. v. Commissioner*, 126 T.C. at 276 (referring to "the 30-year safe harbor provisions of section 1.1031(a)-1(c), Income Tax Regs."), with *Capri, Inc. v. Commissioner*, 65 T.C. at 181 ("section 1.1031(a)-1(c), Income Tax Regs., requires a lease of real property to be 30 years in duration to constitute an interest in real property equivalent to a fee interest"), and *Standard Envelope Mfg. Co. v. Commissioner*, 15 T.C. at 48 ("The lease was for a term of less than 30 years, and, therefore, was not the equivalent of a fee under the terms of *** [the predecessor of section 1.1031(a)-1(c), Income Tax Regs.].").

[1076] CCA 201605017, further stating that its analysis:

> should not be read to imply that a taxpayer whose personal use of property is less than 50 percent has met the "held for" requirement in § 1031(a) for that property. Instead, close scrutiny should be used for any property the taxpayer uses for personal purposes.

For aircraft, the CCA said that the examiner should consider:

> (1) measurement of business/investment use versus personal use based on flight hours, not just flights; (2) percentages of business/investment use versus personal for flights and flight hours for the year before the year of the exchange; and (3) which flights and flight hours were determined to be repositioning flights and the nature of the flight following the repositioning flight.

[1077] In denying Code § 1031 treatment, *Starker v. U.S.*, 602 F.2d 1341 held:

> It has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment. Losses on the sale or exchange of such property cannot be deducted for this reason, despite the general rule that losses from transactions involving trade or investment properties are deductible. Treas. Regs. §1.165.9(a); see *Shields v. Commissioner*, 1978-120 T.C.M. (CCH) Dec. 35,064(M). A similar rule must obtain in construing the term "held for investment" in section 1031. 3 J. Mertens, *Law of Federal Income Taxation* § 20.26 (1972); see *Boesel v. Commissioner*, 65 TC 378, 389 (1975); Rev. Rul. 59-229, 1959-2 Cum. Bull. 180.

Moore v. Commissioner, T.C. Memo. 2007-134, held:

> As a preliminary matter, we accept as a fact that petitioners hoped that both the Clark Hill and Lake Lanier properties would appreciate. However, the mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence. See *Jasionowski v. Commissioner*, 66 T.C. 312, 323 (1976) ("if the anticipation of eventually selling the house at a profit were in itself sufficient to establish that the property was held with a profit-making intent, rare indeed would be the homeowner who purchased a home several years ago who could not make the same claim"). Moreover, a taxpayer cannot escape the residential status of property merely by moving out.

[1078] Section 4.02(1) provides the following safe harbor for the property to be relinquished:

> (a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and
>
> (b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,

rules describe personal use of a dwelling unit,[1080] rental to a family member,[1081] and rental of a principal residence (the latter which does not apply for this safe harbor).[1082]

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

Section 4.04 provides:

Fair rental. For purposes of this revenue procedure, whether a dwelling unit is rented at a fair rental is determined based on all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account.

[1079] Section 4.03 provides:

Personal use. For purposes of this revenue procedure, personal use of a dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under § 280A(d)(2) (taking into account § 280A(d)(3) but not § 280A(d)(4)).

[1080] Code § 280A(d)(2) provides:

Personal use of unit. For purposes of this section, the taxpayer shall be deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day, the unit is used—

(A) for personal purposes by the taxpayer or any other person who has an interest in such unit, or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person;

(B) by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or

(C) by any individual (other than an employee with respect to whose use section 119 applies), unless for such day the dwelling unit is rented for a rental which, under the facts and circumstances, is fair rental.

The Secretary shall prescribe regulations with respect to the circumstances under which use of the unit for repairs and annual maintenance will not constitute personal use under this paragraph, except that if the taxpayer is engaged in repair and maintenance on a substantially full time basis for any day, such authority shall not allow the Secretary to treat a dwelling unit as being used for personal use by the taxpayer on such day merely because other individuals who are on the premises on such day are not so engaged.

Code § 267(c)(4) provides:

The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants….

[1081] Code § 280A(d)(3) provides:

Rental to family member, etc., for use as *principal residence*.

(A) *In general*. A taxpayer shall not be treated as using a dwelling unit for personal purposes by reason of a rental arrangement for any period if for such period such dwelling unit is rented, at a fair rental, to any person for use as such person's principal residence.

(B) *Special rules for rental to person having interest in unit*.

(i) *Rental must be pursuant to shared equity financing agreement*. Subparagraph (A) shall apply to a rental to a person who has an interest in the

The exception for rental to a family member requires that the family member use the dwelling unit as the tenant's "principal residence."[1083] Code § 1031 may also be paired with the exercise of an option to buy real estate.[1084]

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dwelling unit only if such rental is pursuant to a shared equity financing agreement.

(ii) *Determination of fair rental*. In the case of a rental pursuant to a shared equity financing agreement, fair rental shall be determined as of the time the agreement is entered into and by taking into account the occupant's qualified ownership interest.

(C) *Shared equity financing agreement*. For purposes of this paragraph, the term "shared equity financing agreement" means an agreement under which—

(i) 2 or more persons acquire qualified ownership interests in a dwelling unit, and

(ii) the person (or persons) holding 1 or more of such interests—

(I) is entitled to occupy the dwelling unit for use as a principal residence, and

(II) is required to pay rent to 1 or more other persons holding qualified ownership interests in the dwelling unit.

(D) *Qualified ownership interest*. For purposes of this paragraph, the term "qualified ownership interest" means an undivided interest for more than 50 years in the entire dwelling unit and appurtenant land being acquired in the transaction to which the shared equity financing agreement relates.

[1082] Code § 280A(d)(4), titled, "Rental of principal residence," provides:

(A) For purposes of applying subsection (c)(5) to deductions allocable to a qualified rental period, a taxpayer shall not be considered to have used a dwelling unit for personal purposes for any day during the taxable year which occurs before or after a qualified rental period described in subparagraph (B)(i), or before a qualified rental period described in subparagraph (B)(ii), if with respect to such day such unit constitutes the principal residence (within the meaning of section 121) of the taxpayer.

(B) Qualified rental period. For purposes of subparagraph (A), the term "qualified rental period" means a consecutive period of—

(i) 12 or more months which begins or ends in such taxable year, or

(ii) less than 12 months which begins in such taxable year and at the end of which such dwelling unit is sold or exchanged, and

for which such unit is rented, or is held for rental, at a fair rental.

[1083] *Kotowicz v. Commissioner*, T.C. Memo. 1991-563, declining to vary from the literal language cited in fn. 1081, even though family member paid fair rental. If the family member uses it as his or her principal residence and the family member works on the residence, the work may count as rent. *Adams v. Commissioner*, T.C. Memo. 2013-7, describing the family member's work:

> Bill and his family began working on the Eureka house in July 2004. They worked an aggregate of 60 hours per week on the property during July, August, and September 2004. They repaired mold damage, replaced broken doors, fixed holes in walls, repaired rotten subflooring, prepared floors for new carpet installation, scrubbed and repaired surfaces for painting, painted the interior of the house, renovated the kitchen, replumbed the kitchen and laundry room for gas, replaced electrical fixtures and appliances, and performed landscaping. They exterminated rats and other pests and, on one occasion, even chased away a bear. Their efforts made the house livable. For July, August, and September 2004, Adams accepted the services performed by Bill and his family in lieu of monetary rent. (Adams did not reimburse them for the labor and out-of-pocket costs of the home improvements.) The three months of services were worth $3,600.

[1084] Rev. Rul. 84-121 involved the following situation:

If property is a tenancy-in-common, check whether it is taxed as a partnership. If property is in a partnership and partners have different objectives, consider unwinding it well in advance of a sale. See part II.C.9 Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership, especially fn. 453.

A trust did not lack an investment motive for the replacement property when it placed the replacement property in an LLC and then distributed the LLC to its beneficiaries when the trust terminated.[1085]

> A, an individual, owned a parcel of unencumbered real property that is being used in A's trade or business and that had an adjusted basis of 50x dollars. For 5x dollars, A granted to B an option to purchase A's real property for a price of 100x dollars. The option allowed B to pay the option price in cash or to transfer real property equal in value to the option price. At the time the option was granted, A's real property had a fair market value of 100x dollars. B exercised the option before the expiration of the option period, but instead of paying A 100x dollars in cash, B purchased for 100x dollars another parcel of real property with a fair market value of 100x dollars and immediately transferred that property to A. At the time B exercised the option, A's real property had a fair market value of 150x dollars. A used the property acquired form B in A's trade or business. B is neither related to A nor employed by A.

It held:

> Pursuant to section 1031(b) of the Code, A does not recognize gain or loss on the transfer of A's real property in exchange for the real property received from B, except to the extent of the 5x dollars premium paid by B to A for the option. Under section 1031(d), the adjusted basis to A in the property acquired from B is 50x dollars, that is, the adjusted basis of A's old property of 50x dollars decreased by the 5x dollars received by A and increased by the 5x dollars of gain recognized by A on the exchange.
>
> When B transfers to A the property that B had acquired in order to exercise the option, B has disposed of B's property in a taxable transaction because B has not met the requirements of section 1031. On the present facts, B has no gain or loss because the amount considered realized by B (the option price of 100x dollars) equals B's basis in the property (100x dollars). The adjusted basis to B in the property acquired from A is 105x dollars, the option price for the property that B paid to A, plus the premium for the option paid by B to A.

See also part III.B.7.c.vii Stock Options, which also applies to real estate options (see fns. 5625-5627.

[1085] Letter Ruling 200521002 reasoned:

> Your submission expresses two concerns regarding the above exchange. Your first concern is that the proposed transfer of the replacement property to LLC would violate the holding requirement of § 1031(a) (i.e., that the replacement property must be held by the taxpayer for productive use in a trade or business or for investment) as applied in Rev. Rul. 75-292 and Rev. Rul. 77-337. Your second concern is that, as a result of the Trust's terminating distribution of membership interests in LLC to multiple beneficiaries, which will then result in a de facto partnership between the beneficiaries for federal income tax purposes, the holding requirement of § 1031(a) as applied in the revenue rulings would be violated with respect to the replacement property.
>
> With respect to your first concern, you represent that the replacement property will be held by the Trust (and LLC) for investment purposes throughout the Trust's existence. You also represent that LLC will not elect to be taxed as a corporation and will remain a single member LLC until at least Date A. Therefore, LLC will be disregarded as an entity separate from the Trust, its sole owner. Consequently, the transfer by the Trust of the replacement property to LLC will also be disregarded, and the Trust will be considered the direct owner of the replacement property for federal income tax purposes. Because

Although partnership interests are not eligible for Code § 1031 treatment, buying all of the partnership interests at once (and holding them in a disregarded single member LLC) might constitute buying the partnership's underlying property.[1086]

Related party involvement in the exchange might trigger gain recognition.[1087] On the other hand, related party use before the exchange might not necessarily cause problems. In light of nontax considerations involving aircraft, the IRS ruled that a partnership held relinquished aircraft and replacement aircraft "for productive use in a trade or business" under Code § 1031 even though the aircraft, which are leased to a related entity that that is owned by the same individuals who own the partnership, are

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> the Trust represents that it intends to hold the replacement property for investment purposes, the transfer by the Trust of the replacement property to LLC will not violate the holding requirement of § 1031(a).[1]
>
> [1] No ruling is requested on the factual question of whether any specific replacement property is held for a particular purpose.
>
> With respect to your second concern, the Trust represents that it will hold the replacement property for investment purposes until the Trust terminates by its own terms on Date A. Because the Trust is a testamentary trust, the termination date was fixed by Decedent and cannot be modified or changed. As a result, the Trust is not acquiring the replacement property in order to dispose of the property pursuant to a prearranged plan. The Plan of Termination has been approved by the State A probate court and will take effect without regard to whether this exchange of properties is consummated. Consequently, the like-kind exchange in this case is wholly independent from the distribution of the properties under the Plan of Termination. Thus, the facts in this ruling request are distinguishable from those in Rev. Rul. 75-292 and Rev. Rul. 77- 337.
>
> Therefore, based on the facts and representations presented above, we rule that the Trust's termination and distribution of its assets to the beneficiaries will not preclude the replacement property received by the Trust in this exchange from being considered property held either for productive use in a trade or business or investment, within the meaning of § 1031, because this like-kind exchange is independent of the impending termination.

[1086] Letter Ruling 200807005 analyzed Issue 1 as follows:

> Taxpayer will acquire 100 percent of the partners' interests in Partnership. Pursuant to Rev. Rul. 99-6, Partnership is considered to have terminated under § 708(b)(1)(A) and made a liquidating distribution of its real property assets to its partners, and Taxpayer is treated as having acquired such real property assets from the partners for federal tax purposes. Since Taxpayer will acquire 100 percent of the partners' interests in Partnership, Taxpayer is treated as having acquired the real property assets of Partnership rather than as having acquired partnership interests from the partners. Further, this transaction does not constitute an abuse of the type that Congress sought to remedy in the Deficit Reduction Act of 1984, which appears to be aimed at abuses by sellers of partnership interests. We view this transaction as a like-kind exchange under § 1031(a)(1), rather than as an exchange of partnership interests in violation of § 1031(a)(2)(D).
>
> Accordingly, Taxpayer may defer the gain on the sale of Relinquished Property under § 1031 if Taxpayer, through QI, acquires 100 percent of the interests of the partners in Partnership, which owns the Replacement Property.

The ruling then approved acquiring the partnership interests and therefore the replacement property through its wholly owned disregarded LLC.

[1087] Code § 1031(f), which Lipton explains in "Eighth Circuit Sheds Light on Like-Kind Exchanges," *Journal of Taxation* (6/2015).

the partnership's only operating assets and do not generate an economic profit for the partnership.[1088]

A Code § 1031 exchange started before death with a sale can be completed after death with a purchase.[1089] Similarly, a trust's termination after it acquires replacement property might not disqualify the trust on the grounds of not holding the replacement property for

[1088] CCA 201601011, analyzing the situation as follows:

> The facts indicate that the rent P charges O for use of the relinquished property and the replacement property is insufficient for P to make an economic profit on the aircraft rental to O. However, many businesses hold and use properties in a way that, if the use of the property were viewed as an activity, do not and could not generate profit. Nevertheless, the property itself is held for productive use in that business. Thus, P's lack of intent to make an economic profit on the aircraft rental does not establish that the aircraft fails the productive use in a trade or business standard of § 1031. In addition, we agree with the field that A's and B's use of the property for personal purposes is not relevant in determining whether P holds the aircraft for productive use in a trade or business [because O included any personal use in the income of A and B].
>
> Moreover, it is important to point out that businesses, for any number of reasons, opt to hold property, especially aircraft, in a separate entity. In the present case, O, which operates a legitimate business enterprise, requires private aircraft to be available to its senior executives, both for business travel and as an employment perk. However, for business and legal reasons, the aircraft are owned not by O but by P, a related entity. If O owned the aircraft, or was the 100 percent owner of P, we doubt that the field would have raised the issue of whether the aircraft were held for productive use in a trade or business. Were we to disallow § 1031 treatment based on the entity structure presented here, businesses would be forced to structure their transactions in inefficient and potentially risky ways to achieve § 1031 treatment. Thus the entity structure in the present case should not be used as grounds that the aircraft fails to qualify as property held for productive use in a trade or business.
>
> In sum, O operates a legitimate business enterprise and requires private aircraft to be available to its senior executives. For business and legal reasons, O has structured its affairs so that the aircraft are owned through P and leased to O for an amount not intended to generate a profit for P. On these facts, the aircraft are held for productive use in a trade or business.
>
> We are sensitive to two facts raised by the field: P charges below-market rent for the replacement aircraft and A and B, rather than O, own P. While these facts do not disqualify the property from being held for productive use in a trade or business for purposes of § 1031, it may be that other tax provisions such as § 280F or 482 may apply to disallow tax benefits or impose a tax treatment different from the treatment claimed by P, O or A and B.
>
> Finally, our analysis extends only to whether the relinquished and replacement aircraft meet the held for productive use in a trade or business requirement in § 1031(a). We do not express or imply an opinion on whether the exchange met the other requirements under § 1031 to qualify as a like-kind exchange. Nor do we express or imply an opinion regarding other tax aspects of the transaction.

[1089] Letter Ruling 9829025. The letter ruling was extremely favorable, providing a community property basis step-up for both halves of the replacement property. The IRS takes the opposite approach with Code § 1033 condemnation cases, contrary to certain cases. Rev. Rul. 64-161; *Morris v. Commissioner*, 55 T.C. 636 (1971).

investment.[1090] Furthermore, a gift of replacement property might not disqualify the exchange, either.[1091]

[1090] Letter Rulings 8126070 (see fn. 1091 for details) and 200521002, the latter of which reasoned:

> Your submission expresses two concerns regarding the above exchange. Your first concern is that the proposed transfer of the replacement property to LLC would violate the holding requirement of § 1031(a) (i.e., that the replacement property must be held by the taxpayer for productive use in a trade or business or for investment) as applied in Rev. Rul. 75-292 and Rev. Rul. 77-337. Your second concern is that, as a result of the Trust's terminating distribution of membership interests in LLC to multiple beneficiaries, which will then result in a de facto partnership between the beneficiaries for federal income tax purposes, the holding requirement of § 1031(a) as applied in the revenue rulings would be violated with respect to the replacement property.
>
> With respect to your first concern, you represent that the replacement property will be held by the Trust (and LLC) for investment purposes throughout the Trust's existence. You also represent that LLC will not elect to be taxed as a corporation and will remain a single member LLC until at least Date A. Therefore, LLC will be disregarded as an entity separate from the Trust, its sole owner. Consequently, the transfer by the Trust of the replacement property to LLC will also be disregarded, and the Trust will be considered the direct owner of the replacement property for federal income tax purposes. Because the Trust represents that it intends to hold the replacement property for investment purposes, the transfer by the Trust of the replacement property to LLC will not violate the holding requirement of § 1031(a).[1]
>
> > [1] No ruling is requested on the factual question of whether any specific replacement property is held for a particular purpose.
>
> With respect to your second concern, the Trust represents that it will hold the replacement property for investment purposes until the Trust terminates by its own terms on Date A. Because the Trust is a testamentary trust, the termination date was fixed by Decedent and cannot be modified or changed. As a result, the Trust is not acquiring the replacement property in order to dispose of the property pursuant to a prearranged plan. The Plan of Termination has been approved by the State A probate court and will take effect without regard to whether this exchange of properties is consummated. Consequently, the like-kind exchange in this case is wholly independent from the distribution of the properties under the Plan of Termination. Thus, the facts in this ruling request are distinguishable from those in Rev. Rul. 75-292 and Rev. Rul. 77- 337.
>
> Therefore, based on the facts and representations presented above, we rule that the Trust's termination and distribution of its assets to the beneficiaries will not preclude the replacement property received by the Trust in this exchange from being considered property held either for productive use in a trade or business or investment, within the meaning of § 1031, because this like-kind exchange is independent of the impending termination.

[1091] Letter Ruling 8126070, approving a like-kind exchange shortly before a trust terminated, reasoned:

> A recent tax court case, *Wagensen v. Commissioner*, 74 T.C. 653 (1980) pertains in part to an exchange of real property, a ranch, for like kind property subsequently followed by a gift of the newly acquired ranch property to taxpayer's children. The court found the exchange to be one which qualified under section 1031 of the Code. The ranch properties in question were held for use in trade or business or for investment by taxpayer both before and after the exchange.
>
> In the instant case it is represented that the trust will retain legal title to the acquired property, and continue to hold such property for use in trade or business or investment

II.G.16. Economic Substance Penalty and Doctrines

II.G.16.a. What Is the Codified Economic Substance Doctrine

Code § 7701(o) provides that income tax benefits with respect to a transaction (including a series of transactions),[1092] entered into in connection with a trade or business or an activity engaged in for the production of income,[1093] are not allowable if the transaction does not have economic substance or lacks a business purpose.[1094] The discussion below focuses on Code § 7701(o), but common law rules continue to apply as well.[1095]

Amplifying Notice 2010-62, Notice 2014-58[1096] guides us on what a "transaction" is:

> For purposes of determining whether the codified economic substance doctrine applies, " transaction" generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan's steps are aggregated or disaggregated when defining a transaction.

> until the trust terminates as a matter of law on the date the youngest child reaches age 25.
>
> Accordingly, under the facts and circumstances as presented we conclude that the mere fact that the trust will terminate shortly after the exchange will not by itself preclude the property received by the Executor-Trustees in this exchange from being property held either for productive use in trade or business or for investment within the intendment of section 1031(a) of the Code.

1092 Code § 7701(o)(5)(D).

1093 Code § 7701(o)(5)(B).

1094 Code § 7701(o)(5)(A). The legislative history cites *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F.Supp.2d 885 (E.D. Texas 2007), *aff'd* 568 F.3d 537 (5th Cir. 2009); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), vacating and remanding 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *cert. denied*, 127 S.Ct. 1261 (Mem.) (2007). *Klamath* was followed by *Robert E. Smith, III v. Commissioner*, T.C. Memo. 2017-218, which is described in fn. 3694 in part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. An extensive relevant quote from *Coltec* is at fn. 2493, where it was relied upon to disqualify a transaction from Code § 721. See also Lipton, "*Flextronics*, *Sundrup*, and the Application of the Economic Substance Doctrine," *Journal of Taxation* (Mar. 2011), and "In Southgate, Economic Substance, Substance Over Form, and Penalties Are a Dangerous Mix," *Journal of Taxation* (Feb. 2012) (discussing case in which penalties were not applied). For the general rule disallowing losses where economic substance is lacking, see fn. 808. For a ruling that a partnership lacked economic substance that did not mention this penalty, see fn. 3717.

1095 The Joint Committee on Taxation Report on P.L. 111-152 (3/30/2010) said:

> No inference is intended as to the proper application of the economic substance doctrine under present law. The provision is not intended to alter or supplant any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and it is intended the provision be construed as being additive to any such other rule of law.

1096 For analysis of Notice 2014-58, see Lipton, "New Guidance Sheds Light on Economic Substance Doctrine and Related Penalties," *Journal of Taxation* (Dec. 2014).

> Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the " transaction" includes all of the steps taken together – an aggregation approach. This means that every step in the series will be considered when analyzing whether the " transaction" as a whole lacks economic substance. However, when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, an aggregation approach may not be appropriate. In that case, the " transaction" may include only the tax-motivated steps that are not necessary to accomplish the non-tax goals – a disaggregation approach.
>
> Whether the economic substance doctrine is relevant and whether a transaction should be disaggregated will be considered on a case-by-case basis, depending on the facts and circumstances of each individual case. For example, if transfers of multiple assets and liabilities occur and the transfer of a specific asset or assumption of a specific liability was tax-motivated and unnecessary to accomplish a non-tax objective, then the economic substance doctrine may be applied solely to the transfer or assumption of that specific asset or liability. Separable activities may take many forms including, for example, the use of an intermediary employed for tax benefits and whose actions or involvement was unnecessary to accomplish an overarching non-tax objective. These situations are merely examples intended to illustrate the potential application of the disaggregation approach and are not exhaustive or comprehensive.

If this doctrine is relevant, a transaction shall be treated as having economic substance only if the transaction changes in a meaningful way (apart from income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from income tax effects) for entering into such transaction.[1097] Income tax effects include not only federal but also state and local income effects.[1098] Achieving a financial accounting benefit shall be taken into account as a purpose for entering into a transaction not if the origin of such financial accounting benefit is not a reduction of Federal income tax.[1099]

If the taxpayer argues that the transaction has profit potential, the potential profit shall be taken into account only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[1100] If the expected capital loss is virtually certain and the chance of economic benefits is very small, the transaction will not be respected.[1101]

[1097] Code § 7701(o)(1).

[1098] Code § 7701(o)(3). The Treasury Department and the IRS intend to issue regulations pursuant to Code § 7701(o)(2)(B), which directs the issuance of regulations requiring foreign taxes to be treated as expenses in determining pre-tax profit in appropriate cases. In the interim, the enactment of the provision does not restrict the ability of the courts to consider the appropriate treatment of foreign taxes in economic substance cases. Notice 2010-62.

[1099] Code § 7701(o)(4).

[1100] Code § 7701(o)(2)(A).

[1101] *Reddam v. Commissioner*, 113 AFTR.2d 2014-2549 (9th Cir. 6/13/2014). In evaluating the taxpayer's alleged subjective motive, the court noted that the tax shelter promoter, KPMG, recommended obtaining independent counsel to review the very complex transactions, which the

The legislative history carves out some exceptions:[1102]

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taxpayer failed to do, thereby undercutting the taxpayer's alleged profit motive. Objectively evaluating the taxpayer's motive, footnote 10 of the opinion noted an expert report:

> Dr. Miller's report states that only in highly uncommon circumstances would the OPIS transaction make any kind of profit, but that five percent of the time it could make between $3,450,000 and $6,300,000. It defies belief that an objective investor would risk $6,000,000 on a transaction that was designed to lose money at least seventy-five percent of the time, could make a nominal profit twenty percent of the time, but might, only five percent of the time, have generated profits in that range for any reason other than to garner the eight-figure tax loss the transaction was designed to generate.

[1102] Footnotes from this except are:

> [345] The examples are illustrative and not exclusive.
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>
> [346] *See, e.g.*, *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946) (respecting debt characterization in one case and not in the other, based on all the facts and circumstances).
>
> --
>
> [347] *See, e.g.*, *Sam Siegel v. Commissioner*, 45. T.C. 566 (1966), *acq.* 1966-2 C.B. 3. But see *Commissioner v. Bollinger*, 485 U.S. 340 (1988) (agency principles applied to title-holding corporation under the facts and circumstances).
>
> --
>
> [348] *See, e.g.*, 2010-1 I.R.B. 110, Secs. 3.01(38), (39),(40,) and (42) (IRS will not rule on certain matters relating to incorporations or reorganizations unless there is a "significant issue"); compare *Gregory v. Helvering*, 293 U.S. 465 (1935).
>
> --
>
> [349] *See, e.g., National Carbide v. Commissioner*, 336 U.S. 422 (1949), *Moline Properties v. Commissioner*, 319 U.S. 435 (1943); *compare, e.g. Aiken Industries, Inc. v. Commissioner*, 56 T.C. 925 (1971), *acq.*, 1972-2 C.B. 1; *Commissioner v. Bollinger*, 485 U.S. 340 (1988); *see also* sec. 7701(l).
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> [350] *See, e.g., Frank Lyon Co. v. Commissioner*, 435 U.S. 561 (1978); *Hilton v. Commissioner*, 74 T.C. 305, *aff'd*, 671 F.2d 316 (9th Cir. 1982), *cert. denied*, 459 U.S. 907 (1982); *Coltec Industries v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied*, 127 S. Ct. 1261 (Mem) (2007); *BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007), *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Wells Fargo & Company v. United States*, No. 06-628T, 2010 WL 94544, at *60 (Fed. Cl. Jan. 8, 2010) (distinguishing leasing case *Consolidated Edison Company of New York*, No. 06-305T, 2009 WL 3418533 (Fed. Cl. Oct. 21, 2009) by observing that "considerations of economic substance are factually specific to the transaction involved").
>
> --
>
> [351] As examples of cases in which courts have found that a transaction does not meet the requirements for the treatment claimed by the taxpayer under the Code, or does not have economic substance, *see e.g., BB&T Corporation v. United States*, 2007-1 USTC P 50,130 (M.D.N.C. 2007) *aff'd*, 523 F.3d 461 (4th Cir. 2008); *Tribune Company and Subsidiaries v. Commissioner*, 125 T.C. 110 (2005); *H.J. Heinz Company and Subsidiaries v. United States*, 76 Fed. Cl. 570 (2007); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), *cert. denied* 127 S.Ct. 1261 (Mem.) (2007); *Long Term Capital Holdings LP v. United States*, 330 F.Supp.2d 122 (D. Conn. 2004), *aff'd*, 150 Fed. Appx. 40 (2d Cir. 2005); *Klamath Strategic Investment Fund, LLC v. United States*, 472 F.Supp.2d 885 (E.D. Texas 2007); *aff'd*, 568 F.3d 537 (5th Cir. 2009); *Santa Monica Pictures LLC v. Commissioner*, 89 T.C.M. 1157 (2005).

> If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. sec. 1.269-2, stating that characteristic of circumstances in which an amount otherwise constituting a deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), section 45 (production tax credit), section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.
>
> The provision is not intended to alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice are respected, merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages. Among [345] these basic transactions are (1) the choice between capitalizing a business enterprise with debt or equity;[346] (2) a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment;[347] (3) the choice to enter a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C;[348] and (4) the choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.[349] Leasing transactions, like all other types of transactions, will continue to be analyzed in light of all the facts and circumstances.[350] As under present law, whether a particular transaction meets the requirements for specific treatment under any of these provisions is a question of facts and circumstances. Also, the fact that a transaction meets the requirements for specific treatment under any provision of the Code is not determinative of whether a transaction or series of transactions of which it is a part has economic substance.[351]

The Treasury Department and the IRS do not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine either applies or does not apply.[1103] The IRS will not issue a letter ruling regarding whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of Code § 7701(o).[1104] However, the IRS has issued guidance to examiners, including:[1105]

> The following facts and circumstances tend to show that application of the economic substance doctrine to a transaction is likely not appropriate.…

[1103] Notice 2010-62.
[1104] Notice 2010-62.
[1105] "Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties," LB&I Control No. LB&I-4-0711-015 (7/15/2011, identifying as impacted IRM 20.1.1, 20.1.5). The Guidance was applied in CCA 201515020.

- Transaction is not promoted/developed/administered by tax department or outside advisors

- Transaction is not highly structured

- Transaction contains no unnecessary steps

- Transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives

- Transaction is at arm's length with unrelated third parties

- Transaction creates a meaningful economic change on a present value basis (pretax)

- Taxpayer's potential for gain or loss is not artificially limited

- Transaction does not accelerate a loss or duplicate a deduction

- Transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)

- Taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction

- Transaction does not involve a tax-indifferent counterparty that recognizes substantial income

- Transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years

- Transaction has credible business purpose apart from federal tax benefits

- Transaction has meaningful potential for profit apart from tax benefits

- Transaction has significant risk of loss

- Tax benefit is not artificially generated by the transaction

- Transaction is not pre-packaged

- Transaction is not outside the taxpayer's ordinary business operations.

In addition, it is likely not appropriate to raise the economic substance doctrine if the transaction being considered is related to the following circumstances.

- The choice between capitalizing a business enterprise with debt or equity

- A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment

- The choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C

- The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

….

The following facts and circumstances tend to show that application of the economic substance doctrine may be appropriate.

- Transaction is promoted/developed/administered by tax department or outside advisors

- Transaction is highly structured

- Transaction includes unnecessary steps

- Transaction is not at arm's length with unrelated third parties

- Transaction creates no meaningful economic change on a present value basis (pretax)

- Taxpayer's potential for gain or loss is artificially limited

- Transaction accelerates a loss or duplicates a deduction

- Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)

- Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction

- Transaction involves a tax-indifferent counterparty that recognizes substantial income

- Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years

- Transaction has no credible business purpose apart from federal tax benefits

- Transaction has no meaningful potential for profit apart from tax benefits

- Transaction has no significant risk of loss

- Tax benefit is artificially generated by the transaction

- Transaction is pre-packaged

- Transaction is outside the taxpayer's ordinary business operations.

If, after considering all of the above, the examiner wishes to pursue the case, the examiner needs to consider:

1. Is the transaction a statutory or regulatory election? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

2. Is the transaction subject to a detailed statutory or regulatory scheme? If so, and the transaction complies with this scheme, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

3. Does precedent exist (judicial or administrative) that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to the doctrine when considering the transaction? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

4. Does the transaction involve tax credits (e.g., low income housing credit, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

5. Does another judicial doctrine (e.g., substance over form or step transaction) more appropriately address the noncompliance that is being examined? If so, those doctrines should be applied and not the economic substance doctrine. To determine whether another judicial doctrine is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

6. Does recharacterizing a transaction (e.g., recharacterizing debt as equity, recharacterizing someone as an agent of another, recharacterizing a partnership interest as another kind of interest, or recharacterizing a collection of financial products as another kind of interest) more appropriately address the noncompliance that is being examined? If so, recharacterization should be applied and not the economic substance doctrine. To determine whether recharacterization is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

7. In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

….

> This LB&I Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.

Although we cannot rely on this guidance to examiners, many tax advisors have difficulty providing assurances to clients on this issue, so having some insight into the IRS' views, even if nonbinding views, can help tax advisors evaluate a situation.[1106]

The examiner is also directed to coordinate with Counsel.[1107] Finally, any proposal to impose a penalty regarding this doctrine at the examination level must be reviewed and approved by the appropriate Director of Field Operations before the penalty is proposed.[1108]

Notice 2014-58 discusses whether the doctrine will apply when:

> a rule or doctrine … disallows the tax benefits under subtitle A of the Code related to a transaction because:
>
> (1) the transaction does not change a taxpayer's economic position in a meaningful way (apart from Federal income tax effects); or
>
> (2) the taxpayer did not have a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

Notice 2014-58 views such a transaction as a "similar rule of law." It concludes:

> The IRS will not apply a penalty under section 6662(b)(6) (or otherwise argue that a transaction is described in section 6662(b)(6)) unless it also raises section 7701(o) to support the underlying adjustments. If the IRS does not raise section 7701(o) to disallow the claimed tax benefits and instead relies upon other judicial doctrines (e.g., the substance over form or step transaction doctrines) to support the underlying adjustments, the IRS will not apply a section 6662(b)(6) penalty (or otherwise argue that a transaction is described in section 6662(b)(6)) because the IRS will not treat the transaction as failing to meet the requirements of a similar rule of law. Code sections and Treasury regulations, other than section 7701(o) and the regulations under that section, that disallow tax benefits are not similar rules of law for purposes of section 6662(b)(6).

1106 I am not suggesting considering audit risk in determining what the law is. We need to advise our clients on what the law is without considering risk of detection, and audit risk is a separate business issue about which clients ask so that they can weigh the economic advantages or disadvantages of taking various positions. If a client refuses to take a position consistent with the law, one should consult applicable professional and regulatory ethics requirements, particularly if the item is material.

1107 CC-2012-008 (4/3/2012). This directive also provides that the common law economic substance doctrine and codified economic substance doctrine and related penalties require National Office review before briefs or motions are filed with the Tax Court and defense or suit letters are sent to the Department of Justice.

1108 IDD 20140203 (2/3/2014), affecting IRM §§ 20.1.1 and 20.1.5.

II.G.16.b. Penalty For Violating Statutory Economic Substance Doctrine

For transactions entered into after March 30, 2010:[1109] Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirements of any similar rule of law is subject to a 20% penalty.[1110] If the relevant facts affecting the tax treatment are not adequately disclosed[1111] in the return or in a statement attached to the return, then the penalty doubles to 40%.[1112] Although reasonable cause generally is a defense to negligence and other penalties, it is not a defense to this 20% or 40% penalty.[1113]

II.G.16.c. Economic Substance, Sham Transaction, Business Purpose, and Substance Over Form Doctrines

In explaining how *Gregory v. Helvering*[1114] "spawned the economic substance, sham transaction, business purpose, and substance over form doctrines," the Tax Court reasoned:[1115]

> *Gregory*, like much of the caselaw using the economic substance, sham transaction, and other judicial doctrines in interpreting and applying tax statutes, represents an effort to reconcile two competing policy goals. On one hand,

[1109] P.L. 111-152 at §1409(e).

[1110] Code § 6662(b)(6).

[1111] The IRS annually updates what constitutes adequate disclosures for each year's tax returns. See Rev. Proc. 2016-13.

[1112] Code § 6662(i). Notice 2010-62 provides:

> Unless the transaction is a reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), the adequate disclosure requirements of section 6662(i) will be satisfied if a taxpayer adequately discloses on a timely filed original return (determined with regard to extensions) or a qualified amended return (as defined under Treas. Reg. § 1.6664-2(c)(3)) the relevant facts affecting the tax treatment of the transaction. If a disclosure would be considered adequate for purposes of section 6662(d)(2)(B) (without regard to section 6662(d)(2)(C)) prior to the enactment of section 1409 of the Act, then it will be deemed to be adequate for purposes of section 6662(i). The disclosure will be considered adequate only if it is made on a Form 8275 or 8275-R, or as otherwise prescribed in forms, publications, or other guidance subsequently published by the IRS consistent with the instructions and other guidance associated with those subsequent forms, publications, or other guidance. Disclosures made consistent with the terms of Rev. Proc. 94-69 also will be taken into account for purposes of section 6662(i). If a transaction lacking economic substance is a reportable transaction, as defined in Treas. Reg. § 1.6011-4(b), the adequate disclosure requirement under section 6662(i)(2) will be satisfied only if the taxpayer meets the disclosure requirements described earlier in this paragraph and the disclosure requirements under the section 6011 regulations. Similarly, a taxpayer will not meet the disclosure requirements for a reportable transaction under the section 6011 regulations by only attaching Form 8275 or 8275-R to an original or qualified amended return.

[1113] Code § 6664(c)(2). The reasonable cause exception also does not apply to reportable transaction understatements that are subject to this doctrine. Code § 6664(d)(2).

[1114] 293 U.S. 465 (1935).

[1115] *CNT Investors, LLC v. Commissioner*, 144 T.C. No. 11 (2015). The case acknowledged codification of the economic substance doctrine as being a positive step in the development of the doctrines. The transaction at hand preceded the codification. However, the codification would have applied only to penalty issues, as the Tax Court viewed the economic substance doctrine as a mere subset of the larger equitable principles it applied to this case.

having clear, concrete rules embodied in a written Code and regulations that exclusively define a taxpayer's obligations (1) facilitates smooth operation of our voluntary compliance system, (2) helps to render that system transparent and administrable, and (3) furthers the free market economy by permitting taxpayers to know in advance the tax consequences of their transactions. On the other side of the scales, the Code's and the regulations' fiendish complexity necessarily creates space for attempts to achieve tax results that Congress and the Treasury plainly never contemplated, while nevertheless complying strictly with the letter of the rules, at the expense of the fisc (and other taxpayers).

In *Gregory*, the Court confronted such an extreme result and, on the basis of equitable principles, interpreted and applied the relevant statute so as to subject Mrs. Gregory's transaction to tax. Likewise, the various other judicial doctrines applied in tax cases all represent efforts to rein in activity that, while within the technical letter of the rules, deeply offends their spirit.[40] Attempts to parse and define the doctrines merely intellectualize what is, ultimately, an equitable exercise. Those who favor transparency might prefer a strictly circumscribed taxonomy of judicial doctrines, to include exclusive definitions of the circumstances in which they should be applied. Those who favor administrability, protection of the fisc, and respect for congressional purpose might prefer that courts exercise carte blanche in disallowing results of transactions perceived as abusive. *Gregory* and its progeny represent an ongoing effort to reconcile these opposing principles and methodologies. Litigants and courts employ specialized terminology to make this effort appear more rigorous, but candidly, underneath, we are simply engaged in the difficult, commonsense task of judging.

[40] Such efforts lie squarely within the courts' role in interpreting the law in ways consistent with congressional intent. "[C]ourts in the interpretation of a statute have some scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results, *** or would thwart the obvious purpose of the statute[.]" *Helvering v. Hammel*, 311 U.S. 504, 510-511 (1941).

If one engages in a series of transactions designed to offset the tax consequences of the last transaction, the Tax Court held that the invalidity of the initial transactions does not give rise to an argument that the last transaction should be overlooked for tax purposes:[1116]

Neither the sham transaction doctrine nor the step transaction doctrine nor the two combined requires us to disregard the income-producing event along with the shelter transaction designed to offset it. Such an interpretation would render the doctrines toothless and yield absurd results…..

Here, the gain-producing transaction and the shelter transaction occurred pursuant to a plan, and the shelter transaction arguably preceded realization of the gains it was designed to shield. But if we were to disregard the gain-producing transaction along with the shelter transaction, we would encourage taxpayers to hedge against the audit lottery by structuring their tax shelter

[1116] *CNT Investors, LLC v. Commissioner*, 144 T.C. No. 11 (2015).

> transactions to precede and intertwine with their income-producing activities. We will not do so. "[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not". *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974).

If a loan has economic substance and is properly characterized as a loan, an IRS challenge that the interest "lacked economic substance because it was overpriced" would not succeed even if the loan's motive was to avoid taxes.[1117]

II.G.17. Intellectual Property and Other Intangible Assets

II.G.17.a. Taxation of Intellectual Property Generally

One might consult a good primer on income tax planning for intellectual property generally[1118] or for universities.[1119]

Whether the costs of acquiring computer software are deductible currently or capitalized depends on whether they are self-created or purchased.[1120]

II.G.17.b. Sale or Exchange of Intellectual Property - Capital Gain vs. Ordinary Income

Generally, one needs to transfer all of one's rights to an intangible asset to obtain capital gain treatment. A transfer of only some rights tends to be treated as a license, somewhat akin to renting rather than selling property.

In an informal internal memo, the IRS advised that the transfer of certain fishing rights did not a sale or exchange of a capital asset but rather constituted ordinary income.[1121]

The IRS reasoned that the transfer merely provided the use of an asset for a limited time, with limited rights. The IRS stated:

> As discussed above, Taxpayer only transferred the right to fish in the Area on a yearly basis. What was transferred was a time-limited interest carved out from Taxpayer's allocation rights, the remainder of which it retained. Over time, appreciation in the value of the allocation rights, including the catch history,

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[1117] *The Bank of New York Mellon Corporation v. Commissioner*, 801 F.3d 104 (2nd Cir. 2015); the IRS unsuccessfully attacked an interest deduction in another tax shelter case it otherwise won - *Ad Investment 2000 Fund LLC v. Commissioner*, T.C. Memo. 2015-223, which the Tax Court reconsidered and reaffirmed in T.C. Memo. 2016-226.

[1118] See Postlewaite, Cameron & Kittle-Kamp: *Federal Income Taxation of Intellectual Properties & Intangible Assets* (WG&L). Postlewaite authors a treatise on partnership income taxation. See also Hodges & Fowler, "Tax Considerations of Acquiring Intellectual Property," *Journal of Taxation* (Oct. 2014); the authors summarized key points of that article in "Tax Considerations of Acquiring Intellectual Property," *Federal Taxes Weekly Alert Newsletter* (1/22/2015 – Vol. 61, No. 4)

[1119] Mancino and Lion, "Monetizing Colleges' And Universities' Intellectual Property," *Taxation of Exempts* (WG&L) (May/June 2015).

[1120] Rev. Proc. 2000–50, modified by Rev. Proc. 2004-11.

[1121] CCA 2011440230.

> accrued to Taxpayer, not Transferee or other temporary users. As stated in *Gillette*, the term capital asset should be construed narrowly. What Taxpayer transferred was less than the whole directed allocation right stemming from the Act, Vessel's catch history, and the cooperative agreements. "[T]he right to use is not a capital asset, but simply an incident of the underlying... property, the recompense for which is commonly regarded as rent."[1122]

However, depending on its terms, the terms of related agreements, and other factors, a license or sublicense agreement might constitute a transfer of substantially all rights in the subject property that might make the transaction eligible for capital gain treatment.[1123]

II.G.17.c. Patents

As with other intangible assets described above, whether the disposition of a patent is taxed as ordinary income or capital gain can be a challenging issue.

Statutory capital gain treatment applies if the seller is either (1) any individual whose efforts created such property, or (2) another individual who has acquired his or her interest in such property in exchange for consideration in money or money's worth paid to such creator before actual reduction to practice of the invention covered by the patent.[1124] However, the latter cannot be the employer of such creator or related[1125] to such creator. Thus, this treatment is best suited for someone who creates an invention

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[1122] Citing *Commissioner v. Gillette Motor Transport Co.*, 364 U.S. 130, 135 (1960) (compensation for temporary seizure of business facilities is ordinary income).

[1123] *Mylan, Inc. v. Commissioner*, T.C. Memo. 2016-45, reconciling *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), *vacating and remanding* 44 T.C. 549 (1965), with *Merck & Co. v. Smith*, 261 F.2d 162 (3d Cir. 1958), and *E.I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052 (3d Cir. 1970). The Tax Court described the latter two cases:

> … the Court of Appeals held that the transfer of all substantial rights in a patent can result in a disposition for tax purposes qualifying the transferor for capital gains tax treatment while a transfer of anything less is called a license, with proceeds taxed at ordinary income tax rates. In both cases the Court of Appeals examined not only the terms of the contracts but also the intent of the parties and found that all substantial rights were transferred.
>
> ….
>
> In *Danielson*, a taxpayer sought to change the tax consequences of a transaction by challenging the validity of the underlying contract's terms, specifically, allocation of consideration between the sale of stock and the covenant not to compete, because the taxpayer believed these terms did not reflect the agreement of the parties. In *Merck* and *E.I. du Pont de Nemours* the taxpayers did not seek to alter or challenge the agreements in question. Instead, the taxpayers disagreed with the Commissioner's interpretation of those contracts and characterization of the related payments for tax purposes…. The question presented here is a question of proper tax characterization of the proceeds of valid and enforceable contracts, and we are mindful that the Commissioner and taxpayers often disagree on this issue.[4]
>
> [4] To draw a parallel to taxation of real property transactions, we are dealing with the issue similar to whether the agreements as drafted represent a sublease or a lease assignment. See, *e.g.*, *Rochester Dev. Corp. v. Commissioner*, T.C. Memo. 1977-307 (holding that a lease in form was actually a sale for income tax purposes).

[1124] Code § 1235(b).

[1125] As defined in Code § 1235(d).

on his or her own and then transfers it to an entity that then reduces the invention to practice.

For the holder to obtain capital treatment under Code § 1235, the holder must transfer "all substantial rights" to the patent.[1126] "The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction."[1127] Retaining "a right to terminate the transfer at will" means that the transferor has not transferred "all substantial rights."[1128] The courts extend this rule to prevent the transferor from retaining control over the transferee, even if that control is not based on legal rights and does not fall within the level of control prohibited by Code § 1235(d).[1129] Code § 1235 capital gain treatment applied to termination payments

[1126] Code § 1235(a).

[1127] Reg. § 1.1235-2(b)(1).

[1128] Reg. § 1.1235-2(b)(4).

[1129] *Cooper v. Commissioner*, 143 T.C. No. 10 (2014), finding that, although the taxpayer held a minority position in the transferee's stock and the other shareholders were not statutorily related parties to him, he controlled the transferee. The taxpayers cited *Lee v. United States*, 302 F.Supp. 945 (E.D. Wis. 1969), and *Charlson v. United States*, 525 F.2d 1046, 1053 (Ct. Cl. 1975). Although the latter held for the taxpayer, *Cooper* followed its standards and held for the IRS:

> By contrast, TLC did not exercise its rights in the subject patents according to its own discretion. Both *Lee* and *Charlson* are distinguishable because the taxpayers in those cases did not control the transferee corporations. Here, Mr. Cooper—troubled by his deteriorated business relationship with Mr. Leckrone—formed TLC with individuals he could trust and ultimately control. Ms. Coulter and Ms. Walters—the shareholders and directors of TLC (along with Ms. Cooper)—did not have the patent, engineering, or other such skills to make them particularly valuable to a small patent licensing company. Instead, they were individuals whom Mr. Cooper could trust to follow his direction on patent licensing issues. Indeed, Ms. Coulter testified that the technical negotiations regarding licensing and patent infringement were over her head and she deferred to Mr. Cooper on such issues. She further testified that she signed licensing and infringement agreements when directed to do so by TLC's attorneys and signed checks and transferred funds when directed to do so by TLC's accountants.
>
> As officers and directors of TLC, Ms. Coulter and Ms. Walters took numerous actions that are inconsistent with acting independently and in the best interest of the corporation. Among other things, Ms. Coulter and Ms. Walters approved TLC's transfer of potentially valuable patents to Mr. Cooper for no consideration. At least in one instance, Mr. Cooper almost immediately licensed one of these patents to another related corporation for which that corporation received a royalty of $120,000 in 2007. As shareholders Ms. Coulter and Ms. Walters signed a stock restriction agreement placing restrictions on their ability to transfer shares of stock in TLC to anyone other than petitioners, without receiving any consideration in exchange. The stock restriction agreement did not place similar restrictions on petitioners.
>
> Indeed, it is unclear what material decisions, if any, the officers and directors of TLC made independent of Mr. Cooper. [footnote omitted] Mr. Cooper—and not the officers or directors of TLC—provided technical assistance to the Niro firm in interpreting the subject patents and relevant technology and in formulating patent enforcement strategies. Mr. Cooper conducted all technical matters for TLC—which in substance was all or a large part of TLC's activities. Furthermore, in his role as general manager of TLC and under the terms of the letter agreement, Mr. Cooper made all material decisions for TLC with respect to the IP Innovation assignment agreement and the New Medium and AV Technologies agreements.

under which the seller sold all substantial rights to a patent and the buyer agreed to pay the seller based on the sales of a product; when the buyer was acquired by another party, the buyer paid the seller the termination payment in question.[1130]

Although a partnership cannot qualify for this treatment, each member of a partnership who is an individual may qualify as to his or her share of a patent owned by the partnership.[1131] If a qualified individual contributes the patent to a partnership after actual reduction to practice of the invention, the individual retains his or her eligibility for capital gain treatment under this provision as to the individual's share of gain on the partnership's disposition of the patent.[1132]

II.G.18. IRS Audits

Generally, the tax return of the taxpayer from whom the IRS tries to collect tax is the one upon which running the statute of limitations is based.[1133]

> We do not find credible any testimony by petitioners that TLC was an independent corporation that Mr. Cooper did not control. We conclude that petitioners have failed to meet their burden of establishing that they transferred all substantial rights in the subject patents to TLC pursuant to section 1235(a).

1130 Letter Ruling 201701009.

1131 Reg. § 1.1235-2(d)(2).

1132 Letter Ruling 200135015.

1133 *Lardas v. Commissioner*, 99 T.C. 490 (1992) (reviewed decision, with only one judge dissenting), holding:

> We have held that the relevant return for determining whether, at the time a deficiency notice was issued, the period for assessment had expired under section 6501(a) "is that of petitioner against whom respondent has determined a deficiency". *Fehlhaber v. Commissioner*, 94 T.C. 863, 868 (1990) (Court reviewed), *affd.* 954 F.2d 653 (11th Cir. 1992). We have maintained that position consistently, without regard to the nature of the source entity involved. See *id.*, *Bufferd v. Commissioner*, T.C. Memo. 1991-170, *affd.* 952 F.2d 675 (2d Cir. 1992), *cert. granted* 505 U.S. __, 112 S.Ct. 2990 (1992), and *Kelley v. Commissioner*, T.C. Memo. 1986-405, *revd. and remanded* 877 F.2d 756 (9th Cir. 1989) (subchapter S corporations); *Siben v. Commissioner*, T.C. Memo. 1990-435, *affd.* 930 F.2d 1034 (2d Cir. 1991) (partnerships); *Stahl v. Commissioner*, T.C. Memo. 1990-320 and 96 T.C. 798 (1991), and *Fendell v. Commissioner*, 92 T.C. 708 (1989), *revd.* 906 F.2d 362 (8th Cir. 1990) (complex trust); *Bartol v. Commissioner*, T.C. Memo. 1992-141 (grantor trust).
>
> Recently, we reaffirmed our view that " 'the relevant return for purposes of determining the statute of limitations is the return of the taxpayer against whom the tax is sought.'" *Bartol v. Commissioner*, *supra* (quoting *Bufferd v. Commissioner*, 952 F.2d 675, 678 (2d Cir. 1992), *affg.* T.C. Memo. 1991-170, *cert. granted* 505 U.S. __, 112 S.Ct. 2990 (1992)). After consideration, we continue to hold that view.[5]
>
> 5 We have set forth our reasoning on more than one occasion, see, *e.g.*, *Fehlhaber v. Commissioner*, 94 T.C. 863 (1990) (Court reviewed), *affd.* 954 F.2d 653 (11th Cir. 1992), and we need not repeat it here.

The Supreme Court unanimously affirmed *Bufferd*. See fn. 1136.

See also part III.B.2.f Triggering the Statute of Limitations for Grantor Trusts, which includes a reference to nongrantor trusts.

II.G.18.a. Audits of Large C Corporation Returns

Business entities that have formal financial statements are required to account for uncertain tax positions that might materially affect their financial position.

The IRS will require certain corporations[1134] with both uncertain tax positions and assets equal to or exceeding $10 million to file with their tax returns Schedule UTP, reporting uncertain tax positions, if they or a related party issued audited financial statements on their tax returns.[1135]

II.G.18.b. Audits of S Corporation Returns

The statute of limitations for auditing an S corporation's items runs when the statute of limitations runs for each affected shareholder.[1136]

An S corporation shareholder's return must treat a subchapter S item[1137] in a manner which is consistent with the treatment of such item on the corporate return,[1138] unless the shareholder appropriately notifies the IRS of the inconsistent treatment.[1139] Failure to

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[1134] This would apply to corporations filing the following returns to file Schedule UTP: Form 1120, U.S. Corporation Income Tax Return; Form 1120L, U.S. Life Insurance Company Income Tax Return; Form 1120 PC, U.S. Property and Casualty Insurance Company Income Tax Return; and Form 1120F, U.S. Income Tax Return of a Foreign Corporation. Schedule UTP would not be required from any other Form 1120 series filers, pass-through entities, or tax-exempt organizations in 2010 tax years. Thus, S corporations and partnerships would be exempt.

[1135] REG-119046-10, issued 9/7/2010, proposing to add paragraphs (4) and (5) to Reg. § 1.6012-2(a).

[1136] *Bufferd v. Commissioner*, 506 U.S. 523, 71 A.F.T.R.2d 93-573 (1993) (unanimous decision). *Whitesell v. Commissioner*, T.C. Memo. 2017-84, reiterated that position, holding:

> After *Bufferd* was released, Congress enacted the Taxpayer Relief Act of 1997, Pub. L. 105-34, sec. 1284, 111 Stat. at 1038, which in part amended section 6501(a). One of its specifically intended purposes was to clarify this issue with respect to S corporations. See *Robinson v. Commissioner*, 117 T.C. at 317 (and legislative history cited thereat). The legislative history explains that the new provision is intended to clarify that the return that starts the running of the period of limitations on assessment for a taxpayer is the return of the taxpayer and not the return of another "person"[8] from whom the taxpayer has received an item of income, gain, loss, deduction, or credit. See H.R. Rept. No. 105-148, at 609-610 (1997), 1997-4 C.B. (Vol. 1) 323, 931-932; S. Rept. No. 105-33, at 277-278 (1997), 1997-4 C.B. (Vol. 2) 1067, 1357-1358; H.R. Conf. Rept. No. 105-220, at 702-703 (1997), 1997-4 C.B. (Vol. 2) 1457, 2172-2173; see also *Robinson v. Commissioner*, 117 T.C. at 317. Therefore, the controlling return for each period of limitation for assessment in this case is petitioners' respective Form 1040 — not the corresponding Forms 1120S of the related S corporations.
>
> [8] Sec. 7701(a)(1) defines "person" to mean and include "an individual, a trust, estate, partnership, association, company or corporation."

[1137] "Subchapter S item" means any item of an S corporation to the extent that regulations provide that the item is more appropriately determined at the corporation level than at the shareholder level. Code § 6037(c)(4).

[1138] Code § 6037(c)(1).

[1139] Code § 6037(c)(2). *Rubin v. U.S.*, 118 A.F.T.R.2d 2016-6235 (C.D. CA 10/14/2016), noted, "The IRS created Form 8082 to be used to notify the IRS of inconsistencies under this section. IRM 20.1.5.2.5 (Jan. 24, 2012)." The court did not address whether Form 8082 is the exclusive way to notify the IRS, although it did note other areas in which courts addressed whether follow this rule is treated a mathematical or clerical errors assessed under Code § 6213(b)(1)[1140] and may subject the taxpayer to penalties.[1141]

Because adjustments made on the S corporation's return generally[1142] have an impact only on its shareholders, when making adjustments examiners need to consider materiality when adjusting each shareholder's return.[1143]

II.G.18.c. Audits of Partnership Returns

If one holds an interest in a publicly traded partnership with nominal income and K-1s that are always issued way too late, consider reporting a good-faith estimate of income and filing Form 8082.[1144]

Part II.G.18.c.i Overview of Rules Before and After TEFRA Repeal introduces the partnership audit rules, and the rest of this part II.G.18.c discusses the rules effective for returns filed for partnership taxable years beginning after December 31, 2017.

II.G.18.c.i. Overview of Rules Before and After TEFRA Repeal

The statute of limitations for auditing a partnership's items runs when the statute of limitations runs for the partnership's return.[1145] P.L. 114-74, § 1101, deleted this rule, effective for returns filed for partnership taxable years beginning after December 31, 2017; in that case, subject to certain circumstances extending the statute of limitations,[1146] the statute of limitations runs three years after the latest of:[1147]

Form 8082 is required. See https://www.irs.gov/uac/form-8082-notice-of-inconsistent-treatment-or-administrative-adjustment-request-aar.

1140 Code § 6037(c)(3).

1141 Code § 6037(c)(5).

1142 Exception generally are in part II.P.3.c Conversion from C Corporation to S corporation.

1143 Internal Revenue Manual paragraph 4.22.7.2.2.

1144 See https://www.irs.gov/uac/form-8082-notice-of-inconsistent-treatment-or-administrative-adjustment-request-aar.

1145 Code § 6229; *Summit Vineyard Holdings v. Commissioner*, T.C. Memo. 2015-140.
Under the TEFRA rules that are being repealed, an entity that is disregarded for federal tax purposes, but under state law is a general partner of a partnership subject to the TEFRA partnership provisions, may be designated the tax matters partner of the partnership. Rev. Rul. 2004-88, which was cited as recently as footnote 21 of *436, LTD v Commissioner*, T.C. Memo. 2015-28, and expressly upheld by *Seaview Trading, LLC v. Commissioner*, 119 A.F.T.R.2d 2017-2097 (9th Cir. 6/7/2017). I have not researched how TEFRA's repeal might affect this rule.

1146 Code § 6235(a)(2) and (3) provide:

> (2) in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days (plus the number of days of any extension consented to by the Secretary under paragraph (7) thereof) after the date on which everything required to be submitted to the Secretary pursuant to such section is so submitted, or
>
> (3) in the case of any notice of a proposed partnership adjustment under section 6231(a)(2), the date that is 330 days (plus the number of days of any extension consented to by the Secretary under section 6225(c)(7) after the date of such notice.

1147 Code § 6235(a)(1). Code § 6235(b) authorizes the IRS and partnership to agree to extend the statute of limitations.

(A) the date on which the partnership return for such taxable year was filed,

(B) the return due date for the taxable year, or

(C) the date on which the partnership filed an administrative adjustment request with respect to such year under section 6227.

Of course, the statute of limitations never runs for "a false or fraudulent partnership return with intent to evade tax"[1148] (or if a return is never filed)[1149] and is extended from three to six years for a substantial omission of income.[1150]

For later returns (or earlier if the partnership elects into the regime),[1151] Code § 6221 makes audit adjustments at the partnership level, subject to rules allowing certain partnerships with 100 or fewer partners to opt out.[1152] The rule making audit adjustments at the partnership level has the following effects:

- Partner-level defenses would not apply.

[1148] Code § 6235(c)(1).

[1149] Code § 6235(c)(3).

[1150] Code § 6235(c)(2), referring to Code § 6501(e)(1)(A).

[1151] P.L. 114-74, § 1101(g)(4) provides:

> A partnership may elect (at such time and in such form and manner as the Secretary of the Treasury may prescribe) for the amendments made by this section (other than the election under section 6221(b) of such Code (as added by this Act)) to apply to any return of the partnership filed for partnership taxable years beginning after the date of the enactment of this Act and before January 1, 2018.

Reg. § 301.9100-22T(e) authorizes partnerships to opt into the new regime for partnership taxable years beginning after November 2, 2015 and before January 1, 2018.. Generally, such an election must be made within 30 days of the date of notification to a partnership, in writing, that a return of the partnership for an eligible taxable year has been selected for examination (a notice of selection for examination). Reg. § 301.9100-22T(b)(1). However, a partnership that has not been issued such a notice of selection for examination may make an election with respect to a partnership return for an eligible taxable year for the purpose of filing an administrative adjustment request under new Code § 6227. Reg. § 301.9100-22T(c)(1). Reg. § 301.9100-22T is scheduled to expire on August 5, 2019. Reg. § 301.9100-22T(f). For more on Reg. § 301.9100-22T, see T.D. 9780 (8/4/2016).

[1152] Partnerships with partners that are partnerships or nongrantor trusts cannot opt out, unless regulations under Code § §6221(b)(2)(C) allow them to be eligible partners (and the "blue book" contemplates some leniency here). Code § 6221(b)(1) allows opting out if:

(A) the partnership elects the application of this subsection for such taxable year,

(B) for such taxable year the partnership is required to furnish 100 or fewer statements under section 6031(b) with respect to its partners,

(C) each of the partners of such partnership is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner,

(D) the election-

(i) is made with a timely filed return for such taxable year, and

(ii) includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each partner of such partnership, and

(E) the partnership notifies each such partner of such election in the manner prescribed by the Secretary.

- The highest rate in effect under Code § 1 or 11 would apply.[1153] However, if any portion of income would be taxed at a lower rate because the taxpayer is a C corporation[1154] or because the income is a capital gain or qualified dividend allocable to an individual (directly or through an S corporation).[1155] Note the absence of any reference to the 3.8% tax on net investment income (NII);[1156] thus, adjustments under this provision would not be subject to NII tax (or self-employment tax).[1157] However, a partnership may opt out of this payment regime, in which case the partners will be required to file amended returns.[1158] Furthermore, a partner's

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[1153] Code § 6225(b)(1)(A).

[1154] Code § 6225(c)(4)(A)(i).

[1155] Code § 6225(c)(4)(A)(ii).

[1156] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[1157] The Preamble to the Proposed Regulations [REG-136118-15] (6/14/2017) provides:

> Proposed § 301.6221(a)-1(b)(3) defines the term "tax" for purposes of § 301.6221(a)-1 to mean tax imposed by chapter 1 of subtitle A of the Code. Accordingly, for purposes of assessment and collection at the partnership level, taxes imposed by other chapters of the Code are not included in the term "tax." Those taxes that are not covered by the centralized partnership audit regime include taxes imposed by chapter 2 (Tax on Self-Employment Income), chapter 2A (Unearned Income Medicare Contribution), chapter 3 (Withholding of Tax on Nonresident Aliens and Foreign Corporations), chapter 4 (Taxes to Enforce Reporting on Certain Foreign Accounts), and chapter 6 (Consolidated Returns). In addition, taxes imposed by other subtitles of the Code, such as subtitle C (Employment Taxes), are not included within the scope of the centralized partnership audit regime. Accordingly, the IRS may separately examine the partnership or its partners outside the centralized partnership audit regime for purposes of determining and assessing these types of taxes.
>
> In some circumstances, adjustments made under the centralized partnership audit regime may have an effect on the determination of taxes imposed by provisions of the Code outside of chapter 1. For example, if it is determined in a proceeding under the centralized partnership audit regime that a partnership has additional unreported ordinary income, that determination could form the basis for a separate determination that one or more of the partners in that partnership owe additional self-employment tax under chapter 2 of the Code. Additionally, as clarified in proposed § 301.6221(a)-1(d), determinations regarding items covered by the centralized partnership audit regime may be relied upon by the IRS when making determinations of taxes not covered by chapter 1 to the extent they are relevant in making such determinations. For instance, if the IRS determines as part of the centralized partnership audit regime that an individual who is treated as a partner in the partnership has received additional unreported ordinary income from the partnership, the IRS is not precluded from separately examining the partnership or that individual for purposes of determining whether that individual is an employee and not a partner of the partnership for purposes of imposing subtitle C employment taxes with regard to that income or examining the individual for purposes of determining whether the individual owes additional self-employment tax on the income. Any such determinations made in a separate examination outside the centralized partnership audit regime will be solely for purposes of the taxes not covered by chapter 1, will not constitute determinations for purposes of chapter 1, and will not constitute an administrative proceeding with respect to the partnership for purposes of subchapter C of chapter 63. The IRS may use all procedures available, such as obtaining the books and records of the partnership, to make determinations of items covered by the centralized partnership audit regime solely for purposes of taxes not covered by chapter 1. Any determinations for taxes other than chapter 1 taxes are not covered by the centralized partnership audit regime under subchapter C of chapter 63.

[1158] Code § 6226.

amended return might move the adjustment from being taxed at the partnership level to being implemented by changing taxable items on the partner's return.[1159]

- Because the partnership pays the tax, the current partners essentially bear the burden of changes to tax items reported by whoever were the partners during the year being audited. Considering drafting into partnership agreements provisions allocating the burden of any tax imposed on the partnership.

- A partnership would need to include as a balance sheet liability any taxes relating to adjustments for prior years. Lenders might require partnerships to elect out of these rules to avoid having tax liabilities competing with obligations to them.

- States need to update their partnership income tax laws to adopt procedures to take into account federal audits.[1160]

Each partnership must designate a person (not necessarily a partner, which is a change from TEFRA) as the partnership representative who shall have the sole authority to act on behalf of the partnership under these rules.[1161]

When income is misallocated among partners, the new regime causes tax to be paid on any increase in taxable income but has no mechanism for reflecting any decreases in taxable income.[1162] Presumably, some corresponding adjustments would be made to interject some symmetry, but presumably taxpayers would have the burden of carrying through on those adjustments. Certain leading experts in the partnership tax community

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[1159] Code § 6225(c)(2).

[1160] The Multistate Tax Commission is drafting state tax provisions in response to the new federal partnership audit rules. See http://www.mtc.gov/Uniformity/Project-Teams/Partnership-Informational-Project.

[1161] Code § 6223(a). The person must have a substantial presence in the United States.

[1162] Code § 6225(b)(2). The *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16, March 2016), my internal document no. 6409517, provides:

> *Determining imputed underpayment amount: adjustments to distributive shares*
>
> In determining an imputed underpayment, any adjustment that reallocates the distributive share of any item from one partner to another is taken into account by disregarding any decrease in any item of income or gain and disregarding any increase in any item of deduction, loss, or credit.[204]
>
> [204] Sec. 6225(b)(2).
>
> *Example*
>
> For example, assume that a partnership has two partners, L and M. Under the partnership agreement, \$100 of rental income is allocated to L and \$70 of depreciation and interest deductions are allocated to M for the taxable year. The Secretary notifies the partnership and the partnership representative of an administrative proceeding initiated at the partnership level with respect to the partnership's return for 2024. Assume that the Secretary determines that the \$70 distributive share of depreciation and interest deductions should be reallocated from M to L. The imputed underpayment of the partnership is determined without decreasing the \$100 of rental income by the \$70 of depreciation and interest deductions. The adjustment is a \$70 increase in income. Assume that the highest rate of Federal income tax applicable to individuals or corporations in 2024 is 39.6 percent. The product of \$70 and 39.6 percent is \$27.72, the amount of the imputed underpayment. However, the partnership may implement procedures for modifying the imputed underpayment as so determined.

have observed that audits tend to focus on travel and entertainment and the like, that the current system makes audit adjustments a lot of work which reduces audit rates, and that examiners do not appear to know various rules on allocations among partners. By making reallocations profitable and easy for examiners to implement, the new rules will tend to increase the number and intensity of audits. Furthermore, the new rules raise the stakes on how to exercise judgment when faced with choices in ways to allocate partnership items.

After the due date (including an extensions) for the partnership return, a partnership subject to the new rules can amend K-1s only by filing an administrative adjustment request under Code § 6227, which can result in either tax at the partnership level or an equivalent of amended K-1s.[1163]

To avoid the potential unfairness of reallocations, reduce audit risk, and simplify amendment procedures, all partnerships should consider opting out of the new rules.

[1163] The *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16, March 2016), my internal document no. 6409517, provides:

> Restriction on authority to amend partner information statements The provision provides that partner information returns (currently Schedules K–1) required to be furnished by the partnership[255] may not be amended after the due date of the partnership return to which the partner information returns relate. The due date takes into account the permitted extension period. For example, the Schedules K–1 furnished by a partnership with respect to its taxable year 2020 may not be amended after the due date for the partnership 2020 return. If the partnership has a calendar taxable year, the due date for its partnership 2020 return is September 15, 2021 (taking into account the permitted 6-month extension following the due date of March 15, 2021), after which date the Schedules K–1 for 2020 may no longer be amended.[256] The partnership may, however, file an administrative adjustment request pursuant to new section 6227, and the partnership may pay any resulting imputed underpayment at the partnership level.
>
> [255] The requirement of furnishing partner information returns is imposed by section 6031(b). See section 411 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114–113), correcting a conforming amendment to strike the last sentence of section 6031(b) under prior law, which sentence related to repealed provisions on electing large partnerships.
>
> [256] This rule does not, however, preclude the filing of amended returns of reviewed-year partners pursuant to the procedure for modification of an imputed underpayment in section 6225(c)(2).
>
> *Example*
>
> For example, assume that a partnership files its Form 1065 for taxable year 2020 on March 15, 2021. On November 3, 2021, the partnership discovers an omission from income for 2020. The partnership may not issue amended Schedules K–1 to its partners for 2020. However, the partnership may file an administrative adjustment request and pay the underpayment consistently with new section 6227(b)(1) for the partnership taxable year in which the administrative adjustment request is made. In this situation, the partnership does not furnish amended Schedules K–1 to the partners and the partners do not file amended Federal and State income tax returns with respect to the omitted income.[257]
>
> [257] The partnership that files the administrative adjustment request is not precluded from furnishing under section 6227(b)(2) an adjusted statement (similar to a Schedule K–1) to each reviewed-year partner, who is then required to pay tax attributable to the partnership adjustment (as provided under guidance provided by the Secretary).

The AICPA has a “Partnership Audit and Adjustment Rules” resource center at http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/REPRESENTATION/Pages/Partnership-Audit-and-Adjustment-Rules.aspx.

II.G.18.c.ii. Partnership’s Liability for Underpayment under Code § 6225

This part II.G.18.c.ii is subject to parts II.G.18.c.iii Pushing Out Adjustments When Audit Concludes and II.G.18.c.iv Electing Out of Post-TEFRA Rules on Partnership Return.

Code § 6225(a)(1) provides that, if the IRS adjusts the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner’s distributive share thereof, generally the partnership must pay any imputed underpayment with respect to such adjustment in the adjustment year.[1164]

Also, if an adjustment does not result in an imputed underpayment, the partnership takes into account the adjustment in the adjustment year as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate) under Code § 702(a)(8), or in the case of an item of credit, as a separately stated item.[1165]

Except as provided below, for purposes of the audit rules any imputed underpayment with respect to any partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying that net amount by the highest rate of tax in effect for the reviewed year under Code § 1 or 11, by treating any net increase or decrease in loss above as a decrease or increase, respectively, in income, and by taking into account any adjustments to items of credit as an increase or decrease, as the case may be, in the amount determined in that netting.[1166] If any adjustment reallocates the distributive share of any item from one partner to another, the adjustment is taken into account in the paragraph by disregarding any decrease in any item of income or gain, and any increase in any item of deduction, loss, or credit.[1167]

However, the IRS is required to establish procedures under which the imputed underpayment amount may be modified consistent with the requirements described in Code § 6225(c):[1168]

- Those procedures must provide that, if one or more partners file returns (notwithstanding the statute of limitations for the partners’ returns) for the taxable year of the partners that includes the end of the reviewed year, these returns take into account all adjustments under Code § 6225(a) properly allocable to such partners (and for any other taxable year with respect to which any tax attribute is affected by reason of such adjustments), and payment of any tax due is included with such return, then the imputed underpayment amount shall be determined without regard to the portion of the adjustments so taken into account.[1169] If an

[1164] Referring to Code § 6232.
[1165] Code § 6225(a)(2).
[1166] Code § 6225(b)(1).
[1167] Code § 6225(b)(2).
[1168] Code § 6225(c)(1).
[1169] Code § 6225(c)(2)(A).

adjustment reallocates the distributive share of any item from one partner to another, the preceding sentence applies only if all partners affected by the adjustment file returns.[1170]

- These procedures must provide for determining the imputed underpayment without regard to the portion that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity (as defined in Code § 168(h)(2)).[1171]

- These procedures must provide for taking into account a rate of tax lower than the highest rate of tax with respect to any portion of the imputed underpayment that the partnership demonstrates is allocable to a partner which (i) is a C corporation, or (ii) in the case of a capital gain or qualified dividend, is an individual:[1172]

  - The lower rate determined under the preceding sentence cannot be less than the highest rate in effect with respect to the income and taxpayer (C corporation or individual), as the case may be, treating an S corporation as an individual.[1173]

  - Generally, the portion of the imputed underpayment to which the lower rate applies with respect to a partner is determined by reference to the partners' distributive share of items to which the imputed underpayment relates.[1174] However, if the imputed underpayment is attributable to the adjustment of more than one item, and any partner's distributive share of those items is not the same with respect to all of those items, then the portion of the imputed underpayment to which the lower rate applies with respect to a partner is determined referring to the amount that would have been the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year of the partnership.[1175]

- Special rules apply to the Code § 469 passive losses of publicly traded partnerships.[1176]

- The government may by regulations or guidance provide for additional procedures to modify imputed underpayment amounts on the basis of such other factors as the Secretary determines are necessary or appropriate to carry out the purposes of this subsection.[1177]

- Anything required to be submitted under these rules is due not later than the close of the 270-day period beginning on the date on which the notice of a proposed

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[1170] Code § 6225(c)(2)(B).
[1171] Code § 6225(c)(3).
[1172] Code § 6225(c)(4)(A).
[1173] Code § 6225(c)(4)(A) (flush language).
[1174] Code § 6225(c)(4)(B)(i).
[1175] Code § 6225(c)(4)(B)(ii).
[1176] Code § 6225(c)(5).
[1177] Code § 6225(c)(6).

partnership adjustment is mailed under Code § 6231 unless the government consents to extending that period.[1178]

- Any modification of the imputed underpayment amount under this rule can be made only upon the government's approval of the modification.[1179]

II.G.18.c.iii. Pushing Out Adjustments When Audit Concludes

A partnership can shift the consequences of an audit adjustment to its partners if it so elects not later than 45 days after the date of the notice of final partnership adjustment and at such time and in such manner as the government may provide, furnishes to each partner of the partnership for the reviewed year and to the IRS a statement of the partner's share of any adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment).[1180]

The *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16, March 2016), Thompson Coburn LLP doc. no. 6409517, provides:

> **Alternative to payment of imputed underpayment by partnership**
>
> As an alternative to partnership payment of the imputed underpayment in the adjustment year, the audited partnership may elect to furnish to the Secretary and to each partner of the partnership for the reviewed year [the year under audit] a statement of the partner's share of any adjustments to income, gain, loss, deduction and credit as determined in the notice of final partnership adjustment.[213] In this case, each such partner takes these adjustments into account and pays the tax as provided under the provision.[214]
> [213] Sec. 6226(a).
> [214] Sec. 6226(b).
>
> *Payment by reviewed year [the year under audit] partners in year that includes date of the statement*
>
> The reviewed year partner's tax is increased for the partner's taxable year that includes the date of the statement.
>
> *Amount of the reviewed year partner's adjustment*
>
> The reviewed year partner's tax is increased by an amount equal to the aggregate of the adjustment amounts as determined under the provision. This includes the amount by which the partner's tax would increase if the partner's distributive share of the adjustment amounts were included for the partner's taxable year that includes the end of the reviewed year, plus the amount by which the tax would increase by reason of adjustment to tax attributes in years after that year of the partner and before the year of the date of the statement.

[1178] Code § 6225(c)(7).
[1179] Code § 6225(c)(8).
[1180] Code § 6226(a).

Tax attributes in any subsequent taxable year are required to be appropriately adjusted.

Penalties, additions to tax, additional amounts

Penalties, additions to tax, and additional amounts are determined at the partnership level;[215] each reviewed year partner is liable for its share of the penalty, addition to tax, and additional amount.[216]

[215] Secs. 6221 and 6226(c).

[216] Sec. 6226(c).

Interest at partner level from reviewed year [the year under audit], with adjustments

In the case of an imputed underpayment for which the election under this provision is made, interest is determined at the partner level.[217] Interest is determined from the due date of the partner's return for the taxable year to which the increase is attributable. Interest is determined taking into account any increases attributable to a change in tax attributes for an intervening tax year. The rate of interest determined at the partner level is the underpayment rate as modified under the provision, that is, the rate is the sum of the Federal short-term rate (determined monthly) plus 5 percentage points.

[217] Sec. 6226(c)(2).

Time and manner of making election

The partnership may make this election not later than 45 days after the notice of final partnership adjustment.[218] The election is revocable only with the consent of the Secretary. The election may be made whether or not the partnership files a petition for judicial review of the notice of final partnership adjustment.[219]

[218] Sec. 6226(a)(1).

[219] Sec. 6226(d). See section 411 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114-113).

The partnership may make the election within 45 days from the notice of final partnership adjustment, and within 90 days from the notice of final partnership adjustment may file a petition for readjustment with the Tax Court, district court, or Court of Federal Claims.[220] Upon the final court decision, dismissal of the case, or settlement, the partnership is to implement the election by furnishing statements (at the time and manner prescribed by the Secretary) to the reviewed year partners showing each partner's share of the adjustments as finally determined. As part of any settlement, for example, it is contemplated that the Secretary may permit revocation of a previously made election, and the partnership may pay at the partnership level.

[220] Sec. 6234.

Time and manner of furnishing statement

The statement is to be furnished to the Secretary and to partners within such time and in such manner as is prescribed by the Secretary. In the absence of such guidance, the statements are to be furnished to the Secretary and to all partners within a reasonable period following the last day on which to make the election under this provision. The date the statement is furnished (as well as the date of the statement) is the date the statement is mailed, for this purpose.

Information furnished on statement to the Secretary and to partners

The statement furnished to the Secretary and to partners is to include the amounts of and tax attributes of the adjustments allocable to the recipient partner. Under regulatory authority, the Secretary may require the statement to show the amount of the imputed underpayment allocable to the recipient partner. In addition, the statement is to include the name and taxpayer identification number of the recipient partner. The Secretary may require that the statement include such additional information as is necessary or appropriate to carry out the purposes of the provision, such as the address of the recipient partner and the date the statement is mailed.

Treatment of tiered partnerships and other tiered entities

Tiered partnerships. – In the case of tiered partnerships, a partnership that receives a statement from the audited partnership is treated similarly to an individual[221] who receives a statement from the audited partnership. That is, the recipient partnership takes into account the aggregate of the adjustment amounts determined for the partner's taxable year including the end of the reviewed year, plus the adjustments to tax attributes in the following taxable years of the recipient partnership. The recipient partnership pays the tax attributable to adjustments with respect to the reviewed year and the intervening years, calculated as if it were an individual (consistently with section 703), for the taxable year that includes the date of the statement. The recipient partnership, its partners in the taxable year that is the reviewed year of the audited partnership, and its partners in the year that includes the date of the statement, may have entered into indemnification agreements under the partnership agreement with respect to the risk of tax liability of reviewed year partners being borne economically by partners in the year that includes the date of the statement. Because the payment of tax by a partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to the tax are nondeductible.

[221] See section 703, which states, "the taxable income of a partnership shall be computed in the same manner as in the case of an individual . . .."

Deficiency dividends. – A recipient partner that is a RIC or REIT and that receives a statement from an audited partnership including adjustments for a prior (reviewed) year may wish to make a deficiency dividend[222] with respect to the reviewed year. Guidance coordinating the receipt of a statement from an audited partnership by a RIC or REIT with the deficiency dividend procedures is expected to be issued by the Secretary.

[222] Sec. 860.

II.G.18.c.iv. Electing Out of Post-TEFRA Rules on Partnership Return

The partnership may elect out of the rules on its tax return. Electing out causes the pre-TEFRA rules to apply, which discourage IRS audits and prevents the potential unfairness described above.[1181]

These new rules do not apply with respect to any partnership for any taxable year if:[1182]

(A) the partnership elects the application of this subsection for such taxable year,

(B) for such taxable year the partnership is required to furnish 100 or fewer statements under section 6031(b) with respect to its partners,

(C) each of the partners of such partnership is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic,[1183] an S corporation, or an estate of a deceased partner,

(D) the election—

(i) is made with a timely filed return for such taxable year, and

(ii) includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each partner of such partnership, and

(E) the partnership notifies each such partner of such election in the manner prescribed by the Secretary.

[1181] See part II.G.18.c.i Overview of Rules Before and After TEFRA Repeal, fn. 1162.

[1182] Code § 6221(b)(1). Any footnotes in the quoted material below are not from the statute itself.

[1183] The *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16, March 2016), my internal document no. 6409517, provides:

> A partnership with a foreign entity as a partner can meet this eligibility requirement if, under the rules of section 7701, the foreign entity would be taxable as a C corporation if it were domestic; that is, the foreign entity has elected to be, or is, treated as a per se corporation under the check-the-box regulatory rules under section 7701.[189] A C corporation partner that is a regulated investment company ("RIC") or a real estate investment trust ("REIT") does not prevent the partnership from being able to elect out, provided the applicable requirements are met.
>
> [189] See Treas. Reg. sec. 301.7701-2 and -3.
>
> *Example*
>
> For example, a partnership is formed to conduct a joint venture between two corporations, X and Y. X's domestic C corporation subsidiary, W, owns a 50-percent interest in the partnership, and Y's domestic C corporation subsidiary, Z, owns a 50-percent interest in the partnership. The partnership is required to furnish two statements (Schedules K-1), one to W and one to Z. The partnership is eligible to elect out of the centralized system for the taxable year, provided that the partnership meets the requirements (described below) as to the time and manner of electing out, including (among other requirements) disclosing to the Secretary the names and employer identification numbers of W and Z.

An S corporation is an eligible partner above only if the partnership includes (in the manner prescribed by the IRS) a disclosure of the name and taxpayer identification number of each person receiving a K-1 from the S corporation.[1184] The S corporation's K-1s count toward the partnership's 100 K-1 limit in (B) above.[1185]

The government may by regulation or other guidance identify other types of partners to whom rules similar to the special rules in the case of a partner that is an S corporation can apply, such as certain trusts.[1186] August and Cuff, "The TEFRA Partnership Audit

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1184 Code § 6221(b)(2)(A)(i).

1185 Code § 6221(b)(2)(A)(ii). The *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16, March 2016), my internal document no. 6409517, provides:

> *Example*
>
> For example, if a partnership has 50 partners, 49 of which are individuals and one of which is an S corporation with 30 shareholders all of whom are individuals, the partnership is treated as being required to furnish 80 statements. This is the sum of 49 statements for individual partners, one statement for the S corporation partner, and 30 statements for individuals with respect to whom the S corporation must furnish statements. The partnership meets the 100-or-fewer-statements criterion for the partnership's eligibility to elect out.

1186 Code § 6221(b)(2)(C). The *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16, March 2016), my internal document no. 6409517, provides:

> This guidance shall take into account, for purposes of applying the 100-or-fewer-statements criterion, each direct and indirect interest in the partnership of any person to which a statement (comparable to the partner statement under section 6031(b)) is required to be furnished by any person. Such guidance may also take into account any person with respect to which a comparable statement is not required to be furnished but which has an interest (direct or indirect) in the partnership. Further, such guidance shall require the partnership to disclose to the Secretary the name and taxpayer identification number of each person with respect to which a statement (comparable to the partner statement under section 6031(b)) is required to be furnished and of other persons with an interest (direct or indirect) in the partnership.
>
> *Examples*
>
> For example, assume that a partner of a partnership is a disregarded entity such as a State-law limited liability company ("LLC") with only one member, a domestic corporation. Such guidance may provide that the partnership can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each of the disregarded entity and the corporation that is its sole member, and each of them is taken into account as if each were a statement recipient in determining whether the 100-or-fewer-statements criterion is met.
>
> As another example, such guidance may provide that a partnership with a trust as a partner can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of the trustee, each person who is or is deemed to be an owner of the trust, and any other person that the Secretary determines to be necessary and appropriate, and each one of such persons is taken into account as if each were a statement recipient in determining whether the 100-or-fewer-statements criterion is met. Similar guidance may be provided with respect to a partnership with a partner that is a grantor trust, a former grantor trust that continues in existence for the two-year period following the death of the deemed owner, or a trust receiving property from a decedent's estate for a two-year period.
>
> As a further example, to the extent that such rules are consistent with prompt and efficient collection of tax attributable to the income of partnerships and partners, such guidance may provide rules permitting election out in the case of a partnership (the first partnership) with one or more direct or indirect partners which are themselves partnerships. Under any such guidance with respect to tiered partnerships, the sum of all direct and indirect partners

Rules Repeal: Partnership and Partner Impacts," ALI CLE Webcast 6/7/2016, suggest:[1187]

> A non-grantor trust is not permitted to qualify under the statutory language under Section 6221(b)(1)(C) and was not a permitted partner under the current law's small partnership exception under Section 6231(a)(1)(B)(i) ("the term 'partnership' shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner").[54] If any partner in a partnership is a "pass thru partner," then the small partnership exception could not apply regardless of whether there were 10 or fewer ultimate partners. Under the TEFRA regime, a "pass thru" partner includes a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership.[55]
>
> [54] Note, however, that under the small partnership exception the partnership could elect application of the TEFRA audit rules.
>
> [55] Treas. Reg. § 301.6231(a)(1)-1(a)(2).

This seems to be a more restrictive view toward trusts than those that the *General Explanation of Tax Legislation Enacted in 2015* (JCS-1-16, March 2016) suggested in fn. 1186 that the government can approve by regulation or other authority:

> As another example, such guidance may provide that a partnership with a trust as a partner can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of the trustee, each person who is or is deemed to be an owner of the trust, and any other person that the Secretary determines to be necessary and appropriate, and each one of such persons is taken into account as if each were a statement recipient in determining whether the 100-or-fewer-statements criterion is met. Similar guidance may be provided with respect to a partnership with a partner that is a grantor trust, a former grantor trust that continues in existence for the two-year period following the death of the deemed owner, or a trust receiving property from a decedent's estate for a two-year period.

I led an ACTEC task force that suggested to the government that trusts should be eligible partners and how they might count toward the 100-statement limitation.[1188]

Consider prohibiting transfers to persons who would blow the eligibility to opt out.

(including each partnership and its partners) may not exceed 100 persons with respect to which a section 6031(b) statement must be furnished, and each partner must be identified. That is, eligibility of the first partnership to make the election requires the first partnership to include (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each direct partner of the first partnership and each indirect partner (including each partnership and its partners) in every tier, and requires that each is taken into account in determining whether the 100-or-fewer-statements criterion is met.

[1187] My internal document no. 6409516.

[1188] See http://www.actec.org/assets/1/6/ACTEC_Partnership_Audit_Rules_re_Trusts_Dec_13_2016.pdf.

Tenancies in common that are later found to be partnerships would not have elected out of these new rules on their returns, because the election out is required on an annual basis.

II.G.18.c.v. Drafting Partnership Agreements to Take Into Account Post-TEFRA Rules

Large partnerships require detailed procedures to protect various partners' rights, including relationships with the partnership representative, paying for audit defense, and paying any tax due at the partnership level.[1189] The partnership's management should control the partnership representative's action in whatever manner is appropriate. If the partnership representative is the same person who filed the return, the representative might have a conflict of interest. If the representative acts in that role for many partnerships (and perhaps is a partnership promoter) and has no skin in the game for this partnership, query whether the representative might compromise your case to settle other cases.

Provisions requiring electing out of the new rules and protecting the partnership's ability to elect out would apply to any partnerships that could qualify.

II.G.19. Debt vs. Equity; Potential Denial of Deduction for Business Interest Expense

II.G.19.a. Limitations on Deducting Business Interest Expense

Although Code § 163(a) authorizes deducting "all interest paid or accrued within the taxable year on indebtedness," other parts of Code § 163 deviate form that general rule. Furthermore, loss limitations elsewhere in the Code may apply.[1190]

Among the many limitations within Code § 163 are:

- Deductions for investment interest cannot exceed the taxpayer's net investment income, all as described in Code § 163(d); "net investment income" here is very different in scope than the idea in part II.I 3.8% Tax on Excess Net Investment Income (NII).

- Personal interest is not deductible, except for qualified residence interest. Code § 163(h).

- Business interest deduction limitations under Code § 163(j) were greatly expanded to need to be considered by all taxpayers incurring interest expense.

[1189] See August and Cuff, "The TEFRA Partnership Audit Rules Repeal: Partnership and Partner Impacts," ALI CLE Webcast 6/7/2016, my internal document no. 6409516.

[1190] For example, see parts II.G.3.c Basis Limitations for Deducting Partnership and S Corporation Losses, II.G.3.f Passive Loss Limitations (referring to part II.K Passive Loss Rules), and II.G.3.g At Risk Rules (Including Some Related Discussion of Code § 752 Allocation of Liabilities).

For taxable years beginning after December 31, 2017, Code § 163(j)(1) provides:

> *In general*. The amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed the sum of-
>
> > (A) the business interest income of such taxpayer for such taxable year,
> >
> > (B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus
> >
> > (C) the floor plan financing interest of such taxpayer for such taxable year.
>
> The amount determined under subparagraph (B) shall not be less than zero.

"Business interest" means "any interest paid or accrued on indebtedness properly allocable to a trade or business."[1191] It does not include any investment interest under Code § 163(d).[1192]

After looking at carve-outs from what is a "trade or business," we will look at each element of the items that add up to the overall limitation that applies to those businesses that are not carved out. After that, we will look at carryforwards of disallowed interest. Then, we wrap up with the treatment accorded partnerships.

First, small businesses are not subject to this rule.[1193] The business' average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes the taxable year cannot exceed $25,000,000, indexed for inflation, with related businesses aggregated and various other qualifications.[1194]

In applying this rule, "trade or business" does not include:[1195]

> (i) the trade or business of performing services as an employee,
>
> (ii) any electing real property trade or business,
>
> (iii) any electing farming business, or
>
> (iv) the trade or business of the furnishing or sale of-
>
> > (I) electrical energy, water, or sewage disposal services,

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[1191] Code § 163(j)(5).
[1192] Code § 163(j)(5).
[1193] Code § 163(j)(3) provides:

> *Exemption for certain small businesses*. In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year, paragraph (1) shall not apply to such taxpayer for such taxable year. In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.

[1194] Code § 448(c).
[1195] Code § 163(j)(7)(A).

(II) gas or steam through a local distribution system, or

(III) transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

As used above, an "electing real property trade or business" is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business that elects treatment as such.[1196] Any election needs to follow IRS rules regarding timing and manner and is irrevocable.[1197] An electing real property trade or business must use slower depreciation.[1198] Also, the items mentioned in clause (iv) are not eligible for bonus depreciation.[1199]

As used above, "electing farming business" means:[1200]

[1196] Code § 163(j)(7)(B). The list of businesses is from a cross-reference to Code § 469(c)(7)(C), which is further described in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception, especially fns 2176-2178 and the accompanying text.

[1197] Code § 163(j)(7)(B). Footnote 697 of the Senate report explains:

> It is intended that any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included. Because this description of a real property trade or business refers only to the section 469(c)(7)(C) description, and not to other rules of section 469 (such as the rule of section 469(c)(2) that passive activities include rental activities or the rule of section 469(a) that a passive activity loss is limited under section 469), the other rules of section 469 are not made applicable by this reference. It is further intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility.

[1198] Code § 163(j)(10)(A), referring to Code § 168(g)(1)(F), which requires certain property to use the Code § 168(g) alternative depreciation system, that property being described in Code § 168(g)(8), which described that property as:

> *Electing real property trade or business*. The property described in this paragraph shall consist of any nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business (as defined in 163(j)(7)(B)).

[1199] See fn. 946 in part II.G.4.b Bonus Depreciation.

[1200] Code § 163(j)(7)(C). Footnote 698 of the Senate report provides:

> As defined in section 263A(e)(4) (*i.e.*, farming business means the trade or business of farming and includes the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots)). Treas. Reg. sec. 1.263A-4(a)(4) further defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising,

(i) a farming business (as defined in section 263A(e)(4)) which makes an election under this subparagraph, or

(ii) any trade or business of a specified agricultural or horticultural cooperative (as defined in section 199A(g)(2)) with respect to which the cooperative makes an election under this subparagraph.

Again, any election needs to follow IRS rules regarding timing and manner and is irrevocable.[1201] Also, electing farming business must use slower depreciation.[1202]

Now that we have seen which businesses are carved out, let's review the components of the limitation.

In applying the Code § 163(j)(1)(A) limitation of business interest income: "Business interest income" means "the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business."[1203] It does not include any investment income under Code § 163(d).[1204]

In applying the Code § 163(j)(1)(B) limitation of 30% of the taxpayer's adjusted taxable income: Code § 163(j)(8) provides that "adjusted taxable income" is the taxpayer's taxable income:

(A) computed without regard to-

(i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,

(ii) any business interest or business interest income,

(iii) the amount of any net operating loss deduction under section 172,

(iv) the amount of any deduction allowed under section 199A, and

(v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and

(B) computed with such other adjustments as provided by the Secretary.

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shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. See Treas. Reg. sec. 1.263A-4(a)(4)(i) and (ii). A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer. See Treas. Reg. sec. 1.263A-4(a)(4)(i).

1201 Code § 163(j)(7)(C).

1202 Code § 163(j)(10)(B), referring to Code § 168(g)(1)(G), which requires certain property to use the Code § 168(g) alternative depreciation system, that property being:

any property with a recovery period of 10 years or more which is held by an electing farming business (as defined in section 163(j)(7)(C)).

1203 Code § 163(j)(6).

1204 Code § 163(j)(6).

In applying the Code § 163(j)(1)(C) limitation the taxpayer's floor plan financing interest: "Floor plan financing interest" means "interest paid or accrued on floor plan financing indebtedness."[1205] "Floor plan financing indebtedness" means indebtedness used to finance the acquisition of motor vehicles[1206] held for sale or lease, and secured by the inventory so acquired.[1207]

If business interest exceeds the sum of the items described in Code § 163(j)(1), it is treated as business interest paid or accrued in the succeeding taxable year.[1208]

For partnerships:[1209]

(i) this subsection shall be applied at the partnership level and any deduction for business interest shall be taken into account in determining the non-separately stated taxable income or loss of the partnership, and

(ii) the adjusted taxable income of each partner of such partnership-

(I) shall be determined without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, and

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1205 Code § 163(j)(9)(A).

1206 Code § 163(j)(9)(C) provides:

Motor vehicle. The term "motor vehicle" means a motor vehicle that is any of the following:

(i) Any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road.

(ii) A boat.

(iii) Farm machinery or equipment.

1207 Code § 163(j)(9)(B).

1208 Code § 163(j)(2).

1209 Code § 163(j)(4)(A). Further explain a term used here, Code § 163(j)(C) provides:

Excess taxable income. The term "excess taxable income" means, with respect to any partnership, the amount which bears the same ratio to the partnership's adjusted taxable income as-

(i) the excess (if any) of—

(I) the amount determined for the partnership under paragraph (1)(B), over

(II) the amount (if any) by which the business interest of the partnership, reduced by the floor plan financing interest, exceeds the business interest income of the partnership, bears to

(ii) the amount determined for the partnership under paragraph (1)(B).

The Senate report explained:

… the limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income. The excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. The Senate amendment requires that excess taxable income be allocated in the same manner as nonseparately stated income and loss.

(II) shall be increased by such partner's distributive share of such partnership's excess taxable income.

For purposes of clause (ii)(II), a partner's distributive share of partnership excess taxable income shall be determined in the same manner as the partner's distributive share of nonseparately stated taxable income or loss of the partnership.

Special rules apply for business interest from a partnership disallowed and carried forward.[1210]

[1210] Code § 163(j)(4)(B), "Special rules for carryforwards," provides:

(i) *In general*. The amount of any business interest not allowed as a deduction to a partnership for any taxable year by reason of paragraph (1) for any taxable year-
  (I) shall not be treated under paragraph (2) as business interest paid or accrued by the partnership in the succeeding taxable year, and
  (II) shall, subject to clause (ii), be treated as excess business interest which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.

(ii) *Treatment of excess business interest allocated to partners*. If a partner is allocated any excess business interest from a partnership under clause (i) for any taxable year-
  (I) such excess business interest shall be treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income, and
  (II) any portion of such excess business interest remaining after the application of subclause (I) shall, subject to the limitations of subclause (I), be treated as business interest paid or accrued in succeeding taxable years.

For purposes of applying this paragraph, excess taxable income allocated to a partner from a partnership for any taxable year shall not be taken into account under paragraph (1)(A) with respect to any business interest other than excess business interest from the partnership until all such excess business interest for such taxable year and all preceding taxable years has been treated as paid or accrued under clause (ii).

(iii) *Basis adjustments*.
  (I) *In general*. The adjusted basis of a partner in a partnership interest shall be reduced (but not below zero) by the amount of excess business interest allocated to the partner under clause (i)(II).
  (II) *Special rule for dispositions*. If a partner disposes of a partnership interest, the adjusted basis of the partner in the partnership interest shall be increased immediately before the disposition by the amount of the excess (if any) of the amount of the basis reduction under subclause (I) over the portion of any excess business interest allocated to the partner under clause (i)(II) which has previously been treated under clause (ii) as business interest paid or accrued by the partner. The preceding sentence shall also apply to transfers of the partnership interest (including by reason of death) in a transaction in which gain is not recognized in whole or in part. No deduction shall be allowed to the transferor or transferee under this chapter for any excess business interest resulting in a basis increase under this subclause.

The Senate report explained:

> … any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable

S corporations apply similar rules.[1211]

II.G.19.b. When Debt Is Recharacterized as Equity

Sometimes difficulty arises in determining whether payment obligations constitute debt or equity. For example:

- Once a C corporation becomes profitable, its owners cannot extract their original investment without paying tax.[1212]

- Perhaps one owner contributes capital and the other labor, and they want their entity to be taxed as an S corporation. Because an S corporation cannot have two classes of stock,[1213] they need to characterize as the debt the disproportionate contribution of the owner who contributes the capital.[1214]

- Sometimes a family member will loan to another to start a business without wanting to receive an equity interest.[1215]

Congress authorized the promulgation of regulations to distinguish debt from equity generally,[1216] but the effort proved unsuccessful until 2016,[1217] and what was issued in 2016 focused on foreign entities.[1218] Accordingly, one needs to look to court cases. The Tax Court has described the state of the law as follows:[1219]

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income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. Additionally, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest. In the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (*i.e.*, excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). This special rule does not apply to S corporations and their shareholders.

[1211] Code § 163(j)(4)(D) provides:

Application to S corporations. Rules similar to the rules of subparagraphs (A) and (C) shall apply with respect to any S corporation and its shareholders.

[1212] Code § 316.

[1213] See part II.A.2.j Single Class of Stock Rules.

[1214] Safe harbors for debt issued by an S corporation are provided by Code § 1361(c)(5) and Reg. § 1.1361-1(l)(5).

[1215] For complexity that might arise when families invest in businesses with ownership interests other than straight pro rata ownership, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[1216] Code § 385.

[1217] T.D. 7920 (1983).

[1218] See text accompanying fn. 1233.

[1219] *Pepsico Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269. The quote from the case does not include footnotes. *Rutter v. Commissioner*, T.C. Memo. 2017-174, which was also

A "singular defined set of standards" capable of being uniformly applied in debt-versus-equity inquiries remains elusive. See *Segel v. Commissioner*, 89 T.C. 816, 826-828 (1987). In differentiating between loans and capital investments, "It is not always easy to tell which are which, for securities can take many forms, and it is hazardous to try to find moulds into which all arrangements can certainly be poured." *Jewel Tea Co., Inc. v. United States*, 90 F.2d 451, 453 (2d Cir. 1937).

Notwithstanding the difficulty in distinguishing between debt instruments and equity instruments, the focus of a debt-versus-equity inquiry generally narrows to whether there was an intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship. *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968); *Litton Bus. Sys., Inc. v. Commissioner*, 61 T.C. 367, 377 (1973). The key to this determination is primarily the taxpayer's actual intent, evinced by the particular circumstances of the transfer. *A. R. Lantz Co. v. United States*, 424 F.2d 1330, 1333 (9th Cir. 1970); see also *United States v. Uneco, Inc. (In re Uneco, Inc.)*, 532 F.2d at 1209 (in resolving debt-equity questions, both objective and subjective evidence of a taxpayer's intent are considered and given weight in the light of the particular circumstances of a case).

Various Courts of Appeals have identified and considered certain factors in *re Uneco, Inc.)*, 532 F.2d at 1208 (10 factors); *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (13 factors);[1220] *Fin Hay Realty Co. v. United*

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quoted in fns. 792 and 795 in part II.G.3.a.ii Bad Debt Loss – Must be Bona Fide Debt, summarized the Ninth Circuit's position:

> That court has identified 11 nonexclusive factors to determine whether an advance of funds gives rise to bona fide debt as opposed to an equity investment. See *Hardman*, 827 F.2d at 1411-1412 (citing *Bauer*, 748 F.2d at 1368); *Bell v. Commissioner*, __ F. App'x __, 2017 WL 2963547 (9th Cir. July 12, 2017) (reaffirming 11-factor test), *aff'g* T.C. Memo. 2015-111. Those factors are: (1) the labels on the documents evidencing the alleged indebtedness; (2) the presence or absence of a maturity date; (3) the source of payment; (4) the right of the alleged lender to enforce payment; (5) whether the alleged lender participates in management of the alleged borrower; (6) whether the alleged lender's status is equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) the adequacy of the alleged borrower's capitalization; (9) if the advances are made by shareholders, whether the advances are made ratably to their shareholdings; (10) whether interest is paid out of "dividend money"; and (11) the alleged borrower's ability to obtain loans from outside lenders. *Hardman*, 827 F.2d at 1411-1412.

[1220] After this case was decided, in affirming a Tax Court decision, *DF Systems, Inc. v. Commissioner*, 112 A.F.T.R.2d 2013-7331 (5th Cir. 12/10/2013), in an unpublished *per curiam* opinion, quoted the *Mixon* factors as follows in finding a lack of bona fide debt:

> (1) the names given to the certificates evidencing the indebtedness; (2) [t]he presence or absence of a fixed maturity date; (3) [t]he source of payments; (4) [t]he right to enforce payment of principal and interest; (5) participation in management flowing as a result; (6) the status of the contribution in relation to regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stockholder; (10) source of interest payments; (11) the ability of the corporation to obtain loans from outside lending institutions; (12) the extent to which the advance was

> *States*, 398 F.2d at 697 (16 factors). This Court has articulated a list of 13 factors germane to such an analysis: (1) names or labels given to the instruments; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payments; (5) participation in management as a result of the advances; (6) status of the advances in relation to regular corporate creditors; (7) intent of the parties; (8) identity of interest between creditor and stockholder; (9) "thinness" of capital structure in relation to debt; (10) ability of the corporation to obtain credit from outside sources; (11) use to which advances were put; (12) failure of debtor to repay; and (13) risk involved in making advances. *Dixie Dairies Corp. v. Commissioner*, 74 T.C. 476, 493 (1980).

Regarding "thinness" of capital structure in relation to debt, the court reasoned:

> The purpose of examining the debt-to-equity ratio in characterizing an advance is to determine whether a corporation is so thinly capitalized that repayment would be unlikely. *CMA Consol., Inc. v. Commissioner*, T.C. Memo. 2005-16. In such a circumstance, the advance would be indicative of venture capital rather than a loan. *Bauer v. Commissioner*, 748 F.2d 1365, 1369 (9th Cir. 1984); see also *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72, 96-97 (2005), *aff'd in part*, *vacated in part* and *remanded on other grounds* 230 Fed. Appx. 526 (6th Cir. 2007).[1221]

The court then noted how the taxpayer's debt-to-equity ratio compared to the industry's debt-to-equity ratio,[1222] accepting the taxpayer's expert's conclusion that the instrument

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used to acquire capital assets; and (13) the failure of the debtor to repay on the due date or to seek a postponement.

1221 The court's footnote 75 here stated:

> Respondent relies on Fifth Circuit precedent which recognizes that thin capitalization is "very strong evidence" of a capital investment where: (1) the debt-to-equity ratio was initially high; (2) the parties understood that it would likely go higher; and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations. See *Estate of Mixon*, 464 F.2d at 408 (citing *United States v. Henderson*, 375 F.2d 36, 40 (5th Cir. 1967)). Respondent contends that petitioners cannot satisfy this standard; he submits that, in particular, petitioners have not conclusively demonstrated that PGI used advances to purchase capital assets or to meet expenses needed to commence operations.
>
> However, neither this Court nor the Court of Appeals for the Second Circuit has embraced this more nuanced test for thin capitalization in a debt-versus-equity analysis. See, *e.g.*, *Nassau Lens Co. v. Commissioner*, 308 F.2d 39, 47 (2d Cir. 1962), remanding 35 T.C. 268 (1960); *Kraft Foods Co. v. Commissioner*, 232 F.2d at 127; *Hubert Enters., Inc. v. Commissioner*, 125 T.C. 72, 96 (2005); *Anchor Nat'l Life Ins. Co. v. Commissioner*, 93 T.C. 382, 401 n.16 (1989); *Recklitis v. Commissioner*, 91 T.C. 874, 903-905 (1988). Indeed, the Second Circuit has stated that the isolated debt-to-equity ratio is of "great importance in determining whether an ambiguous instrument is a debt or an equity interest." *Kraft Foods Co. v. Commissioner*, 232 F.2d at 127. Moreover, the other elements in the Fifth Circuit standard are subsumed within our larger inquiry. Accordingly, we approach the "thin capitalization" factor without addressing the additional Fifth Circuit elements.

1222 Citing *Recklitis v. Commissioner*, 91 T.C. 874, 904 (1988).

was equity for U.S. income tax purposes. It also said the law focuses on the willingness of unrelated lenders to make a loan on the same terms or similar terms.[1223]

"The absence of an unconditional right to demand payment is practically conclusive that an advance is an equity investment rather than a loan for which an advancing taxpayer might be entitled to claim a deduction for a bad debt loss."[1224] "The salient fact of this case is the lack of written evidence demonstrating that there was a valid and enforceable obligation to repay on the part of any of the companies at issue that received advances from Mr. Sensenig through CLCL."[1225] "The three companies at issue were objectively risky debtors, and an unrelated prospective lender would probably have concluded that they would likely be unable to repay any proposed loan."[1226] Although an advance may be properly characterized as a loan, the substance needs to support that conclusion.[1227]

[1223] Citing *Segel v. Commissioner*, 89 T.C. at 832, which in turn was citing *Scriptomatic, Inc. v. United States*, 555 F.2d 364, 368 (3d Cir. 1977), and *Fin Hay Realty Co. v. United States*, 398 F.2d at 697).

[1224] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, supporting its statement as follows:

> Secs. 166(a), 385; *Fischer v. United States*, 441 F.Supp. at 37 (*Fin Hay* factor 7); *Scriptomatic Inc. v. United States*, 397 F.Supp. 753, 759 (E.D. Pa. 1975). Thus, courts have found the lack of any formality to be inimical to a contention that a loan exists when there is no provision for interest, no enforceable obligation to repay the funds advanced, no maturity date, and no provision for superiority. *Fischer*, 441 F.Supp. at 37; see also *PepsiCo Puerto Rico, Inc. v. Commissioner*, T.C. Memo. 2012-269 (finding that a definite maturity date for payment, without reservation or condition, is a fundamental characteristic of a debt and that if a financial instrument does not provide any means to ensure payment of interest, it is a strong indication of an equity interest).

Because the case was appealable to the Third Circuit, the case relied heavily on *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3rd Cir. 1968).

[1225] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, supporting its statement as follows:

> (*Fin Hay* factor 11.) There is no written evidence of an enforceable obligation between CLCL and any of the companies at issue, much less a provision for a fixed maturity date or a fixed rate of interest. (*Fin Hay* factors 10 and 13.)

[1226] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, further stated:

> Mr. Sensenig emphasized that, with respect to the advances at issue here, he generated no formal written financial projections and that he did not know what those projections would be. He was satisfied to go with the "gut feel of everybody involved". He considered business plans a waste of time and emphasized the importance of being able to "turn on a dime" on the basis of the facts of the moment, unconstrained by any formal plan. We think an unrelated lender would have considered this approach too cavalier.

[1227] *Sensenig v. Commissioner*, T.C. Memo. 2017-1, further stated:

> To the same effect, an advance may have the economic substance of a loan where the funds are advanced with a reasonable expectation of repayment regardless of the success of the venture or are placed at the risk of the business. *Steiner v. Commissioner*, T.C. Memo. 1981-212. Mr. Sensenig's expectation of repayment to CLCL, however, was completely dependent on the future financial success of the companies (which were not successful). See *Scriptomatic, Inc.*, 397 F.Supp. at 764 (holding advances were not debt where repayment "can only be reasonably assured by the chance of profits or from the liquidation of the business"). Repayment of any amount advanced by CLCL to one of the companies was not anticipated until the project had been "completed". Moreover, as to WSC, any expectation of repayment was even more remote, given that CLCL's interest was necessarily subordinate to the interest of WSC's prior mortgage lender. (*Fin Hay* factor 8.)

The Second and Fifth Circuits have spoken in a high profile debt vs. equity case involving partnerships in the foreign arena.[1228]

If a debt instrument with a term of more than five years from issuance original issue discount that exceeds the AFR by more than 5%, the excess may be reclassified as a dividend. [1229] Straight debt the term of which was an unknown length between 3 and 9 years was not equity even though its length might be extended to up to 15 years after issuance.[1230]

Although payments made within two years of a partner investing in a partnership generally are presumed to be disguised sales, payments of not more than 150% of the AFR are not presumed to be disguised sales.[1231]

See Schneider, "Is Debt vs. Equity Different in a Partnership?" *Taxes* (CCH (3/2015).[1232]

On April 8, 2016, the government issued proposed regulations under Code § 385, providing certain guidelines for recharacterizing debt as equity.[1233] Final regulations were issued October 21, 2016 as T.D. 9790. The final regulations and their preamble are lengthy. In response to comments, the final regulations narrowed the entities to which they apply, as part III of the preamble explains:

> Changes to the overall scope of the regulations:
>
> - *Exclusion of foreign issuers*. The final regulations reserve on all aspects of their application to foreign issuers; as a result, the final regulations do not apply to foreign issuers.

> Also at odds with a conclusion that this was a genuine loan transaction is Mr. Sensenig's not charging any loan origination fees for the advances and his lack of interest in obtaining third-party audits, financial statements, or credit reports for the companies he had chosen to invest in.
>
> CLCL's advances simply do not have the appearance of loans. We believe that no reasonable third-party lender would have extended money to these companies when none of the objective attributes which denote a bona fide loan are present, including a written promise of repayment, a repayment schedule, and security for the loan.
>
> The transfers simply did not give rise to a reasonable expectation or enforceable obligation of repayment. For these reasons, we find that the relationship between Mr. Sensenig and CLCL on the one hand and the three companies on the other was not that of creditor and debtor, and we conclude that Mr. Sensenig's advances of CLCL funds were in substance equity and that the IRS properly disallowed the deduction for tax year 2005.

[1228] Chiand and Du, "The Debt-Equity Debate in the *Castle Harbour* Case," *Practical Tax Strategies* (April 2013), analyzing *TIFD III-E, Inc. v. United States*, 342 F.Supp.2d 94 (D. Conn. 2004), *rev'd* 459 F.3d 220, 231 (2d Cir. 2006), *on remand* 660 F.Supp.2d 367, 395 (D. Conn. 2009), *rev'd* 666 F.3d 836 (2d Cir. 2012). See fn. 3717 for the Fifth Circuit's analysis. Note that 2015 changes to Code §§ 704(e) and 761(b) would affect the analysis.

[1229] Code § 163(e)(5), (i).

[1230] Letter Ruling 201405005. This ruling involved a stock redemption followed by stock being issued to key employees and included number of representations.

[1231] Reg. § 1.707-4(a)(3)(ii).

[1232] Saved as Thompson Coburn LLP doc. no. 6544618.

[1233] REG-108060-15, Fed. Reg. Vol. 81, No. 68, p. 20911.

- *Exclusion of S corporations and non-controlled RICs and REITs*. S corporations and non-controlled regulated investment companies (RICs) and real estate investment trusts (REITs) are exempt from all aspects of the final regulations.

- *Removal of general bifurcation rule*. The final regulations do not include a general bifurcation rule. The Treasury Department and the IRS will continue to study this issue.

Significant changes to the documentation requirements in § 1.385-2:

- *Extension of period required for timely preparation*. The final regulations eliminate the proposed regulations' 30-day timely preparation requirement, and instead treat documentation and financial analysis as timely prepared if it is prepared by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).

- *Rebuttable presumption based on compliance with documentation requirements*. The final regulations provide that, if an expanded group is otherwise generally compliant with the documentation requirements, then a rebuttable presumption, rather than per se recharacterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument.

- *Delayed implementation*. The final regulations apply only to debt instruments issued on or after January 1, 2018.

Significant changes to the rules regarding distributions of debt instruments and similar transactions under § 1.385-3:

- *Exclusion of debt instruments issued by regulated financial groups and insurance entities*. The final and temporary regulations do not apply to debt instruments issued by certain specified financial entities, financial groups, and insurance companies that are subject to a specified degree of regulatory oversight regarding their capital structure.

- Treatment of cash management arrangements and other short-term debt instruments. The final and temporary regulations generally exclude from the scope of § 1.385-3 deposits pursuant to a cash management arrangement as well as certain advances that finance short-term liquidity needs.

- *Limiting certain "*cascading*" recharacterizations*. The final and temporary regulations narrow the application of the funding rule by preventing, in certain circumstances, the so-called "cascading" consequence of recharacterizing a debt instrument as stock.

- *Expanded earnings and profits exception*. The final and temporary regulations expand the earnings and profits exception to include all the earnings and profits of a corporation that were accumulated while it was a member of the same expanded group and after the day that the proposed regulations were issued.

- *Expanded access to $50 million exception*. The final and temporary regulations remove the "cliff effect" of the threshold exception under the proposed regulations, so that all taxpayers can exclude the first $50 million of indebtedness that otherwise would be recharacterized.

- *Credit for certain capital contributions*. The final and temporary regulations provide an exception pursuant to which certain contributions of property are "netted" against distributions and transactions with similar economic effect.

- *Exception for equity compensation*. The final and temporary regulations provide an exception for the acquisition of stock delivered to employees, directors, and independent contractors as consideration for the provision of services.

- *Expansion of 90-day delay for recharacterization*. The 90-day delay provided in the proposed regulations for debt instruments issued on or after April 4, 2016, but prior to the publication of final regulations, is expanded so that any debt instrument that is subject to recharacterization but that is issued on or before October 21, 2016, will not be recharacterized until immediately after October 21, 2016.

Notice 2017-36, part II, described the documentation requirements and postponed their applicability until 2019:

> The Documentation Regulations in § 1.385-2 have two principal purposes. The first is to provide guidance regarding the documentation and other information that must be prepared, maintained, and provided to be used in the determination of whether an instrument subject to the Documentation Regulations will be treated as indebtedness for federal tax purposes. The second is to establish certain operating rules, presumptions, and factors to be taken into account in the making of any such determination. The Documentation Regulations, once applicable, implement these purposes by generally requiring taxpayers to prepare and maintain documentation that evidences specified "indebtedness factors" with respect to purported debt instruments subject to the regulations. Thus, compliance with the Documentation Regulations does not establish that an interest is indebtedness; it serves only to satisfy the minimum documentation for the determination to be made under general federal tax principles.
>
> ….
>
> In response to the concern that taxpayers have continued to raise with the application of the Documentation Regulations to interests issued on or after January 1, 2018, and in light of further actions concerning the final and temporary regulations under section 385 in connection with the review of those regulations, the Treasury Department and the IRS have determined that these concerns warrant a delay in the application of the Documentation Regulations by 12 months. Accordingly, the Treasury Department and the IRS intend to amend the Documentation Regulations to apply only to interests issued or deemed issued on or after January 1, 2019. Pending the issuance of those regulations, taxpayers may rely on the delay in application of the Documentation Regulations set forth in this notice.

Key to much of this is multinational entities documenting loans properly.[1234] Also, transfers between related companies 36 months before or after a loan generally are deemed to be a repayment of debt rather transactions affecting equity.[1235]

The final regulations under Code § 385 do not recharacterize debt issued by a partnership as equity; instead, they treat a partnership as an aggregate and test as if the partners had made the loan or investment.[1236]

II.G.20. Employee Stock Ownership Plans (ESOPs) and Other Code § 401(a) Qualified Retirement Plans Investing in Businesses

Although qualified retirement plans can invest in the employer's business (with incentives to use ESOPs), the IRS has long been wary of doing so for a start-up business.[1237] Part II.G.21 IRA as Business Owner describes special issues that apply to IRAs.

Any qualified retirement plan that holds an interest in a partnership will be required to pay unrelated business income tax on its distributive share of any business income, debt-financed income, or other unrelated business income.[1238]

Any qualified retirement plan that holds an interest in an S corporation will be required to pay unrelated business income tax on its distributive share of <u>all</u> of the S corporation's income,[1239] unless the qualified retirement plan is an Employee Stock Ownership Plan (ESOP).[1240] An ESOP is a plan that invests primarily in qualifying employer securities.[1241] "Employer securities" means "common stock issued by the employer."[1242] An entity that is a partnership for tax purposes does not have "stock" and therefore does not have "qualifying employer securities;" therefore, it fails to operate as an ESOP.[1243] Thus, if the goal is to have the business owned by an ESOP, then an S corporation would be ideal. See also part II.A.2.j.vi Special Price Protection for Leveraged ESOP Approved.

1234 See Connors, de Marigny, and Rodgers, "The Final § 385 Regulations," *TM Memorandum* (BNA) 2/20/2017, saved as Thompson Coburn doc. no. 6515888.

1235 Reg. § 1.385-3(b)(3)(iii)(A).

1236 See part 3, "Aggregate Treatment of Partnerships," of section Part V, "Comments and Changes to § 1.385-3—Certain Distributions of Debt Instruments and Similar Transactions," of the preamble to T.D. 9790 (10/21/2016).

1237 The IRS calls the latter, "Rollovers as Business Start-Ups." See http://www.irs.gov/Retirement-Plans/Retirement-News-for-Employers---Fall-2010-Edition---Rollovers-as-Business-Start-Ups-Compliance-Project. See also, "Employee Plans Compliance Unit (EPCU) - Completed Projects - Project with Summary Reports – Rollovers as Business Start-Ups (ROBS)," found at http://www.irs.gov/Retirement-Plans/Employee-Plans-Compliance-Unit-(EPCU)-Completed-Projects-Project-with-Summary-Reports-%E2%80%93-Rollovers-as-Business-Start-Ups-(ROBS), following up on http://www.irs.gov/pub/irs-tege/robs_guidelines.pdf.

1238 Code §§ 511(a)(2)(A) (referring to Code § 401(a), which describes qualified retirement plans), 512. See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction.

1239 Code §§ 511(a)(2)(A) (referring to Code § 401(a), which describes qualified retirement plans), 512(e)(1).

1240 Code § 512(e)(3).

1241 Code § 4975(e)(7)(A).

1242 Code § 409(*l*).

1243 *K.H. Company, LLC v. Commissioner*, T.C. Memo. 2014-31.

To avoid all of the complexity above, a qualified plan might own its business through a C corporation. Even if it can get past various ERISA hurdles, consider that a C corporation does not have favorable capital gain tax rates, which means that the sale of its business assets (including goodwill) can be much more expensive than if a partnership or S corporation sold its assets. Also, various tools used to make C corporation business sales less tax-inefficient[1244] might be unavailable or might face ERISA regulatory hurdles. Furthermore, the C corporation stock does not receive a basis step-up at death; and, whenever the C corporation sale proceeds are distributed, they are distributed as ordinary income.

Any accrued compensation payable to an employee who participates in the ESOP is not deductible until paid.[1245] If the ESOP owns 100% of an S corporation, presumably it would not pay tax and therefore this rule would not be a concern.

Many other ESOP rules are beyond the scope of my materials.

II.G.21. IRA as Business Owner

An IRA would be subject to unrelated business income tax and other tax advantages and disadvantages, as described in part II.G.20 Employee Stock Ownership Plans (ESOPs) and Other Code § 401(a) Qualified Retirement Plans Investing in Businesses.

The IRS attacks the mechanics of the rollover, and taxpayers should do their best to roll over successfully.[1246]

[1244] See parts II.Q.1.b Leasing, II.Q.1.c Personal Goodwill and Covenants Not to Compete, and II.Q.1.d Nonqualified Deferred Compensation.

[1245] *Petersen v. Commissioner*, 148 T.C. No. 22 (6/13/2017), holding that participants were beneficiaries of a trust under Code § 267(c) and therefore deduction deferral under Code § 267(a)(2) applied.

[1246] *McGaugh v. Commissioner*, T.C. Memo. 2016-28, *aff'd* 119 A.F.T.R.2d 2017-2359 (7th Cir. 6/26/2017), finding in favor of the taxpayer, reviewed prior cases for and against taxpayers and discussed how to make the rollover work:

> If we analyze the situation for possible "constructive receipt" of the funds from Merrill Lynch by Mr. McGaugh (and constructive transfer of the funds by him to FPFC), the outcome still does not change. "It is well established that the mere receipt and possession of money does not by itself constitute gross income." *Liddy v. Commissioner*, T.C. Memo. 1985-107, *aff'd*, 808 F.2d 312 (4th Cir. 1986). "We accept as sound law the rule that a taxpayer need not treat as income moneys which he did not receive under a claim of right, which were not his to keep, and which he was required to transmit to someone else as a mere conduit." *Diamond v. Commissioner*, 56 T.C. 530, 541 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974).
>
> Thus, money received as a mere agent or conduit is not includible in gross income. *Liddy v. Commissioner*, 808 F.2d at 314; *Diamond v. Commissioner*, 56 T.C. at 541. We have held that this principle may apply in the case of a taxpayer and an IRA, see *Ancira v. Commissioner*, 119 T.C. 135, 138 (2002); and the IRS so acknowledges.[5] The question at issue here is whether, in the wire transfer and subsequent stock purchase, Mr. McGaugh acted as a conduit to or an agent of the IRA fiduciary and custodian, Merrill Lynch.
>
> [5] As the Commissioner states in his supplemental opposition (at 7-8) to the motion for summary judgment, "if Merrill Lynch, as custodian of petitioner's IRA, purchased the

> shares with funds from petitioner's IRA, either through petitioner as an agent/conduit or otherwise, then there may not have been a distribution. See *Ancira v. Commissioner*, 119 T.C. 135, 137-40 (2002) (the withdrawal of funds from an IRA did not give rise to a distribution, where the withdrawal was in the form of a check that could not be negotiated by the account owner, and the funds were used by the IRA custodian to acquire stock)."

Neither the Code nor the applicable regulations provide specific guidance on whether or when an amount is considered to have been "paid or distributed out of an individual retirement plan" through the use of the beneficiary as a conduit from the custodian to the investment. This Court has, however, addressed a case involving facts similar to Mr. McGaugh's: In *Ancira v. Commissioner*, 119 T.C. at 136, the taxpayer maintained a self-directed IRA, and during the year at issue he requested that his IRA custodian purchase a particular company's stock for his IRA. While the issuing company's stock was a permissible asset that could be held by the IRA, company policy of the custodian of the account did not permit it to directly purchase stock that was not publicly traded. *Id.* The taxpayer therefore requested a check made payable to the non-public issuing company, and the custodian sent the taxpayer the requested check. *Id.* The taxpayer forwarded the check to the issuing company, and the issuing company issued the stock certificate. *Id.* at 136-137. The certificate stated that the taxpayer's IRA was the owner of the shares of the stock, and the taxpayer presumed that the issuing company had sent the stock certificate to the IRA custodian as instructed. *Id.* At 137. However, for unspecified reasons the certificate was not delivered to the custodian, and the taxpayer did not discover the mistake until after receiving a notice of deficiency from the IRS. *Id.* After learning of the error, the taxpayer directed the issuing company to send the stock certificate to him, and he then delivered it directly to the custodian. *Id.*

In *Ancira* we held that no distribution from the IRA to the taxpayer occurred when the custodian delivered the check to him. *Id.* at 139. We observed that no distribution would have occurred if the custodian had either purchased stock directly from the issuing company or sent a check to a broker who then purchased the stock for the IRA. *Id.* At 137-138. We held that the taxpayer acted as an agent or conduit for the custodian because the taxpayer arranged the purchase but was not in constructive receipt of the check and the ownership of the stock was directly assumed by the IRA. *Id.* at 138. Moreover, we determined that the delay of the delivery of the stock certificate to the custodian was a bookkeeping error, which "did not alter the ownership of the stock by the IRA and certainly did not transfer the ownership to *** [the taxpayer]." *Id.* at 140.

Like the taxpayer in *Ancira*, Mr. McGaugh wished to acquire for his IRA stock that apparently could not be purchased directly by the custodian, Merrill Lynch. Mr. McGaugh therefore arranged the purchase of FPFC stock, instructed Merrill Lynch to make the wire transfer to FPFC, and instructed FPFC to deliver the certificate directly to Merrill Lynch. Moreover, unlike the taxpayer in *Ancira*, who received a check from the IRA and delivered it to the issuing company, Mr. McGaugh never personally handled any check by which the IRA funds were transmitted to FPFC. Instead, he requested that Merrill Lynch transfer the funds via wire transfer directly to the issuing company, and that transfer was duly made without Mr. McGaugh's interposition. And unlike the stock in *Ancira*, the FPFC stock certificate was sent directly to the custodian.

The Commissioner emphasizes that "[i]t appears that petitioner is in possession of the purported stock certificate." Even if Mr. McGaugh had physical possession of the stock certificate, he was not in constructive receipt of the asset. The "essence [of constructive receipt] is that funds which are subject to a taxpayer's unfettered command and which he is free to enjoy at his option are constructively received by him whether he sees fit to enjoy them or not." *Ancira v. Commissioner*, 119 T.C. at 138 (quoting *Estate of Brooks v. Commissioner*, 50 T.C. 585, 592 (1968)). Here, the stock was issued not in Mr. McGaugh's name but in the name "Raymond McGaugh IRA FBO Raymond McGaugh". Even with physical possession of the stock certificate, Mr. McGaugh could not have

The IRS tends to audit Roth IRA ownership of a business, requiring certain situations to be reported as "listed transactions" on special disclosure forms.[1247] The IRS unsuccessfully tried to expand its Roth IRA attacks when a father's business was

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realized any practical utility or benefit from the certificate in the name of the IRA. (And if Merrill Lynch's attempts to mail the IRA's stock certificates to Mr. McGaugh in "early 2012" (contrary to his instructions and intention) gave him ownership of the shares, then that was a distinct 2012 transaction that would not affect his 2011 income tax liability.)

We are not persuaded by the Commissioner's argument that Mr. McGaugh's circumstances are similar to that of the taxpayer in *Dabney v. Commissioner*, T.C. Memo. 2014-108. In *Dabney* this Court found a taxable distribution from the taxpayer's IRA when the taxpayer explicitly requested an IRA distribution (to himself) with the goal of purchasing land for his IRA but failed to return the distribution (or any other property) to the account within the 60-day rollover period of section 408(d)(3). *Id.* at *5. The policies of the custodian, Charles Schwab, did not permit real property to be an asset of its IRAs, *id.* at *4, *11, so in March 2009 Mr. Dabney requested a distribution of his IRA funds and a transfer of those funds to the title company handling the property sale. Contrary to Schwab's policies, Mr. Dabney directed the company to issue title in the name of the IRA, but it failed to do so and put the property in his name. He tried to sell the property and finally succeeded in January 2011 and wired the proceeds to Schwab as a purported "rollover contribution". We held that the transfer of the funds from the IRA to Mr. Dabney constituted a taxable distribution.

Here, by contrast, Merrill Lynch previously permitted FPFC stock as an asset to be held in Mr. McGaugh's IRA, and its subsequent correspondence seems to indicate that if the stock at issue had been received within the 60-day period, it would have been accepted. And here the stock certificate bears the name of the IRA as its owner; and it is therefore not like the real property in *Dabney* that, for more than a year, was titled in the name of the individual taxpayer. Mr. Dabney requested a distribution in order to conduct a real estate transaction not permitted by the IRA, whereas Mr. McGaugh directed the IRA to make a permissible investment. This case is not like *Dabney*.

Rather, this case resembles *Ancira*. We hold that Mr. McGaugh did not receive a distribution when Merrill Lynch made the wire transfer to FPFC; and to the extent that he had control over the wired funds, he at most acted as a conduit for the IRA custodian. Consequently, the 60-day limitation on a rollover under section 408(d)(3) does not really come into play in this case. The timing of the mailing of the shares (i.e., more than 60 days after the wire transfer) does not alter our conclusion that there was no distribution from the IRA to Mr. McGaugh. We will therefore grant Mr. McGaugh's motion for summary judgment.

In *Vandenbosch v. Commissioner*, T.C. Memo. 2016-29, the taxpayer moved money from his IRA to a joint account, moved it from the joint account into his personal account, and wired it to a borrower, in exchange for a note from the borrower payable to the taxpayer (not to his IRA). Not surprisingly, the taxpayer's claim that he was a conduit for his IRA in the same manner as in *McGaugh* got him nowhere, although he was able to avoid penalties because he had discussed the situation with his CPA income tax return preparer.

In *Powell v. U.S.*, 117 A.F.T.R.2d 2016-1001 (Ct. Fed. Cl. 2016), the taxpayers claimed to have set up a "Business Owners Retirement Savings Account" but failed to produce even a shred of documentation establishing a trust for the supposed retirement plan; naturally, the taxpayers lost on summary judgment.

[1247] Notice 2004-8. *Polowniak v. Commissioner*, T.C. Memo. 2016-31, imposed a 30% penalty under Code § 6662A for 2004 on the original amount reflected in the notice of deficiency. See also *Yari v. Commissioner*, 143 T.C. 157 (2014) *aff'd* in an unpublished opinion, 118 A.F.T.R.2d 2016-6096 (9th Cir. 2016) (penalty based on original return, not amended return).

discontinued and his son's Roth IRAs started a new corporation engaging in what the IRS viewed to be a continuation of the old business.[1248]

However, the Tax Court has held that an IRA that invests in a business engages in a prohibited transaction when the business compensates the IRA's owner (even when the compensation is modest).[1249] If the business does not compensate the IRA's owner, the IRA's owner might be deemed to have received compensation and then made a contribution to the IRA.[1250] Furthermore, when an IRA's owner guarantees the IRA's corporation's seller-financed purchase of business assets from an unrelated third party, the guarantee is a prohibited transaction that disqualifies the IRA.[1251] Thus, activities very common for start-up businesses – the owner or the owner's family working in the business and the owner guaranteeing loans – are forbidden to businesses owned by IRAs.

[1248] See part II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014), particularly fn. 3702.

[1249] *Ellis v. Commissioner*, T.C. Memo. 2013-245:

> In essence, Mr. Ellis formulated a plan in which he would use his retirement savings as startup capital for a used car business. Mr. Ellis would operate this business and use it as his primary source of income by paying himself compensation for his role in its day-to-day operation. Mr. Ellis effected this plan by establishing the used car business as an investment of his IRA, attempting to preserve the integrity of the IRA as a qualified retirement plan. However, this is precisely the kind of self-dealing that section 4975 was enacted to prevent. For the foregoing reasons, the Court sustains respondent's determination that Mr. Ellis engaged in prohibited transactions under section 4975(c)(1)(D) and (E) when he caused CST to pay him compensation of $9,754 in tax year 2005.

The court also upheld an accuracy-related penalty. The Eighth Circuit affirmed, 787 F.3d 1213 (2015), and also rebuffed the taxpayers' argument that Code § 4975(d)(10) excluded fees for their services from being a prohibited transaction, holding that the exclusion applies only to services for the IRA and not to services performed for businesses owned by the IRA. The formation of the LLC itself did not constitute a *per se* prohibited transaction, and the court declined to address the IRS' assertion that the initial intent to engage in prohibited transactions tainted the formation, because the payment of wages that was definitely a prohibited transaction occurred in the same taxable year as the LLC's formation.

See also *Repetto v. Commissioner*, T.C. Memo. 2012-168, in which the court recharacterized service payments made to purported service corporations that were owned by Roth IRAs, holding that the agreements were designed to permit, and did permit, the taxpayer to make excessive contributions to the Roth IRAs through the disguised service payments. *Polowniak v. Commissioner*, T.C. Memo. 2016-31, had a similar result.

[1250] See *Mazzei v. Commissioner*, T.C. Memo. 2014-55 (commissions paid from taxpayers' business to a foreign sales corporation owned by taxpayers' Roth IRAs might be deemed to be commissions paid to taxpayers followed by a contribution to their IRAs; this case held that passage of statute of limitations on the income tax compensation issue did not preclude IRS from assessing an excise tax for excess contribution to an IRA).

[1251] *Thiessen v. Commissioner*, 146 T.C. No. 7 (2016) (6-year statute of limitations applied because the issue of prohibited transaction was not disclosed anywhere), following *Peek v. Commissioner*, 140 T.C. 216 (2013).

An IRA's purchase of real estate that would tend to benefit adjoining real estate owned by the IRA's owner was a prohibited transaction.[1252]

After two false starts,[1253] the IRS successfully attacked IRAs' formation of a DISC in Tax Court, before being rebuked by the Sixth Circuit. A DISC is a statutory scheme designed to give a tax break to exporters by allowing them to deduct commissions paid to companies (even shell companies).[1254] The Tax Court held that the IRS properly recharacterized commissions as dividends to the exporter's shareholders followed by excess contributions to their Roth IRAs when the taxpayers' "sole reason for entering into the transaction at issue was to transfer money into the … Roth IRAs so that income on assets could accumulate and be distributed tax free. Petitioners had no nontax business purpose for the transactions, nor did they receive any economic benefit from the transactions."[1255] However, the Sixth Circuit pointed out, "By congressional design,

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[1252] *Kellerman v. Rice*, 116 A.F.T.R.2d 2015-6133 (D. Ark. 2015), holding that this prohibited transaction disqualified the IRA and caused the IRA's assets to be subject to the IRA's owner's bankruptcy creditors.

[1253] *Swanson v. Commissioner*, 106 T.C. 76 (1996) (formation of DISC by traditional IRA was not a prohibited transaction; taxpayer awarded legal fees because IRS' position wasn't substantially justified); *Hellweg v. Commissioner*, T.C. Memo. 2011-58 (IRS could not challenge the substance of the transaction for income tax purposes in the absence of fraud or an illegal purpose behind the DISC transaction).

[1254] *Summa Holdings, Inc. v. Commissioner*, T.C. Memo. 2015-119, explained:

> A DISC provides a mechanism for deferral of a portion of the Federal income tax on income from exports. The DISC itself is not taxed, but instead the DISC's shareholders are currently taxed on a portion of the DISC's earnings in the form of a deemed distribution. Secs. 991, 995(b)(1). This allows for deferral of taxation on the remainder of the DISC's earnings until those earnings are actually distributed, the shareholders dispose of their DISC stock in a taxable transaction, or the corporation ceases to qualify as a DISC, Secs. 995(b)(2), 996(a)(1).
>
> A DISC sometimes does not generate the income it reports on its returns and might otherwise not be recognized as a corporate entity for tax purposes if it were not a DISC. *Addison Int'l, Inc. v. Commissioner*, 90 T.C. 1207 (1988), *aff'd*, 887 F.2d 660 (6th Cir. 1989); *Jet Research, Inc. v. Commissioner*, T.C. Memo. 1990-463; see also sec. 1.992-1(a), Income Tax Regs. "The DISC may be no more than a shell corporation, which performs no functions other than to receive commissions on foreign sales made by its parent." *Thomas Int'l Ltd. v. United States*, 773 F.2d 300, 301 (Fed. Cir. 1985); *Foley Mach. Co. v. Commissioner*, 91 T.C. 434, 438 (1988); see also *Jet Research, Inc. v. Commissioner*, T.C. Memo. 1990-463.

Polowniak v. Commissioner, T.C. Memo. 2016-31, also reallocated income, not under Code § 482 but rather allocating the income to the taxpayer who truly earned it.

[1255] *Summa Holdings, Inc. v. Commissioner*, T.C. Memo. 2015-119, also addressed arguments regarding DISCs being statutorily favored, rejecting taxpayers' arguments that *Hellweg v. Commissioner*, T.C. Memo. 2011-58, protected them:

> Petitioners argue that since Congress could have prohibited transactions involving DISCs owned by IRAs but chose not to do so, Congress was comfortable with IRAs' holding DISC stock. We rejected this argument in *Hellweg*. As we stated in *Hellweg*, this argument is logically erroneous. See *Hellweg v. Commissioner*, slip op. at 13. Congress' choice to prevent one particular abusive transaction involving DISCs and IRAs does not indicate that Congress approves of all other abusive transactions involving DISCs and IRAs. See *id*. at 13-14.
>
> Section 995(g) was enacted in 1988, almost 10 years before the enactment of the Roth IRA provisions, which were enacted as part of the Taxpayer Relief Act of 1997, sec. 302.

DISCs are all form and no substance, making it inappropriate to tag Summa Holdings with a substance-over-form complaint with respect to its use of DISCs," further explaining, "No court has used this power to override statutory provisions whose only function is to enable tax savings, as the Commissioner seeks to do in this instance."[1256] Furthermore, "the Code authorizes investors to avoid significant taxes on capital gains and dividends by using their Roth IRAs in all manner of tax-avoiding ways, including by buying shares in promising new companies whose share prices may rise considerably over time or which may pay out large dividends over time."[1257] The Sixth Circuit pointed out that any deemed or actual dividend received from a DISC and any gain on the disposition of DISC shares received by an IRA are subject to unrelated business income tax,[1258] so Congress has addressed tax-exempt entities owning DISCs, and courts should not let the IRS override the statutory scheme.[1259]

For more about IRAs, consult me or check out www.ataxplan.com, the web page of IRA guru Natalie Choate, whose book I commend to all estate planning professionals and the latest version of which is available at https://www.retirementbenefitsplanning.com for $9 per month, cancelable at any time. For more on self-dealing issues that are especially risky with IRAs but can also cause problems with qualified plans, check out the web page of Texas attorney Noel Ice.[1260]

Natalie recommends that every IRA owner file Form 5329 annually to run the statute of limitations on excess contributions and other penalties involving IRAs; consider following that advice if the IRA owns a business, otherwise engages in any activity that might possibly generate an excise tax, or is or might be required to make minimum distributions that year.

However, note that disqualification of an IRA can cause it to lose its protection from creditors, so tax and penalties are not the only concern here.[1261]

> They became effective for tax years beginning after December 31, 1997. *Id.* sec. 302(f), 111 Stat. at 829. Congress could not have been aware of the type of abusive transaction involving Roth IRAs at issue here at the time of enactment of section 995(g).

[1256] *Summa Holdings, Inc. v. Commissioner*, 119 A.F.T.R.2d 2017-xxxx (6th Cir. 2/16/2017). The taxpayer had deducted the DISC commissions, and the Tax Court had held that the taxpayer could not deduct the payments. The Sixth Circuit case applies only to this taxpayer. The other taxpayers involved - the Roth IRA owners and a trust that owned the DISC – have appealed the Tax Court's findings to the First and Second Circuits.

[1257] *Summa Holdings, Inc. v. Commissioner*, 119 A.F.T.R.2d 2017-xxxx (6th Cir. 2/16/2017).

[1258] Code § 995(g); see ¶ D-6834 DISC dividends as unrelated trade or business income, *Federal Tax Coordinator Analysis* (RIA).

[1259] *Summa Holdings, Inc. v. Commissioner*, 119 A.F.T.R.2d 2017-xxxx (6th Cir. 2/16/2017), concluding:

> If Congress sees DISC-Roth IRA transactions of this sort as unwise or as creating an improper loophole, it should fix the problem. Until then, the DISC will continue to provide tax savings to the owners of U.S. export companies, just as Congress intended—even if subsequent changes to the Code have increased the scale of the savings beyond Congress's original estimation. The last thing the federal courts should be doing is rewarding Congress's creation of an intricate and complicated Internal Revenue Code by closing gaps in taxation whenever that complexity creates them.

[1260] http://trustsandestates.net/retirement-planning.html.

[1261] See fn. 1252.

II.G.22. Employee vs. Independent Contractor

Whether a service provider is an independent contractor or an employee is important for FICA (Social Security),[1262] FUTA (unemployment),[1263] and income tax withholding.[1264]

The IRS looks at 20 factors as part of a facts-and-circumstances test.[1265] The Tax Court focuses on the ones that seem to be the most relevant to the situation.[1266]

II.G.23. Taxing Entity or Individual Performing Services

An individual performing services cannot say that payments from a third party for those services belong to an entity employing the service provider unless:[1267]

(1) The individual providing the services is an employee of the corporation whom the corporation can direct and control in a meaningful sense; and

(2) The entity and the person using the services have a contract or similar indicium recognizing the entity's controlling position.

A person who performs services is taxed on the services, even if the person assigns the earnings to another person.[1268]

II.G.24. Code § 199 Deduction for Domestic Production Activities (repealed)

Code § 199 has been repealed, effective taxable years beginning after December 31, 2017, so this part II.G.24 would not apply after then.

Code § 199 provides a deduction for domestic production activities. The deduction is equal to 9% of the lesser of (1) the qualified production activities income of the taxpayer for the taxable year, or (2) taxable income (determined without regard to this section) for the taxable year.[1269] However, it cannot exceed 50% of the W-2 wages paid by the taxpayer for the taxable year.[1270] Compensation paid a partner is reported as guaranteed payments on Schedule K-1 instead of on Form W-2,[1271] so generally the

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1262 Reg. § 31.3121(d)-1(c).

1263 Reg. § 31.3306(i)-1.

1264 Reg. § 31.3401(c)-1.

1265 Rev. Rul. 87-41.

1266 *Rahman v. Commissioner*, T.C. Summary Opinion 2014-35.

1267 *Fleischer v. Commissioner*, T.C. Memo. 2016-238. The court mentioned that this test is consistent with the FICA test under Reg. § 31.3121(d)-1(c)(2), which provides:

> Generally such relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

For a similar ruling involving an attempted assignment of earnings to a limited partnership, see *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 5/24/2016), affirming T.C. Memo. 2013-271., described in fn. 2410 in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

1268 *Lucas v. Earl*, 281 U.S. 111 (1930).

1269 Code § 199(a).

1270 Code § 199(b)(1).

1271 See fn. 438, found in part III.B.7.c.viii Creative Bonus Arrangements.

Code § 199 deduction would be higher for an S corporation or a C corporation than it would be for a comparable partnership.

II.G.25. Real Estate Dealer vs. Investor

A taxpayer's amount or type of real estate activity affects many aspects of tax law, including:

- Whether gain or loss from the sale of real estate is ordinary income or loss or capital gain or loss.[1272]

- Whether ordinary income is recharacterized as capital gain and whether capital loss is recharacterized as ordinary loss under Code § 1231.[1273] Generally, this special treatment applies (a) if the taxpayer has a non-real estate trade or business and uses the real estate in that business, or (b) if the taxpayer holds the property for rental.

- Whether installment sale deferral is available for none, part, or all of the sale.[1274]

- Whether gain is subject to self-employment tax.[1275]

- Whether the taxpayer is a real estate professional for purposes of deducting losses that might otherwise be passive losses (that might be suspended)[1276] and for purposes of avoiding treatment as passive income triggering the 3.8% tax on net investment income.[1277]

The U.S. Supreme Court held that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly."[1278] Whether an asset is a capital asset depends on:[1279]

1272 Discussing how to obtain capital gain on pre-development appreciation and whether the taxpayer already has enough activity that investments are considered to be inventory, see part II.G.12 Future Development of Real Estate, especially fn. 1042.

1273 See part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business.

1274 See part II.Q.3 Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future, especially the text accompanying fn. 3100.

1275 Real estate rental income is not subject to self-employment tax. See parts II.L.2.a.ii Rental Exception to SE Tax, especially the detailed rules accompanying fn. 2378, and II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax, especially fn. 2388.

1276 See part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.

1277 See parts II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals, II.I.8.c.iii Rental as a Trade or Business and II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

1278 *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955).

1279 *Boree v. Commissioner*, 118 A.F.T.R.2d 2016-5742 (11th Cir. 9/12/2016), citing:

> *United States v. Winthrop*, 417 F.2d 905, 909-10 (5th Cir. 1969); *see Sanders v. United States*, 740 F.2d 886, 889 (11th Cir. 1984) (applying the *Winthrop* factors). No factor or combination of factors is controlling. *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 415 (5th Cir. 1976) (en banc). Rather, each case must be decided on its particular facts. *Id.* Still, the "frequency and substantiality" of sales is the "most

(1) the nature and purpose of the acquisition of the property and the duration of the ownership;

(2) the extent and nature of the taxpayer's efforts to sell the property;

(3) the number, extent, continuity and substantiality of the sales;

(4) the extent of subdividing, developing, and advertising to increase sales;

(5) the use of a business office for the sale of the property;

(6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and

(7) the time and effort the taxpayer habitually devoted to the sales.

Although a "taxpayer may hold some property for sale in the ordinary course of business and some for investment," "the burden is on the taxpayer to establish that the parcels held primarily for investment were segregated from other properties held primarily for sale. The mere lack of development activity with respect to parts of a large property does not sufficiently separate those parts from the whole to meet the taxpayer's burden."[1280] Thus, when a taxpayer starts developing a tract of real estate and sells some property in a different manner than originally intended, the taxpayer must prove that the portion sold is not held for development the way that the rest of the real estate is.[1281]

Part II.I.8.c.iii Rental as a Trade or Business includes a detailed excerpt from the preamble promulgating the regulations governing net investment income tax.

II.G.26. Importance of Keeping Depreciable or Amortizable Property Outside of a Corporation; Strategy for Related Party Sales

See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.

Also, when an S corporation sells depreciable property to a related party, which sale may include a liquidating distribution, the sale may trigger ordinary income tax for the entire gain – not just depreciation recapture.[1282] However, if it sells a partnership

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important" of these factors. *Id* . at 416. This is because "the presence of frequent sales ordinarily belies the contention that property is being held `for investment' rather than 'for sale.'" *Suburban Realty Co.*, 615 F.2d at 178.

[1280] *Boree v. Commissioner*, 118 A.F.T.R.2d 2016-5742 (11th Cir. 9/12/2016), citing: *Suburban Realty Co.,* 615 F.2d at 185. Whether a taxpayer segregated property for investment as opposed to inventory purposes would appear to be a question of fact, just as is the taxpayer's overall primary purpose for holding the property. *See id.* at *180-81* ("[T]he question of taxpayer's purpose or purposes for holding the property is primarily factual, as is the question of which purpose predominates.").

[1281] *Boree v. Commissioner*, 118 A.F.T.R.2d 2016-5742 (11th Cir. 9/12/2016).

[1282] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

interest, the ordinary income portion is limited to depreciation recapture.[1283] The partnership should not be formed too close to the sale.[1284] For strategies to place corporate assets into a partnership, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

Partnerships are subject to similar rules when selling to a related party; see part II.Q.8.c Related Party Sales of Non-Capital Assets By or To Partnerships. However, often distributions from partnerships will not constitute a sale; see part II.Q.8.b Partnership Redemption or Other Distribution.

Whether a corporation or a partnership, an entity that wants to sell to a related party might instead consider forming a preferred partnership with that related party; see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion. After waiting long enough (perhaps two but more likely seven years),[1285] the parties may decide to redeem the original transferor's retained interest; see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

II.G.27. Avoid Securing Loans with an Account Holding Muni Bonds

Code § 265(a)(2) disallows deductions for interest "on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from the taxes imposed by this subtitle."[1286]

"Direct evidence of a purpose to *purchase* tax-exempt obligations exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations."[1287]

"Direct evidence of a purpose to *carry* tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness."[1288] Even where tax-exempt

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1283 See part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

1284 See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially text accompanying fns. 3681-3684.

1285 The parties should wait at least two years to avoid the disguised sale rules; see part II.M.3.e Exception: Disguised Sale. However, seven years is probably needed; see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

1286 Reg. § 1.265-1(a)(1) provides:

> No amount shall be allowed as a deduction under any provision of the Code for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income other than a class or classes of exempt interest income.

Reg. § 1.265-2(a) elaborates:

> No amount shall be allowed as a deduction for interest on any indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from tax under subtitle A of the Code, such as municipal bonds….

1287 Rev. Proc. 72-18, § 3.02 (emphasis in original), which cited and then elaborated:

> *Wynn v. United States*, 411 F.2d 614 (1969), certiorari denied 396 U.S. 1008 (1970). Section 265(2) does not apply, however, where proceeds of a bona fide business indebtedness are temporarily invested in tax-exempt obligations under circumstances similar to those set forth in Revenue Ruling 55-389, C.B. 1955-1, 276.

obligations are not used as collateral for indebtedness, they might taint loans for other purposes[1289] except where the loans are fully secured by other property.[1290]

When direct evidence establishes a purpose to purchase or carry tax-exempt obligations (either because tax-exempt obligations were used as collateral for indebtedness or the proceeds of indebtedness were directly traceable to the holding of particular tax-exempt obligations), Rev. Proc. 72-18 assets that no part of the interest paid or incurred on such indebtedness may be deducted.[1291] However, if only a fractional part of the indebtedness is directly traceable to the holding of particular tax- exempt obligations, Rev. Proc. 72-18 assets that the same fractional part of the interest paid or incurred on such indebtedness would be disallowed.[1292] In any other case where interest is disallowed under Rev. Proc. 72-18, an allocable portion of the interest on such indebtedness will be disallowed.[1293]

[1288] Rev. Proc. 72-18, § 3.03 (emphasis in original), which cited and then elaborated:

> "[O]ne who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position. Section 265(2) makes no distinction between them." *Wisconsin Cheeseman v. United States*, 338 F.2d 420, at 422 (1968).

[1289] Rev. Proc. 72-18, § 4.04 provides this example:

> Taxpayer *A*, an individual, owns common stock listed on a national securities exchange, having an adjusted basis of $200,000; he owns rental property having an adjusted basis of $200,000; he has cash of $10,000; and he owns readily marketable municipal bonds having an adjusted basis of $41,000. *A* borrows $100,000 to invest in a limited partnership interest in a real estate syndicate and pays $8,000 interest on the loan which he claims as an interest deduction for the taxable year. Under these facts and circumstances, there is a presumption that the $100,000 indebtedness which is incurred to finance A's portfolio investment is also incurred to carry A's existing investment in tax-exempt bonds since there are no additional facts or circumstances to rebut the presumption. Accordingly, a portion of the $8,000 interest payment will be disallowed under section 265(2) of the Code.

[1290] Rev. Proc. 72-18, § 4.02 provides:

> An individual taxpayer may incur a variety of indebtedness of a personal nature, ranging from short-term credit for purchases of goods and services for personal consumption to a mortgage incurred to purchase or improve a residence or other real property which is held for personal use. Generally, section 265(2) of the Code will not apply to indebtedness of this type, because the purpose to purchase or carry tax-exempt obligations cannot reasonably be inferred where a personal purpose unrelated to the tax-exempt obligations ordinarily dominates the transaction. For example, section 265(2) of the Code generally will not apply to an individual who holds salable municipal bonds and takes out a mortgage to buy a residence instead of selling his municipal bonds to finance the purchase price. Under such circumstances the purpose of incurring the indebtedness is so directly related to the personal purpose of acquiring a residence that no sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations may reasonably be inferred.

[1291] Section 7.01.

[1292] Section 7.01, which continues:

> For example, if *A* borrows $100,000 from a bank and invests $75,000 of the proceeds in tax-exempt obligations, 75 percent of the interest paid on the bank borrowing would be disallowed as a deduction.

[1293] Section 7.02, which continues:

Investing up to 2% of one's assets in tax-exempt investments might be disregarded.[1294]

II.G.28. Missouri Income Tax Cut for Pass-Through Entities and Sole Proprietorships

RSMo. § 143.022 allows individuals to subtract from their federal adjusted gross income[1295] a portion of the income they earn as sole proprietors[1296] or as owners of partnerships or S corporations.[1297] The portion is expected to start at 5% in calendar year 2018 [1298] and increase in 5% increments until it reaches 25% in calendar year 2022,[1299] if Missouri's revenue increases sufficiently.

The deduction applies to income reported on Form 1040, Schedule C or Schedule E, Part II. Interest and dividends from pass-through entities are reported on Schedule B and therefore do not qualify for this break. Same with gain on the sale of assets, which are reported on Schedule D (gain from the sale of capital assets and the long-term capital gain component of gain from the sale of business assets) or Form 1040, line 14 (depreciation recapture from the sale of business assets). Because gain from the sale of business assets is not eligible for this deduction, but income that is not offset by depreciation is eligible, this provision encourages business owners to consider Code § 1031 nontaxable like-kind exchanges of business assets (to the extent such a small tax cut is capable of motivating any actions).

> The amount of interest on such indebtedness to be disallowed shall be determined by multiplying the total interest on such indebtedness by a fraction, the numerator of which is the average amount during the taxable year of the taxpayer's tax-exempt obligations (valued at their adjusted basis) and the denominator of which is the average amount during the taxable year of the taxpayer's total assets (valued at their adjusted basis) minus the amount of any indebtedness the interest on which is not subject to disallowance to any extent under this Revenue Procedure.

[1294] Rev. Proc. 72-18, § 3.05, which provides:

> Generally, where a taxpayer's investment in tax-exempt obligations is insubstantial, the purpose to purchase or carry tax-exempt obligations will not ordinarily be inferred in the absence of direct evidence as set forth in sections 3.02 and 3.03. In the case of an individual, investment in tax- exempt obligations shall be presumed insubstantial only where during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2 percent of the average adjusted basis of his portfolio investments (as defined in section 4.04) and any assets held in the active conduct of a trade or business. In the case of a corporation, an investment in tax-exempt obligations shall be presumed insubstantial only where during the taxable year the average amount of the tax-exempt obligations (valued at their adjusted basis) does not exceed 2 percent of the average total assets (valued at their adjusted basis) held in the active conduct of the trade or business. This paragraph shall not apply to a dealer in tax-exempt obligations.

[1295] RSMo. § 143.022.2.

[1296] RSMo. § 143.022.1(1) refers to the "total combined profit as properly reported to the Internal Revenue Service on each Schedule C, or its successor form, filed."

[1297] RSMo. § 143.022.1(2) refers to the "total partnership and S corporation income or loss properly reported to the Internal Revenue Service on Part II of Schedule E, or its successor form."

[1298] It would have started in 2017 if Missouri's revenue had increased enough for the fiscal year that ended in 2016, RSMo. § 143.022.6, but the target described in RSMo. § 143.022.5 was not reached until the fiscal year that ended in 2017.

[1299] RSMo. § 143.022.4.

An individual owning a single member LLC that is a disregarded entity who reports rental income on Schedule E, Part I will not get this break. By adding a member to the LLC (for example, a spouse), the LLC reports its rental income on a partnership return and the owners report their K-1 income on Schedule E, Part II, making the rental income eligible for this tax break. Note that, unless the income is large enough, this tax break does not justify the expense of filing a partnership tax return.

The subtraction is "apportioned in proportion to their share of ownership of the business as reported on the taxpayer's schedule K-1, or its successor form, for the tax period for which such deduction is being claimed when determining the Missouri adjusted gross income" of owners of partnerships or S corporations.[1300]

II.H. Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property)

With the estate and gift tax rate at only 40%, one might consider whether ordinary income assets are better candidates for retention and basis step-up than assets that would generate capital gain. When one considers ordinary income rates, present and future, not only federal but also state and local income tax, one might determine that obtaining a basis step-up might be more important than saving estate tax on an ordinary income asset.[1301]

Also consider that perhaps estates might use assets not protected by GST exemption to pay the estate tax, and the assets with the stepped-up basis go to GST-exempt trusts.

Paul S. Lee of Northern Trust (formerly Bernstein), in various presentations with "Venn Diagrams" in the title, discusses the continuum of assets (regarding tax rates when various assets are sold) and approaches to obtaining basis increases.

At the 2015 Heckerling Institute, John Bergner's presentation, "Oh, What a Relief It Is: Curing Estate Plans That No Longer Make Sense in Light of the American Taxpayer Relief Act of 2012," mentioned basis step-up ideas. Another good source is Yuhas & Radom, "The New Estate Planning Frontier: Increasing Basis," *Journal of Taxation* (1/2015).[1302]

II.H.1. Ordinary Income Assets

Ordinary income assets include the following depreciable property:[1303]

- Equipment, furniture, and other tangible personal property, which is even more of a concern with recently expanded opportunities for Code § 179 write-offs and bonus depreciation[1304]

[1300] RSMo. § 143.022.3.
[1301] Jerome M. Hesch suggested that estates of 2010 decedents might consider paying estate tax rather than electing out of estate tax and into basis carryover. "A 2010 Estate that Holds Depreciable Property Might Benefit from Paying Estate Tax," Steve Leimberg's Estate Planning Email Newsletter (Archive Message #1771).
[1302] Saved as document number 6108884 in my system.
[1303] PPC's *1040 Deskbook*, Table T801: Depreciation Recapture. I have not verified all of this.
[1304] Code § 1245.

- Components of buildings that have been segregated into Code § 1245 assets as a result of a cost-segregation study geared toward having faster depreciation on those components than is permitted for buildings[1305]

- Amortizable goodwill, going concern value, and other intangibles[1306]

- Real property held for one year or less

- Real property held for more than one year described below (dates approximate):

  - Residential real property acquired 1981-1986, to the extent depreciated faster than straight-line would have allowed

  - Nonresidential real property held more than one year, with accelerated depreciation method used under ACRS (acquired 1981-1986)[1307]

  - Certain real property bought before 1981

See part II.G.17 Intellectual Property and Other Intangible Assets.

II.H.2. Basis Step-Up Issues

Assets includible in the decedent's gross estate for estate tax purposes are subject to a Code § 1014 basis adjustment.[1308] So is property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent."[1309] It has been suggested that the latter applies to property held in an irrevocable trust, that is outside of the decedent's gross estate but was deemed owned by the decedent until death, because for income tax purposes the decedent is deemed to have held the assets.[1310] The IRS would argue that the basis adjustment provisions apply to transfers made for transfer tax

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[1305] Code § 1245(a)(3)(C) treats as Code § 1245 ordinary income recapture property "so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 179A, 179B, 179C, 179D, 179E, 185, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 194…." For allocations involving such real property, see Notice 2013-59.
[1306] Code § 197. Amortizable goodwill is a not a capital asset, but other goodwill is. Letter Ruling 200243002. However, amortizable goodwill may be eligible for capital gain treatment as described in part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 962.
[1307] Code § 1245(a)(5), repealed by the Tax Reform Act of 1986 but is said to apply to future dispositions of the property for which certain depreciation methods apply.
[1308] Code § 1014(b)(9).
[1309] Code § 1014(b)(1).
[1310] Rev. Proc. 2015-37 added to the list of areas with respect to which the IRS will not rule (which will show up in the annual revenue procedure regarding issuing private letter rulings):

> *Section 1014. Basis of Property Acquired from a Decedent*. Whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code.

purposes, not based on transfers made for income tax purposes.[1311] However, relying in part on the rule that foreign real property that is inherited by a United States citizen from a nonresident alien will receive a step-up in basis under Code § 1014(b)(1),[1312] Letter Ruling 201245006 held that Code § 1014(b)(1) applied on the termination of an irrevocable trust created by a nonresident alien who had retained the right to all of the trust's income and could receive principal distributions in the trustees' absolute discretion (the trustees being the grantor and an unrelated party).[1313]

A generation-skipping transfer (GST) might generate a new basis as well. If property is transferred in a taxable termination[1314] which occurs at the same time as and as a result of the death of an individual, the basis of property not protected by the allocation of GST exemption is adjusted in a manner similar to the manner provided under Code § 1014(a).[1315] For any other GST, the transferred property's basis is increased (but not above the fair market value of such property) by an amount equal to that portion of the GST tax imposed with respect to the transfer which is attributable to the excess of the fair market value of such property over its adjusted basis immediately before the transfer.[1316] This basis adjustment is applied after any Code § 1015 basis adjustment with respect to the transfer.[1317]

A taxable termination providing a basis step-up creates some powerful estate planning possibilities when the beneficiary's estate, outside of the trust, is significantly above the estate tax exemption. Not granting the beneficiary a (perhaps contingent) general power of appointment might save state estate tax (if any) and opens the door for "generation jumping." For an example of generation jumping, suppose Mom leaves a trust for Daughter that is not protected by Mom's GST exemption, Daughter has a large estate of

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[1311] See fn. 4974, citing CCA 200937028 for the proposition that Code § 1014(b)(1) would not apply; see also fn. 4920, citing a letter ruling providing that assets in a GRIT received a Code § 1015(d) basis increase for gifts tax paid.

[1312] Rev. Rul. 84-139.

[1313] The facts were:

> Taxpayer, a citizen and resident of Country, proposes to transfer assets to Trust, an irrevocable trust subject to the laws of Country. The assets of Trust include cash and stock in Company 1 and Company 2 that are publicly traded in Country and on the New York Stock Exchange. Taxpayer and X, an unrelated party, are Trustees.
>
> Under the terms of Trust, Trustees are to pay all of the income of Trust to Taxpayer during his lifetime and may, in Trustees' absolute discretion, pay principal of Trust to Taxpayer. Article IV. Upon the death of Taxpayer, any income of Trust and any corpus remaining in Trust are to be paid or transferred to or in trust for one or more of Taxpayer's issue in such proportions as Taxpayer may appoint by deed or will. In default of appointment, corpus and accumulated income will be held in further trust for the benefit of Taxpayer's issue. Article V. Trust further provides that during Taxpayer's lifetime no adverse party within the meaning of § 672(a) is eligible to serve as Trustee. Article XI.

[1314] "Taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless immediately after such termination, a non-skip person has an interest in such property, or at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person. Code § 2612.

[1315] Code § 2654(a)(2).

[1316] Code § 2654(a)(1).

[1317] Code § 2654(a)(1).

her own, and Daughter has a nongeneral power of appointment. Daughter might choose to leave part or all of the trust to her own grandchildren or more remote descendants at Daughter's death. To the extent Daughter does that, the property incurs only one level of transfer tax even though it passed two or more generations below Daughter. Although the property is not included in Daughter's estate, it receives a new basis by reason of Daughter's death. Daughter would also have the option to direct property to her siblings or other nonskip persons, free from transfer tax but without a new basis. The main disadvantage to exposing property to GST tax instead of estate tax is that, although Code § 6166 allows deferral of estate tax on certain business interests,[1318] that deferral does not apply to GST tax. Also, the Code § 2013 credit for tax on prior transfers does not provide relief from GST tax.[1319] Giving a married beneficiary a general power of appointment permits a free basis step-up, but using a nongeneral power of appointment provides other benefits that one would carefully weigh.[1320]

A property's value used to determine federal estate tax when its owner dies is presumed to be the basis under Code § 1014, which presumption may be rebutted by clear and convincing evidence.[1321] However, Code § 1014 basis may not exceed the final value that has been determined for estate tax purposes,[1322] or, if not finally determined, the value shown on a statement has been furnished under Code § 6035(a) identifying the value of such property.[1323] This limitation applies only to property whose inclusion in the decedent's estate increased estate tax liability.[1324]

[1318] See part III.B.5.d.ii Code § 6166 Deferral.

[1319] Harrington, Plaine & Zaritsky, ¶ 3.06[2] No Credit for Property Previously Taxed, *Generation-Skipping Transfer Tax* (WG&L).

[1320] If the beneficiary has a general power of appointment, then estate tax is avoided at the beneficiary's death (when keeping the property in the family) only when the spouse receives a marital deduction bequest, which at a minimum entails giving the surviving spouse all of the income. If the beneficiary has a nongeneral power of appointment that includes the child's surviving spouse as an eligible appointee, the child can make the surviving spouse's interest in trust income discretionary, shift income to children and grandchildren at their presumably lower rates, make medical and tuition payments for grandchildren and other skip persons that are excluded from GST tax, and include various flexibility and protections, while still deferring GST tax on the trust property until the child's surviving spouse's death.

[1321] Rev. Rul. 54-97. This ruling has been followed, distinguished, or questioned in a variety of cases. For a discussion of any duty of consistency, see *Van Alen v. Commissioner*, T.C. Memo. 2013-235.

[1322] Code § 1014(f)(1)(A). Code § 1014(f)(3) provides that basis of property has been determined for estate tax purposes if:

(A) the value of such property is shown on a return under section 6018 and such value is not contested by the Secretary before the expiration of the time for assessing a tax under chapter 11,

(B) in a case not described in subparagraph (A), the value is specified by the Secretary and such value is not timely contested by the executor of the estate, or

(C) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

[1323] Code § 1014(f)(1)(B). Code § 6035(a) requires a statement by the executor (or, under Code § 6018(b), a beneficiary, if the executor if unable to make a complete return) of an estate required to file an estate tax return.

[1324] Code § 1014(f)(2).

The cleansing effect of a basis step-up at death is a powerful planning tool.[1325]

For a discussion of the basis an owner has in an entity (outside basis) contrasted with the basis the entity has in the assets the entity owns (inside basis),[1326] see parts II.Q.8.e.iii.(a) Illustration of Inside Basis Issue and II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), the latter including a discussion on whether a basis increase by reason of gift tax paid generates a basis step-up.[1327]

For estate planning and income tax considerations when drafting bequests of a partnership or S corporation, see parts II.O.2 Spousal Issues in Buy-Sell Agreements and Related Tax Implications, III.A.3.c.iii Deadlines for QSST and ESBT Elections, and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.

II.H.2.a. Free Basis Step-Up When First Spouse Dies

When the first spouse dies, assets included in the first spouse's estate for estate tax purposes generate a new tax basis,[1328] but the marital deduction can be used to avoid any estate tax at that time.[1329] Using a QTIP trust (a special type of marital deduction trust)[1330] allows the executor[1331] to choose to keep all of the trust outside of the surviving spouse's estate for estate tax purposes, include all of the trust inside the estate tax

[1325] See Rev. Rul. 73-183 (no gain or loss is recognized on the decedent's final income tax return as a result of the transfer of stock – that received a basis adjustment on Code § 1014 upon death - to the executor of the decedent's estate).

[1326] A discussion suitable for clients is in my blog, "Tax basis: The key to reducing gain on sale or deducting asset purchases," at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.

[1327] This discussion is in fn. 4144.

[1328] Code § 1014(b)(9).

[1329] Code § 2056.

[1330] Code § 2056(b)(7)(B) provides:

> *Qualified terminable interest property defined*. For purposes of this paragraph-
>
> (i) *In general*. The term "qualified terminable interest property" means property-
>   (I) which passes from the decedent,
>   (II) in which the surviving spouse has a qualifying income interest for life, and
>   (III) to which an election under this paragraph applies.
>
> (ii) *Qualifying income interest for life*. The surviving spouse has a qualifying income interest for life if-
>   (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and
>   (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.
>
> Subclause (II) shall not apply to a power exercisable only at or after the death of the surviving spouse. To the extent provided in regulations, an annuity shall be treated in a manner similar to an income interest in property (regardless of whether the property from which the annuity is payable can be separately identified).

Letter Ruling 8943005 approves of giving the surviving spouse an inter vivos power of appointment that the surviving spouse can exercise in favor of others, notwithstanding Code § 2056(b)(7)(B)(ii)(II).

[1331] Reg. § 20.2056(b)-7(b)(3).

system at the surviving spouse's death, or a combination.[1332] The executor makes the election on "the last estate tax return filed by the executor on or before the due date of the return, including extensions or, if a timely return is not filed, the first estate tax return filed by the executor after the due date,"[1333] the latter suggesting that a surviving spouse might want to avoid filing an estate tax return until the surviving spouse has a better idea of whether estate tax inclusion or basis step-up would be more beneficial – even to the point of filing a late return many years after the first spouse's death. (This ability to make a late-filed QTIP election applies for estate tax purposes but not for gift tax purposes.)[1334] Some people had expressed concern that the IRS might use Rev. Proc. 2001-38, which had allowed taxpayers to undo certain unnecessary QTIP elections made by mistake, to undo a QTIP election that the taxpayer did not need to save estate tax but is using to achieve a basis step-up. However, Rev. Proc. 2016-49 revoked Rev. Proc. 2001-38 and provided a new procedure that clearly avoids this concern.

"Portability" allows the surviving spouse to use the first spouse's estate/gift tax exemption,[1335] but not the first spouse's GST exemption; to use the latter, use a QTIP marital deduction trust with a Code § 2652(a)(3) "reverse QTIP" election. The executor

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[1332] Reg. § 20.2056(b)-7(b)(2) provides:

> Property for which an election may be made.
>
> (i) *In general*. The election may relate to all or any part of property that meets the requirements of section 2056(b)(7)(B)(i), provided that any partial election must be made with respect to a fractional or percentage share of the property so that the elective portion reflects its proportionate share of the increase or decrease in value of the entire property for purposes of applying sections 2044 or 2519. The fraction or percentage may be defined by formula.
>
> (ii) *Division of trusts*.
>
> (A) *In general*. A trust may be divided into separate trusts to reflect a partial election that has been made, or is to be made, if authorized under the governing instrument or otherwise permissible under local law. Any such division must be accomplished no later than the end of the period of estate administration. If, at the time of the filing of the estate tax return, the trust has not yet been divided, the intent to divide the trust must be unequivocally signified on the estate tax return.
>
> (B) *Manner of dividing and funding trust*. The division of the trust must be done on a fractional or percentage basis to reflect the partial election. However, the separate trusts do not have to be funded with a pro rata portion of each asset held by the undivided trust.
>
> (C) *Local law*. A trust may be divided only if the fiduciary is required, either by applicable local law or by the express or implied provisions of the governing instrument, to divide the trust on the basis of the fair market value of the assets of the trust at the time of the division.

[1333] Reg. § 20.2056(b)-7(b)(4)(i). However, if the estate tax return preparer put the QTIP trust on the wrong part of Schedule M, classifying it as marital deduction property not subject to a QTIP election, then the IRS might allow a supplemental estate tax return to correct that mistake. Letter Ruling 201714020.

[1334] Letter Ruling 201109012, retroactively revoking Letter Ruling 201025021:

> The time for filing the inter vivos QTIP election is expressly prescribed by § 2523(f)(4). Because § 301.9100-3 is applicable only to requests for extensions of time fixed by regulations or other published guidance, the Service does not have the discretion to grant an extension of time under § 301.9100-3 to make the QTIP election under § 2523(f)(4) for the Year 1 transfer to Trust.

[1335] Code § 2010(c)(2)(B).

of the estate of the first spouse to die might elect to take a marital deduction beyond that needed for estate tax purposes, so that the property will get a basis step-up at the surviving spouse's death without any estate tax being due, if the surviving spouse's taxable estate does not exceed the sum of the first spouse's estate/gift tax exemption (if and to the extent available)[1336] and the surviving spouse's estate tax exemption. A disadvantage of portability is keeping open until the surviving spouse's death the statute of limitations for determining the value of assets in the first spouse's estate to the extent that they determine the first spouse's unused exemption.[1337] Another possible disadvantage of portability might be loss of the state estate tax exemption of the first spouse to die, if and to the extent that the estate plan fails to use all of the first spouse's state estate tax exemption.[1338] Also, generally state death taxes do not apply portability.

Portability requires filing a timely estate tax return.[1339] However, this election is one for which the IRS may grant administrative relief.[1340] One might be able to filing an untimely

[1336] In addition to using the deceased spouse's exemption, the surviving spouse would lose it if and to the extent the surviving spouse remarries, does not use that exemption, and the new spouse predeceases the surviving spouse. Code § 2010(c)(4)(B)(i).

[1337] Reg. § 20.2010-2(d) provides:

> *Authority to examine returns of decedent*. The IRS may examine returns of a decedent in determining the decedent's DSUE amount, regardless of whether the period of limitations on assessment has expired for that return. See § 20.2010-3(d) for additional rules relating to the IRS's authority to examine returns. See also section 7602 for the IRS's authority, when ascertaining the correctness of any return, to examine any returns that may be relevant or material to such inquiry.

[1338] A state death tax chart is at http://www.actec.org/resources/state-death-tax-chart. The executor files the estate tax return. Reg. § 20.2010-2(a)(6).

[1339] Code § 2010(c)(5)(A) provides, "No election may be made under this subparagraph if such return is filed after the time prescribed by law (including extensions) for filing such return."

[1340] Reg. § 20.2010-2(a)(1) provides:

> *Timely filing required*. An estate that elects portability will be considered, for purposes of subtitle B and subtitle F of the Internal Revenue Code (Code), to be required to file a return under section 6018(a). Accordingly, the due date of an estate tax return required to elect portability is nine months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). See §§ 20.6075-1 and 20.6081-1 for additional rules relating to the time for filing estate tax returns. An extension of time to elect portability under this paragraph (a) will not be granted under § 301.9100-3 of this chapter to an estate that is required to file an estate tax return under section 6018(a), as determined without regard to this paragraph (a). Such an extension, however, may be available under the procedures applicable under §§ 301.9100-1 and 301.9100-3 of this chapter to an estate that is not required to file a return under section 6018(a), as determined without regard to this paragraph (a).

Letter Ruling 201532002 allowed an extension where the sum of the gross estate and taxable gifts was less than the basic exclusion amount. No explanation for reasonable cause was listed – the ruling stated only, "The estate discovered its failure to elect portability after the due date for making the election." The ruling granted an extension until 120 days after the date of the ruling. The taxpayer sought the ruling in 2015. The IRS conditioned the relief, "If it is later determined that, based on the value of the gross estate and taking into account any taxable gifts, Decedent's estate is required to file an estate tax return pursuant to § 6018(a), the Commissioner is without authority under § 301.9100-3 to grant to Decedent's estate an extension of time to elect portability and the grant of the extension referred to in this letter is deemed null and void." Similar relief was granted in Letter Rulings 201535004 (same), 201626008 (same), 201706003 (same), 201706016 request for an extension and get retroactive relief within 15 months after death, without obtaining a private letter ruling; however, for a period of time after the spring of 2016, relief without a private letter ruling was unlikely.[1341] Fortunately, Rev. Proc. 2017-34 provides an automatic extension for estates that were not required to file and did not file timely;[1342] the extension is until the later of January 2, 2018 or the second annual anniversary of the decedent's date of death.[1343] One might also be able to obtain

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(same), and 201536002 (attorney who prepared timely filed estate tax return failed to make QTIP election; no condition based on size of estate).

1341 Given that Reg. § 20.2010-2(a)(1) refers to Reg. § 20.6081-1, let's look at Reg. § 20.6081-1(c):

> *Extension for good cause shown*. In its discretion, the Internal Revenue Service may, upon the showing of good and sufficient cause, grant an extension of time to file the return required by section 6018 in certain situations. Such an extension may be granted to an estate that did not request an automatic extension of time to file Form 706 prior to the due date under paragraph (b) of this section, to an estate or person that is required to file forms other than Form 706, or to an executor who is abroad and is requesting an additional extension of time to file Form 706 beyond the 6-month automatic extension. Unless the executor is abroad, the extension of time may not be for more than 6 months beyond the filing date prescribed in section 6075(a). To obtain such an extension, Form 4768 must be filed in accordance with the procedures under paragraph (a) of this section and must contain a detailed explanation of why it is impossible or impractical to file a reasonably complete return by the due date. Form 4768 should be filed sufficiently early to permit the Internal Revenue Service time to consider the matter and reply before what otherwise would be the due date of the return. Failure to file Form 4768 before that due date may indicate negligence and constitute sufficient cause for denial of the extension. If an estate did not request an automatic extension of time to file Form 706 under paragraph (b) of this section, Form 4768 must also contain an explanation showing good cause for not requesting the automatic extension.

Instructions for Form 4768 (Rev. August 2012), which have a spirit that seems more generous to the taxpayer than the tone of the regulation authorizing the extension, provide:

> **Extension for cause**. If you have not filed an application for an automatic extension for Form 706, and the time for filing such an application has passed, an extension of time to file may still be granted if good cause is shown. File Form 4768, along with explanations of why the automatic extension was not requested and why a complete return was not filed by the due date, as soon as possible.

They also say the following:

> We will contact you only if your request for extension of time to file is denied. Keep a copy of the form for your records.

Consider obtaining a transcript or other verification that the extension was approved.

An attorney reported to me filing a late Form 4768 on March 31, 2016 and on April 19, 2016 receiving a denial of the extension, with the explanation, "An error made by the office of your attorney in determining and meeting the due date of Form 4768 is not exercising ordinary business care and prudence standards." When called, the IRS responded that the denial could be appealed or they should obtain a private letter ruling. The attorney opted for the latter and received one in early October 2016, and the estate qualified for a reduced filing fee ($6,500).

1342 Section 3.02 denies relief to timely filed returns. A governmental official pointed out that any untimely filed return needs to be re-filed with an original signature to comply with this procedure; presumably this is required by Section 4.01(1).

1343 Section 3.01 imposes the following requirements:

(1) The decedent:
  (a) was survived by a spouse;
  (b) died after December 31, 2010; and
  (c) was a citizen or resident of the United States on the date of death.

automatic administrative relief within six months after the original due date if one discovers that one inadvertently opted out of portability.[1344]

An estate that is not required to file an estate tax return has reduced reporting requirements regarding marital or charitable deduction property.[1345] For such property, the return is "required to report only the description, ownership, and/or beneficiary of such property, along with all other information necessary to establish the right of the estate to the" marital or charitable deduction,[1346] so long as the "the executor exercises due diligence to estimate the fair market value of the gross estate, including the property" subject to the reduced reporting requirements.[1347] The executor should include evidence that either that particular property[1348] or the entire residue[1349] passes to the

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(2) The executor is not required to file an estate tax return under § 6018(a) as determined based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes;

(3) The executor did not file an estate tax return within the time required by § 20.2010-2(a)(1) for filing an estate tax return; and

(4) The executor satisfies all requirements of section 4.01 of this revenue procedure.

Section 4.01 imposes the following requirements:

(1) A person permitted to make the election on behalf of the estate of a decedent—that is, an executor described in § 20.2010-2(a)(6)—must file a complete and properly prepared Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, on or before the later of January 2, 2018, or the second annual anniversary of the decedent's date of death. The Form 706 will be considered complete and properly prepared if it is prepared in accordance with § 20.2010-2(a)(7).

(2) The executor filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

[1344] Reg. § 301.9100-2(b).

[1345] Reg. § 20.2010-2(a)(7)(ii)(A), referring to property the value of which is deductible under Code § 2056, 2056A, or 2055(a).

[1346] Reg. § 20.2010-2(a)(7)(ii)(A), referring to "§§ 20.2056(a)-1(b)(i) through (iii) and 20.2055-1(c), as applicable."

[1347] Reg. § 20.2010-2(a)(7)(ii)(B) provides:

> *Return requirements when reporting of value not required for certain property*. Paragraph (a)(7)(ii)(A) of this section applies only if the executor exercises due diligence to estimate the fair market value of the gross estate, including the property described in paragraph (a)(7)(ii)(A) of this section. Using the executor's best estimate of the value of properties to which paragraph (a)(7)(ii)(A) of this section applies, the executor must report on the estate tax return, under penalties of perjury, the amount corresponding to the particular range within which falls the executor's best estimate of the total gross estate, in accordance with the Instructions for Form 706.

[1348] Reg. § 20.2010-2(a)(7)(ii)(C), Example (1), provides:

(i) *Facts*. The assets includible in H's gross estate consist of a parcel of real property and bank accounts held jointly with W with rights of survivorship, a life insurance policy payable to W, and a survivor annuity payable to W for her life. H made no taxable gifts during his lifetime.

(ii) *Application*. E files an estate tax return on which these assets are identified on the proper schedule, but E provides no information on the return with regard to the date of death value of these assets in accordance with paragraph (a)(7)(ii)(A) of this section. To establish the estate's entitlement to the marital deduction in accordance with § 20.2056(a)-1(b) (except with regard to establishing the value of the property) and the instructions for the estate tax return, E includes with the estate tax return evidence to verify the title of each jointly held asset, to confirm that W is the sole surviving spouse. However, that reduced reporting rule does not apply to marital or charitable deduction property if:[1350]

(1) The value of such property relates to, affects, or is needed to determine, the value passing from the decedent to a recipient other than the recipient of the marital or charitable deduction property;

(2) The value of such property is needed to determine the estate's eligibility for the provisions of sections 2032, 2032A, or another estate or generation-skipping transfer tax provision of the Code for which the value of such property or the value of the gross estate or adjusted gross estate must be known (not including section 1014 of the Code);

(3) Less than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property; or

(4) A partial disclaimer or partial qualified terminable interest property (QTIP) election is made with respect to a bequest, devise, or transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property.

For example, if half of the residue passes to marital deduction trust and half passes to a nonmarital trust, the residue is not eligible for the reduced reporting requirements.[1351]

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beneficiary of both the life insurance policy and the survivor annuity, and to verify that the annuity is exclusively for W's life. Finally, E reports on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

[1349] Reg. § 20.2010-2(a)(7)(ii)(C), Example (2), provides:

(i) *Facts*. H's will, duly admitted to probate and not subject to any proceeding to challenge its validity, provides that H's entire estate is to be distributed outright to W. The non-probate assets includible in H's gross estate consist of a life insurance policy payable to H's children from a prior marriage, and H's individual retirement account (IRA) payable to W. H made no taxable gifts during his lifetime.

(ii) *Application*. E files an estate tax return on which all of the assets includible in the gross estate are identified on the proper schedule. In the case of the probate assets and the IRA, no information is provided with regard to date of death value in accordance with paragraph (a)(7)(ii)(A) of this section. However, E attaches a copy of H's will and describes each such asset and its ownership to establish the estate's entitlement to the marital deduction in accordance with the instructions for the estate tax return and § 20.2056(a)-1(b) (except with regard to establishing the value of the property). In the case of the life insurance policy payable to H's children, all of the regular return requirements, including reporting and establishing the fair market value of such asset, apply. Finally, E reports on the estate return E's best estimate, determined by exercising due diligence, of the fair market value of the gross estate in accordance with paragraph (a)(7)(ii)(B) of this section. The estate tax return is considered complete and properly prepared and E has elected portability.

[1350] Reg. § 20.2010-2(a)(7)(ii)(A).

[1351] Reg. § 20.2010-2(a)(7)(ii)(C), Example (3), reasoning:

The amount passing to the non-marital trust cannot be verified without knowledge of the full value of the property passing under the will. Therefore, the value of the property of

Thus, a formula bequest to marital deduction and nonmarital trusts would not qualify for portability. However, a one-lung plan – described below – would be eligible.

I quite often draft estate plans where the entire residue goes into a trust for the surviving spouse that is eligible for the QTIP election – sometimes called a one-lung plan. For a number of reasons, this type of plan provides significant flexibility. Extra caution is required, however, when a surviving spouse who has estate planning goals that might not necessarily be consistent with the first spouse's goals (for example, the surviving spouse is not a parent of the decedent's children). A trust for which a QTIP election is made is included in the surviving spouse's estate for estate tax purposes,[1352] and generally it pays estate tax equal to the excess of the amount due with inclusion over the amount due if the trust were not included in the surviving spouse's taxable estate.[1353] No law requires the surviving spouse to use the deceased spouse's estate/gift tax exemption to protect the QTIP trust's assets from estate tax. Sometimes, the first spouse to die might consider making any trust for the surviving spouse ineligible for the QTIP election to the extent that doing so will exhaust the first spouse's remaining estate/gift tax exemption; although these issues might be contractually addressed, contractual obligations might be impractical or impossible to enforce, even with excellent drafting. Situations of concern include:

- <u>Benign Neglect</u>. The surviving spouse has an estate – beyond the QTIP trust - that exceeds the surviving spouse's estate own gift/tax exemption. The first spouse's estate tax exemption will be used against the surviving spouse's bequest, leaving the QTIP with the requirement to pay estate tax.

- <u>Potentially Unfair Actions</u>. The surviving spouse uses all the first spouse's estate/gift tax exemption and the surviving spouse's estate tax exemption to make gifts to those the surviving spouse wishes to benefit. No estate/gift tax exemption remains to shelter the QTIP trust from estate tax.

Suppose, to protect against this situation, the executor decides not to make a QTIP election, but the estate has unused exemption. Is the executor required to file a return to elect portability? The Oklahoma Supreme Court affirmed a trial court's order compelling the executor to file a federal estate tax return and elect portability, notwithstanding a prenuptial agreement waiving inheritance rights (but not referring to portability).[1354]

II.H.2.b. Basis Step-Up for All Property When First Spouse Dies

Consider using community property or a marital estate trust.

II.H.2.b.i. Community Property

Community property receives a new basis for both spouse's halves when the first spouse dies.[1355] This rule applies whether the property is held as an individual or

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the marital trust relates to or affects the value passing to the trust for W and the descendants of H and W.

[1352] Code § 2044.

[1353] Code § 2207A.

[1354] *Estate of Vose*, 2017 WL 167587, --- P.3d ---- (1/17/2017).

[1355] Code § 1014(b)(6).

through a joint revocable trust that constitutes community property under applicable state law.[1356] Beware, however, that converting property to community property may subject it to both spouses' creditors.[1357]

If each spouse is treated as owning one-half of each asset held as community property, valuation discounts would reduce the new basis, relative to what it would have been had the property not been fractionalized.[1358] It has been suggested that, if state law or the

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[1356] Rev. Rul. 66-283, involving the following facts:

> H and W are husband and wife and domiciliaries of the State of California. Under California community property law a husband and wife may by agreement characterize their property as community or separate. Section 158 of the California Civil Code; *Mears v. Mears* (1960) 4 Cal. Rptr. 618; *Tomaier v. Tomaier* (1944) 146 P.2d 905. Under California law, community property may also be held by a trustee without losing its character as such. *Berniker v. Berniker* (1947) 182 P.2d 557. In 1958 H and W executed a revocable trust and transferred to it certain property held by them as community property under the laws of California. The trust instrument provides that the property transferred to the trust shall retain its character as community property. Under the terms of the trust, H and W, as long as both are alive, may at any time alter, amend or revoke the trust in whole or in part, provided that any part of the trust estate so withdrawn shall be transferred to H and W as community property. The net income from the trust is community property, and is to be paid to or applied for the benefit of the grantors.
>
> Upon the death of either H or W, the trust estate is to be divided into two equal shares, each to be held and administered as a separate trust. One share is to consist of the community interest of H, and the other of the community interest of W. During the lifetime of the survivor, the trustee is to pay to the survivor all of the net income from his or her share, and to pay to the survivor and another designated beneficiary the net income from the decedent's share. The trust consisting of the community interest of the decedent is to be irrevocable, but the trust consisting of the survivor's community interest may be altered, amended, or revoked by the survivor at any time.

It held:

> In this case, one-half of the value of the community interest in the property held in the revocable trust is includible under sections 2033, 2036(a)(1), and 2038(a)(1) of the Code in determining the value of the gross estate of the first spouse to die, because both spouses had retained for their lives the right to the income from the community property held in the trust and possessed at the date of the decedent spouse's death a power to alter, amend or revoke the trust. The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under section 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and, accordingly, its basis is determined under the provisions of section 1014(a) of the Code.

[1357] See fn. 5428 in part III.B.5.d.iv.(a) Imposition of the Estate Tax Lien.

[1358] *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982) (15% discount under California law; valuing separately was the issue – amount of discount was not challenged). In upholding the taxpayer's legal arguments that valuation discounts applied to each half, *Estate of Bright v. U.S.,* 658 F.2d 999 (5th Cir. 1981), held:

> First, the government argues that the property to be valued for estate tax purposes is an undivided one-half interest in the control block of 55% of the stock, and that the proper method of valuation would be to value the 55% control block, including a control premium, and then take one-half thereof. Both parties agree that the estate tax is an excise tax on the transfer of property at death, and that the property to be valued is the property which is actually transferred, as contrasted with the interest held by the decedent before death or the interest held by the legatee after death. *United States v. Land*, 303 F.2d 170 (5th Cir. 1962). See also *Ithaca Trust Co. v. United States*,

trust agreement has adopted the aggregate theory of community property, one can argue that a partial interest discount does not apply.[1359] One might consider using a

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279 U.S. 151, 49 S.Ct. 291, 73 L.Ed. 647 (1929); *Edwards v. Slocum*, 264 U.S. 61, 44 S.Ct. 293, 68 L.Ed. 564 (1924); *Connecticut Bank and Trust Company v. United States*, 439 F.2d 931 (2nd Cir. 1971); *Walter v. United States*, 341 F.2d 182 (6th Cir. 1965); *Commissioner v. Chase Manhattan Bank*, 259 F.2d 231 (5th Cir. 1958). Both also agree that state law, Texas in this case, determines precisely what property is transferred. *Morgan v. Commissioner*, 309 U.S. 78, 60 S.Ct. 424, 84 L.Ed. 585 (1940); *Duncan v. United States*, 247 F.2d 845 (5th Cir. 1957). Both parties agree that, under Texas law, the stock at issue was the community property of Mr. and Mrs. Bright during her life, that Mrs. Bright's death dissolved the community, that upon death the community is divided equally, that each spouse can exercise testamentary disposition over only his or her own half of the community, and that "only the decedent's half is includable in his gross estate for federal tax purposes." *Commissioner v. Chase Manhattan Bank*, 259 F.2d at 239. Under Texas law, upon the division of the community at death, each spouse owns an undivided one-half interest in each item of community property. *Caddell v. Lufkin Land & Lumber Co.*, 255 S.W. 397 (Tex. Com. App., 1923).

In its brief the government argued that, because the interest to be valued was an undivided one-half interest in the full 55% control block, the proper method would be to value the whole, including its control premium, and then take one-half thereof to establish the value of the estate's undivided one-half interest. The estate points out that the government's argument overlooks the fact that the block of stock is subject to the right of partition under Texas law at the instance of either the surviving spouse or the estate of the deceased's spouse. Tex. Prob. Code Ann. § 385 (Vernon 1980). The government has not argued that partition would not be freely granted in a case involving fungible shares, such as this case. Thus, the estate has no means to prevent the conversion of its interest into shares representing a 27½% block, and we conclude that the estate's interest is the equivalent of a 27½% block of the stock. Accordingly, we reject the government's approach of valuing the 55% control block, with its control premium, and then taking one-half thereof. Accord *Estate of Lee v. Commissioner*, 69 T.C. 860 (1978).

The *Bright* dissent was troubled that the legal and not the factual valuation issues were addressed. The dissent portrayed the valuation discount as 50% for illiquidity and unmarketability of minority interest and 23% to take into account term loan agreements, guarantees and pledges that affect the stock's value, for a cumulative 73% discount.

[1359] It has been suggested that Alaska (Sec. 34.77.155), Arizona (ARS §§ 14-3916, 14-10816(22)), and Nevada have adopted the aggregate theory. It has been suggested that one read "The Modified Item Theory: An Alternative Method of Dividing Community Property Upon the Death of a Spouse," 28 Idaho L. Rev. 1047 (1991-1992), for an explanation of the item theory and aggregate theory. I invite readers to email me with citations or any other further information.

One California lawyer commented about California law:

> Technically is an item theory state, based on older case law. It was believed that two living spouses could affirmatively enter into a marital agreement opting out of item theory treatment and establishing different rules governing the division of community property at the first death. Probate code § 100 was enacted in 1990 to confirm that this is allowed.
>
> Probate Code § 104.5 was enacted in 1999, which provides that a transfer of community property to revocable trust is presumed to be an agreement pursuant to § 100. The legislative history suggests that the agreement so presumed is that the aggregate theory applies to division, rather than the item theory; but the language in the statute is a little dodgy, stating, "an agreement, for purposes of § 100 …, that those assets retain their character in the aggregate for purposes of any division under the trust." If ability to divide using aggregate theory approach is desired (and who wouldn't want this), the best practice is to explicitly provide in trusts and Wills and not rely on § 104.5.

community property agreement to govern the rights of all community property, whether or not in trust, which property may include IRAs.[1360]

If residents of a community property state buy real property in that state using common law titling and under that state's law the property retains the community property character of the funds used to buy the property, the real property receives a new basis as to both halves; in that case, the property was titled as joint tenants with right of survivorship and received a basis equal to the property's full value (undiscounted for community property fractional interest).[1361] To avoid proof issues when that occurs,[1362] consider titling using a community property trust.

If spouses owning community property move to a common law state, the property does not lose its community character; similarly, merely moving from a common law state to a community property state does not cause separate property to become community property.[1363]

[1360] See Letter Ruling 199925033.

[1361] Rev. Rul. 87-98; *Estate of Wayne-Chi Young v. Commissioner*, 110 T.C. 297 (1998) (taxpayers failed in their attempt to characterize jointly held property as community property to obtain a discount for property passing to a noncitizen spouse).

[1362] Rev. Rul. 87-98, which ruled in favor of community property status, illustrated this issue:

> D and D's spouse S, residents of community property state X, purchased real property in X with community funds and took title as joint tenants with rights of survivorship. However, D and S later executed joint wills in which they declared the property to be a community asset.
>
> Although X is a community property state, under the laws of X, spouses may hold property in joint tenancy or other common law estate. Because the laws of X do not make specific provision for the coexistence of a common law estate and a community property interest, taking title in a common law estate raises the presumption that the spouses intended to terminate the community interest, effectively transmuting the property's character from community to separate. This presumption is overcome by evidence that the spouses intended for the property not to be transmuted to separate property, in such a case, the community nature of the property is preserved. Under the law of X, an express statement of such intent in joint wills precludes transmutation by reason of taking title in joint tenancy.

Rev. Rul. 87-98 deferred to the state law characterization.

[1363] *Quintana v. Ordono*, 195 So.2d 577 (Fla. App. 3rd D. 1967); Restatement (First) of Conflict of Laws § 290 (1934) ("Interests of one spouse in movables acquired by the other during the marriage are determined by the law of the domicil of the parties when the movables are acquired."); Restatement (Second) of Conflict of Laws § 259 Removal of Movables of Spouses to Another State (A marital property interest in a chattel, or right embodied in a document, which has been acquired by either or both of the spouses, is not affected by the mere removal of the chattel or document to a second state, whether or not this removal is accompanied by a change of domicil to the other state on the part of one or both of the spouses. The interest, however, may be affected by dealings with the chattel or document in the second state.") and Comments a and b thereto:

> a. *Rationale*. Considerations of fairness and convenience require that the spouses' marital property interests in a chattel or right embodied in a document should not be affected by the mere removal of the chattel or document to another state. Likewise these interests are not affected by a change of domicil to another state by one or both of the spouses. Similarly, an interest in a right not embodied in a document that was acquired by either or both of the spouses during the marriage is not affected by a subsequent

II.H.2.b.ii. Marital Estate Trust

In a common law state, consider a marital estate trust.[1364] H creates a trust for W, with discretionary distributions to W. On W's death, the trust passes to W's estate. If H terminates the trust before W's death, the trust goes outright to W. The trust qualifies for the marital deduction because it cannot pass to anyone other than W.[1365] The gift is completed because the beneficiary is known with certainty.[1366] The trust is includible in H's estate under Code § 2038[1367] and in W's estate as an asset. Thus, it gets a new

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> change of domicil to another state by one or both of the spouses. The rule of this Section is an application of that of § 247.
>
> b. *Dealings with movable upon interests of spouses*. When a chattel or document is taken into a second state and is there exchanged for some other movable or immovable, the spouses acquire the same interests therein as they had in the original chattel or document. Thus, when a husband takes an automobile, which is his alone, from a separate property state to a community property state and then, having sold the automobile, uses the proceeds to purchase a truck, the truck will be the husband's separate property. On the other hand, if the husband had originally held the automobile in community with his wife and had exchanged it for a truck in a separate property state, the wife's interests in the truck would be the same as those she had previously had in the automobile.

Kingma, "Property Division at Divorce or Death for Married Couples Migrating Between Common Law and Community Property States," 35 ACTEC J. 74, 80 (Summer 2009) states:

> With respect to personal property acquired during marriage or coverture, courts held that the law of the marital domicile at the time the property was acquired governs the character of such property and related property rights.[56] Moving from a common law state to a community property state, or vice versa, does not change the character or interests in that property.[57] The Supreme Court of Ohio summarized this rule in Estate of Kessler:[58]
>
> > "It is generally recognized that the character of community property, even though it is personalty, does not change as to the nature of the holding, where the married couple remove themselves from a community-property state to a common-law state. The converse is also true, that is, the character of property acquired in a common-law state is not altered merely by the removal of the couple to a community-property state."
>
> [56] RESTATEMENT (SECOND) CONFLICT OF LAWS § 258 (1971); 15A Am. Jur. 2d *Community Property* §§ 16-18 (2008); A.M. Swarthout, ANNOTATION, CHANGE OF DOMICILE AS AFFECTING CHARACTER OF PROPERTY PREVIOUSLY ACQUIRED AS SEPARATE OR COMMUNITY PROPERTY, 14 A.L.R.3d 404 (2008). *See also* Estate of Crichton, 49 Misc.2d 405, 408-09 and 412-13, 267 N.Y.S.2d 706 (1966) (providing that when spouses have separate domiciles, conflict-of-law rules provide that the law of the state of domicile of the spouse who acquired the personal property controls as to the ownership of the property).
>
> [57] RESTATEMENT (SECOND) CONFLICT OF LAWS § 259 (1971). However, marital property interests may be affected by subsequent dealings with such property in the second state. *Id.*
>
> [58] Estate of Kessler, 177 Ohio St. 136, 138, 203 N.E.2d 221 (1964). For additional authorities regarding spouses migrating to a common law state from a community property state, *see* the treatises and case law cited in Rev. Rul. 72-443, 1972-2 C.B. 531.

[1364] Handler and Dunn, "The Estate Trust Revival: Maximizing the Full Basis Step-Up for Spouses," *Trusts & Estates* (8/2001).

[1365] Reg. §§ 25.2523(b)-1(a)(2) (gift tax), 20.2056(b)-1(c)(1) (estate tax).

[1366] Reg. § 25.2511-2(d).

[1367] Reg. § 20.2038-1(a), which includes the following statement:

basis at the death of the first to go of H or W.[1368] Note, however, that a reverse-QTIP election[1369] would not be available to preserve H's GST exemption with respect to this trust.

II.H.2.c. QTIP Trusts - Code § 2519 Trap

If the spouse makes a disposition of all or part of a qualifying income interest for life in a QTIP trust, he or she is treated gift and estate tax purposes as transferring all interests in property other than the qualifying income interest.[1370] Thus, the spouse is treated as making a gift under Code § 2519 of the entire trust less the qualifying income interest, and is treated for purposes of Code § 2036 as having transferred the entire trust corpus, including that portion of the trust corpus from which the retained income interest is payable.[1371] Code § 2702 provides in valuing the gift made by the spouse under Code § 2519.[1372] However, litigation might cause the gift not to be a gift.[1373]

> For example, section 2038 is applicable to a power reserved by the grantor of a trust to accumulate income or distribute it to A, and to distribute corpus to A, even though the remainder is vested in A or his estate, and no other person has any beneficial interest in the trust.

Note that, because the income and principal are discretionary, the Code § 2038 power extends to both income and principal and the basis change is plenary.

Letter Rulings 200919008, 200919009, and 200919010 (and, I am told, 200247037 and 200303016) held that the modification of an irrevocable trust by all interested parties did not implicate Code § 2038, so make the grantor's exercise of the power exercisable alone.

[1368] Reg. § 1.015-1(c) provides, "The date that the donee acquires an interest in property by gift is when the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee." Query whether the IRS might argue that H's authority to terminate the trust means that H continues to have dominion over the property, thereby triggering Code § 1014(e) on W's death, even though for gift tax purposes H has relinquished dominion and control.

Code § 1014(b)(3) is among the grounds for including it in H's estate.

[1369] Code § 2652(a)(3).

[1370] Code § 2519; Reg. § 25.2519-1(a).

[1371] Reg. § 25.2519-1(a).

[1372] Reg. § 25.2519-1(a).

[1373] FSA 199916025 described what happened when H, the surviving spouse, quarreled with S, the son of marriage to the deceased grantor:

> Although the inter vivos disposition of the qualifying income interest under section 2511 may be characterized as a transfer of property made in the ordinary course of business under Treas. Reg. § 25.2512-8, that does not affect the application of section 2519.
>
> The facts and documents provided indicate that there was animosity between H and S. Litigation was pending, pleadings were filed, temporary restraining orders were obtained, and negotiations ensued. Based on the facts presented, it appears that the transfers were free from donative intent, and the transfers may have been at arm's length and bona fide due to the acrimonious relationship. Without further factual development, we do not believe H made a gift of the qualifying income interest under section 2511 and express no opinion whether the terms of the marital trust satisfied the requirements of section 2056(b)(7)(B).

Unless the spouse establishes to the contrary, Code § 2519 applies to the entire trust at the time of the disposition.[1374] One can avoid this result by dividing the trust, so that Code § 2519 applies only to the trust that was severed and is subject to that gift.[1375]

The exercise by any person of a power to appoint property to the spouse is not treated as a disposition under Code § 2519, even though the spouse subsequently disposes of the appointed property.[1376] Thus, distributing the property to the spouse, free from trust, might be the only way to remove the future possible application of Code § 2519.

Rev. Rul. 98-8 held that, if a surviving spouse acquires the remainder interest in a QTIP trust by transferring property or cash to the holder of the remainder interest, the surviving spouse makes a gift equal to the greater of (i) the value of the remainder interest under Code § 2519), or (ii) the value of the property or cash transferred to the holder of the remainder interest under Code §§ 2511 and 2512. Letter Ruling 199908033 asserted that the remaindermen's consent to terminating a QTIP trust such that the surviving spouse received all of the property without restriction, without receiving consideration for that consent, constitutes a gift of their remainder interest.

In a second marriage situation, note that any inter vivos gift by the surviving spouse would be detrimental to the surviving spouse, if the surviving spouse has a taxable estate. For example, suppose the estate and lifetime gift tax exemption is $5M, estate tax is 40%, the surviving spouse has a $5M estate of her own and a QTIP life estate in a $1M asset. Suppose the spouse considers buying the remaindermen's interest for its $400K actuarial value. If the surviving spouse had not done anything, the surviving spouse's taxable estate would have been $6M ($5M own assets pays $1M QTIP asset), generating a $400K estate tax (40% multiplied by the $1M excess of $6M estate over $5M exemption), all of which is payable out of the QTIP assets under Code § 2207A(a). If the surviving spouse buys the remaindermen's interest, then she is deemed to have made a $400K taxable gift (paying no gift tax because of her lifetime gift tax exemption)[1377] and has $5.6M assets remaining ($6M own assets plus $1M former QTIP assets minus $400K paid to remaindermen and her estate will have to pay the $400K estate tax (based on a $4.6M exemption after using up $400K of her exemption on the deemed gift, leaving her estate of $5.6M being $1M over her $4.6M exemption, which $1M excess is taxed at 40%). Thus, by buying the remainder, she has shifted $400K estate tax from the remaindermen to the beneficiaries of her estate.

If avoiding Code § 2519 is important, one might also consider applying for relief under Rev. Proc. 2016-49 if the QTIP election was unnecessary.

[1374] Reg. § 25.2519-1(b).

[1375] Reg. § 25.2519-1(c)(5). See Letter Ruling 201426016 and various others cited in Zaritsky, ¶ 6.03[3][g] Making Gifts From QTIP Funds, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms* (WG&L).

[1376] Reg. § 25.2519-1(e).

[1377] If she had used up her gift tax exemption before the transaction, the remaindermen would have had to pay the gift tax. Code § 2207A(b).

II.H.2.d. Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate

Suppose property receives a basis adjustment because it is "acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate."[1378] If the property is acquired before the death of the decedent, that basis adjustment is reduced by the amount allowed to the taxpayer as deductions in computing taxable income for depreciation, amortization, depletion, etc. on such property before the decedent's death.[1379] Note that, if and to the extent that the trust is a grantor trust with respect to those deductions, the trust is not the taxpayer to whom the deductions are allocated, so this basis adjustment would not apply regarding those deductions.

I am uncertain how this rule might apply to marital deduction trusts when the surviving spouse dies. The property is eligible for a new basis.[1380] Presumably only the depreciation allocated to the remaindermen would be subject to this rule; that allocation occurs only if the trustee maintained a reserve for depreciation and the trust is not a grantor trust.[1381]

II.H.2.e. IRD Assets Not Eligible for a Basis Step-Up

Property which constitutes a right to receive an item of income in respect of a decedent (IRD) under Code § 691 does not receive a basis step-up.[1382]

For whether property constitutes IRD, see part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured, fns. 3165-3177.

The basis step-up for a partnership interest is affected by the partnership's IRD items.[1383] The basis step-up for S corporation stock is affected by the corporation's IRD items.[1384] For more on S corporation stock basis, see https://www.irs.gov/pub/int_practice_units/sco_c_53_04_01_02_02.pdf.

Farm inputs deducted on the decedent's final returns received a basis step-up at death and could be deducted by his widow on her return.[1385]

[1378] Code § 1014(b)(9).
[1379] Code § 1014(b)(9). See Reg. § 1.1014-6.
[1380] Code § 1014(b)(10).
[1381] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).
[1382] Code § 1014(c).
[1383] See part II.H.2.g Partnership Basis Adjustments, especially the text accompanying fn. 1394.
[1384] Code § 1367(b)(4); Reg. § 1.1367-1(j).
[1385] *Estate of Backemeyer v. Commissioner*, 147 T.C. No. 17 (2016), holding that the tax benefit rule factors of the companion cases of *Hillsboro Nat'l Bank v. Commissioner* and *Bliss Dairy, Inc. v. United States*, 460 U.S. 370 (1983), did not cause the tax benefit rule to apply here. The court

If an IRD asset is likely to appreciate after death, consider triggering income recognition under Code § 691(a)(2),[1386] so that future increases in growth may receive capital gain treatment.[1387]

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viewed Code § 1014 as so fundamental that, when applying the *Bliss Dairy* considerations, the basis step-up controlled. The Tax Court quoted *Bliss Dairy*, 460 U.S. at 386 n. 20:

> An unreserved endorsement of the Government's formulation might dictate the results in a broad range of cases not before us. For instance, the Government's position implies that an individual proprietor who makes a gift of an expensed asset must recognize the amount of the expense as income, *but cf. Campbell v. Prothro*, 209 F.2d 331, 335 (CA5 1954). Similarly, the Government's view suggests the conclusion that one who dies and leaves an expensed asset to his heirs would, in his last return, recognize income in the amount of the earlier deduction. Our decision in the cases before us now, however, will not determine the outcome in these other situations; it will only demonstrate the proper analysis. Those cases will require consideration of the treatment of gifts and legacies as well as §§ 1245(b)(1), (2), and 250(d)(1), (2), which are a partial codification of the tax benefit rule, and which exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rule s. Although there may be an inconsistent event in the personal use of an expensed asset, that event occurs in the context of a nonrecognition rule, and resolution of these cases would require a determination whether the nonrecognition rule or the tax benefit rule prevails. [Some citations omitted.]

(Regarding Code § 1245 assets receiving a basis step-up, see part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured, fn. 3177.) The Tax Court concluded:

> It is telling that the depreciation recapture rules, which, we are reminded, are "a partial codification of the tax benefit rule," *Bliss Dairy*, 460 U.S. at 386 n. 20, do not extend to transfers at death. The regulations bespeak this by omitting from the list of nonrecognition Code sections overridden by the depreciation recapture provisions of sections 1245 and 1250 those sections governing the treatment of a decedent's property. See secs. 1.1245-6(b), 1.1250-1(c)(2), Income Tax Regs. In *Bliss Dairy*, 460 U.S. at 398, the Supreme Court observed that depreciation recapture under sections 1245 and 1250 was an important exception to the nonrecognition statute at issue there. This is not the case with transfers at death, to which the depreciation recapture rules do not apply. Since sections 1245 and 1250 codify the tax benefit rule as it relates to depreciated property and expressly exclude transfers at death from the rule's scope, see *id.* at 386 n. 20 ("[Sections] 1245(b)(1), (2), and 1250(d)(1), (2) … are a partial codification of the tax benefit rule … [and] exempt dispositions by gift and transfers at death from the operation of the general depreciation recapture rules."), it follows that the uncodified remainder of the common law tax benefit rule, with which we are concerned in this case, operates in a similar fashion….

[1386] Code § 691(a)(2) provides:

> If a right, described in paragraph (1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

II.H.2.f. Partnership Basis Shifting Opportunities

Part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property how to shift basis from a low basis asset to a higher basis asset.

Part II.Q.8 Exiting From or Dividing a Partnership describes partnership tax rules and explains why a person with multiple business assets outside of a corporate structure might want to form a master partnership to facilitate future basis shifting opportunities.

Part II.Q.7.h Distributing Assets; Drop-Down into Partnership discusses how to move corporate assets into a partnership structure.

II.H.2.g. Partnership Basis Adjustments

A Code § 754 election provides a basis adjustment when a partner dies.[1388] Also see parts II.Q.8.e.i Distribution of Partnership Interests and II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership, to which part III.A.6 Post-Mortem Trust and Estate Administration briefly refers.

The basis adjustment wipes out so-called "negative basis" (a technically inaccurate term describing a situation where partners would recognize what they view as "phantom income" when a partnership interest is sold).[1389]

A "negative basis" situation arises as follows:

- A partnership borrows money, increasing the partners' adjusted basis.[1390] They then distribute the loan proceeds, which simply reduces the tax basis rather than triggering income.[1391] Now the partnership has liabilities without retaining the assets that triggered the liabilities. A discharge of liabilities is a deemed distribution to the partners,[1392] who already used their basis against prior distributions, so the discharge of liability can trigger income to the extent that the deemed cash distribution exceeds

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[1387] *Hurford Investments No 2, Ltd. v. Commissioner*, cited in fn. 1016 in part II.G.6 Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A, holding that a contribution to a partnership attained this result, without mentioning that Code § 721(a) ordinarily blocks income recognition.

[1388] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[1389] See Rev. Rul. 73-183 (no gain or loss is recognized on the decedent's final income tax return as a result of the transfer of stock – that received a basis adjustment on Code § 1014 upon death - to the executor of the decedent's estate) and Reg. § 1.742-1 (basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death, increased by the estate's share of partnership liabilities, and reduced to the extent that such value is attributable to IRD). Any increase in the basis of the partnership interest generates an increase in the basis of the partnership's assets other than IRD only to the extent the basis of the partnership interest is not attributable to partnership liabilities. Reg. § 1.755-1(a)(4)(i)(A), incorporated by reference by Code § 743(c) and Reg. § 1.755-1(e).

[1390] Code § 752(a).

[1391] Code § 731(a)(1).

[1392] Code § 752(b).

their remaining basis. Partners view this as an unfair result, but it really isn't, because if they simply put back the money they had taken out then they would have enough basis to avoid the tax.[1393] As described further below, this equity stripping can be very beneficial. However, when one engages in such an approach, one needs to consider ways to trigger estate inclusion to purge possible negative income tax effects.

- Alternatively, a partnership borrows money to fund losses.

For more details on when partnership distributions trigger gain recognition and when they don't, see part II.Q.8.b.i Distribution of Property by a Partnership.

Note that partnership interests do not receive a basis step-up to the extent the underlying property constitutes income in respect of a decedent (IRD),[1394] consistent with part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

II.H.2.h. Basis Step-Up for Property Held Outside an Entity; Moving Liabilities Outside of an Entity to Maximize Deductions for Estate Tax Purposes

When property is held outside an entity,[1395] assets and associated liabilities are reported on an estate tax return as follows:[1396]

- If the debt is recourse, then the asset and its associated liability are reported on separate asset and liability schedule. Thus, any valuation discounts on the asset would not create corresponding discounts in the associated liabilities.

- If the debt is nonrecourse, the asset and liability are netted and reported as a net asset. This would tend to cause any valuation discounts to reduce the amount by which the debt reduces the taxable estate. For income tax purposes,[1397] in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

[1393] Code § 722

[1394] See fns. 4154, 4203, and 4231.

[1395] "Entity" includes a single member LLC, which exists as a separate entity for transfer tax purposes. See fn. 2943, found in part II.P.3.g Conversions from Partnership to Sole Proprietorships and Vice Versa. Once a single-member LLC is valued, its value is allocated among its assets and liabilities to determine basis. See fns. 274-275 in part II.B Limited Liability Company (LLC).

[1396] See Schiller, "Leveraged Tenancies in Common - The Next Great Great Planning Tool?" (subtitled "Valuation Benefits with Leveraged Co-Ownerships May Exceed Benefits of Entity-Related Valuation Adjustments for Minority Interests"), *Steve Leimberg's Estate Planning Email Newsletter* (Archive Message #1057), available at http://www.leimbergservices.com. See Reg. §§ 20.2031-1(b), 2053-7; *Estate of Stevens v. Commissioner*, T.C. Memo. 2000-53, *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982); *Estate of Fung v. Commissioner*, 117 T.C. 21 (2001); Letter Ruling 8423007;

[1397] Code § 7701(g).

Note that the netting that applies to nonrecourse liabilities also applies to assets and liabilities held inside an entity. Thus, if one would like a larger deduction for liabilities, one should take the liabilities out of the entity and be subject to them directly. Of course, business issues might very well make such a suggestion a bad idea; however, if all parties are on the hook for loan guarantees, the suggestion might be more realistic.

The distinction between recourse and non-recourse debt can also be significant for nonresident aliens, when the deduction for recourse debt gets pro-rated and diluted as any other debt, making nonrecourse debt important for any U.S. real estate.

II.H.2.i. Avoiding a Basis Step-Down

Suppose property has basis in excess of value. That property would get a reduced basis at death.

Once solution is to sell the property for a loss and obtain current income tax benefits (to the extent available). That applies not only to property held directly but also property held in a partnership. If a partnership has a built-in loss exceeding $250,000, then a partner's death (or post-mortem trust funding)[1398] generally would trigger an inside basis reduction,[1399] even if a Code § 754 election is not in place.[1400] Therefore, a partnership with a substantial built-in loss might consider selling its loss assets to avoid this unfortunate result.

Another way to avoid a basis step-down is to transfer that property by gift or sale to an irrevocable grantor trust. The donee or trust would be unable use the built-in loss if the property if the property is sold for less than its basis, but it would be able to use the full basis for purposes of determining gain on sale.[1401] However, if the donee is the donor's spouse (or perhaps former spouse), then the donee would be able to use the built-in loss.[1402]

II.H.2.j. Effect of Chapter 14 on Basis Step-Up

Chapter 14 increases the value of business entities and other arrangements for the following purposes:

- Code § 2701 Anti-Freeze: Any increases in value provided under part III.B.7.b Code § 2701 Overview[1403] apply solely for gift tax purposes (including whether a sale includes a gift element).[1404]

[1398] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
[1399] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.
[1400] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.
[1401] Code § 1015(a); Reg. § 1.1015-1(a)(1).
[1402] Code § 1015(e).
[1403] See also part III.B.7.c Code § 2701 Interaction with Income Tax Planning.
[1404] Code § 2701(a)(1) ("Solely for purposes of determining whether a transfer … is a gift (and the value of such transfer)"); Reg. §§ 25.2701-1(a)(1), 25.2701-1(b)(1), the latter providing:

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- Code § 2703 Buy-Sell Provisions: Any increases in value provided under part III.B.7.e Code § 2703 Overview apply solely for estate, gift, and generation-skipping transfer tax purposes.[1405]

- Code § 2704 Restrictions on Cashing Out: Any increases in value provided under part III.B.7.f Code § 2704 Overview apply solely for estate, gift, and generation-skipping transfer tax purposes.[1406]

Code § 1014 determine basis by referring to property's "fair market value." As noted above, Chapter 14 applies for transfer tax purposes, not for income tax purposes.

However:

- If an estate tax return is required to be filed because the gross estate exceeds the relevant threshold, the basis of certain property is determined with reference to its estate tax value.[1407]

- For other property, the value shown on an estate tax return controls.[1408]

Thus, to tax advantage of estate tax values inflated by Chapter 14, the subject property seems to need to be reported on an estate tax return.

> *Completed transfers*. Section 2701 applies to determine the existence and amount of any gift, whether or not the transfer would otherwise be a taxable gift under chapter 12 of the Internal Revenue Code. For example, section 2701 applies to a transfer that would not otherwise be a gift under chapter 12 because it was a transfer for full and adequate consideration.

Note that Code §§ 2703(a)(1) and 2704(a)(1) provide "for purposes of this subtitle," so query whether Code § 2701(a)(1) not referring specifically to Chapter 12 has any significance. However, note that Reg. § 25.2701-2(a) refers to Chapter 12:

> *In general*. In determining the amount of a gift under § 25.2701-3, the value of any applicable retained interest (as defined in paragraph (b)(1) of this section) held by the transferor or by an applicable family member is determined using the rules of chapter 12, with the modifications prescribed by this section. See § 25.2701-6 regarding the indirect holding of interests.

Reg. § 25.2701-5 provides estate tax mitigation rules relating to Code § 2701 gifts.

[1405] Code § 2703(a)(1); Reg. § 25.2703-1(a)(1).

[1406] Code § 2704(a)(1). The 2016 proposed regulations refer to applying for "purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes)".

[1407] Code § 1014(f).

[1408] Reg. § 1.1014-3(a) provides:

> *Fair market value*. For purposes of this section and § 1.1014-1, the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall be deemed to be its fair market value. If no estate tax return is required to be filed under section 6018 (or under section 821 or 864 of the Internal Revenue Code of 1939), the value of the property appraised as of the date of the decedent's death for the purpose of State inheritance or transmission taxes shall be deemed to be its fair market value and no alternate valuation date shall be applicable.

II.H.2.k. Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap

Property included in one's estate for estate tax purposes receives a new basis, even if a power of appointment is the only trigger for estate inclusion.[1409]

To the extent of its inclusion ratio (and therefore subject to GST tax), property subject to a taxable termination[1410] also receives a new basis based on fair market value.[1411]

If estate tax and GST tax are repealed and Code § 1014 is not changed, presumably the above provisions would not generate a basis step-up. However, other parts of Code § 1014 may generate a basis step-up, including:

- "Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent;"[1412]
- "Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;"[1413]
- "In the case of decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust;"[1414] and

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[1409] Code § 1014(b)(9) refers to "property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code of 1939." Reg. § 1.1014-2(b)(1).

[1410] Code § 2612(a) provides:

(1) *General rule*. For purposes of this chapter, the term "taxable termination" means the termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in a trust unless—

(A) immediately after such termination, a non-skip person has an interest in such property, or

(B) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person.

(2) *Certain partial terminations treated as taxable*. If, upon the termination of an interest in property held in trust by reason of the death of a lineal descendant of the transferor, a specified portion of the trust's assets are distributed to 1 or more skip persons (or 1 or more trusts for the exclusive benefit of such persons), such termination shall constitute a taxable termination with respect to such portion of the trust property.

[1411] Code § 2654(a)(2).

[1412] Code § 1014(b)(1).

[1413] Code § 1014(b)(2).

[1414] Code § 1014(b)(3).

- "Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will;"[1415]

Note that the basis step-up for a general power of appointment applies only if the decedent actually exercised the power. Similarly, for federal income tax purposes, a general power of appointment shifts the grantor, from the settlor to the person holding the power, only if exercised.[1416] If shifting the grantor for federal purposes also shifts it for state income tax purposes, consider whether shifting the grantor for state income tax purposes is desirable or undesirable.[1417] If that shift is undesirable and the estate tax is in effect, consider:

- Using the Delaware Tax Trap[1418] to trigger estate inclusion, as the Delaware Tax Trap is the exercise of a limited power of appointment in a way that triggers estate inclusion under the general power of appointment rules, or

- Planning for a taxable termination instead of using a general power of appointment. Using a taxable termination allows the decedent to exercise a power of appointment without shifting the grantor.

II.H.3. Valuation Discounts – Friend or Enemy

Adjustments for lack of control and lack of marketability are not really some magical artificial value reduction – they merely reflect proper valuation. Nevertheless, the fact that the value of an interest in an entity often is smaller than a pro rata share of the entity's underlying assets is popularly referred to as a discount, so we will reluctantly use that term here.

Although a discount might save estate taxes, it also causes a reduced basis. If the discount does not save estate tax, then it reduces the basis of a discounted asset included in one's estate.

Although partnerships work better than other entities on a few levels,[1419] having a discounted partnership interest included in one's estate can cause an unfavorable basis change in assets held in the partnership (an "inside basis"):[1420]

- if the partnership has a Code § 754 election in place, or

- if the partnership's assets (in the aggregate) have a basis that exceeds their value by more than $250,000.

[1415] Code § 1014(b)(4).
[1416] Reg. § 1.671-2(e)(5).
[1417] See part II.J.3.e State and Local Income Tax.
[1418] Code § 2041(a)(3). For how to exercise the Delaware Tax Trap, see Trytten, Blattmachr, Davis, and Gorin, "Yes, I'll Order That Trust 'Fully Loaded,'" pages II-B-(1)-98 (100th page of PDF) through II-B-(1)-100, Special Session II-B, 51st Annual Heckerling Institute on Estate Planning (2017), which is also saved as my document no. 6456656.
[1419] See part II.E Recommended Structure for Entities.
[1420] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

This effect on inside basis depends on whether the asset has unrealized gain or loss:[1421]

- If the asset has an unrealized gain, the valuation discount can reduce or eliminate a basis increase but cannot generate a basis reduction.

- If the asset has an unrealized loss, the valuation discount can generate a basis reduction, but not below the asset's value.

Also see part III.C Fairness Within Families; Valuation.

II.H.4. How the Presence or Absence of Goodwill Affects the Desirability of Basis Step-Up in a Partnership or S Corporation

Self-created goodwill (goodwill created through business entity operations rather than purchased from the seller of a business) generally has a zero tax basis yet very substantial value. A partnership structure is important to secure the basis step-up or to facilitate a tax-efficient seller-financed sale.[1422]

Some entities do not have any significant goodwill. Goodwill generally is measure by an entity's rate of return in excess of what an owner could earn investing capital in other places. An entity that is not an operating business generally would not have goodwill. Also, some businesses do not generate a high enough rate of return on their capital to have significant goodwill; they earn just enough to pay their owners and employees reasonable compensation for services provided and perhaps a very modest profit on invested capital. See parts II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? and II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).

If a partnership or an S corporation has no significant goodwill and its other assets have values close to basis, then the basis of owner's interest in the company might be relatively close to a proportionate share of the basis and fair market value of the assets that the company owns. In that case, including the owner's interest in the company in the owner's estate might produce no significant basis increase or might even produce a basis decrease when the owner dies; see part II.H.2.i Avoiding a Basis Step-Down.

Note that goodwill that is not being amortized and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[1423]

Whether or not goodwill is being amortized, a controlled corporation's sale or distribution of goodwill might generate ordinary income.[1424] Using a partnership that essentially

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[1421] See part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, especially fn. 4195.

[1422] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis. See also parts II.E Recommended Structure for Entities and II.Q.7.h Distributing Assets; Drop-Down into Partnership.

[1423] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 4155.

[1424] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially fns. 3675-3679.

allows one to deduct the goodwill's value in a manner that avoids capital gain on the sale of goodwill prevents this result.[1425]

II.H.5. Irrevocable Trust Planning and Basis Issues

II.H.5.a. Irrevocable Trust Planning and Basis Issues - Generally

For various strategies involving grantor trusts, see part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.[1426] One of the problems with those techniques is that the estate tax saved might not make up for the lack of basis step-up on death, if the techniques use low-basis assets. If that is a concern, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

If the grantor trust has high basis assets (including businesses whose assets have values that are not in excess of basis; see parts II.H.2.i Avoiding a Basis Step-Down and II.H.4 How the Presence or Absence of Goodwill Affects the Desirability of Basis Step-Up in a Partnership or S Corporation), keeping them outside the estate tax system might make a lot of sense, in that the grantor is paying the income tax on each year's earnings (which earnings add to the basis in the trust's assets).

It has been suggested that one should not use one's estate tax exemption to give away assets to avoid estate tax on their appreciation. Generally, a leveraged transaction, such as a GRAT or a sale to an irrevocable grantor trust, would be better. However, if the asset has a high basis and will continue to have a high basis and the client does not want to mess with a sale, then a gift to an irrevocable grantor trust might be appropriate.

II.H.5.b. Moving Real Estate from Irrevocable Trust to Grantor

If a grantor trust has a low basis asset, consider selling it to the grantor for a high basis asset.

If an irrevocable trust is not a grantor trust, consider establishing an identical trust that is a grantor trust (perhaps using a swap power) and merging the nongrantor trust into the grantor trust, so that the above sale can be done.[1427] However, if the existing trust has liabilities in excess of basis, consider any income tax consequences that might result from such a merger.

If the grantor is buying the assets using debt, not everyone is comfortable using a promissory note that the grantor owes the trust, out of concern over the note's basis.[1428]

[1425] See parts II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis and II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[1426] Especially parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System, and III.B.2.j Tax Allocations upon Change of Interest in a Business, especially part III.B.2.j.i Changing Grantor Trust Status.

[1427] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially part III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment, fn. 4921.

[1428] The IRS might argue that the note has basis equal to the basis of the common interest. Before the grantor dies, for income tax purposes the trust didn't exist. For income tax purposes, the grantor – not the trust – owned whatever property was in the trust until the grantor died. So

To avoid this concern, consider having someone other than the trust loan the money to the grantor. A bank would be willing to loan 100%, if it keeps a security interest in the loan proceeds. For a full description of this strategy, see part II.H.10 Extracting Equity to Fund Large Gift; however, where part II.H.10 suggests the donor paying a guarantee fee to the donee, in this case the grantor would pay a guarantee fee to the trust.

II.H.5.c. Preferred Partnership In Conjunction with GRAT or Sale to Irrevocable Grantor Trust of an S Corporation

Suppose the client has determined that an S corporation needs to be moved outside of the estate tax system using, for example, part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

Generally, the S corporation's assets do not receive an inside basis step-up on the client's death or even on the trust's sale of its stock in the S corporation. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

Although an S corporation might in certain limited circumstances replicate an inside basis step-up upon death, that strategy does not necessarily work well. See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.

Therefore, in conjunction with the sale, the S corporation might form a preferred partnership.[1429] For a general explanation of preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion. For migrating into a preferred partnership, see part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure, as well as part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

The irrevocable grantor trust would need to be funded with or borrow from a bank or a related party enough cash to contribute to invest in the 99% common interest in the partnership (the S corporation would retain a 1% common interest, perhaps as a general partner, in the partnership). See also part II.M.3 Buying into or Forming a Partnership.

Eventually, the grantor might buy the common interest from the irrevocable grantor trust, preferably borrowing from a bank in a manner similar to that described in part II.H.10 Extracting Equity to Fund Large Gift, not only to fund the grantor's purchase

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the grantor's death should be taken as the event that first created the trust for income tax purposes. For income tax purposes, there was no sale – simply a gift or bequest by the grantor of a note to the trust. Therefore, such an IRS argument would appear not to work. However, given that no authority directly addresses this issue, let's consider it: If the IRS were to win that argument and the Code § 1276 market discount rules were to apply, any principal payments in excess of basis would have a character similar to that of interest income; however, Code § 1278(a)(1)(D) would seem to preclude those rules from applying; therefore, the character of any supposed gain on repayment of the notes presumably would be capital gain.

[1429] Formation of the preferred partnership when the sale occurs is not required, but doing so would provide more efficiency in appraisal fees incurred.

but also to strip the increase in equity that might occur if the property increases in value. This strategy would provide for a basis step-up at little or no estate tax cost.

II.H.6. Basis Shifting Opportunities Other Than Grantor Trusts

One could simply distribute low-basis property to a partner in redemption of the low basis partnership interest of a partner with a short life expectancy, to better focus basis step-up at the partner's death or avoid the need to make a Code § 754 election.

See parts II.Q.8.a Partnership as a Master Entity and II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property, which also discusses like-exchanges, for opportunities to:

- Shift basis from assets that are intended to be held for a while to assets that likely to sold in the near future, or

- Strip basis from high basis property to property that is then distributed to a partner with a short life expectancy, so that basis step-up at death is focused on targeted assets.

A gift to a person with a short life expectancy would be eligible for a basis step-up, so long as the donee does not die within one year of the gift or the gifted property does not pass back to the donor.[1430]

II.H.7. Passive Losses – When Basis Step-Up Might Not Be Favorable

A decedent's suspended passive losses are lost to the extent that the asset generating the passive losses received a basis step-up at the decedent's death.[1431]

In planning for basis step-up, consider which is more valuable - the suspended passive losses or the basis step-up.

If the former, consider using a beneficiary grantor trust to hold the passive asset.[1432]

II.H.8. Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up

As described in part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, S corporation assets do not receive a new basis when a shareholder dies or sells stock.

[1430] Code § 1014(e). The legislative history says that a bargain sale is subject to the provision to the extent of the gift element.
[1431] See part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Losses.
[1432] See text accompanying fn. 2323 for an explanation; see also parts III.B.2.i Code § 678 (Beneficiary Grantor) Trusts and III.A.3.e QSSTs and ESBTs (a QSST is a type of beneficiary grantor trust).

However, S corporations can sometimes replicate the equivalent of a basis step-up when the sole owner dies. For how to get property out of a corporation to enable it to receive a basis step-up without going through this analysis, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.H.8.a. Depreciable Real Estate in an S Corporation – Possible Way to Replicate Effect of Basis Step-Up If the Stars Align Correctly

II.H.8.a.i. Solution That Works for Federal Income Tax Purposes (To an Extent)

II.H.8.a.i.(a). Model for Attempting to Replicate an Inside Basis Step-Up

Although a partner's share of partnership assets can obtain a basis step-up at that partner's death,[1433] no such relief is available with respect to the assets of a corporation (whether C or S).

Generally, an S corporation can replicate the basis step-up if it holds nondepreciable property in a separate entity, by liquidating after death. That is because the capital gain on the shareholder's K-1 is offset by a capital loss when the corporation is liquidated.[1434]

Sale of Depreciable Property to Third Party
or
Liquidation of Real Property
(Zero basis, $1M value)

Proceeds from sale	$ 1M
Basis of real estate	0
Gain on K-1	$ 1M
Stock basis after death	$ 1M
Gain on K-1	$ 1M
Stock basis after sale of real estate	$ 2M
Liquidation proceeds	$ 1M
Stock basis	($ 2M)
Loss on liquidation	($ 1M)
Long-term capital gain on K-1	$ 1M
Long-term capital loss on liquidation	($ 1M)
Net long-term capital gain (loss)	$ 0

II.H.8.a.i.(b). Challenging Issues When S Corporate Liquidates Holding Depreciable Property or Other Ordinary Income Property

If the property is depreciable and the corporation liquidates, then Code § 1239 might apply to convert the K-1 income to ordinary income.[1435] Being a related party transaction

[1433] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.
[1434] Letter Rulings 9218019, 9622012.

might also preclude capital gain treatment given patents in certain situations.[1436] Furthermore, if the taxpayer previously sold depreciable property and took an ordinary loss under Code § 1231, gains on the sale of depreciable property will be taxed as ordinary income to the extent of those prior ordinary losses (referred to as Code § 1231 recapture). Finally, the recapture of depreciation deductions taken on personal property constitutes ordinary income under Code § 1245 (see part II.H.8.b Depreciable Personal Property in an S Corporation).

Depreciable property is not the only concern. Consider an S corporation that holds marketable securities. Depending on the nature of a security, its sale might generate ordinary income. For example, if and to the extent that gain on sale of a bond (whether or not the interest is exempt from income tax) results from basis below the bond's face amount, the gain might be taxed as ordinary income under the market discount rules.[1437]

In these cases, the K-1 would include ordinary income, which cannot be offset in any significant measure by the long-term capital loss on liquidation.

With multiple depreciable real properties in an S corporation, one might not be able to sell all the property to a third party in one year, and liquidation would cause this mismatch for the remaining properties. Thus, depreciable real estate should be spun off into a separate S corporation for each property; it's best to do the spin-off at least five years before death;[1438] even then, establishing the required business purpose for a spin-off in real estate might be challenging when

To avoid these complications for an S corporation, and to try to get some benefits for real estate currently held in a C corporation, consider getting the real estate or other assets out of the corporation into an entity taxed as a partnership, as described in part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.H.8.a.ii. State Income Tax Disconnect

Suppose the owner of the S corporation lives in a state (the "owner's state") that is not the same as the state where the S corporation is domiciled and the property is sold (the "business state").

Generally, the business state will tax the gain on the sale of the real estate.

However, the owner's disposition of the S corporation's stock will not be considered activity in the business state, because generally only the owner's state can tax the sale of intangible personal property (and stock is intangible personal property).

In the planning stages, taxpayers might try two approaches to avoid this problem, which might or might not work:

1435 Code § 1239 is discussed at part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.

1436 See part II.G.17.c Patents, especially fn. 1129.

1437 See Code § 1276.

1438 See part II.Q.7.f Corporate Division.

- Change the Owner's Residence. If the owner resides in the business state, the loss will be allowed. This might not be easily solved if the owner indirectly holds real estate in many states. On the other hand, suppose the owner is a trust. The trustee could divide the trust, moving to the business state the part of the trust attributable to the property located in that state. Whether this strategy works depends on whether the business state allows a trust to be a resident trust when its grantor was not domiciled in the state when the trust was created.[1439]

- Change the Corporation's Domicile. Some states do not tax the sale of a business, even though they tax the business' operations, because the sale of the business itself is not considered in the ordinary course of business. If the corporation is not domiciled in the state in which the property is located, the gain on sale of the real estate might not be taxable to the state in which the real estate is located.

Unless one wants to research all of the above issues, one might consider planning with the following assumptions:

- If one is forming a business entity to hold property in another state, one should consider forming the entity in the owner's state of residence or in a state that does not impose income tax. Depending on state law, creating domicile in the other state might give it grounds for taxation of certain transactions that might not otherwise exist.

- If the trustee of a nongrantor trust is aware of the need for the planning described in part II.H.8.a Depreciable Real Estate in an S Corporation, consider researching splitting the trust if the trust is in a different state than the business state and the real estate is in one of the states listed above. Note that splitting the trust in this manner would work best if each S corporation owns property in only one state. As mentioned above, depreciable real estate should be spun off into a separate S corporation for each property; it's best to do the spin-off at least five years before the grantor's death,[1440] even if the trust division does not occur until the sale is contemplated and before any contract is signed.

- If the S corporation formed a new partnership to hold the real estate, then the S corporation might sell its partnership interest and avoid state income tax on the sale of real estate. The partnership would probably not be formed well in advance of the transaction, because the buyer probably would not want to assume the liabilities of an ongoing entity. This in turn might cause step transaction issues at the state level.

II.H.8.b. Depreciable Personal Property in an S Corporation

The disposition of most depreciable personal property, including certain building components depreciated as personal property, will be taxed as ordinary income, whether

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[1439]See "State Income Taxation of Trustees: Some Updates," TM Memorandum (BNA), Vol. 54, No. 11 (6/3/2013) and "2013 Trust Nexus Survey," Tax Management Weekly State Tax Report (Vol. 2013, No. 34, 8/23/2013).
[1440] See part II.Q.7.f Corporate Division.

or not sold to a related party.[1441] Thus, all the problems in part II.H.8.a, Depreciable Real Estate in an S Corporation, apply and cannot be avoided for personal property inside an S corporation.

This issue is even more of a concern with current tax laws that allow very quick write-offs on purchases of tangible personal property. Heavy equipment creates a larger concern in that it tends to retain its value for longer.

A solution might be to form an LLC taxed as a partnership that is the original purchaser and leases the equipment to the business. The LLC might even borrow from the S corporation at the AFR. When an owner dies, his or her share will receive a new basis if a Code § 754 election is in place.[1442] A disadvantage of this strategy for higher-income taxpayers is that rental might be classified as a passive activity,[1443] which means that the rental income would be subject to the 3.8% supplemental tax[1444] unless an exception is satisfied.[1445] This tax would not apply if the property were merely held inside the S corporation in which the taxpayer actively operates the business.

II.H.8.c. Basis Step-Up for Publicly-Traded Stock and Other Nondepreciable Property

Generally, liquidating an S corporation that holds publicly-traded stock and other nondepreciable property will provide a new basis to its assets by reason of a deemed sale (but perhaps with no taxable income generated), as described in part II.H.8.a.i.(a) Model for Attempting to Replicate an Inside Basis Step-Up, subject to the concerns described in part II.H.8.a.ii State Income Tax Disconnect, but perhaps without the concerns described in part II.H.8.a.i.(b) Challenging Issues When S Corporate Liquidates Holding Depreciable Property or Other Ordinary Income Property.

The corporation could do a formless conversion or merger into an LLC taxed as a disregarded entity or partnership, as described in part II.P.3.b From Corporations to Partnerships and Sole Proprietorships. If the entity is an LLC taxed as a corporation, it might effectuate this change retroactively for two months and 15 days by filing IRS Form 8832.

II.H.9. Basis Step-Up In S Corporations That Had Been C Corporations

An S corporation that used to be a C corporation generate dividend income to its shareholders to the extent that distributions exceed its accumulated adjustments

[1441] Code § 1245.
[1442] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.
[1443] Code § 469(c)(2). An exception applies to active rental of real estate, not personal property. See Code § 469(c)(7).
[1444] See II.I 3.8% Tax on Excess Net Investment Income.
[1445] For whether rental constitutes a passive activity, see II.K.1.e Rental Activities. For other exceptions, see II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

account (AAA). See part II.P.3.c.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

A basis step-up does not change this result, even if it results from the S corporation receiving life insurance proceeds. See part II.Q.7.b.iv S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds.

Furthermore, some redemptions are taxed as distributions, resulting in similar dividend issues.[1446]

However, if the S corporation has never been a C corporation or otherwise does not have any C corporation earnings and profits (E&P), these concerns do not arise.[1447]

II.H.10. Extracting Equity to Fund Large Gift

II.H.10.a. General Concept of Extracting Equity to Fund Large Gift

Consider extracting the fair market value equity from depreciated property, take steps to get the extracted equity out of the estate tax system, and exposing the small net value property to the estate tax system to get a very low cost basis stepped-up. This is done in three steps:

(1) Borrow against the property and distribute the cash to the owner(s). A bank might very well require loan guarantees from other entities that would post collateral. See part II.H.10.c Consider Use of Guarantee Fee. Alternatively, a related party might make the loan at the AFR.

(2) Each owner invests the proceeds in taxable income-producing property. This is important for income tax purposes. If the owner simply gives away the cash, the debt would be incurred for personal purposes and the interest would be nondeductible personal interest. The owner needs to invest first in taxable investments;[1448] tax-free investments, such as municipal bonds, would also make the interest expense nondeductible.

(3) Each owner then makes annual exclusion gifts or otherwise engages in leveraged estate planning techniques. If the plan will take some time to accomplish and the owner has an irrevocable grantor trust with low basis assets, consider using the cash to buy those low basis assets so that those assets can get a basis step-up as well.

If the real estate is in an entity taxed as a partnership and the partnership is distributing cash from the loan to a partner, beware of the disguised sale rules. Absent an exception, if the partner contributed property to the partnership within 2 years of

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[1446] See part II.Q.7.b.i Redemptions or Distributions Involving S Corporations - Generally, especially fns. 3507-3509.

[1447] See part II.Q.7.b.i Redemptions or Distributions Involving S Corporations - Generally, especially the paragraph of text accompanying fn. 3511, the latter explaining how to eliminate E&P.

[1448] Code § 163(d)(3), which is reproduced in fn. 1532, which is found in part II.I.6 Deductions Against NII.

receiving the distribution or if a partner borrows against the property within two years, a disguised sale of the contributed property is presumed to have taken place.[1449]

This strategy may also work with low basis marketable securities, which might be monetized without generating capital gain tax.[1450]

II.H.10.b. Example: Leveraging Property to Extract Equity to Fund Large Gift

Suppose property with a $10M fair market value was fully depreciated as to the value of the building, with $2M of land value remaining:

1. Borrow $9M against the building and transfer the $9M using leveraged estate planning techniques as described above (after first having invested the borrowed money in taxable investments).

2. Keep the $1M ($10M value minus $9M liabilities) until death, and pay estate tax on the $1M.

3. The $8M of building ($10M total value minus $2M land value) receives a basis step-up from zero to $8M:[1451]

   - At a 40% income rate, this basis step-up secures tax deductions worth $3.2M (40% of $8M).

   - Even if the property were later sold, the capital gain tax savings would likely be $2.4M (30%[1452] of $8M) or more.

4. Possible estate tax on $1M is a small price to pay for that income tax savings.

II.H.10.c. Consider Use of Guarantee Fee

A loan guarantee is not a gift. For gift and income tax issues related to guarantees, see part III.B.1.a.ii Loan Guarantees.

However, if the loan guarantee is from a donee, the IRS might claim that the donor has retained an interest in the gifted property and asset Code § 2036 inclusion.

Therefore, consider paying a market-rate guarantee fee so that the grantor pays adequate and full consideration for the use of the credit instead of possibly appearing to have retained the use of the gifted property. Consider the following commercial models:

- Home equity lines of credit charge no maintenance fees. They are well-secured, simple loans.

1449 Reg. § 1.707-3(c). See part II.M.3.e Exception: Disguised Sale.
1450 See part II.A.1.d Monetizing Founder's Remaining Shares After Going Public.
1451 If held in a partnership, a Code § 754 election would need to be made. See II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.
1452 This example assumes that state and local income tax increases a 25% capital gain rate by 5%. Capital gain that represents the recapture of straight line depreciation is taxed at a maximum rate of 25% instead of 20%. Code § 1(h)(1)(D).

- Commercial lines of credit might involve maintenance fees. They are well-secured, complex loans.

- If the borrower has little equity or income outside of an asset that is being purchased, then the lender's or guarantor's risk increases dramatically when the loan-to-value ratio is high. If the asset being purchased is being appraised, consider asking the appraiser to also determine a reasonable guarantee fee.

II.H.10.d. Maintaining the Security Interest in the Loan Proceeds If Using a Donee Guarantee

If the loan proceeds are transferred using leveraged estate planning techniques, tracking the lender's security interest might become tricky.

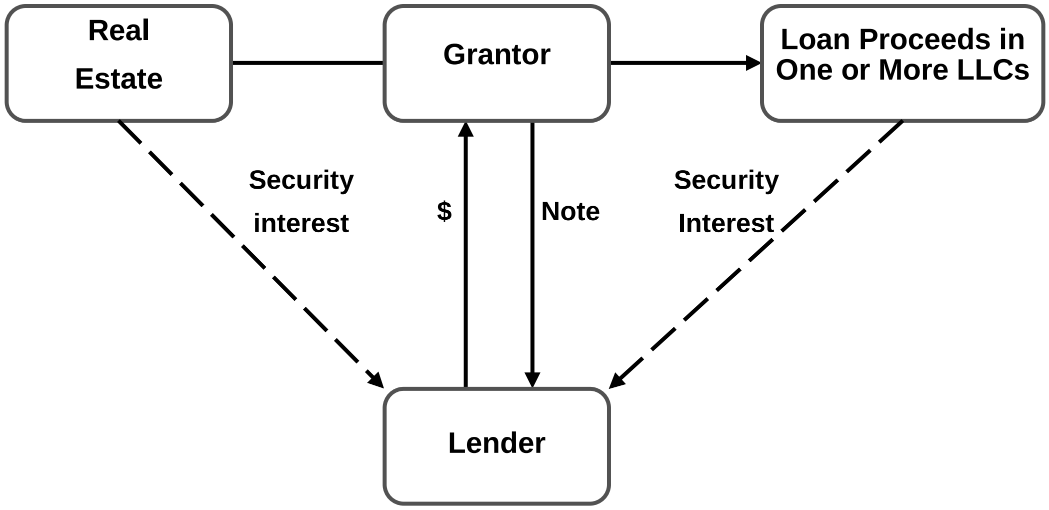
For example, suppose one uses a series of 2-year GRATs to transfer marketable securities, establishing a separate GRAT each year for each asset class.[1453] The number of accounts could quickly multiply. One might consider establishing an LLC to hold each asset class, so that the security interest is imposed on the LLC's account and interests in the LLC can be freely transferred among trusts to implement the strategy.[1454] Also note that an account with multiple owners might be deemed a partnership in certain situations.[1455]

II.H.10.e. Illustration of Equity Strip and Gift

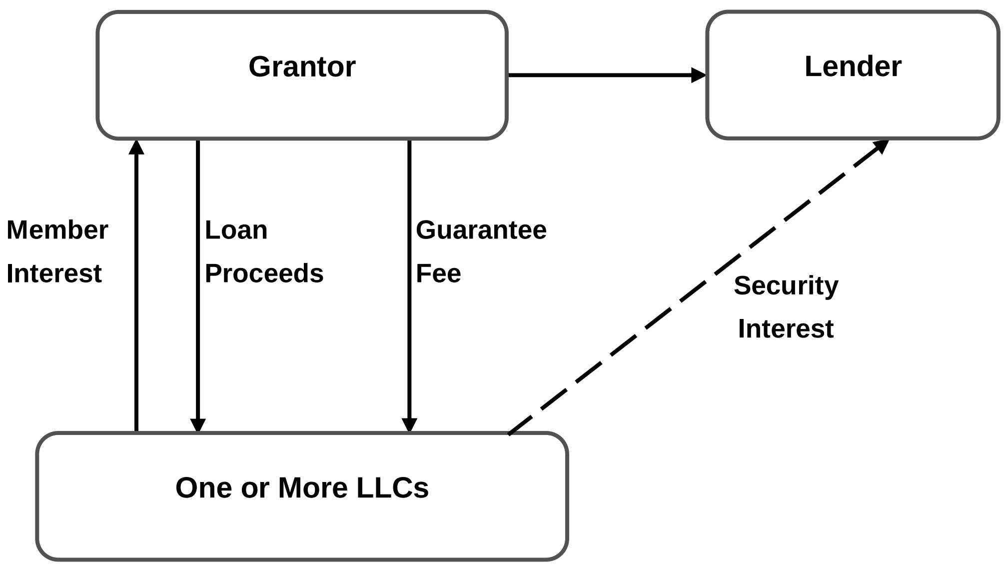
See parts II.H.10.e.i Flowchart of Equity Strip, II.H.10.e.ii Flowchart of Placing Loan Proceeds into Entity, and II.H.10.e.iii Flowchart of Transfer of Loan Proceeds.

[1453] This is called a rolling, asset-splitting GRAT strategy and is described in part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text accompanying fn. 4901.
[1454] See part II.Q.8.a Partnership as a Master Entity, especially fns. 3838-3840 and the accompanying text.
[1455] See part II.C.9 Whether an Arrangement (Including Tenancy-in-Common.

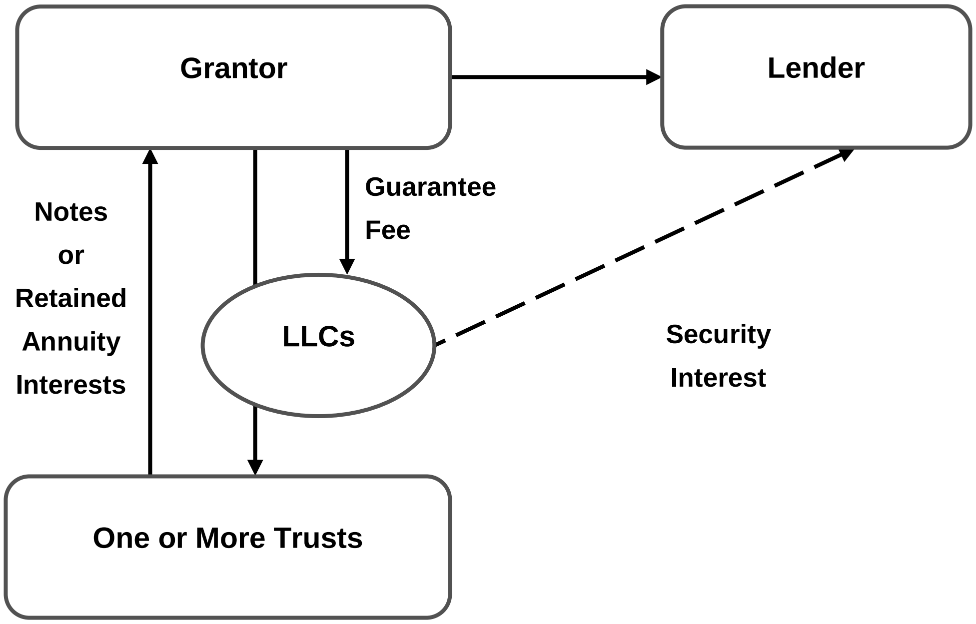
II.H.10.e.i. Flowchart of Equity Strip



II.H.10.e.ii. Flowchart of Placing Loan Proceeds into Entity



II.H.10.e.iii. Flowchart of Transfer of Loan Proceeds



II.H.11. Preferred Partnership to Obtain Basis Step-Up on Retained Portion

If all of the equity has been extracted, the future growth is still an estate planning issue. Furthermore, the client might not be comfortable with extracting the equity. In either case, consider contributing the real estate to a preferred partnership, in which the client receives a preferred distribution of profits as a fixed percentage of the fair market value of the contributed property, as well as receiving a capital account equal to the fair market value of the contributed property, plus perhaps a straight 1% of the residual profits; the client then transfers the remaining residual profits – the so-called "common interest."

If the partnership has a Code § 754 election in place, a partner's allocable share of the partnership's non-IRD assets will receive a new basis when the partner dies.[1456] Thus, a preferred partnership can be an excellent vehicle for transferring future growth while obtaining a basis step-up on the portion retained. This is particularly useful for a person whose taxable estate and adjusted taxable gifts would be less than the estate tax exemption with the current value included but would exceed the estate tax exemption if the property grows in value or generates income in excess of the preferred return.

II.H.11.a. Basics of Preferred Partnerships

In a preferred partnership, one or more partners has a preferred interest and one or more partners has a common interest. The preferred interest includes a capital account that receives a percentage return on that capital account, which preferred return is paid generally before making distributions to the partners owning the common interest. A common interest is a capital account plus a flat percentage of the profits distributed after

[1456] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

the preferred interest receives its distributions. As described further below, the goal is to maximize the initial value of the preferred partnership interest and to minimize the initial value of the common interest.

The preferred interests receive operating distributions before the common interests and receive a return of their capital accounts before the common interests receive their capital accounts. The preferred returns are not guaranteed; rather they are preferred distributions of cash from operations. Because they are contingent on cash flow, they are more risky than mere loans and therefore require a higher return. See part II.H.11.c Payment of Preferred Return.

Maximizing the value of the preferred interests reduces the payment required on the capital account, reducing the pressure on the partnership to generate operating cash and leaving more cash available for the common interests.[1457] Usually the partnership is a limited partnership, and the preferred interest is accompanied by a 1% common interest as the controlling general partner;[1458] providing the preferred interest owner with this controlling common interest increases the likelihood of actually receiving the preferred distributions and therefore reduces risk and the required return. The remaining 99% common interest generally is comprised of interests as limited partners, although it might include interests as general partners that aggregate to less than 1%. If and to the extent that operating cash flow beyond the preferred return is used to repay the preferred partner's capital account, beware of tax issues. This excess operating cash flow is taxed to the common interests, because the income is allocated to them, becomes capital and only then is used to pay the preferred partner; this is an inherent part of partnership accounting. In many cases, the partnership agreement should require distributions to the common interests to pay these taxes before the excess operating cash flow is used to pay the preferred partners' capital accounts.

Forming the partnership usually does not trigger income tax.[1459] Because the right to receive preferred payments depends on cash flow and is not guaranteed, forming the partnership is presumed not to constitute a disguised sale.[1460] Although a guaranteed payment within certain limits is also presumed not be a disguised sale,[1461] using property to satisfy the obligation (because cash flow is inadequate) would probably constitute a sale and trigger income tax.[1462] The tax laws strongly encourage the preferred payment to be cumulative, meaning that make-up distributions are made in future years if current cash flow is insufficient;[1463] these rules strongly encourage payments no later than four years after the due date,[1464] and payments using property should constitute tax-free distributions.[1465]

[1457] See part II.H.11.d Valuing Preferred Partnership Interests.
[1458] There is nothing wrong with stapling a common interest as a general partner that exceeds 1%, aside from the desire to allocate growth (the common interest) to the next generation.
[1459] See part II.M.3 Buying into or Forming a Partnership.
[1460] See part II.M.3.e.i.(b) Distributions Presumed <u>Not</u> to Be Disguised Sales.
[1461] See part II.M.3.e.i.(b) Distributions Presumed <u>Not</u> to Be Disguised Sales.
[1462] Code § 707.
[1463] See part III.B.7.b Code § 2701 Overview.
[1464] Code § 2701(d)(2)(C).
[1465] See part II.Q.8.b.i Distribution of Property by a Partnership.

When one creates an entity with preferred distributions and receives preferred distributions equal to the value of what one contributed, Code § 2036 does not include in one's estate the right to the common interest.[1466] However, if one does everything wrong, Code § 2036 will apply to a preferred partnership.[1467]

II.H.11.b. Preferred Partnership Compared to Sale to Irrevocable Grantor Trust

The disadvantages of a preferred partnership relative to a sale for a note are the higher required return (preferred stock generally pays dividends much higher than the AFR) and the higher equity investment required by the other owners (although Code § 2701 generally requires the common interest to be worth at least 10%, in practice appraisers require it to be 15%-20% or more).

However, the preferred partnership interest has an advantage of basis step-up. If one sells low basis assets to an irrevocable grantor trust and dies shortly thereafter, there is no growth on which estate taxes are paid, the note is included at roughly the same value as the sold asset, and the sold property does not receive a basis step-up. On the other hand, if one uses a preferred partnership, the underlying assets attributable to the preferred partnership will receive a new basis when the preferred partner dies.[1468]

One might consider pairing the two concepts: retain the preferred interest and have an irrevocable grantor trust hold the common interest. If the senior family member gets ill,

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[1466] *Hutchens Non-Marital Trust v. Commissioner*, T.C. Memo. 1993-600 (preferred stock) (Missouri case). Also, preferential liquidation rights and the right to distributions that were greatly disproportionate to that enjoyed by another class of equity, the other class of which the decedent had transferred, did not constitute a retention of rights to the transferred shares. *Boykin v. Commissioner*, T.C. Memo. 1987-134. Presumably the IRS wanted to include the transferred shares because they were voting, whereas the retained shares were nonvoting. After *Boykin* and before *Hutchens*, Congress repealed Code § 2036(c) and enacted Chapter 14 in its place. The legislative history says:

> The committee believes that an across-the-board inclusion rule is an inappropriate and unnecessary approach to the valuation problems associated with estate freezes. The committee believes that the amount of any tax on a gift should be determined at the time of the transfer and not upon the death of the transferor.

Stacy Eastland's Heckerling materials suggest that, because of this favorable history and case law, preferred partnerships might be less susceptible to Code § 2036 attacks than other entities.

[1467] *Estate of Liljestrand v. Commissioner*, T.C. Memo. 2011-259, applying *Bongard*:

> As part of the partnership agreement, Dr. Liljestrand was guaranteed a preferred return of 14 percent of the value of his class A limited partnership interest. Dr. Liljestrand's class A limited partnership interest was valued at $310,000, thus Dr. Liljestrand was guaranteed annual payments equal to $43,400. Moss-Adam's appraisal estimated the partnership's annual income would equal $43,000. We find this guaranteed return indicative of an agreement to retain an interest or right in the contributed property....
>
> Dr. Liljestrand received a disproportionate share of the partnership distributions, engineered a guaranteed payment equal to the partnership expected annual income and benefited from the sale of partnership assets. The objective evidence points to the fact that Dr. Liljestrand continued to enjoy the economic benefits associated with the transferred property during his lifetime.

[1468] For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

(s)he buys the common interest from the trust,[1469] so that the common interest can receive a basis step-up at death.

II.H.11.c. Payment of Preferred Return

Generally, the preferred return should be paid out of operating cash flow.[1470]

Although guaranteed payments might seem attractive from a gift tax viewpoint,[1471] they are undesirable from an income tax viewpoint.[1472]

II.H.11.d. Valuing Preferred Partnership Interests

Rev. Rul. 83-120 explains how to value preferred and common stock. Presumably its concepts would apply to partnerships. Key ideas include:

- The preferred distributions must exceed the interest paid to the entity's creditors.[1473] Because AFRs are based on government bonds that are viewed as having no credit risk, the rates charged by creditors to businesses generally exceed the AFR. In other words, preferred rates exceed lenders' rate which exceed the AFR. Thus, preferred distribution rates are significantly greater than the AFR.

- Preferred distribution rates also requires sufficient coverage, which means the entity's ability to pay the preferred return. The entity needs plenty of income-generating assets to assure payment.[1474]

1469 See fn. 1428, found in part II.H.5.b Moving Real Estate from Irrevocable Trust to Grantor.

1470 See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.

1471 Guaranteed payments do not trigger the special rules for family partnerships described in part III.B.7.b Code § 2701 Overview. See Code § 2701(c)(1)(B)(iii).

1472 Guaranteed payments would generally be limited to 150% of AFR (which is much lower than market now). See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales. Also, because a guaranteed payment under Code § 707(c) is not a regular partnership distribution under Code § 731, gain or loss would be triggered on the distribution of assets in kind to satisfy that pecuniary obligation. Contrast that with a partnership distribution, which generally does not trigger gain or loss, as described in part II.Q.8.b.i Distribution of Property by a Partnership. Although it might seem common sense that a distribution out of operating cash flow would be satisfied out of cash from operations so that assets do not need to be sold, the situation for family partnerships is not so simple. Family partnerships need to make their preferred payments no later than four years after they accrue. Code § 2701(d)(2)(C). This four-year requirement should not cause problems with the disguised sale rules, which are mainly concerned about payments within two years after the preferred partner has contributed assets to the partnership. See part II.M.3.e Exception: Disguised Sale. Thus, using a preferred payment out of operating cash flow instead of a guaranteed payments not only adds helpful flexibility for partnerships generally but also is very important for family partnerships.

1473 Rev. Rul. 83-120, § 4.02.

1474 Rev. Rul. 83-120, § 4.03 includes the following explanation:

> Coverage of the dividend is measured by the ratio of the sum of pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends. *Standard & Poor's Ratings Guide*, 58 (1979). Inadequate coverage exists where a decline in corporate profits would be likely to jeopardize the corporation's ability to pay dividends on the preferred stock . The ratio for the preferred

- The entity needs to have ample equity to be able to pay the equity's stated liquidation right.[1475]

If the partnership is a family entity, watch out for the complexities and uncertainty in valuation described in Code § 2701 later in these materials.[1476] Although the rules governing family entities generally require that the common interest have a value of at least 10% of the deal,[1477] typically it's at least 20% of the deal, so that the preferred profits distribution is kept at a reasonable rate. In a marketable securities partnership, the common is a much higher proportion, because the equity rates paid on the preferred stock often will significantly exceed the annual expected investment income on the marketable securities.

A recapitalization can constitute a gift, whether under general principles[1478] or under these special rules for family partnerships.

II.H.11.e. Using Preferred Partnership that Intentionally Violates Code § 2701

Consider making placing $5M into a preferred partnership that is a family entity, retaining a $4M preferred interest with noncumulative preferred distributions redeemable at par in the holder's discretion, and giving $1M in common to the next generation.

The preferred return is a nice income stream. If the preferred holder needs more cash for unexpected spending needs, the preferred holder can require a partial redemption of the preferred's par value.

The gift and estate tax consequences are as follows:

- If the partnership violates Code § 2701, the gift of common generates a $5M taxable gift, because the preferred is valued at zero.

- If a Code § 2701 interest in existence on the date of the initial transferor's death is held by an applicable family member and therefore is not included in the gross estate of the initial transferor, the Code § 2701 interest is deemed to be transferred at the death of the initial transferor to or for the benefit of an individual other than the initial transferor or an applicable family member of the initial transferor. In such case, the

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stock in question should be compared with the ratios for high quality preferred stock to determine whether the preferred stock has adequate coverage.

1475 Rev. Rul. 83-120, § 4.04 provides:

> Whether the issuing corporation will be able to pay the full liquidation preference at liquidation must be taken into account in determining fair market value. This risk can be measured by the protection afforded by the corporation's net assets. Such protection can be measured by the ratio of the excess of the current market value of the corporation's assets over its liabilities to the aggregate liquidation preference. The protection ratio should be compared with the ratios for high quality preferred stock to determine adequacy of coverage. Inadequate asset protection exists where any unforeseen business reverses would be likely to jeopardize the corporation's ability to pay the full liquidation preference to the holders of the preferred stock.

1476 See part III.B.7.b Code § 2701 Overview.

1477 See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.

1478 Rev. Rul. 86-39.

transfer tax value of the interest is the value that the executor can demonstrate would be determined for gift tax purposes if the interest were transferred immediately before the initial transferor's death.[1479]

Code § 2701 applies "[s]olely for purposes of determining whether a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family is a gift." Thus, it does not apply for GST purposes, as described in this example from a treatise:[1480]

> Grandfather gives common stock of Family Corporation to Granddaughter, while retaining preferred stock. The gift tax under Chapter 12 will be calculated by valuing the common stock under Section 2701. The GST tax under Chapter 13 will be determined by valuing the common stock without regard to Section 2701.

So, even though the noncompliant partnership freeze can use the entire gift tax exemption, it will not use a corresponding amount of GST exemption.

Although a taxable gift generally reduces the donor's lifetime gift/estate tax exemption, "adjusted taxable gifts" reported on the estate tax return do not include gifts that are includible in the donor's gross estate.[1481] Thus, adjusted taxable gifts arising from a noncompliant preferred interest are washed out when the preferred interest is included in the donor's gross estate.

If the donor splits gifts with the spouse, the order and manner in which the mitigation occurs depends on who dies first.[1482] Consider leaving the preferred interest in a trust for the surviving spouse and electing a QTIP marital deduction[1483] only to the extent that the mitigation provisions do not wipe out the estate inclusion.

II.H.11.f. Practical Implementation of Estate Freezes

Many of the ideas discussed below are illustrated in materials put together by Stacy Eastland for 2015 Heckerling, ideas on which he has worked for many years and continues to improve.[1484] Stacy's materials contain many creative ideas not listed below, including combining leverage with preferred partnerships and GRATs.

II.H.11.f.i. Increasing Investment Yield to Enable Owner to Transfer More Outside of Estate Tax System

The example below is for a bypass trust and the surviving spouse, but it could just as easily apply to:

[1479] Reg. § 25.2701-5(c)(3)(ii).
[1480] Zaritsky & Aucutt, ¶ 2.03[4] Scope of Section 2701, ¶ 2.03[4][a] Generation-Skipping Transfer Tax, *Structuring Estate Freezes: Analysis With Forms* (WG&L), citing the preamble to the proposed regulations, 56 Fed. Reg. § 14322 (1991).
[1481] Code § 2001(b).
[1482] See Reg. § 25.2701-5(e).
[1483] See fn. 1330, found in part II.H.2.a Free Basis Step-Up When First Spouse Dies.
[1484] Discussions with Ellen Harrison and Stacy when preparing for our 2015 Heckerling panel have sharpened my thinking in this area. ACTEC Fellows can see some of Ellen's thoughts by looking at the Business Planning Committee materials for the 2015 Annual Meeting.

- An irrevocable grantor trust created by the spouse instead of the bypass trust, or

- A partnership between a GST-exempt trust and either its beneficiary or a non-GST-exempt trust for the benefit of the GST-exempt trust's beneficiary.

A surviving spouse might engage in an estate freeze with a bypass trust created by the deceased spouse. The surviving spouse contributes assets and receives a preferred interest (with enhancements described in part II.H.11.a Basics of Preferred Partnerships), and the bypass trust contributes assets and receives a common interest. The surviving spouse receives a nice annual income flow, and the preferred interest will receive a new basis at the surviving spouse's death.

Furthermore, if the surviving spouse has some DSUE and is at risk of losing it because of remarriage, the surviving spouse might consider electing to treat the preferred interest as gifted to the bypass trust, even though the surviving spouse has not in fact gifted the interest.[1485] presumably the gifted interest would be included in the surviving spouse's estate because of actual ownership, but the amount of inclusion should be washed out, as described in part II.H.11.e Using Preferred Partnership that Intentionally Violates Code § 2701.

Although a QTIP trust could engage in a freeze transaction, Code § 2519 poses risks if the valuation is wrong. A QTIP trust might make distributions or loans to the surviving spouse so that the surviving spouse can later engage in the preferred partnership planning. Therefore, one might consider entering into the preferred partnership before the QTIP trust is funded, being wary, however, that Code § 2701 views transactions by a trust as transactions by its beneficiaries.[1486]

A portfolio of marketable securities might be a good candidate for such planning. Because the preferred return is significantly higher than general interest and dividend rates, the surviving spouse can boost the surviving spouse's annual cash return on the assets contributed. Essentially, the partnership would use the income from the bypass trust's contributed assets to make preferred payments to the surviving spouse in exchange for the growth of the surviving spouse's contributed assets. In the example below, the surviving spouse's contributed assets would need to comprise approximately 30% of the partnership to attain this result.

Suppose, for example, the surviving spouse contributed $3 million of marketable securities and the bypass trust contributed $7 million of marketable securities, each portfolio generating 2.5% cash distributions. Thus, the partnership's $10 million generates $250,000 annual cash yield. Dividing the $250,000 annual cash yield by the surviving spouse's $3 million contribution constitutes an 8.3% yield, which might be comparable to an annual cash preferred dividend. Note that the surviving spouse's income has increased from $75,000 per year to $250,000 per year. Now the surviving spouse can afford to used leveraged transfers to shift other assets outside the estate tax system. Or the surviving spouse could, in a separate transaction that was not planned until after the preferred partnership formation had seasoned sufficiently, simply sell to an irrevocable grantor trust $2 million of preferred partnership interest yielding 8.3% in

[1485] Code § 2701(c)(3)(C)(i).
[1486] Reg. § 25.2701-6(a)(4).

exchange for a note bearing the AFR (much lower than 8.3% when this analysis was written) and retain $1 million of preferred partnership interest, earning $83,000 per year income (up from $75,000) but decreasing the amount subject to estate tax from $3 million down to $1 million (if the sale price simply goes to pay taxes on the irrevocable grantor trust). Furthermore, the $2 million capital account preferred interest would be worth less than $2 million if the surviving spouse retained the general partner interest, the control feature of which supported the value of the preferred in the surviving spouse's hands but which is not available to support the value of the $2 million preferred interest that is sold to the trust. Thus, the irrevocable grantor trust would pay less than $2 million for its preferred interest. Or, instead of doing a sale to an irrevocable grantor trust, the surviving spouse could use a GRAT, which will be guaranteed to succeed to the extent that the preferred return exceeds the Code § 7520 rate. (This example illustrates an extreme, in that the yield would likely be set at an amount lower than the partnership's annual income, to ensure coverage.)[1487]

The above strategy could be supercharged if the bypass trust contributed its partnership interest to an S corporation and the surviving spouse made a QSST election. That would cause the surviving spouse to pay the income tax on the common interest's capital gains (and other income allocable to it). If one were to use this strategy, the partnership agreement should not require distributions to pay tax on the common interests' income (contrary to the general recommendation of part II.H.11.a. Basics of Preferred Partnerships). Furthermore, one should consider how this approach affects the exit strategy – what happens to the bypass trust after the surviving spouse dies – described in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

A simpler alternative with more modest results might be available. Consider dividing the trust, converting one portion to a unitrust and giving away another portion.[1488] The unitrust might be a higher rate of distribution than interest and dividends, allowing the surviving spouse to feel comfortable giving away that other portion.

Commercial real estate might not be a great candidate for directly engaging in increasing one's rate of cash flow return using the preferred partnership planning described above. First, the cash yield for privately managed commercial real estate tends to be close to preferred rates, making the type of leverage described in the example above difficult to achieve. (That doesn't mean that a preferred partnership is a bad idea; it simply does not create as much opportunity to enhance the surviving spouse's rate of return on retained assets.) Second, losing the basis step-up on the real estate would be quite painful. However, the leveraged planning described above could work <u>indirectly</u> for commercial real estate. Strip the real estate's equity, as described in part II.H.10 Extracting Equity to Fund Large Gift, then engage in this type of planning for the loan proceeds.

If one has an operating business in an S corporation, a preferred partnership is not available[1489] to replicate this result unless the transferor is the sole owner or the other

[1487] See part II.H.11.d Valuing Preferred Partnership Interests.
[1488] See Letter Ruling 201426016.
[1489] A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.f.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity.

owners have similar objective. The S corporation itself could contribute its assets to a preferred partnership in lieu of its shareholder(s) directly forming the preferred partnership.

Also note that preferred partnerships can be an excellent tool for getting future growth out of corporate solution, whether or not the corporation has an S election in place.[1490]

Also note that any freeze could be undone by switching from preferred/common to being all common, although the unrealized appreciation would need to be accounted for and the IRS might argue that the recapitalization constituted a gift. Accounting for unrealized appreciation would be a matter of determining the gain that would have been recognized if all assets had been sold for fair market value at the time of the change and specially allocating it to each partner; usually this is done by restating capital accounts to take these calculations into account – a process called booking up.[1491]

II.H.11.f.ii. Reverse Freeze to Guarantee Successful Sale to Irrevocable Grantor Trust

Normally one would have the transferor retain preferred and transfer common – to get the growth outside of the estate tax system. Consider doing the reverse, as described below.

Preferred partnership returns significantly exceed the AFR.[1492] The principal amount generally remains stable, because the entity needs to start with ample cushion to make sure that the stated liquidation amount will be paid.[1493] The main risk of decline in value is if interest rates increase, causing the present value of payments to decrease. However, if the holder of the preferred equity has the right to redeem for its stated value at any time, the preferred equity should hold its value.

Thus, a grantor could sell a preferred partnership interest to an irrevocable grantor trust for a note at the AFR, and the transaction would have a very high likelihood of succeeding.

I have seen this idea promoted for life insurance policies, where the preferred return is sufficient to pay not only the interest on the note to the grantor but also the life insurance premiums.

[1490] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially II.Q.7.h.viii Value Freeze as Conservative Alternative.

[1491] For the rules on revaluing partnership assets and adjusting capital accounts when that occurs, see part II.C.7 Maintaining Capital Accounts (And Be Wary of “Tax Basis” Capital Accounts), especially fn. 422. The related gain allocation is called a “reverse-Code § 704(c) allocation” and is provided by fn. 3932 of part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[1492] See part II.H.11.d Valuing Preferred Partnership Interests, especially fn. 1473.

[1493] See part II.H.11.d Valuing Preferred Partnership Interests, especially fn. 1475.

II.H.11.f.iii. Getting Business Value Out of Corporate Solution

Holding a business in an entity taxed as a partnership has several income tax advantages over holding the business in a C or S corporation; see part II.E Recommended Structure for Entities.

Foe how to migrate to that structure, see part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially part II.Q.7.h.viii Value Freeze as Conservative Alternative.

See also part II.H.5.c Preferred Partnership In Conjunction with GRAT or Sale to Irrevocable Grantor Trust of an S Corporation.

II.H.11.f.iv. Shifting Income or Growth from High Tax State

Suppose grantor previously created an irrevocable trust while in a high tax jurisdiction and later creates (or the grantor's spouse later creates) another one in a low- or no-income tax state.

If the trust in the high tax state has low basis assets, a preferred partnership might be a way to shift growth to the other state – perhaps even after seven years[1494] getting the low basis assets outside of the high tax state altogether.

Conversely, if the trust in the high tax state has high income but expects little or no capital gain, perhaps a preferred partnership can shift the income to the other state and leave the never-to-be-taxed unrealized appreciation in the high tax state.

However, if the trust in the high tax state has high basis assets, selling the assets and lending the money to the other trust in exchange for a long-term AFR note might do the trick more simply than engaging in a preferred partnership. If the trust in the higher tax state is a credit shelter trust and the surviving spouse does not need the income, the trustee could contribute the note to an S corporation and have the spouse make a QSST election so that all of the income is taxable to the surviving spouse, whether or not it is distributed; the S corporation then distributes only enough to pay the surviving spouse's income tax and invests the rest of the note payments.[1495]

II.I. 3.8% Tax on Excess Net Investment Income (NII)

For the IRS' basic overview, see http://www.irs.gov/uac/Newsroom/Net-Investment-Income-Tax-FAQs.

[1494] See part II.Q.8.b.i Distribution of Property by a Partnership, especially part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[1495] See part III.A.3.e QSSTs and ESBTs, especially part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).

II.I.1. Taxpayers and Years Affected

For taxable years beginning after December 31, 2012,[1496] net investment income in excess of certain thresholds is subject to a 3.8% tax.[1497] The preamble to the final regulations explains:[1498]

> Section 1402(a)(1) of the HCERA added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012. Section 1411 imposes a 3.8 percent tax on certain individuals, estates, and trusts. See section 1411(a)(1) and (a)(2). The tax does not apply to a nonresident alien or to a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B). See section 1411(e).

II.I.2. Regulatory Framework

The preamble to the final regulations described the regulatory framework:[1499]

> On December 5, 2012, the Treasury Department and the IRS published a notice of proposed rulemaking in the Federal Register (REG-130507-11; 77 FR 72612) relating to the Net Investment Income Tax. On January 31, 2013, corrections to the proposed regulations were published in the Federal Register (78 FR 6781). The Treasury Department and the IRS received numerous comments in response to the proposed regulations. All comments are available at www.regulations.gov[1500] or upon request. The Treasury Department and the IRS held a public hearing on the proposed regulations on April 2, 2013.
>
> In addition to these final regulations, the Treasury Department and the IRS are contemporaneously publishing a notice of proposed rulemaking in the Federal Register (REG-130843-13) relating to the Net Investment Income Tax.

The preamble to the final regulations explained taxpayer reliance on proposed and final regulations:[1501]

> These regulations are effective for taxable years beginning after December 31, 2013, except that § 1.1411-3(d) applies to taxable years beginning after December 31, 2012. Taxpayers are reminded that section 1411 is effective for taxable years beginning after December 31, 2012.
>
> Part 12 of the preamble to the proposed regulations stated that taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. Furthermore, the preamble stated that any election made in reliance on the proposed regulations will be in effect for

[1496] P.L. 111-152, section 1402(b)(3).
[1497] Code § 1411(a).
[1498] T.D. 9644.
[1499] T.D. 9644.
[1500] A more direct link is http://www.regulations.gov/#!docketBrowser;rpp=25;po=0;dct=PS;D=IRS-2012-0049.
[1501] T.D. 9644.

> the year of the election, and will remain in effect for subsequent taxable years. In addition, taxpayers who opt not to make an election in reliance on the proposed regulations are not precluded from making that election pursuant to these final regulations.
>
> For taxable years beginning before January 1, 2014, taxpayers may rely on either the proposed regulations or these final regulations for purposes of compliance with section 1411. See § 1.1411-1(f). However, to the extent that taxpayers take a position in a taxable year beginning before January 1, 2014 that is inconsistent with these final regulations, and such position affects the treatment of one or more items in a taxable year beginning after December 31, 2013, then such taxpayer must make reasonable adjustments to ensure that their section 1411 tax liability in the taxable years beginning after December 31, 2013, is not inappropriately distorted. For example, reasonable adjustments may be required to ensure that no item of income or deduction is taken into account in computing net investment income more than once, and that carryforwards, basis adjustments, and other similar items are adjusted appropriately.

Effective/Applicability Date

> These final regulations apply to taxable years beginning after December 31, 2013, except that § 1.1411-3(d) applies to taxable years beginning after December 31, 2012.

The final regulations were issued with additional proposed regulations, the preamble to which explained the regulatory background:[1502]

> The Treasury Department and the IRS received comments on the 2012 Proposed Regulations requesting that they address the treatment of section 707(c) guaranteed payments for capital, section 736 payments to retiring or deceased partners for section 1411 purposes, and certain capital loss carryovers. After consideration of all comments received, the Treasury Department and the IRS believe that it is appropriate to address the treatment of these items in regulations. Because such guidance had not been proposed in the 2012 Proposed Regulations, it is being issued for notice and comment in these new proposed regulations.
>
> The Treasury Department and the IRS also received comments on the simplified method for applying section 1411 to income recipients of charitable remainder trusts (CRTs) that was proposed in the 2012 Proposed Regulations. The comments recommended that the section 1411 classification incorporate the existing category and class system under section 664. These proposed regulations provide special rules for the application of the section 664 system to CRTs that derive income from controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs) with respect to which an election under § 1.1411-10(g) is not in place. Specifically, these proposed regulations coordinate the application of the rules applicable to shareholders of CFCs and

[1502] REG-130843-13.

> PFICs in § 1.1411-10 with the section 664 category and class system adopted in § 1.1411-3(d)(2) of the 2013 Final Regulations.
>
> Furthermore, these proposed regulations allow CRTs to elect to apply the section 664 system adopted in the 2013 Final Regulations or the simplified method set forth in the 2012 Proposed Regulations. Some comments responding to the 2012 Proposed Regulations requested that we provide an election. The Treasury Department and the IRS request comments with regard to whether or not taxpayers believe this election is preferable to the section 664 system adopted in the 2013 Final Regulations. If it appears that there is no significant interest in having the election, the Treasury Department and the IRS may omit it from the regulations when finalized, and the simplified method contained in the 2012 Proposed Regulations would no longer be an option.
>
> These proposed regulations also address the net investment income tax characterization of income and deductions attributable to common trust funds (CTFs), residual interests in real estate mortgage investment conduits (REMICs), and certain notional principal contracts.
>
> The Treasury Department and the IRS also received comments on the 2012 Proposed Regulations questioning the proposed regulation's methodology for adjusting a transferor's gain or loss on the disposition of its partnership interest or S corporation stock. In view of these comments, the 2013 Final Regulations removed § 1.1411-7 of the 2012 Proposed Regulations and reserved § 1.1411-7 in the 2013 Final Regulations.
>
> This notice of proposed rulemaking proposes revised rules regarding the calculation of net gain from the disposition of a partnership interest or S corporation stock (each a "Passthrough Entity") to which section 1411(c)(4) may apply.

The preamble to the 2013 proposed regulations explained effective dates:[1503]

> These regulations are proposed to apply for taxable years beginning after December 31, 2013, except that § 1.1411-3(d)(3) is proposed to apply to taxable years beginning after December 31, 2012.

II.I.3. Tax Based on NII in Excess of Thresholds

The preamble describes how to calculate the tax:[1504]

> In the case of an individual, section 1411(a)(1) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the individual's net investment income for such taxable year, or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. Section 1411(b) provides that the threshold amount is: (1) in the case of a taxpayer making a joint return under

[1503] REG-130843-13.
[1504] T.D. 9644.

> section 6013 or a surviving spouse (as defined in section 2(a)), $250,000; (2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, $125,000; and (3) in the case of any other individual, $200,000. Section 1411(d) defines modified adjusted gross income as adjusted gross income increased by the excess of: (1) the amount excluded from gross income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amount excluded from gross income under section 911(a)(1). Section 1.1411-2 of the final regulations provides guidance on the computation of the net investment income tax for individuals.
>
> In the case of an estate or trust, section 1411(a)(2) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the estate's or trust's undistributed net investment income, or (B) the excess (if any) of: (i) the estate's or trust's adjusted gross income (as defined in section 67(e)) for such taxable year, over (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year. Section 1.1411-3 of the final regulations provides guidance on the computation of the net investment income tax for estates and trusts.

Thus, the threshold amount is not indexed for inflation for individuals but is for trusts.[1505]

Short taxable years use the full threshold,[1506] without proration,[1507] unless the short year results from a change in the annual accounting period.[1508]

II.I.4. Calculating NII - General Overview Provided by Preambles

The preamble describes how to calculate net investment income:[1509]

> Section 1411(c)(1) provides that net investment income means the excess (if any) of: (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income derived from a trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply; over (B) the deductions allowed by subtitle A that are properly allocable to such gross income or net gain. Sections 1.1411-4 and 1.1411-10 of the final regulations provide guidance on the calculation of net investment income under section 1411(c)(1).
>
> Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). A trade or business is described in section 1411(c)(2) if such trade or business is: (A) a passive activity

[1505] Compare Code §§ 1411(a)(1)(B)(ii) and 1411(b) (fixed dollar amounts for individuals) with Code § 1411(a)(2)(B)(ii) (referring to the annually indexed top bracket for trusts and estates).
[1506] Reg. § 1.1411-1(d)(1) sets forth the thresholds.
[1507] Reg. § 1.1411-1(d)(2).
[1508] Reg. § 1.1411-1(d)(3).
[1509] T.D. 9644.

(within the meaning of section 469) with respect to the taxpayer, or (B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

Section 1.1411-5 of the final regulations provides guidance on the trades or businesses described in section 1411(c)(2).

Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. Section 1.1411-6 of the final regulations provides guidance on working capital under section 1411(c)(3).

In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

Section 1411(c)(5) provides that net investment income does not include distributions from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b). Section 1.1411-8 of the final regulations provides guidance on distributions from qualified plans under section 1411(c)(5).

Section 1411(c)(6) provides that net investment income also does not include any item taken into account in determining self-employment income for a taxable year on which a tax is imposed by section 1401(b). Section 1.1411-9 of the final regulations provides guidance regarding self-employment income under section 1411(c)(6).

Regarding properly allocable deductions in excess of investment income, the preamble to the final regulations provides:[1510]

Proposed § 1.1411-4(f)(1)(ii) provided that any deductions described in § 1.1411-4(f) in excess of gross income and net gain are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. Many commentators recommended that the final regulations provide that negative net investment income (when section 1411(c)(1)(B) deductions exceed section 1411(c)(1)(A) income) be carried over and become a section 1411(c)(1)(B) deduction in the subsequent year.

The final regulations do not adopt this recommendation. Section 1411(c)(1)(B) provides that, in order for a deduction to be allowed, it must be: (1) allowed by

[1510] T.D. 9644.

subtitle A, and (2) be properly allocable to section 1411(c)(1)(A) income. Section 1411(c)(1)(B) only allows deductions allowed by other Code sections; it does not establish a basis for a deduction that does not exist elsewhere in the Code. However, as discussed in the following part of this preamble, the final regulations do permit deductions of net operating losses otherwise allowed by subtitle A that are properly allocable to section 1411(c)(1)(A) income.

Regarding net operating losses (NOLs), the preamble to the final regulations provides:[1511]

Proposed § 1.1411-4(f)(1)(ii) provided that, in no event, will a net operating loss (NOL) deduction allowed under section 172 be taken into account in determining net investment income for any taxable year. The proposed regulations requested comments on whether a deduction should be allowed for an NOL in determining net investment income. Several commentators argued that, for purposes of section 1411(c)(1)(B), at least some portion of an NOL deduction should be a deduction properly allocable to gross income included in net investment income and therefore allowed in determining net investment income. Three commentators recommended that taxpayers be allowed to keep track of the portions of an NOL attributable to investment income for the loss year. One commentator recommended that the IRS adopt a simple rule for determining a portion of an NOL that is attributable to a "net investment loss" for a loss year (for example, using a ratio of the portion of the loss attributable to "net investment loss" to the NOL) and allow taxpayers to take a prorated portion of the NOL deduction into account in determining net investment income for a taxable year to which the NOL is carried.

The final regulations adopt a modified version of the commentator's approach in § 1.1411-4(f)(2)(iv) and (h). Because NOLs are computed and carried over year-by year, a separate ratio must be determined for each year. Thus, the final regulations provide that taxpayers may deduct a portion of an NOL deduction in determining their net investment income. The portion of an NOL deduction for a taxable year that may be deducted for section 1411 purposes is calculated by first determining the applicable portion of the NOL for each loss year. The applicable portion of the NOL is the lesser of: (1) the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine net investment income and only properly allocable deductions were taken into account in determining the NOL in accordance with section 172(c) and (d), or (2) the amount of the taxpayer's NOL for the loss year. Next, the amount of the NOL carried from each loss year and deducted in the taxable year is multiplied by a fraction. The numerator of this fraction is the applicable portion of the NOL for the loss year as determined above. The denominator of the fraction is the total NOL for the loss year. A separate fraction is determined for each loss year. The result of this multiplication is the amount of the NOL deduction from the loss year that is allowed as a section 1411(c)(1)(B) deduction in the taxable year, referred to as the section 1411 NOL amount. The sum of the section 1411 NOL amounts for each NOL carried to and deducted in the taxable year, referred to as the total section 1411 NOL amount, is the amount

[1511] T.D. 9644.

of the NOL deduction for the taxable year that is properly allocable to net investment income.

Reg. § 1.1411-4(h) describes Code § 1411 NOLs.

II.I.5. What is Net Investment Income Generally

Except as otherwise provided, all provisions that apply for Chapter 1 of the Code purposes in determining taxable income[1512] also apply in determining net investment income ("NII").[1513]

NII[1514] is the excess (if any) of:[1515]

1. The sum of:

   a. Gross income from interest,[1516] dividends,[1517] annuities,[1518] royalties,[1519] and rents,[1520] except to the extent excluded by the ordinary course of a trade or business exception;[1521]

[1512] As defined in Code § 63(a)

[1513] Reg. § 1.1411-1(a). However, Code § 1411 treatment does not affect treatment under any provision of the Code other than Code § 1411. Reg. § 1.1411-1(c). Also, credits generally allowable against income tax or other taxes are not creditable against the tax on NII. Reg. § 1.1411-1(e).
To add some levity to your day, note that approximately 30 years ago NII was suggested to be a very bad word. If you don't believe me, see https://www.youtube.com/watch?v=zIV4poUZAQo (short version) or https://www.youtube.com/watch?v=QTQfGd3G6dg (long version) from *Monty Python and the Holy Grail*.

[1514] Reg. § 1.1411-1(d)(8) provides:

> The term net investment income (NII) means net investment income as defined in section 1411(c) and § 1.1411-4, as adjusted pursuant to the rules described in § 1.1411-10(c).

[1515] Reg. § 1.1411-4(a).

[1516] Reg. § 1.1411-1(d)(6) provides:

> The term gross income from interest includes any item treated as interest income for purposes of chapter 1 and substitute interest that represents payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

[1517] Reg. § 1.1411-1(d)(3) provides:

> The term gross income from dividends includes any item treated as a dividend for purposes of chapter 1. See also § 1.1411-10 for additional amounts that constitute gross income from dividends. The term gross income from dividends includes, but is not limited to, amounts treated as dividends--
> (i) Pursuant to subchapter C that are included in gross income (including constructive dividends);
> (ii) Pursuant to section 1248(a), other than as provided in § 1.1411-10;
> (iii) Pursuant to § 1.367(b)-2(e)(2);
> (iv) Pursuant to section 1368(c)(2); and
> (v) Substitute dividends that represent payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

[1518] Reg. § 1.1411-1(d)(1) provides:

b. Other gross income derived from a passive trade or business;[1522] and

c. Net gain from the disposition of property,[1523] except to the extent attributable to property held in an active trade or business[1524] or otherwise provided,[1525]

The term gross income from annuities under section 1411(c)(1)(A) includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income as a result of the application of section 72(a) and section 72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under section 72(e). In the case of a sale of an annuity, to the extent the sales price of the annuity does not exceed its surrender value, the gain recognized would be treated as gross income from an annuity within the meaning of section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i). However, if the sales price of the annuity exceeds its surrender value, the seller would treat the gain equal to the difference between the basis in the annuity and the surrender value as gross income from an annuity described in section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i) and the excess of the sales price over the surrender value as gain from the disposition of property included in section 1411(c)(1)(A)(iii) and § 1.1411-4(a)(1)(iii). The term gross income from annuities does not include amounts paid in consideration for services rendered. For example, distributions from a foreign retirement plan that are paid in the form of an annuity and include investment income that was earned by the retirement plan does not constitute income from an annuity within the meaning of section 1411(c)(1)(A)(i).

[1519] Reg. § 1.1411-1(d)(11) provides:

The term gross income from royalties includes amounts received from mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property.

[1520] Reg. § 1.1411-1(d)(10) provides:

The term gross income from rents includes amounts paid or to be paid principally for the use of (or the right to use) tangible property.

[1521] See generally part II.I.8 Application of 3.8% Tax to Business Income.

[1522] See generally part II.I.8 Application of 3.8% Tax to Business Income.

[1523] Reg. § 1.1411-4(d)(1) provides:

Definition of disposition. For purposes of section 1411 and the regulations thereunder, the term disposition means a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition (including a deemed disposition, for example, under section 877A).

Reg. § 1.1411-4(d)(2) provides:

Limitation. The calculation of net gain may not be less than zero. Losses allowable under section 1211(b) are permitted to offset gain from the disposition of assets other than capital assets that are subject to section 1411.

Reg. § 1.1411-4(d)(3)(i) provides:

General rule. Net gain attributable to the disposition of property is the gain described in section 61(a)(3) recognized from the disposition of property reduced, but not below zero, by losses deductible under section 165, including losses attributable to casualty, theft, and abandonment or other worthlessness. The rules in subchapter O of chapter 1 and the regulations thereunder apply. See, for example, § 1.61-6(b). For purposes of this paragraph, net gain includes, but is not limited to, gain or loss attributable to the disposition of property from the investment of working capital (as defined in § 1.1411-6); gain or loss attributable to the disposition of a life insurance contract; and gain attributable to the disposition of an annuity contract to the extent the sales price of the annuity exceeds the annuity's surrender value.

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2. Deductions allowable for income tax purposes that are properly allocable to such gross income or net gain.[1526]

The corollary to self-employment income being excluded from NII is that items excluded from SE income might constitute NII.[1527] Note also that wages are not among the type of income constituting NII.

II.I.6. Deductions Against NII

The following deductions in determining regular adjusted gross income also apply to NII:

- Deductions allocable to gross income from rents and royalties included in NII.[1528]
- Deductions allocable to gross income from trades or businesses included in NII, to the extent the deductions have not been taken into account in determining self-employment income.[1529]
- Penalty on early withdrawal of savings.[1530]

1524 See generally part II.I.8.b 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets and also part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

1525 Reg. § 1.1411-4(d)(4)(ii) provides:

> Other gains and losses excluded from net investment income. Net gain, as determined under paragraph (d) of this section, does not include gains and losses excluded from net investment income by any other provision in §§ 1.1411-1 through 1.1411-10. For example, see § 1.1411-7 (certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations) and § 1.1411-8(b)(4)(ii) (net unrealized appreciation attributable to employer securities realized on a disposition of those employer securities).

1526 Reg. § 1.1411-4(f). See part II.I.6 Deductions Against NII.

1527 Reg. § 1.1411-9(a) provides:

> General rule. Except as provided in paragraph (b) of this section [income derived from a trade or business of trading in financial instruments or commodities], net investment income does not include any item taken into account in determining self-employment income that is subject to tax under section 1401(b) for such taxable year. For purposes of section 1411(c)(6) and this section, taken into account means income included and deductions allowed in determining net earnings from self-employment. However, amounts excepted in determining net earnings from self-employment under section 1402(a)(1)-(17), and thus excluded from self-employment income under section 1402(b), are not taken into account in determining self-employment income and thus may be included in net investment income if such amounts are described in § 1.1411-4. Except as provided in paragraph (b) of this section, if net earnings from self-employment consist of income or loss from more than one trade or business, all items taken into account in determining the net earnings from self-employment with respect to these trades or businesses (see § 1.1402(a)-2(c)) are considered taken into account in determining the amount of self-employment income that is subject to tax under section 1401(b) and therefore not included in net investment income.

1528 Reg. § 1.1411-4(f)(2)(i).

1529 Reg. § 1.1411-4(f)(2)(ii).

- Net operating loss arising from NII items.[1531]

The following itemized deductions also apply to NII:

- Investment interest expense.[1532]

- Investment expenses.[1533]

- State, local, and foreign income, war profits, and excess profit taxes that are allocable to net investment income.[1534]

- Deduction for unrecovered investment in an annuity in the decedent's final income tax return if the annuity was NII.[1535]

- Deductions for estate GST tax allocable to income in respect of a decedent that is NII.[1536]

- Deductions in connection with the determination, collection, or refund of any tax arising from NII.[1537]

[1530] Reg. § 1.1411-4(f)(2)(iii).

[1531] Reg. § 1.1411-4(f)(2)(iv), cross-referencing Reg. § 1.1411-4(h).

[1532] Reg. § 1.1411-4(f)(3)(i) , cross-referencing Code § 163(d)(3), which provides:

> *Investment interest*. For purposes of this subsection—
>
> (A) *In general*. The term "investment interest" means any interest allowable as a deduction under this chapter (determined without regard to paragraph (1)) which is paid or accrued on indebtedness properly allocable to property held for investment.
>
> (B) *Exceptions*. The term "investment interest" shall not include—
>
> (i) any qualified residence interest (as defined in subsection (h)(3)), or
>
> (ii) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer.
>
> (C) *Personal property used in short sale*. For purposes of this paragraph, the term "interest" includes any amount allowable as a deduction in connection with personal property used in a short sale.

Reg. § 1.163-8T provides interest tracing rules, which provide taxpayer with significant latitude to trace loan proceeds as they wish. Notice 88-74 provides guidance on various issues relating to the home mortgage interest deduction under Code § 163(h)(3).

[1533] Reg. § 1.1411-4(f)(3)(ii), cross-referencing Code § 163(d)(4)(C).

[1534] Reg. § 1.1411-4(f)(3)(iii), cross-referencing Code § 164(a)(3). For the effect of refunds of those taxes, see Reg. § 1.1411-4(g)(2).

[1535] Reg. § 1.1411-4(f)(3)(iv).

[1536] Reg. § 1.1411-4(f)(3)(v).

[1537] Reg. § 1.1411-4(f)(3)(vi) provides:

> Amounts described in section 212(3) and § 1.212-1(*l*) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

Reg. § 1.212-1(*l*) provides:

> Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with

- Amortizable bond premium on a taxable bond.[1538]

- Fiduciary expenses.[1539]

Other deductions include:

- Loss deductions.[1540]

- Ordinary loss deductions for certain debt instruments.[1541]

- Other deductions not yet announced.[1542]

Generally, deductions limited for regular income tax purposes are also limited for NII purposes.[1543]

> any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

[1538] Reg. § 1.1411-4(f)(3)(vii).

[1539] Reg. § 1.1411-4(f)(3)(viii) provides:

> In the case of an estate or trust, amounts described in § 1.212-1(i) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

Reg. § 1.212-1(i) provides:

> Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642(g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

Such fees include the trust's reimbursement of legal fees paid by the beneficiaries to change the trustee and improve the investment of the trust's assets. Letter Rulings 201642027, 201642028.

[1540] Reg. § 1.1411-4(f)(4)(i) provides:

> *General rule*. Losses described in section 165, whether described in section 62 or section 63(d), are allowed as properly allocable deductions to the extent such losses exceed the amount of gain described in section 61(a)(3) and are not taken into account in computing net gain by reason of paragraph (d) of this section.

[1541] Reg. § 1.1411-4(f)(5) provides:

> An amount treated as an ordinary loss by a holder of a contingent payment debt instrument under § 1.1275-4(b) or an inflation-indexed debt instrument under § 1.1275-7(f)(1).

[1542] Reg. § 1.1411-4(f)(6) provides:

> Any other deduction allowed by subtitle A that is identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) as properly allocable to gross income or net gain under this section.

[1543] Reg. § 1.1411-4(f)(7) provides:

> *Application of limitations under sections 67 and 68*. Any deductions described in this paragraph (f) that are subject to section 67 (the 2-percent floor on miscellaneous itemized deductions) or section 68 (the overall limitation on itemized deductions) are allowed in determining net investment income only to the extent the items are deductible for chapter 1 purposes after the application of sections 67 and 68. For this purpose,

If a properly allocable deduction is allocable to both NII and taxable items of income that are not NII, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method.[1544] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items. When using expenses to offset taxable items of income, consider which items of income constitute NII,[1545] as well as the overall federal and state income tax rates that apply to those items.

If a taxpayer is refunded, reimbursed, or otherwise recovers any portion of an amount deducted as a deduction against NII in a prior year, and such amount is not otherwise included in NII in the year of recovery, the amount of the recovery will reduce the taxpayer's total deductions against NII in the year of recovery (but not below zero).[1546]

Deductions in respect of a decedent also count against NII if they are described in any of the preceding paragraphs.[1547]

Deductions on termination of a trust or estate generally receive NII treatment consistent with their character.[1548]

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section 67 applies before section 68. The amount of deductions subject to sections 67 and 68 that may be deducted in determining net investment income after the application of sections 67 and 68 is determined as described in paragraph (f)(7)(i) and (f)(7)(ii) of this section.

[1544] Reg. § 1.1411-4(g)(1) provides:

Deductions allocable to both net investment income and excluded income. In the case of a properly allocable deduction described in section 1411(c)(1)(B) and paragraph (f) of this section that is allocable to both net investment income and excluded income, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method. Examples of reasonable methods of allocation include, but are not limited to, an allocation of the deduction based on the ratio of the amount of a taxpayer's gross income (including net gain) described in § 1.1411-4(a)(1) to the amount of the taxpayer's adjusted gross income (as defined under section 62 (or section 67(e) in the case of an estate or trust)). In the case of an estate or trust, an allocation of a deduction pursuant to rules described in § 1.652(b)-3(b) (and § 1.641(c)-1(h) in the case of an ESBT) is also a reasonable method.

[1545] See part II.I.5 What is Net Investment Income Generally.

[1546] Reg. § 1.1411-4(g)(2) provides additional details how this works.

[1547] Reg. § 1.1411-4(g)(3) provides:

Deductions described in section 691(b). For purposes of paragraph (f) of this section, properly allocable deductions include items of deduction described in section 691(b), provided that the item otherwise would have been deductible to the decedent under § 1.1411-4(f). For example, an estate may deduct the decedent's unpaid investment interest expense in computing its net investment income because section 691(b) specifically allows the deduction under section 163, and § 1.1411-4(f)(3)(i) allows those deductions as well. However, an estate or trust may not deduct a payment of real estate taxes on the decedent's principal residence that were unpaid at death in computing its net investment income because, although real estate taxes are deductible under section 164 and specifically are allowed by section 691(b), the real estate taxes would not have been a properly allocable deduction of the decedent under § 1.1411-4(f).

[1548] Reg. § 1.1411-4(g)(4), referring to Code § 642(h) items. See part II.J.3.i Planning for Excess Losses.

Special rules apply to losses allowed in computing taxable income by reason of the rules governing former passive activities[1549] or losses allowed when a passive activity is disposed of.[1550]

II.I.7. Interaction of NII Tax with Fiduciary Income Tax Principles

Generally,[1551] a trust or estate is taxed on the lesser of its undistributed net investment income (UNII) or the excess (if any) of its adjusted gross income[1552] over the taxable income threshold[1553] for its highest marginal income tax bracket.[1554]

Regarding grantor trusts, the tax is imposed on the deemed owner rather than the trust:[1555]

- Thus, the beneficiary of a qualified subchapter S trust (QSST)[1556] would include the S corporation's income in the beneficiary's income and determine the applicability of the tax based on the beneficiary's tax attributes and participation in the S corporation's activity. Consider switching from an ESBT to one or more QSSTs in

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[1549] Reg. § 1.1411-4(g)(8), referring to losses under Code § 469(f)(1).
[1550] Reg. § 1.1411-4(g)(9), referring to losses under Code § 469(g)(1).
[1551] Reg. § 1.1411-3(a)(1)(i). Reg. § 1.1411-3(b)(1) exempts the following trusts from the tax:

(i) A trust or decedent's estate all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).
(ii) A trust exempt from tax under section 501.
(iii) A charitable remainder trust described in section 664. However, see paragraph (d) of this section for special rules regarding the treatment of annuity or unitrust distributions from such a trust to persons subject to tax under section 1411.
(iv) Any other trust, fund, or account that is statutorily exempt from taxes imposed in subtitle A. For example, see sections 220(e)(1), 223(e)(1), 529(a), and 530(a).
(v) A trust, or a portion thereof, that is treated as a grantor trust under subpart E of part I of subchapter J of chapter 1. However, in the case of any such trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.
(vi) Electing Alaska Native Settlement Trusts subject to taxation under section 646.
(vii) Cemetery Perpetual Care Funds to which section 642(i) applies.
(viii) Foreign trusts (as defined in section 7701(a)(31)(B) and § 301.7701-7(a)(2)) (but see §§ 1.1411-3(e)(3)(ii) and 1.1411-4(e)(1)(ii) for rules related to distributions from foreign trusts to United States beneficiaries).
(ix) Foreign estates (as defined in section 7701(a)(31)(A)) (but see § 1.1411-3(e)(3)(ii) for rules related to distributions from foreign estates to United States beneficiaries).

A charitable remainder trust's beneficiaries are taxed when the CRT distributes to them NII the CRT received for all taxable years that begin after December 31, 2012. Reg. § 1.1411-3(d)(iii). Although in the past a CRT that had a huge capital gain tier would have been neutral to whether to harvest losses (because accumulated capital gain would exceed distributions whether or not the losses were taken), now one should consider the 3.8% tier as well. Thus, consider recognizing losses to offset post-12/31/2012 gains.
[1552] As defined in Code § 67(e) and as adjusted under Reg. § 1.1411-10(e)(2), if applicable.
[1553] Code § 1(e).
[1554] Reg. § 1.1411-3(a)(1)(ii).
[1555] Reg. § 1.1411-3(b)(1)(v).
[1556] See part III.A.3.e.i QSSTs.

light of not only issues relating to the 3.8% tax but also increases in the top income tax bracket (to which all ESBT S corporation income is subject) relative to the beneficiaries' income tax rates.[1557] For more about ESBTs and QSSTs, see parts II.J.14 Application of 3.8% Tax to ESBTs and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

- See generally part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts regarding other trusts that are deemed owned by beneficiaries rather than grantors, including part III.B.2.i.vi Portion Owned When a Gift (discussing how to compute the portion deemed owned by the beneficiary during and after the lapse of a withdrawal right). A minor beneficiary of a trust is treated as the owner of any portion of the trust with respect to which the minor has a power to vest the corpus or income in the minor, notwithstanding that no guardian has been appointed for the minor.[1558]

- See part III.B.2.h How to Make a Trust a Grantor Trust, regarding how to make the settlor the deemed owner.

UNII[1559] is the estate's or trust's NII reduced by distributions of net investment income to beneficiaries[1560] and by charitable deductions[1561] (but note that the charitable deduction does not reduce DNI allocated to mandatory income beneficiaries).[1562]

[1557] See part III.A.3.e QSSTs and ESBTs, especially part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

[1558] Rev. Rul. 81-6.

[1559] Reg. § 1.1411-3(e)(2). Generally, an estate's or trust's net investment income is calculated in the same manner as that of an individual. Reg. § 1.1411-3(e)(1). Reg. § 1.1411-3(e)(5) provides examples.

[1560] Reg. § 1.1411-3(e)(3) provides:

(i) In computing the estate's or trust's undistributed net investment income, net investment income is reduced by distributions of net investment income made to beneficiaries. The deduction allowed under this paragraph (e)(3) is limited to the lesser of the amount deductible to the estate or trust under section 651 or section 661, as applicable, or the net investment income of the estate or trust. In the case of a deduction under section 651 or section 661 that consists of both net investment income and excluded income (as defined in § 1.1411-1(d)(4)), the distribution must be allocated between net investment income and excluded income in a manner similar to § 1.661(b)-1 as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. See § 1.661(c)-1 and Example 1 in paragraph (e)(5) of this section.

(ii) If one or more items of net investment income comprise all or part of a distribution for which a deduction is allowed under paragraph (e)(3)(i) of this section, such items retain their character as net investment income under section 652(b) or section 662(b), as applicable, for purposes of computing net investment income of the recipient of the distribution who is subject to tax under section 1411. The provisions of this paragraph (e)(3)(ii) also apply to distributions to United States beneficiaries of current year income described in section 652 or section 662, as applicable, from foreign estates and foreign nongrantor trusts.

[1561] Reg. § 1.1411-3(e)(4) provides:

<u>Deduction for amounts paid or permanently set aside for a charitable purpose</u>. In computing the estate's or trust's undistributed net investment income, the estate or trust is allowed a deduction for amounts of net investment income that are allocated to amounts allowable under section 642(c). In the case of an estate or trust that has items

To the extent that the rules governing the allocation of deductions for regular income tax purposes conflict with their NII counterparts, the regular income tax rules control.[1563] See parts II.I.6 Deductions Against NII (especially the text accompanying fns. 1544-1545) and II.J.8.f.i.(a) Allocating Deductions to Various Income Items.

The beneficiary's NII includes the beneficiary's share of distributable net income (DNI) distributed to the beneficiary, as described in the rules governing inclusion in the beneficiary's income under the regular income tax rules, to the extent that the character of such income constitutes NII.[1564] Distributions include amounts required to be distributed[1565] and any other amounts properly paid, credited, or required to be distributed to such beneficiary.[1566] Generally, an amount is considered credited if the

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> of income consisting of both net investment income and excluded income, the allowable deduction under this paragraph (e)(4) must be allocated between net investment income and excluded income in accordance with § 1.642(c)-2(b) as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. For an estate or trust with deductions under both sections 642(c) and 661, see § 1.662(b)-2 and Example 2 in paragraph (e)(5) of this section.

If the trust does not sufficiently authorize distributions to charity, consider forming a partnership (which also might have benefits under part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries) that makes gifts deductible to the charity under Rev. Rul. 2004-5, which is discussed in fn. 3534, which is found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Query whether the trustee would be violating fiduciary duties in allowing the partnership to make donations to charity and whether a beneficiary who fails to object is deemed to be the donor for income tax purposes. A safer approach in planning mode would be granting the noncharitable beneficiaries an inter vivos power to appoint gross income to charity; if the trust is already in place, consider decanting to grant the beneficiary such an inter vivos power. Letter Ruling 200906008. However, under 2017 tax reform, which was adopted after the NII regulations were finalized, Code § 642(c) does not apply to an ESBT; see fn 4529 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview and also note that fn 4528 allows an ESBT to deduct charitable contributions against its S corporation income only to the extent they are on the K-1 from the S corporation.

[1562] See fns. 1768 and 1769 in part II.J.4.c Charitable Distributions.

[1563] Reg. §§ 1.1411-1(c) (NII rules do not affect regular income rules), 1.1411-3(e)(3) (if any NII comprises all or part of a distribution for which an NII distribution deduction is allowed, such items retain their character as NII for purposes of computing the recipient's NII). Reg. § 1.652(b)-3(b), reproduced in fn. 1917, controls the allocation of deductions to items comprising DNI for regular income tax purposes.

[1564] Reg. § 1.1411-4(e)(1)(i) provides:

> Net investment income includes a beneficiary's share of distributable net income, as described in sections 652(a) and 662(a), to the extent that, under sections 652(b) and 662(b), the character of such income constitutes gross income from items described in paragraphs (a)(1)(i) and (ii) of this section or net gain attributable to items described in paragraph (a)(1)(iii) of this section, with further computations consistent with the principles of this section, as provided in § 1.1411-3(e).

For how the rules of Code §§ 652 and 662 work, see fn. 1927 and the discussion in part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries).

[1565] Code §§ 652(a), 662(a)(1).

[1566] Code § 662(a)(2). Reg. § 1.662(a)-3(a) provides:

> There is included in the gross income of a beneficiary under section 662(a)(2) any amount properly paid, credited, or required to be distributed to the beneficiary for the taxable year, other than (1) income required to be distributed currently, as determined under § 1.662(a)-2, (2) amounts excluded under section 663(a) and the regulations

trustee must pay it on the beneficiary's demand (without the trustee exercising any discretion when the beneficiary makes the demand) and there is no practical or legal impediment to making the payment.[1567] Query whether, instead of or in addition to exercising discretion by making payments to or for a beneficiary, a trustee can inform a beneficiary that the trustee is crediting $____ (but no more than 5% of the trust's assets at any time from the time of grant until the end of the year), that the beneficiary may withdraw that at any time during the year, and that this withdrawal right will lapse at the end of the year, perhaps with the effect that the beneficiary is taxed on the amount credited (even without receiving it)[1568] and that the lapse would make the trust a partial grantor trust taxable to the beneficiary.[1569] This might be more appropriate for converting a trust to a partial grantor trust than as the preferred method for deeming income to be distributed, in case the IRS argues that one is making a gift by allowing the lapse of a payment made from income instead of made from any part of the trust.[1570] Because the lapse does not constitute a gift for gift tax purposes, the lapse does not cause a portion of the trust to be included in the beneficiary's estate for estate tax purposes. The latter might be important even for QTIP marital deduction trusts that are included in the beneficiary's estate anyway, because the inclusion of such a trust's assets might be valued at a lower rate as a QTIP asset than as an incomplete gift or Code § 2036 asset.[1571]

Trustee fees are not NII to the recipient and do not constitute self-employment income unless the trustee is engaging in a trade or business.[1572] Paying reasonable trustee

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> thereunder, and (3) amounts in excess of distributable net income (see paragraph (c) of this section). An amount which is credited or required to be distributed is included in the gross income of a beneficiary whether or not it is actually distributed.

[1567] See *Cecelia K. Frank Trust of 1931 v. Commissioner*, 8 T.C. 368 (1947), *aff'd* 165 F.2d 992 (3d Cir. 1948); *Commissioner v. Stearns*, 65 F.2d 371 (2d Cir.), *cert. den.* 290 U.S. 670 (1933); *Weed's Estate v. United States*, 110 F.Supp. 149 (E.D. Tex. 1952); *Igoe v. Commissioner*, 19 T.C. 913 (1953); *Estate of Cohen v. Commissioner*, 8 T.C. 784 (1947); *Estate of Bruner v. Commissioner*, 3 T.C. 1051 (1944); *Estate of Johnson v. Commissioner*, 88 T.C. 225, *aff'd* 838 F.2d 1202 (2d Cir. 1987); *Estate of Hubbard v. Commissioner*, 41 B.T.A. 628 (1941); *cf. Harkness v. United States*, 469 F.2d 310 (Ct. Cl. 1972), *cert. denied* 414 U.S. 820 (1973); *Warburton v. Commissioner*, 193 F.2d 1008 (3d Cir. 1952). The author thanks Lad Boyle for providing the above citations from F. Ladson Boyle & Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (15th ed. 2008). Additional authority includes *Bohan v. U.S.*, 326 F.Supp. 1356 (W.D. Mo. 1971), *aff'd* 456 F.2d 851 (8th Cir. 1972), *nonacq.* Rev. Rul. 82-396; see also Reg. § 1.451-2, "Constructive receipt of income." Note also that Code § 643(g) provides circumstances under which a trustee may credit a beneficiary with the trust's estimated tax payments.

[1568] If the withdrawal right were included in the agreement instead of the crediting taking place, the beneficiary would be taxed on a portion of the trust instead of being treated as having been credited with a distribution. Rev. Rul. 67-241; see parts III.B.2.i.i Trusts Intended to Be Beneficiary Grantor Trusts from Inception, especially fn. 5074, and III.B.2.i.ii Can a Trust without a Withdrawal Right Be a Code § 678 Trust?, especially fn. 5082.

[1569] See parts II.J.3.h Drafting for Flexibility and III.B.2.i.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

[1570] Code § 2514(e)(2) excludes from gift tax consequences lapses in an amount that does not exceed "5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied."

[1571] For the potentially lower valuation of QTIP assets, see fn. 2713.

[1572] Rev. Rul. 58-5 held:

fees[1573] to a trustee who is a beneficiary would reduce NII while maintaining the same aggregate taxable income between the trust and beneficiary, subject to the following caveats:

> In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Whether or not a person is engaged in a trade or business is dependent upon all of the facts and circumstances in the particular case. However, the following will serve as guides in determining this question in the case of fiduciaries of decedents' estates:
>
> (1) Professional fiduciaries will always be treated as being engaged in the trade or business of being fiduciaries, regardless of the assets contained in the estate.
>
> (2) Generally, nonprofessional fiduciaries (that is, for example, persons who serve as executor or administrator in isolated instances, and then as personal representative for the estate of a deceased friend or relative) will not be treated as receiving income from a trade or business unless all of the following conditions are met:
>
> (a) There is a trade or business among the assets of the estate,
>
> (b) The executor actively participates in the operation of this trade or business,
>
> (c) The fees of the executor are related to the operation of the trade or business.

After citing some examples, including imposing self-employment tax on a trustee who manages a trade or business (see fn. 2296, found in part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues), the ruling concluded with a caveat:

> In some cases the activities of the executor of a single estate may constitute the conduct of a trade or business even though the assets of the estate do not include a trade or business as such. If, for example, an executor manages an estate which requires extensive management activities on his part over a long period of time, an examination of the facts may show that such activities are sufficient in scope and duration to constitute the carrying on of a trade or business. If doubt exists concerning the status of a fiduciary believed to be in this category, the complete facts should be transmitted to the National Office for consideration. See Rev. Rul. 54-172, C.B. 1954-1, 394.

[1573] For authority on constructive receipt of trustee fees, see Rev. Ruls. 56-472 (waiver by executor did not constitute gift or assignment of income), 64-225 (waiver after serving for many years <u>not</u> respected when, under the circumstances, the services performed by the trustees were not intended to be rendered gratuitously), and 66-167 (waiver made six months after beginning to serve given retroactive effect); see *Breidert v. Commissioner*, 50 T.C. 844 (1968), which held:

> Not only did petitioner waive his right to executor's fees, he did not even have sufficient cash on hand in the estate after paying the claims of creditors and the expenses of administration to pay himself such fees had he desired them. In fact, the cash on hand was insufficient to cover the fees of the attorney and the accountants who rendered substantial services to the estate. There was never any point at which executor's fees in the amount of $9,100.20, or any other sum, were credited to petitioner's account, set apart for him, or otherwise made available to him either by the estate or by the legatees and devisees of the estate. See sec. 1.451-2, Income Tax Regs. Thus, there is no factual basis here for application of the doctrine of constructive receipt. See *Mott v. Commissioner*, 85 F.2d 315, 317-318 (C.A. 6), *affirming on this issue* 30 B.T.A. 1040, 1044-1045; *Estate of W. H. Kiser*, 12 T.C. 178, 180; *S.A. Wood*, 22 B.T.A. 535, 537, *Cf. Weil v. Commissioner*, 173 F.2d 805 (C.A. 2).
>
> Although the Government's principal contention is based upon "constructive receipt," a doctrine that we have found inapplicable on the facts of this case, it also suggests that petitioner must be charged with the executor's fees because he "earned" them. It does not go so far as to argue that an executor may never waive his fees so as to prevent them from being included in his gross income, but it relies upon certain revenue rulings (Rev. Rul. 66-167, 1966-1 C.B. 20; *cf.* Rev. Rul. 64-225, 1964-2 C.B. 15; Rev. Rul. 56-472, 1956-2 C.B. 21) to support its position that petitioner must in any event be

- If the trust has tax-exempt income, some of the trustee fees will be disallowed as a deduction.[1574]

- If and to the extent that trustee fees reduce qualified dividend income or other income taxed at lower rates, the tax rate on the trustee might exceed the tax benefit of the deduction.

See also part II.J.3.a Who Is Best Taxed on Gross Income, for some strategic considerations regarding whether income is best trapped inside the trust or allocated to the beneficiaries to the extent influence by overall income tax, whether federal income tax, NII tax, or state income tax.

For a description of special NII rules governing charitable remainder trusts, see the text accompanying fn. 1502 in part II.I.2 Regulatory Framework.

The AICPA has resources on the Estate and Trust Impact of 3.8% Net Investment Income Tax.[1575]

II.I.8. Application of 3.8% Tax to Business Income

II.I.8.a. General Application of 3.8% Tax to Business Income

Gross income from interest,[1576] dividends, annuities, royalties,[1577] and rents is excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive

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accountable for the executor's fees. The precise theory of these rulings is not clear. Rev. Rul. 66-167, *supra*, appears to indicate that an executor may waive his right to compensation without incurring income tax liability, and the test is whether the waiver "will at least primarily constitute evidence of an intent to render a gratuitous service" (p. 21). Accordingly, if a waiver is made "within a reasonable time" after commencing to serve, it is regarded as "consistent with an intention to render gratuitous service" (headnote), but "if the timing, purpose, and effect of the waiver make it serve any other important objective, it may then be proper to conclude that the fiduciary has thereby enjoyed a realization of income by means of controlling the disposition thereof" (p. 21). We need not consider whether this represents sound theory, because from our appraisal of the evidence we think petitioner never had any intention to receive compensation for his services, and that the factual foundation for applying the ruling against him is absent.

To be sure, the record before us contains material that is confusing and contradictory in respect of petitioner's intentions. Much of the confusion is attributable to the bungling manner in which petitioner's counsel handled the matter. But we are satisfied from the evidence as a whole, with particular reliance upon our impression of petitioner himself on the witness stand, notwithstanding contradictions in his testimony, that petitioner never in fact intended to receive any executor's fees, and that the subsequent written waiver merely formalized that intention.

We hold that petitioner could render gratuitous services without subjecting himself to income tax liability therefor and that the factual basis does not exist on this unusual record to charge him with having realized income on the theory of the revenue rulings, whatever that may be.

[1574] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 1916.

[1575] See http://www.aicpa.org/InterestAreas/Tax/Resources/TrustEstateandGift/ToolsandAids/Pages/EstateandTrustImpactof38MedicareSurtax.aspx.

[1576] Self-charged interest is treated as business income. Reg. § 1.1411-4(g)(5) provides:

activity;[1578] however, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[1579] Gain from the

> Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

As described in fn. 1579, other than self-charged interest described above, interest income generally will constitute NII, even if it is fully business-related, unless the business is in the nature of a bank, etc.

[1577] See part II.K.1.f Royalty as a Trade or Business. If licensing royalties does not rise to the level of a trade or business, consider obtaining a preferred profits interest in lieu of royalty income (if the owner of the property being provided is active in the business) or a structure such as described in part II.E Recommended Structure for Entities (with some extra share of profits allocated to the person who contributed the property).

[1578] Reg. § 1.1411-4(b), which provides:

> Gross income described in paragraph (a)(1)(i) of this section is excluded from net investment income if it is derived in the ordinary course of a trade or business not described in § 1.1411-5….

[1579] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411-4(f) for rules regarding properly allocable deductions with respect to an investment of working capital…

Reg. § 1.469-2T(c)(3)(ii) treats only the following as gross income derived in the ordinary course of a trade or business:

> (A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
>
> (B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
>
> (C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
>
> (D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);
>
> (E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);
>
> (F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

sale of an asset is excluded from NII if it is derived in the ordinary course of a trade or business that is not a passive activity;[1580] however, any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business.[1581] Other gross income from a trade or business is NII if it a passive activity.[1582]

Passive income is subject to the NII tax, and Code § 469 and the regulations thereunder determine whether a trade or business is passive.[1583]

Income from a trade or business of trading in financial instruments[1584] or commodities[1585] is also subject to NII tax.[1586] This rule applies to traders – not to dealers or investors.[1587]

> (G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

[1580] Reg. § 1.1411-4(a)(1)(iii).

[1581] Reg. § 1.1411-6(a), which also provides:

> In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See ... § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

It also provides an example showing how strict this rule is: The taxpayer uses an interest-bearing checking account at a local bank to make daily deposits of the restaurant's cash receipts and to pay the restaurant's recurring ordinary and necessary business expenses. The account's average daily balance is approximately $2,500, but at any given time the balance may be significantly more or less than this amount, depending on the business' short-term cash flow needs. Any interest the account generates constitutes NII.

[1582] Reg. § 1.1411-4(c).

[1583] Reg. § 1.1411-5(b)(1)(ii).

[1584] Reg. § 1.1411-5(c)(1) provides:

> *Definition of financial instruments*. For purposes of section 1411 and the regulations thereunder, the term financial instruments includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the items described in this paragraph (c)(1). An evidence of an interest in any of the items described in this paragraph (c)(1) includes, but is not limited to, short positions or partial units in any of the items described in this paragraph (c)(1).

[1585] Reg. § 1.1411-5(c)(2) provides:

> *Definition of commodities*. For purposes of section 1411 and the regulations thereunder, the term commodities refers to items described in section 475(e)(2).

[1586] Code § 1411(c)(2)(B); Reg. § 1.1411-5(a)(2).

[1587] The final regulations adopted the proposed regulations. The preamble to the latter, REG-130507-11, provides:

> **C. Trading in Financial Instruments or Commodities**
>
> **i. Distinguishing Between Dealers, Traders, and Investors**
>
> Determining whether trading in financial instruments or commodities rises to the level of a section 162 trade or business is a question of fact. *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 33 (2d Cir. 1989). In general, section 475(c)(1) provides that the term dealer in securities means a taxpayer who (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (B) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. In contrast, a trader seeks profit from short-term market swings and

This tax favors (by excluding) trade or business income from partnerships and S corporations in which the taxpayer significantly or materially participates, which for many taxpayers simply means work for more than 100 hours in a year.[1588] Although a partnership's income from a trade or business generally would be subject to self-employment tax, whereas an S corporation income from a trade or business is not,[1589] one should consider that exit strategies[1590] and basis step-up issues[1591] tend to favor partnerships over S corporations. One might consider combining a partnership for the business operations themselves with an S corporation to block self-employment income from passing through to the ultimate owners.[1592]

II.I.8.a.i. Passive Activity Recharacterization Rules

Various passive activity recharacterization rules also provide NII exclusions for trade or business activity:

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receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzinger v. Comm'r*, 771 F.2d 269, 274-275 (7th Cir. 1985), *aff'd* 480 U.S. 23 (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). A person will be a trader, and therefore engaged in a section 162 trade or business, if his or her trading is frequent and substantial, which has been rephrased as "frequent, regular, and continuous." *Boatner v. Comm'r*, T.C. Memo. 1997-379, *aff'd* in unpublished opinion 164 F.3d 629 (9th Cir. 1998).

An investor is a person who purchases and sells securities with the principal purpose of realizing investment income in the form of interest, dividends, and gains from appreciation in value over a relatively long period of time (that is, long-term appreciation). The management of one's own investments is not considered a section 162 trade or business no matter how extensive or substantial the investments might be. See *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *King v. Comm'r*, 89 T.C. 445 (1987). Therefore, an investor is not considered to be engaged in a section 162 trade or business of investing.

For purposes of section 1411(c)(2)(B), in order to determine whether gross income is derived from a section 162 trade or business of trading in financial instruments or commodities, the gross income must be derived from an activity that would constitute trading for purposes of chapter 1. Therefore, a person that is a trader in commodities or a trader in financial instruments is engaged in a trade or business for purposes of section 1411(c)(2)(B). The Treasury Department and the IRS emphasize that the proposed regulations do not change the state of the law with respect to classification of traders, dealers, or investors for purposes of chapter 1.

[1588] See part II.K.1.a Counting Work as Participation, being careful to consider part II.K.1.a.v What Does Not Count as Participation. Other than work as a mere investor, almost any type of work appears to qualify towards material participation for purposes of the Code § 1411. For the more-than-100 hours rule, see fn. 1593.

[1589] See part II.L.1 FICA: Corporation.

[1590] See part II.Q Exiting from or Dividing a Business. However, when considering a Code § 736 redemption, see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411. Also see part II.G.14 Limitations on the Use of Installment Sales, but note that the suggestion in that part about forming a partnership to hold property that is to be sold would not work with an S corporation, because a partnership is not eligible to hold stock in an S corporation.

[1591] See part II.H.2 Basis Step-Up Issues.

[1592] See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

- Significant participation activities (more than 100 hours of participation).[1593]

- Certain rental activities.[1594]

- To the extent that any gain from a trade or business is recharacterized as "not from a passive activity" by reason of certain rules relating to the disposition of substantially appreciated property formerly used in nonpassive activity[1595] and is not from the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities,[1596] such trade or business is a nonpassive activity solely with respect to such recharacterized gain.[1597]

- To the extent that any income or gain from a trade or business is recharacterized as a nonpassive activity and is further characterized as portfolio income under certain provisions, then such trade or business constitutes a passive activity solely with respect to such recharacterized income or gain.[1598] The relevant portfolio income provision is either:

    - the rental of nondepreciable property, equity-financed lending activities, and royalty income from passthrough entities,[1599] or

    - the disposition of an interest in property that was held for investment for more than 50% of the period during which the taxpayer held that interest in property in nonpassive activities.[1600]

[1593] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2T(f)(2), which is described in fn. 2224 of part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[1594] Reg. § 1.1411-5(b)(2)(i), referring to Reg. § 1.469-2(f)(5) or 1.469-2(f)(6), which are described in fns. 2210 and 2171, respectively, within part II.K.1.e Rental Activities.

[1595] Reg. § 1.469-2(c)(2)(iii), which provides, generally:

> If an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity unless the interest in property was used in a passive activity for either:
>
> (1) 20 percent of the period during which the taxpayer held the interest in property; or
>
> (2) The entire 24-month period ending on the date of the disposition.

An interest in property is substantially appreciated if the fair market value of the interest in property exceeds 120% of the adjusted basis of the interest. Reg. § 1.469-2(c)(2)(iii)(C).

[1596] Reg. § 1.469-2(c)(2)(iii)(F).

[1597] Reg. § 1.1411-5(b)(2)(i).

[1598] Reg. § 1.1411-5(b)(2)(iii).

[1599] Reg. § 1.1411-5(b)(2)(iii) refers to Reg. § 1.469-2T(f)(10), which refers to Reg. § 1.469-2(f)(10). Sutton & Howell-Smith, *Federal Income Taxation of Passive Activities* (WG&L), ¶ 7.01[2][b] Recharacterized Items, refers to Reg. § 1.469-2(f)(10) as the rental of nondepreciable property (¶ 10.05 of the treatise), equity-financed lending activities (¶ 7.03 of the treatise), and royalty income from passthrough entities (¶ 13.05 of the treatise).

[1600] Reg. § 1.469-2(c)(2)(iii)(F).

II.I.8.a.ii. Passive Activity Grouping Rules

Regarding how the Code § 469 grouping rules interact with classifying income under Code § 469, the preamble explains:[1601]

> Section 1.469-4 provides rules for defining an activity for purposes of applying the passive activity loss rules of section 469 (grouping rules). The grouping rules will apply in determining the scope of a taxpayer's trade or business in order to determine whether such trade or business is a passive activity for purposes of section 1411(c)(2)(A). However, a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

For example, if a partner in a partnership participates in one trade or business for more than 500 hours and another trade or business for only 50 hours and the individual groups both activities as one activity in a way that qualifies both trades or businesses as nonpassive, business income from both trades or businesses is excluded from NII.[1602]

For more information about the Code § 469 grouping rules, including regrouping as a result of the NII tax, see part II.K.1.b Grouping Activities.

II.I.8.a.iii. Qualifying Self-Charged Interest or Rent Is Not NII

Certain self-charged interest[1603] or rent[1604] received from a business are automatically deemed nonpassive trade or business income if the borrower/tenant is a nonpassive

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[1601] Part 6.B.1.(b)(4) of the preamble.

[1602] Reg. § 1.1411-5(b)(3), Example (2).

[1603] Reg. § 1.1411-4(g)(5) provides:

> Treatment of self-charged interest income. Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

[1604] Reg. § 1.1411-4(f)(6)(i) provides:

> Gross income from rents. To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

trade or business; however, self-charged interest is excluded only to the extent it is self-charged.[1605]

Note that the taxpayer must materially participate, satisfying the more-than-500-hours or similar rules,[1606] to satisfy the self-rental exception of footnote 1604:

- Although significant participation (more than 100 hours) suffices for other business income,[1607] it does not for the self-rental exception. If this contrast in treatment (between material participation and significant participation) is significant (particularly if the property is about be sold)[1608] and avoiding the NII tax on the rental income becomes important, consider using the structure depicted in part II.E.6 Recommended Partnership Structure – Flowchart,[1609] perhaps migrating as depicted in part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

- Material participation requires ownership.[1610]

If self-charged rental is excluded from NII, gain on the sale of the rental property is also excluded.[1611]

See fn. 1644 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income. See part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity for an explanation of Reg. § 1.469-2(f)(6).
See fn. 2171 for the text of Reg. § 1.469-2(f)(6).

[1605] Reg. § 1.469-7 (treatment of self-charged items of interest income and deduction), which applies "in the case of a lending transaction (including guaranteed payments for the use of capital under section 707(c)) between a taxpayer and a passthrough entity in which the taxpayer owns a direct or indirect interest, or between certain passthrough entities." Reg. § 1.469-7(a)(1). See parts II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation, II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income, and II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736 regarding the interaction of partnership tax rules with the passive loss rules and rules governing NII.

[1606] See part II.K.1.a.ii Material Participation.

[1607] See part II.I.8.a.i Passive Activity Recharacterization Rules. If at all practical, an owner should materially participate instead of significantly participate. See part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[1608] See fn. 1611

[1609] This structure often is ideal; see part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons. However, it might need to be unwound by subjecting the real estate to a long-term business lease and distributing the real estate to the client's beneficiaries not active in the business, to try to disentangle the active from the inactive beneficiaries. Note, however, that splitting up an entity taxed as a partnership generally can be done on a tax-free basis; see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.b.i Distribution of Property by a Partnership.

[1610] See fn. 2170 and part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[1611] Reg. § 1.1411-4(f)(6)(ii) provides:

> <u>Gain or loss from the disposition of property</u>. To the extent that gain or loss resulting from the disposition of property is treated as nonpassive gain or loss by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), then such gain or loss is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

II.I.8.a.iv. Determination of Trade or Business Status, Passive Activity Status, or Trading Status of Pass-Through Entities

If an individual, estate, or trust owns or engages in a trade or business,[1612] the determination of whether such gross income is derived in a trade or business is made at the owner's level.[1613]

If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation:[1614]

- whether gross income is a passive trade or business activity is determined at the owner level; and
- whether gross income is derived in trade or business of a trader trading in financial instruments or commodities[1615] is determined at the entity level.

II.I.8.a.v. Working Capital Is NII

II.I.8.a.v.(a). Policy of Working Capital as NII

The tax applies to interest, dividends, etc. whether inside or outside an entity, and arguments that such income was derived from working capital used to generate active business income will not help any.[1616] The preamble to the proposed regulations explains:[1617]

> Section 1411(c)(3) provides that a rule similar to the rule of section 469(e)(1)(B) applies for purposes of section 1411 (the working capital rule). Section 469(e)(1)(B) provides that, for purposes of determining whether income is treated as from a passive activity, any income or gain attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.
>
> The term working capital is not defined in either section 469 or section 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business. Because the capital may not be necessary for the immediate conduct of the trade or business, the amounts are often invested by businesses in income-producing liquid assets such as savings accounts, certificates of deposit, money market accounts, short-term government and commercial bonds, and other similar investments. These investment assets will usually produce portfolio-type income, such as interest. Under section 469(e)(1)(B), portfolio-type income

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See fns. 1644 and 2172 regarding Reg. § 1.469-2(f)(6).

[1612] Directly or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under the check-the-box rules of Reg. § 301.7701-3.

[1613] Reg. § 1.1411-4(b)(1).

[1614] Reg. § 1.1411-4(b)(2).

[1615] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

[1616] Code § 1411(c)(3) provides that any income, gain, or loss which is attributable to an investment of working capital is deemed not to be derived in the ordinary course of a trade or business in applying this rule.

[1617] Part 7 of the preamble.

> generated by working capital is not derived in the ordinary course of a trade or business, and therefore, it is not treated as passive income. Under section 1411(c)(3), gross income from and net gain attributable to the investment of working capital is not derived in the ordinary course of a trade or business, and therefore such gross income and net gain is subject to section 1411.
>
> A taxpayer may take into account the properly allocable deductions (related to losses or deductions properly allocable to the investment of such working capital) in determining net investment income. See part 5.E of this preamble regarding properly allocable deductions.

The preamble to the final regulations simply mentions:[1618]

> Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. Section 1.1411-6 of the final regulations provides guidance on working capital under section 1411(c)(3).

Of course, if the taxpayer does not materially participate in the business, generally all of the business' income will be NII, so the working capital exception would be moot.[1619]

II.I.8.a.v.(b). What Is Working Capital

Reg. § 1.1411-6(a) provides:[1620]

> *General rule*. For purposes of section 1411, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business, and any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business. In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(ii) apply. See § 1.1411- 4(f) for rules regarding properly allocable deductions with respect to an investment of working capital and § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute

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[1618] T.D. 9644.

[1619] Reg. § 1.1411-5(b)(3), Example (5).

[1620] Reg. § 1.1411-6(b) provides an example holding that cash used in daily operations constitute working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

> working capital under § 1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts … constitutes gross income from interest under § 1.1411-4(a)(1)(i).

To place context on this reference to Reg. § 1.469-2T(c)(3)(ii), Reg. § 1.469-2T(c)(3)(i) excludes from passive activity gross income items of portfolio income and further provides:

> For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of paragraph (c)(3)(ii) of this section), that is attributable to—
>
> (A) Interest (including amounts treated as interest under paragraph (e)(2)(ii) of this section, relating to certain payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of section 856), regulated investment company (within the meaning of section 851), real estate mortgage investment conduit (within the meaning of section 860D), common trust fund (within the meaning of section 584), controlled foreign corporation (within the meaning of section 957), qualified electing fund (within the meaning of section 1295(a)), or cooperative (within the meaning of section 1381(a));
>
> (B) Dividends on S corporation stock (within the meaning of section 1368(c)(2));
>
> (C) The disposition of property that produces income of a type described in paragraph (c)(3)(i)(A) of this section; and
>
> (D) The disposition of property held for investment (within the meaning of section 163(d)).

Reg. § 1.469-2T(c)(3)(ii) provides:

> *Gross income derived in the ordinary course of a trade or business*. Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only—
>
> (A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
>
> (B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
>
> (C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;

(D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);

(E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);

(F) Amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and

(G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

As to (G) above, it has been suggested that the IRS has informally indicated its intention to broaden the definition of mineral royalty income derived in a trade or business, but taxpayers should request a ruling to receive a proper determination.[1621] The same author said that several private letter rulings held that "float revenue, as a substitute for service fees, is derived in the ordinary course of a trade or business."[1622]

II.I.8.a.vi. What is a "Trade or Business"?

The preamble to the final regulations discuss what is a "trade or business" for purposes of the 3.8% tax:[1623]

> Several commentators requested guidance concerning the meaning of "trade or business." Commentators suggested that the regulations include references to relevant case law and administrative guidance. A commentator requested that the regulations expand upon existing guidance by including bright-line examples of what constitutes a trade or business to aid taxpayers in determining if income is derived in the ordinary course of a trade or business and thus is excluded from net investment income.
>
> As noted in part 6.A. of the preamble to the proposed regulations, the rules under section 162 have long existed as guidance for determining the existence of a trade or business and are applied in many circumstances. Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in Higgins v. Commissioner, 312 U.S. 212 (1941), the Supreme Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case." 312 U.S. at 217. Except for certain clarifications made in

[1621] Sutton & Howell-Smith, ¶ 12.03[3][a] Royalties, *Federal Income Taxation of Passive Activities* (WG&L).
[1622] Sutton & Howell-Smith, ¶ 2.02[1][f][vii] Other income identified by the Commissioner, *Federal Income Taxation of Passive Activities* (WG&L), pointing to Letter Rulings 199924020, 199924022, and 199924023.
[1623] T.D. 9644.

response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.

In response to these commentators, § 1.1411-1(d) of the final regulations provides that the term trade or business, when used in section 1411 and the final regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162.

One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed § 1.1411-4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that § 1.183-1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.

The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of "activity" within the meaning of § 1.183-1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183-1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within § 1.183-1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of "activity" can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining whether a trade or business exists using the activity determinations of Code provisions unrelated to section 162 is appropriate.

For further analysis, see part II.G.3.i.i.(a) "Trade or Business" Under Code § 162.

II.I.8.a.vii. Former Passive Activities – NII Implications

The preamble to the final regulations addressed former passive activities:[1624]

> The final regulations clarify, for section 1411 purposes, the treatment of income, deductions, gains, losses, and the use of suspended losses from former passive activities. The Treasury Department and the IRS considered three alternatives. One approach is the complete disallowance of all suspended losses once the activity is no longer a passive activity (in other words, becomes a former passive activity or a nonpassive activity). The rationale behind this approach is that the income from the activity would not be includable in net investment income, thus the suspended losses become irrelevant. Another approach is the unrestricted allowance of all suspended losses in the year in which they are allowed by section 469(f), regardless of whether the nonpassive income is included in net investment income. The rationale behind this approach is that the losses were generated during a period when the activity was a passive activity, and if such losses were allowed in full, they would have potentially reduced net investment income, and therefore the losses should continue to retain their character as net investment income deductions. The third approach is a hybrid approach that allows suspended losses from former passive activities in calculation of net investment income (as properly allocable deductions under section 1411(c)(1)(B) or in section 1411(c)(1)(A)(iii) in the case of losses) but only to the extent of the nonpassive income from such former passive activity that is included in net investment income in that year. The final regulations adopt this hybrid approach.
>
> For example, in the case of a former passive trade or business activity with suspended losses of $10,000 that generates $3,000 of net nonpassive income, section 469(c)(1)(A) allows $3,000 of the $10,000 suspended loss to offset the nonpassive income in the current year. Since the gross nonpassive income is not included in section 1411(c)(1)(A)(ii) (or in section 1411(c)(1)(A)(iii) in the case of

[1624] T.D. 9644. For general issues regarding former passive activities, see part II.K.1.i Former Passive Activities. The preamble describes the interaction of these rules with Code § 1411:

> If a taxpayer materially participates in a former passive trade or business activity, the gross income produced by that activity (and associated section 1411(c)(1)(B) properly allocable deductions) in the current year generally would not be net investment income because the activity is no longer a trade or business that is a passive activity within the meaning of section 469. However, in the case of rental income not derived in the ordinary course of a trade or business, a classification of the rental income as nonpassive for purposes of section 469 will not result automatically in the exclusion of such rental income and associated deductions from net investment income. Furthermore, it is possible that a section 469 former passive activity may still generate net investment income on its disposition to the extent the gain is included in section 1411(c)(1)(A)(iii) and not entirely excluded by, for example, section 1411(c)(4).
>
> Suspended losses that are allowed by reason of section 469(f)(1)(A) or (C) may constitute properly allocable deductions under section 1411(c)(1)(B) and § 1.1411-4(f)(2) (to the extent those losses would be described in section 62(a)(1) or 62(a)(4)) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) and § 1.1411-4(d) (to the extent those losses would be described in section 62(a)(3) in the year they are allowed, depending on the underlying character and origin of such losses). The treatment of excess suspended losses of a former passive activity upon a fully taxable disposition is discussed in the next section of this preamble.

> gains from the disposition of property in such trade or business), none of the deductions and losses associated with such income are properly allocable deductions under section 1411(c)(1)(B) (or in section 1411(c)(1)(A)(iii) in the case of losses from the disposition of property in such trade or business). Thus, under the facts of this example, the final regulations provide that the $3,000 is not a properly allocable deduction (or a loss included in section 1411(c)(1)(A)(iii)). However, to the extent that the remaining suspended passive loss deduction of $7,000 is allowed by section 469(f)(1)(C) to offset other net passive activity income (which is included in net investment income by reason of section 1411(c)(1)(A) less deductions allowed by section 1411(c)(1)(B)), such amounts are considered properly allocable deductions under section 1411(c)(1)(B), or as a loss included in section 1411(c)(1)(A)(iii), as appropriate.

Reg. § 1.1411-4(g)(8) provides the details described above. For more information on former passive activities, see part II.K.1.i Former Passive Activities.

II.I.8.b. 3.8% Tax Does Not Apply to Gain on Sale of Active Business Assets

Net gain from the disposition of property does not include gain or loss attributable to property held in a nonpassive[1625] trade or business.[1626]

However, this exception does not apply to the gain or loss attributable to the disposition of investments of working capital.[1627]

Although a partnership interest or S corporation stock generally is not property held in a trade or business qualifying for the exclusion,[1628] the portion of the sale proceeds attributable to business assets does qualify.[1629]

If an individual, estate, or trust owns or engages in a trade or business directly (or indirectly through a disregarded entity), the determination of whether net gain is attributable to property held in a trade or business is made at the individual, estate, or trust level.[1630] If an individual, estate, or trust that owns an interest in a passthrough entity such as a partnership or S corporation and that entity is engaged in a trade or business, the determination of whether net gain is attributable to (i) a passive activity is made at the owner level; and (ii) the trade or business of a trader trading in financial instruments or commodities is made at the entity level.[1631]

[1625] By "nonpassive" I mean not described in Reg. § 1.1411-5. See part II.I.8 Application of 3.8% Tax to Business Income, especially fn. 1583.
[1626] Reg. §§ 1.1411-4(a)(1)(iii), 1.1411-4(d)(4)(i)(A).
[1627] Reg. § 1.1411-4(d)(4)(i)(A). See Reg. § 1.1411-6 regarding working capital, which is described in part II.I.8.a.v Working Capital Is NII.
[1628] Reg. § 1.1411-4(d)(4)(i)(B)(1).
[1629] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[1630] Reg. § 1.1411-4(d)(4)(i)(B)(2).
[1631] Reg. § 1.1411-4(d)(4)(i)(B)(3).

II.I.8.c. Application of 3.8% Tax to Rental Income

As mentioned above, rental income is NII unless it is self-rental[1632] or not only is from a trade or business but also nonpassive.[1633]

Because the self-rental exception is relatively straightforward, this part II.I.8.c focuses on whether the rental not only is from a trade or business but also is nonpassive.

II.I.8.c.i. If Not Self-Rental, Most Rental Income Is *Per Se* Passive Income and Therefore NII

Generally, rental constitutes passive income, even if it constitutes a trade or business in which the taxpayer materially participates.[1634] The NII rules elaborate on exceptions to this general rule. For example, short-term equipment leasing income is not NII,[1635] if the taxpayer materially participates.[1636]

[1632] See fn. 1604.

[1633] See fn. 1578. Note that *Erbs v. Commissioner*, T.C. Summary Opinion 2001-85, held that the material participation rules "govern whether a trade or business is passive and do not address the more fundamental question of whether an activity constitutes a trade or business." See generally "¶L-1103, Regular activity in business is required for being engaged in a trade or business—trade or business expenses," Fed. Tax. Coord.2d. See also Bittker & Lokken, "¶47.3, Property Used in a Trade or Business," *Federal Taxation of Income, Estates, and Gifts*; "¶L-1115, Renting and/or managing rental real estate as a trade or business," *Fed. Tax. Coord.2d*.

[1634] See part II.K.1.e Rental Activities.

[1635] Reg. § 1.1411-5(b)(3), Example (3) provides:

> *Application of the rental activity exceptions*. B, an unmarried individual, is a partner in PRS, which is engaged in an equipment leasing activity. The average period of customer use of the equipment is seven days or less (and therefore meets the exception in § 1.469-1T(e)(3)(ii)(A)). B materially participates in the equipment leasing activity (within the meaning of § 1.469-5T(a)). The equipment leasing activity constitutes a trade or business. In Year 1, B has modified adjusted gross income (as defined in § 1.1411-2(c)) of $300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity, and all of PRS's property is held in the equipment leasing activity. Of B's allocable share of income from PRS, $275,000 constitutes gross income from rents (within the meaning of § 1.1411-4(a)(1)(i)). While $275,000 of the gross income from the equipment leasing activity meets the definition of rents in § 1.1411-4(a)(1)(i), the activity meets one of the exceptions to rental activity in § 1.469-1T(e)(3)(ii) and B materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Because the rents are derived in the ordinary course of a trade or business not described in paragraph (a) of this section, the ordinary course of a trade or business exception in § 1.1411-4(b) applies, and the rents are not described in § 1.1411-4(a)(1)(i). Furthermore, because the equipment leasing trade or business is not a trade or business described in paragraph (a)(1) or (a)(2) of this section, the $25,000 of other gross income is not net investment income under § 1.1411-4(a)(1)(ii). However, the $25,000 of other gross income may be net investment income by reason of section 1411(c)(3) and § 1.1411-6 if it is attributable to PRS's working capital. Finally, gain or loss from the sale of the property held in the equipment leasing activity will not be subject to § 1.1411-4(a)(1)(iii) because, although it is attributable to a trade or business, it is not a trade or business to which the section 1411 tax applies.

[1636] Reg. § 1.1411-5(b)(3), Example (4) provides:

II.I.8.c.ii. Real Estate Classified as Nonpassive for Real Estate Professionals

The general rule that rental is per se passive does not apply to certain real estate professionals.[1637] Therefore, if a real estate professional who meets this exceptions engages in a real estate trade or business, the rental income would not constitute NII.

Although the final regulations declined to provide broad relief for real estate professionals, the preamble informs us:[1638]

> The final regulations do, however, provide a safe harbor test for certain real estate professionals in § 1.1411-4(g)(7). The safe harbor test provides that, if a real estate professional (within the meaning of section 469(c)(7)) participates in a rental real estate activity for more than 500 hours per year, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Alternatively, if the taxpayer has participated in a rental real estate activity for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to the effective date of section 1411), then the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. The safe harbor test also provides that, if the hour requirements are met, the real property is considered as used in a trade or business for purposes of calculating net gain under section 1411(c)(1)(A)(iii). The Treasury Department and the IRS recognize that some real estate professionals with substantial rental activities may derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the 500 hour requirement in the safe harbor test. As a result, the final regulations specifically provide that such failure will not preclude a taxpayer from establishing that such gross rental income and gain or loss from the disposition of real property, as applicable, is not included in net investment income.

Thus, the annual threshold is reduced from more than 750 hours under the passive loss rules to more than 500 hours.[1639]

> Application of section 469 and other gross income under §1.1411-4(a)(1)(ii). Same facts as Example 3, except B does not materially participate in the equipment leasing trade or business and therefore the trade or business is a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Accordingly, the $275,000 of gross income from rents is described in § 1.1411-4(a)(1)(i) because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the $25,000 of other gross income from the equipment leasing trade or business is described in § 1.1411-4(a)(1)(ii) because the gross income is derived from a trade or business described in paragraph (a)(1) of this section. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to § 1.1411-4(a)(1)(iii) because the trade or business is a passive activity with respect to B, as described in paragraph (b)(1)(ii) of this section.

[1637] See fns. 2162-2177.

[1638] T.D. 9655.

[1639] Reg. § 1.1411-4(g)(7) provides:

> (7) *Treatment of certain real estate professionals*
>
> (i) *Safe Harbor*. In the case of a real estate professional (as defined in section 469(c)(7)(B)) that participates in a rental real estate activity for more than

Also, Reg. § 1.1411-4(g)(7)(ii)(B) does not require that each rental activity owned by the real estate professional be a trade or business. On June 16, 2014, I informally confirmed with a drafter of the regulation that, if a real estate professional groups activities so that real estate trade or business undertakings are grouped with real estate undertakings that are not trade or business undertakings, the latter nevertheless receive treatment as not constituting NII. For example, suppose a real estate professional actively manages several real estate properties that are trade or business undertakings and also owns several properties rented using triple-net leases. If the professional groups all of those undertakings as a single activity, income from the triple-net leases does not constitute NII.

See also part II.G.25 Real Estate Dealer vs. Investor.

II.I.8.c.iii. Rental as a Trade or Business

If rental activity is nonpassive under special exceptions or by reason of the taxpayer being a real estate professional, the taxpayer would apply the concepts below in conjunction with the rules of part II.I.8.a General Application of 3.8% Tax to Business Income.

Grouping passive activities will not convert gross income from rents into other gross income derived from a trade or business.[1640]

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500 hours during such year, or has participated in such real estate activities for more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year, then—

(A) Such gross rental income from that rental activity is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section; and

(B) Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

(ii) *Definitions*—

(A) *Participation*. For purposes of establishing participation under this paragraph (g)(7), any participation in the activity that would count towards establishing material participation under section 469 shall be considered.

(B) *Rental real estate activity*. The term rental real estate activity used in this paragraph (g)(7) is a rental activity within the meaning of § 1.469-1T(e)(3). An election to treat all rental real estate as a single rental activity under §1.469-9(g) also applies for purposes of this paragraph (g)(7). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469-4(d)(1)(i)(A) or (d)(1)(i)(C) is not a rental real estate activity.

(iii) *Effect of safe harbor*. The inability of a real estate professional to satisfy the safe harbor in this paragraph (g)(7) does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of section 1411.

[1640] Part 6.B.1.(b)(4) of the preamble explains:

> … a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

The preamble to the final regulations explains how the IRS views rental as a trade or business (emphasis added):[1641]

> The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically, commentators stated that Example 1 of proposed § 1.1411-5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as Fackler v. Commissioner, 45 BTA 708 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943); Hazard v. Commissioner, 7 T.C. 372 (1946); and Lagreide v. Commissioner, 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.
>
> The Treasury Department and the IRS agree with commentators that, in certain circumstances, the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business within the meaning of Section 162. However, the Treasury Department and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. For example, § 1.212-1(h) provides that the rental of real property is an example of a for-profit activity under section 212 and not a trade or business.[1642]
>
> Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a section 162 trade or business, bright-line definitions are impractical and would be imprecise. The same is true wherever the section 162 trade or business standard is used and is not unique to section 1411. The Treasury Department and the IRS decline to provide guidance on the meaning of trade or business solely within the context of section 1411. However, the Treasury Department and the IRS have modified Example 1 in § 1.1411-5(b)(3) to explicitly state that the rental property in question is not a trade or business under applicable section 162 standards.

[1641] T.D. 9655.

[1642] This comment in the preamble seems to take out of context Reg. § 1.212-1(h), the full text of which is:

> Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

That regulation does not say that rental is not a trade or business (although it appears in a regulation designed for activities that do not constitute trades or businesses. Rather, that regulation points out that property formerly held for personal use can later be used for the production or collection of income.

> In cases where other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, the IRS will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of section 1411, but not a trade or business for such other provisions. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of section 1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.

The example cited above is as follows (emphasis added):[1643]

> Rental activity. A, an unmarried individual, rents a commercial building to B for $50,000 in Year 1. A is not involved in the activity of the commercial building on a regular and continuous basis, therefore, A's rental activity does not involve the conduct of a trade or business, and under section 469(c)(2), A's rental activity is a passive activity. Because paragraph (b)(1)(i) of this section is not satisfied, A's rental income of $50,000 is not derived from a trade or business described in paragraph (b)(1) of this section. However, A's rental income of $50,000 still constitutes gross income from rents within the meaning of § 1.1411-4(a)(1)(i) because rents are included in the determination of net investment income under § 1.1411-4(a)(1)(i) whether or not derived from a trade or business described in paragraph (b)(1) of this section.

The preamble explains how the final regulations relaxed the rules for nonpassive rental to one's business:[1644]

> With regard to grouping and recharacterizations, commentators recommended that the final regulations clarify that determining whether income is net investment income should be based solely on its recharacterized or grouped status as nonpassive under section 469 and the regulations thereunder. Although the Treasury Department and the IRS recognize the administrative simplicity of this rule, the Treasury Department and the IRS believe that this rule is too broad as it would 'deem' certain items to be derived in a trade or business when it is unlikely that a section 162 trade or business is present. For example, see §§ 1.469-1T(e)(3)(ii)(D) (rental of property incidental to an investment activity) and 1.469-2T(f)(3) (rental of nondepreciable property). Therefore, the final regulations do not adopt this broad approach.

[1643] Reg. § 1.1411-5(b)(3), Example 1.

[1644] T.D. 9655. Reg. §1.1411-4(g)(6)(i):

> To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section.

For what is a rental activity under Reg. § 1.469-2(f)(6), see part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity. No relief is provided for self-charged royalties. Consider the structure described in part II.E Recommended Structure for Entities.

> Another option advanced by some commentators is a special rule for self-charged rents similar to § 1.469-7 pertaining to self-charged interest. However, a proposed rule for self-charged rents would be more complex than the rule for self-charged interest because the amount of the net investment income exclusion must take into account the deductions allowed (depreciation, taxes, interest, etc.) that are not present in self-charged interest. A self-charged rent rule would have to exclude from gross income rents in the same way as self-charged interest, and would also exclude a share of the deductions attributable to earning the income. In addition, a rule based on § 1.469-7 would cover only rents within the context of section 1411(c)(1)(A)(i) and would not provide relief from the inclusion of the gain upon the sale of the property from net investment income. Accordingly, the final regulations do not adopt this recommendation.
>
> However, the Treasury Department and the IRS appreciate the concerns raised by the commentators. Therefore, the final regulations provide special rules for self-charged rental income. The final regulations provide that, in the case of rental income that is treated as nonpassive by reason of § 1.469-2(f)(6) (which generally recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under § 1.469-4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

It has been suggested that multiple rental properties in which the taxpayer invests considerable and regular effort should meet the standard of trade or business, even when an agent is engaged to carry out some of the responsibility to manage and maintain the properties.[1645] It has been further suggested that the Board of Tax Appeals and Tax Court have found the mere rental of real property sufficient to constitute a trade or business but that contrary decisions in various appeals courts would suggest that jurisdiction may be an important factor.[1646] The article that made these comments offers

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[1645] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnote 76 of that articles asserts:

> The fact that services were performed by agents was not detrimental in attaining trade or business status in the following cases: *Reiner v. U.S.*, 222 F.2d 770 (7th Cir. 1955); *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Post v. Commissioner*, 26 T.C. 1055 (1956). See, however, *Chicago Title & Trust Co. v. U.S.*, 209 F.2d 773 (7th Cir. 1954), where the operation of 25 rental properties managed by real estate firms was considered an investment, rather than a trade or business, of the taxpayer as he was not sufficiently engaged in the operation.

[1646] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013), also appearing in the *TM Real Estate Journal* (April 3, 2013). Footnotes 77-79 cited *Fackler v. Commissioner*, 45 B.T.A. 708, 714 (1941); *Hazard v. Commissioner*, 7 T.C. 372 (1946) (former residence rented for three years prior to sale) (real estate, even a single property in appropriate circumstances, devoted to rental purposes excellent planning tips.[1647] Additional clues regarding when rental is a trade or business might be found in the rules governing tax-free split-ups/spin-offs.[1648] Equipment rental appears to have much easier standards in qualifying as a trade or business.[1649]

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constitutes property used in a trade or business); *Fegan v. Commissioner*, 71 T.C. 791 (1979); *Lagriede v. Commissioner*, 23 T.C. 508 (1954); *Curphey v. Commissioner*, 73 T.C. 766 (1980) (noting that the ownership and management of such properties would not necessarily, as a matter of law, constitute a trade or business, referring to *Grier v. U.S.*, 218 F.2d 603 (2d Cir. 1955), *aff'g* 120 F. Supp. 395 (D. Conn. 1954)); 561 T.M., "Capital Assets," V.D. The latter included a reference to FSA 200120036 (for purposes of the earned income credit, rental was a trade or business when the taxpayer leased the building to the corporation with continuity and regularity, and the taxpayer's primary purpose for engaging in the rental activity was for profit). Also cited by the "Capital Assets" treatise as favoring trade or business treatment when the taxpayer only holds a single parcel of real property for rent were *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5 (rental of a building managed by an agent was a trade or business); *Campbell v. Commissioner*, 5 T.C. 272 (1945), *acq*., 1947-1 C.B. 1 (inherited property was placed for sale or rent immediately upon being inherited); *Ohio County & Ind. Agr. Soc., Del. County Fair v. Commissioner*, 43 T.C.M. 1126 (1982) (rental property held to constitute a trade or business for Code § 513 purposes); *Crawford v. Commissioner*, 16 T.C. 678, 680-681 (1951), *acq.*, 1951-2 C.B. 2. The "Capital Assets" treatise also mentioned that the standard tends to higher for inherited property that is sold before being operated as a business. All parentheticals above in this footnote describing cases are based on these secondary sources' summaries and not the result of my reading the cases themselves. *Central States, Southeast and Southwest Areas Pension Fund v. Messina Products, LLC*, 2013 WL 466196 (7th Cir. 2013), held that rental to one's own trade or business itself constituted a trade or business for pension withdrawal liability purposes (not a tax case); the court stated that its determination was based on general "trade or business" principles as required by *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). "Simply upgrading his homes with the desire to make a profit on a sale at some time in the future is not sufficient to meet the regular-and-continuous-activity test for a trade or business." *Ohana v. Commissioner*, T.C. Memo. 2014-83, which also rejected an alleged conversion from personal to business use:

> We use five factors to determine whether an individual has converted his personal residence into property held for the production of income:
>
> - the length of time the house was occupied by the individual as his home before placing it on the market for sale;
> - whether the individual permanently abandoned all further personal use of the house;
> - the character of the property;
> - offers to rent; and
> - offers to sell.
>
> *Grant v. Commissioner*, 84 T.C. 809, 825 (1985), *aff'd without published opinion*, 800 F.2d 260 (4th Cir. 1986); *Bolaris v. Commissioner*, 81 T.C. 840 (1983), *aff'd in part, rev'd in part on another issue*, 776 F.2d 1428, 1433 (9th Cir. 1985).

[1647] Holthouse and Ritchie, "Inoculating Real Estate Against the Obamacare Tax," *TM Memorandum* (BNA) (March 11, 2013) , also appearing in the *TM Real Estate Journal* (April 3, 2013). For additional cases and commentary, see Kehl, "Passive Losses and Tax on Net Investment Income," *T.M. Real Estate Journal* (BNA), Vol. 29, No. 06 (6/5/2013).

[1648] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[1649] See fns. 2383-2384 in part II.L.2.a.ii Rental Exception to SE Tax, discussing cases in the unrelated business income area (regarding qualified retirement plans, etc.) that apply a very low threshold of activity for treating leasing tangible personal property as a trade or business, using statutory language similar to that used in determining whether income is subject to self-employment tax. I am unaware of any authority addressing the issue of leasing tangible personal property as a trade or business outside of this arena.

Combining all of the ideas above:

- The IRS considers:
  - The type of property (commercial real property versus a residential condominium versus personal property),
  - The number of properties rented, the day-to-day involvement of the owner or its agent, and
  - The type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease).
- The IRS believes that rental of a single property may require regular and continuous involvement to constitute a trade or business, and an example in its regulations requires such participation when an individual leases a commercial property to another person.

Thus, in planning rental activities:

1. First consider the extent to which the rental income qualifies as self-charged rental that is excluded from NII.

2. If the self-charged rental rules do not provide sufficient protection (or if the rental is not self-charged), consider moving away from triple-net leases and moving towards leases in which the landlord provides significant services, such as insider and outside maintenance, repairs, etc., even if the tenant ultimately bears the burden of the expenses. However, as noted in the discussion of Reg. § 1.1411-4(g)(7)(ii)(B) in part II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals, a real estate professional might not need to take this step if the professional has enough activity that does constitute a trade or business.

3. Consider that the self-charged rules might not always apply in the same way in the future as they do today. Even if the law does not change, owner, consider that ownership of the business or ownership of the rental property might change in a way that makes the self-charged rental rules no longer apply. Because grouping elections are difficult to change, consider making grouping elections with these possible ownership changes in mind. Also, grouping elections can affect whether rental is considered self-charged.

4. Finally, consider contributing the property to the partnership and receiving a preferred profit return in lieu of rent, as well as a special allocation of any gain on the sale of the property. See part II.E Recommended Structure for Entities.

If the tax savings are significant enough, one might want to avoid the uncertainty of the rental issue and instead place the business operations and the rented property in the same umbrella.[1650]

[1650] See part II.E.9 Real Estate Drop Down into Preferred Limited Partnership.

See also part II.G.25 Real Estate Dealer vs. Investor.

II.I.8.d. Partnership Structuring in Light of the 3.8% Tax on Net Investment Income

II.I.8.d.i. Interest for Use of Capital Compared with Distributive Share

Based on the principles described in this part II.I.8.d:

For operating businesses, a distributive share provides better tax treatment than a guaranteed payment of interest, if the partner is a limited partner in a partnership and materially participates.

Note, however, that, for taxpayers with modest incomes, NII tax does not apply, and self-employment (SE) tax looms large, because SE tax is at a high rate all the way up to the taxable wage base and applies to SE earnings regardless of the taxpayer's overall adjusted gross income.[1651]

For high income taxpayers, SE tax might be better than NII tax, because they can deduct 1.45% of the 2.9% or 3.8% Medicare tax.

II.I.8.d.ii. Overview of Interaction between Code § 1411 and Code §§ 707(c) and 736

The preamble to 2013 proposed regulations explain their concerns regarding certain compensation and exit strategies:[1652]

> Section 731(a) treats gain from distributions as gain from the sale or exchange of a partnership interest. In general, the section 1411 treatment of gain to a partner under section 731 is governed by the rules of section 1411(c)(1)(A)(iii). Such gain is thus generally treated as net investment income for purposes of section 1411 (other than as determined under section 1411(c)(4)). However, certain partnership payments to partners are treated as not from the sale or exchange of a partnership interest. These payments include section 707(c) guaranteed payments for services or the use of capital and certain section 736 distributions to a partner in liquidation of that partner's partnership interest. Because these payments are not treated as from the sale or exchange of a partnership interest, their treatment under section 1411 may differ from the general rule of section 1411(c)(1)(A)(iii). The proposed regulations therefore provide rules for the section 1411 treatment of these payments.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

[1651] For self-employment tax rates and strategies, see part II.L Self-Employment Tax (FICA), especially part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax, as well as part II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation, especially fn. 3079, the latter for rates.

[1652] REG-130843-13, which would apply "to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012 in accordance with § 1.1411-1(f).

II.I.8.d.iii. Treatment of Code § 707(c) Guaranteed Payments under Code § 1411

Regarding guaranteed payments, the preamble to the 2013 proposed regulations explains:[1653]

> Section 707(c) provides that a partnership payment to a partner is a "guaranteed payment" if the payment is made for services or the use of the capital, and the payment amount does not depend on partnership income. Section 1.707-1(c) provides that guaranteed payments to a partner for services are considered as made to a person who is not a partner, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, section 162(a) (relating to trade or business expenses). Section 1.704-1(b)(2)(iv)(o) provides that guaranteed payments are not part of a partner's distributive share for purposes of section 704(b).
>
> The proposed regulations' treatment of section 707(c) guaranteed payments under section 1411 depends on whether the partner receives the payment for services or the use of capital. The proposed regulations exclude all section 707(c) payments received for services from net investment income, regardless of whether these payments are subject to self-employment tax, because payments for services are not included in net investment income.
>
> The Treasury Department and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as net investment income. This treatment is consistent with existing guidance under section 707(c) and other sections of the Code in which guaranteed payments for the use of capital are treated as interest. See, for example, §§ 1.263A-9(c)(2)(iii) and 1.469-2(e)(2)(ii).

Prop. Reg. § 1.1411-4(g)(10) provides the above rules.[1654]

[1653] REG-130843-13.

[1654] The proposed regulation provides:

> Treatment of section 707(c) guaranteed payments. Net investment income does not include section 707(c) payments received for services. Except to the extent provided in paragraph (g)(11)(iii)(A) of this section, section 707(c) payments received for the use of capital are net investment income within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section.

However, I do not believe that the last sentence of the quote above ends the story; I believe that it merely suggests under what category payments for the use of capital would be tested. Prop. Reg. § 1.1411-4(g)(11)(iii)(A), described further below, applies to Code § 736(a)(2) payments for Code § 751(c) unrealized receivables and for goodwill and states that those payments are included in NII under the sale-of-business category. Prop. Reg. § 1.1411-4(g)(11)(iii)(B) coordinates with (A) and characterizes payments other than for unrealized receivables and goodwill as for services or interest. To me, this reference to treatment as NII under these buckets means merely that one tests these items under those buckets – not that they will automatically be NII; otherwise, the sale of an active business under Code § 736 would be treated less favorably than the sale of a partnership interest other than to the partnership or the sale of an interest in a sole proprietorship or S corporation, and the spirit of the preamble to the proposed regulations is to provide parity to partnership redemptions – not to place them at a disadvantage. Fn. 1659

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

For the self-employment consequences of guaranteed payments for services, see parts II.L.3 Self-Employment Tax: General Partner or Sole Proprietor and II.L.4 Self-Employment Tax Exclusion for Limited Partner.

II.I.8.d.iv. Treatment of Code § 736 Redemption Payments under Code § 1411

Regarding payments to a retiring partner,[1655] the preamble to the 2013 proposed regulations explains certain general ideas:[1656]

> Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership. Section 736 does not apply to distributions made to a continuing partner, distributions made in the course of liquidating a partnership entirely, or to payments received from persons other than the partnership in exchange for the partner's interest. Section 736 categorizes liquidating distributions based on the nature of the payment as in consideration for either the partner's share of partnership property or the partner's share of partnership income. Section 736(b) generally treats a payment in exchange for the retiring partner's share of partnership property as a distribution governed by section 731. Section 736(a) treats payments in exchange for past services or use of capital as either distributive share or a guaranteed payment. Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").
>
> Because the application of section 1411 depends on the underlying nature of the payment received, the section 736 categorization controls whether a liquidating distribution is treated as net investment income for purposes of section 1411. Thus, the treatment of the payment for purposes of section 1411 differs depending on whether the distribution is a section 736(b) distribution in exchange for partnership property or a section 736(a) distribution in exchange for past services, use of capital, or Section 736(a) Property. Among section 736(a) payments, the proposed regulations further differentiate the treatment of payments depending on: (i) whether or not the payment amounts are determined with regard to the income of the partnership and (ii) whether the payment relates to Section 736(a) Property or relates to services or use of capital.
>
> Section 1.469-2(e)(2)(iii) contains rules pertaining to whether section 736 liquidating distributions paid to a partner will be treated as income or loss from a

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clarifies that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

The self-charged interest rules apply to Code § 707(c) payments. Reg. § 1.469-7(a)(1). I believe that the "better" reading is that they apply to treat Code § 707(c) guaranteed payments for the use of capital as interest subject to the self-charged interest exclusion from NII . See fn. 1605.

[1655] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[1656] REG-130843-13.

> passive activity. Where payments to a retiring partner are made over a period of years, the composition of the assets and the status of the partner as passive or nonpassive may change. Section 1.469-2(e)(2)(iii) contains rules on the extent to which those payments are classified as passive or nonpassive for purposes of section 469. The proposed regulations generally align the section 1411 characterization of section 736 payments with the treatment of the payments as passive or nonpassive under § 1.469-2(e)(2)(iii).

These rules regarding Code § 736 payments do not apply to distributions from qualified retirement plans or self-employment earnings.[1657]

Regarding Code § 736(b) payments for partnership property, the preamble to the 2013 proposed regulations explains certain general ideas:[1658]

> Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under section 731(a).
>
> The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4).[1659] Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).
>
> In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made

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[1657] Prop. Reg. § 1.1411-4(g)(11)(i) provides:

> In general. The treatment of payments received by a retiring partner or a deceased partner's successor in interest described in section 736 is determined under the rules of this paragraph (g)(11). Section 736 payments are not distributions from a plan or arrangement described in section 1411(c)(5) and § 1.1411-8 [qualified retirement plans, etc.]. To the extent that any portion of a section 736 payment is taken into account in computing a taxpayer's net earnings from self-employment (within the meaning of § 1.1411-9), then such amount is not taken into account in computing net investment income by reason of section 1411(c)(6) and § 1.1411-9.

[1658] REG-130843-13.

[1659] This sentence is key to interpreting Prop. Reg. § 1.1411-4(g)(11)(iii). One might construe Prop. Reg. § 1.1411-4(g)(11)(iii)(A) as making certain payments per se NII; this sentence instead provides the correct context – Prop. Reg. § 1.1411-4(g)(11)(iii)(A) merely described under which bucket to categorize the payment if it is NII, and then apply the Code § 1411(c)(4) exclusion from gain on sale after placing the item in the bucket.

> at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411 purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in § 1.469-2(e)(2)(iii)(A).

Thus, Code § 736(b) payments are treated as sales of partnership interests,[1660] and Code § 736(b) payments are treated as an installment sale in the year of disposition for Code § 1411 purposes[1661] even though for income tax purposes each year's payment stands alone.[1662]

Regarding Code § 736(a) payments for partnership goodwill, etc., the preamble to the 2013 proposed regulations explains certain general ideas:[1663]

> As described in part 2.B.i., section 736 provides for several different categories of liquidating distributions under section 736(a). Payments received under section 736(a) may be an amount determined with regard to the income of the partnership taxable as distributive share under section 736(a)(1) or a fixed amount taxable as a guaranteed payment under section 736(a)(2). The categorization of the payment as distributive share or guaranteed payment will govern the treatment of the payment for purposes of section 1411.
>
> The determination of whether section 736(a) payments received over multiple years are characterized as passive or nonpassive depends on whether the payments are received in exchange for Section 736(a) Property. With respect to section 736(a)(1) payments in exchange for Section 736(a) Property, § 1.469-2(e)(2)(iii)(B) provides a special rule that computes a percentage of passive income that would result if the partnership sold the retiring partner's entire share of Section 736(a) Property at the time that the liquidation of the partner's interest commenced. The percentage of passive income is then applied to each payment received. See § 1.469-2(e)(2)(iii)(B)(1). These rules apply to section 736(a)(1) and section 736(a)(2) payments for Section 736(a) Property. The proposed regulations adopt this treatment as set forth in section 469 for purposes of section 1411.

When Code § 736(a) payments for partnership goodwill, etc. are taxable as a distributive share, the preamble to the 2013 proposed regulations explains:[1664]

> Section 736(a)(1) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is

[1660] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest.

[1661] Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:

> A taxpayer who elects under § 1.736-1(b)(6) must apply the principles that are applied to installment sales in § 1.1411-7(d).

[1662] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, especially fns. 3979 and 4006 and the accompanying text.

[1663] REG-130843-13.

[1664] REG-130843-13.

> determined with regard to the partnership's income, then the payment is treated as a distributive share of income to the retiring partner. For purposes of section 1411, the items of income, gain, loss, and deduction attributable to the distributive share are taken into account in computing net investment income under section 1411(c)(1) in a manner consistent with the item's chapter 1 character and treatment. For example, if the partner's distributive share includes income from a trade or business not described in section 1411(c)(2), that income will be excluded from net investment income. However, if the distributive share includes, for example, interest income from working capital, then that income is net investment income.
>
> The proposed regulations treat section 736(a)(1) payments unrelated to Section 736(a) Property as characterized annually as passive or nonpassive by applying the general rules of section 469 to each payment in the year received. To the extent that any payment under section 736(a)(1) is characterized as passive income under the principles of section 469, that payment also will be characterized as passive income for purposes of section 1411.

Thus, the 2013 proposed regulations treat Code § 736(a)(1) payments consistent with their character for regular income tax purposes, including their character under the passive loss rules.[1665] If a retiring partner receives a distributive share of the partnership's income in exchange for that partner's shares of the partnership's unrealized receivables and the partner materially participated in the partnership's trade or business before retiring, the distributive share is not NII.[1666] However, payments that exceeded the partner's shares of the partnership's unrealized receivables needed to be tested annually to determine whether the distributive share of operating income and deductions would be NII, presumably because the payments (described as an incentive to retire early) were not for the partnership's underlying assets;[1667] note that a retired partner generally would not be materially participating, although it is possible that the retired partner might still have some time remaining under the rule that looks to participation in 5 of the past 10 years[1668] or if the activity were a personal service activity in which the taxpayer materially participated for any 3 years.[1669]

[1665] Prop. Reg. § 1.1411-4(g)(11)(ii)(A) provides:

> General rule. In the case of a payment described in section 736(a)(1) as a distributive share of partnership income, the items of income, gain, loss, and deduction attributable to such distributive share are taken into account in computing net investment income in section 1411(c) in a manner consistent with the item's character and treatment for chapter 1 purposes. See § 1.469-2(e)(2)(iii) for rules concerning the item's character and treatment for chapter 1.

See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. Fn. 1659 points out that the Code § 1411(c)(4) exclusion from NII on the sale of a partnership interest would apply.

[1666] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (1). However, the example did not exclude the income if it was from financial instruments and commodities.

[1667] Prop. Reg. § 1.1411-4(g)(11)(ii)(B), Example (2).

[1668] See part II.K.1.a.ii Material Participation.

[1669] See part II.K.1.a.ii Material Participation, including fn. 2050, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.

When Code § 736(a) payments for partnership goodwill, etc. are taxable as guaranteed payments, the preamble to the 2013 proposed regulations explains:[1670]

> Section 736(a)(2) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined without regard to the partnership's income, then the payment is treated as a guaranteed payment as described in section 707(c). Payments under section 736(a)(2) might be in exchange for services, use of capital, or Section 736(a) Property. The section 1411 treatment of guaranteed payments for services or the use of capital follows the general rules for guaranteed payments set forth in part 2.A of this preamble. Thus, section 736(a)(2) payments for services are not included as net investment income, and section 736(a)(2) payments for the use of capital are included as net investment income.
>
> Section 736(a)(2) payments in exchange for Section 736 Property are treated as gain or loss from the disposition of a partnership interest, which is generally included in net investment income under section 1411(c)(1)(A)(iii). If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). To the extent that section 736(a)(2) payments exceed the fair market value of Section 736(a) Property, the proposed regulations provide that the excess will be treated as either interest income or as income in exchange for services, in a manner consistent with the treatment under § 1.469-2(e)(2)(iii).

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

When Code § 736 payments are taxable as guaranteed payments or considered attributable to the sale of the partnership's underlying assets, the preamble to the 2013 proposed regulations explains:[1671]

> The proposed regulations provide that section 1411(c)(4) applies to section 736(a)(2) and section 736(b) payments. Thus, the inclusion of these payments as net investment income may be limited if the retiring partner materially participated in all or a portion of the partnership's trade or business. The extent of any limitation is determined under the rules of § 1.1411-7.
>
> The proposed regulations provide that, when section 736 payments are made over multiple years, the characterization of gain or loss as passive or nonpassive and the values of the partnership assets are computed for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced, similar to the treatment in § 1.469-2(e)(2)(iii)(A).
>
> If a partner's net investment income is reduced pursuant to section 1411(c)(4), then the difference between the amount of gain recognized for chapter 1 and the

[1670] REG-130843-13.
[1671] REG-130843-13.

> amount includable in net investment income after the application of section 1411(c)(4) is treated as an addition to basis, in a manner similar to an installment sale for purposes of calculating the partner's net investment income attributable to these payments.

To the extent that a guaranteed payment redeeming a partner's interest is allocable to the partnership's unrealized receivables[1672] and goodwill,[1673] for NII purposes it is treated as gain from the disposition of a partnership interest.[1674] To the extent that a guaranteed payment redeeming a partner's interest is not allocable to the partnership's unrealized receivables and goodwill, for NII purposes it is treated as payment for services[1675] or the payment of interest consistent with its characterization under the passive loss rules.[1676]

To summarize testing regarding the passive or nonpassive character of income from trade or business activities:

- Code § 736(a)(2) guaranteed payments and Code § 736(b) payments are tested at the time of the disposition, even though for regular income tax purposes they are treated as separate payments each year.

- Code § 736((a)(1) payments are tested annually, which might be a disadvantage to a partner who no longer participates in the business, subject to certain favorable rules regarding prior participation.[1677]

II.I.8.e. NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation

Part 8 of the preamble to the 2012 proposed regulations describes how Code § 1411 approaches the sale of an interest in a partnership or S corporation:

> In most cases, an interest in a partnership or S corporation is not property held in a trade or business. Therefore, gain or loss from the sale of a partnership interest or S corporation stock will be subject to section 1411(c)(1)(A)(iii). See also section 731(a) and section 1368(b)(2) (providing that the gain recognized when cash is distributed in excess of the adjusted basis of, as applicable, a

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[1672] Within the meaning of Code § 751(c).
[1673] As described and calculated in Reg. § 1.469-2(e)(2)(iii)(B). See part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736, especially fn. 2161.
[1674] Prop. Reg. § 1.1411-4(g)(11)(iii)(A).
[1675] Because this characterization is only for NII purposes (see fn. 1513), presumably it has no effect on the favorable treatment for self-employment tax of payments described in part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.
[1676] Prop. Reg. § 1.1411-4(g)(11)(iii)(B), referring to Reg. § 1.469-2(e)(2)(ii); see part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736. The provision cross-references Reg. § 1.1411-4(g)(9), which provides that losses allowed in computing taxable income by reason of Code § 469(g) (disposition of an entire interest in a passive activity) are taken into account in computing net gain under Reg. § 1.1411-4 (d) or as properly allocable deductions under Reg. § 1.1411-4(f), as applicable, in the same manner as such losses are taken into account in computing taxable income under Code § 63. Note that part or all of a self-charged interest component may be excluded from NII. See fn. 1605.
[1677] For the favorable rules regarding prior participation, see text accompanying fns. 1668-1669.

partner's interest in a partnership or a shareholder's stock in an S corporation is treated as gain from the sale or exchange of such partnership interest or S corporation stock).

Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor under section 1411(c)(1)(A)(iii) if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) applies a similar rule to a loss from a disposition.

For purposes of section 1411, Congress intended section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor). However, the gain or loss upon the sale of an interest in the entity and a sale of the entity's underlying properties will not always match. First, there may be disparities between the transferor's adjusted basis in the partnership interest or S corporation stock and the transferor's share of the entity's adjusted basis in the underlying properties. See Example 2 of proposed § 1.1411-7(e). Second, the sales price of the interest may not reflect the proportionate share of the underlying properties' fair market value with respect to the interest sold.

In order to achieve parity between an interest sale and an asset sale, section 1411(c)(4) must be applied on a property-by-property basis, which requires a determination of how the property was held in order to determine whether the gain or loss to the transferor from the hypothetical disposition of such property would have been gain or loss subject to section 1411(c)(1)(A)(iii). As described in proposed § 1.1411-4(a)(1)(iii) and proposed § 1.1411-4(d), section 1411(c)(1)(A)(iii) applies if the property disposed of is either not held in a trade or business, or held in a trade or business described in proposed § 1.1411-5. In other words, under the proposed regulations, the exception in section 1411(c)(4) is only applicable where the property is held in a trade or business not described in section 1411(c)(2). See JCT 2011 Explanation, at 364, fn. 976 (and accompanying text); Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10) (Mar. 21, 2010), at 135 fn. 286 (and accompanying text) (JCT 2010 Explanation). This means that the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed § 1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed § 1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed § 1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4). For example, if the transferor is passive with respect to the entity's trade or business, the application of the deemed asset sale rule under section 1411(c)(4), as described in part 8.A

> of this preamble, would not adjust the transferor's section 1411(c)(1)(A)(iii) gain on the disposition of the interest….

Getting into the details, Reg. § 1.1411-4(a)(1)(iii) taxes as net investment income:

> Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception described in paragraph (d)(4)(i)(A) of this section for gain or loss attributable to property held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(A) provides:

> Net gain does not include gain or loss attributable to property (other than property from the investment of working capital (as described in § 1.1411-6)) held in a trade or business not described in § 1.1411-5.

Reg. § 1.1411-4(d)(4)(i)(B)(1) provides:

> A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally gain described in paragraph (a)(1)(iii) of this section. However, net gain does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations as provided in § 1.1411-7.

Reg. § 1.1411-5(a) provides:

> *In general*. A trade or business is described in this section if such trade or business involves the conduct of a trade or business, and such trade or business is either--
>
> (1) A passive activity (within the meaning of paragraph (b) of this section) with respect to the taxpayer; or
>
> (2) The trade or business of a trader trading in financial instruments (as defined in paragraph (c)(1) of this section) or commodities (as defined in paragraph (c)(2) of this section).

For whether assets are used in a business, see part II.I.8.a.v Working Capital Is NII (as describing Reg. § 1.1411-6). However, ultimately part II.I.8.a.v.(b) What Is Working Capital provides an additional exclusion under Reg. § 1.1411-7, which needs to be addressed anyway, as described in Reg. § 1.1411-4(d)(4)(i)(B)(1) above.

The preamble to the final regulations explains:[1678]

> In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain

[1678] T.D. 9655

or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411-7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

The preamble to the 2013 proposed regulations summarized these rules:[1679]

9. Calculation of Gain or Loss Attributable to the Disposition of Certain Interests in Partnerships and S Corporations

Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or of stock in an S corporation (either, a "Passthrough Entity"), gain from the disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be taken into account by the transferor if the Passthrough Entity sold all of its property for fair market value immediately before the disposition of the interest. Section 1411(c)(4)(B) provides a similar rule for losses from dispositions.

The 2012 Proposed Regulations required that a transferor of a partnership interest or S corporation stock first compute its gain (or loss) from the disposition of the interest in the Passthrough Entity to which section 1411(c)(4) may apply, and then reduce that gain (or loss) by the amount of non-passive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the Passthrough Entity's assets for fair market value immediately before the transfer. The Treasury Department and the IRS received several comments questioning this approach based on the commentators' reading of section 1411(c)(4) to include gain/loss from the disposition of a partnership interest or S corporation stock only to the extent of the transferor's share of gain/loss from the Passthrough Entity's passive assets.

The 2013 Final Regulations do not provide rules regarding the calculation of net gain from the disposition of an interest in a Passthrough Entity to which section 1411(c)(4) may apply. After considering the comments received, the Treasury Department and the IRS have withdrawn the 2012 Proposed Regulations implementing section 1411(c)(4) and are issuing this notice of proposed rulemaking to propose revised rules for the implementation of section 1411(c)(4) adopting the commentators' suggestion. Accordingly, the 2013 Final Regulations reserve on this issue.

Proposed § 1.1411-7(b) provides a calculation to determine how much of the gain or loss that is recognized for chapter 1 purposes is attributable to property owned, directly or indirectly, by the Passthrough Entity that, if sold, would give rise to net gain within the meaning of section 1411(c)(1)(A)(iii) ("Section 1411 Property"). Section 1411 Property is any property owned by, or held through, the Passthrough Entity that, if sold, would result in net gain or loss allocable to the

[1679] REG-130843-13.

partner or shareholder that is includable in determining the partner or shareholder's net investment income under § 1.1411-4(a)(1)(iii). This definition recognizes that the items of property inside the Passthrough Entity that constitute Section 1411 Property might vary among transferors because a transferor may or may not be "passive" with respect to the property.

Proposed § 1.1411-7(c) provides an optional simplified reporting method that qualified transferors may use in lieu of the calculation described in proposed § 1.1411-7(b). Proposed § 1.1411-7(d) contains additional rules that apply when a transferor disposes of its interest in the Passthrough Entity in a deferred recognition transaction to which section 1411 applies. Proposed § 1.1411-7(f) provides rules for adjusting the amount of gain or loss computed under this paragraph for transferors subject to basis adjustments required by § 1.1411-10(d). Proposed § 1.1411-7(g) provides rules for information disclosures by a Passthrough Entity to transferors and for information reporting by individuals, trusts, and estates.

Net gain constituting NII does not include gain or loss attributable to property (other than property from the investment of working capital)[1680] held in a nonpassive trade or business.[1681]

Thus, to determine whether net gain is from property held in a trade or business:[1682]

1. A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally NII. However, net gain constituting NII does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations that is attributable to their business assets, to the extent provided in Reg. § 1.1411-7.

2. In the case of an individual, estate, or trust that owns or engages in a trade or business,[1683] the determination of whether net gain that is ordinarily NII is attributable to property held in a trade or business is made at the individual, estate, or trust level.[1684]

3. In the case of an individual, estate, or trust that owns an interest in a partnership or an S corporation, and that entity is engaged in a trade or business, the determination of whether net gain that is ordinarily NII from such entity is:[1685]

   - from a passive trade or business activity is determined at the owner level; and

   - derived in trade or business of a trader trading in financial instruments or commodities[1686] is determined at the entity level.

[1680] As described in Reg. § 1.1411-6.
[1681] Reg. § 1.1411-4(d)(4)(i)(A).
[1682] Reg. § 1.1411-4(d)(4)(i)(B).
[1683] Whether directly or indirectly through ownership of an interest in an entity that is disregarded under the check-the-box rules under Reg. § 301.7701-3.
[1684] Reg. § 1.1411-4(d)(4)(i)(B)(3).
[1685] Reg. § 1.1411-4(d)(4)(i)(B)(3).

See also part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

The preamble to the final regulations explains how rules governing the disposition of a passive activity interact with the 3.8% tax:[1687]

> Section 469(g)(1) provides, in relevant part, that if all gain or loss realized on a disposition is recognized, the excess of any loss from that activity for such taxable year (determined after the application of section 469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss which is not from a passive activity. The preamble to the proposed regulations requested comments on "whether the losses triggered under section 469(g)(1) upon the disposition should be taken into account in determining the taxpayer's net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered properly allocable deductions to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii)." Because section 469(g)(1) provides that the allowed loss is treated as a loss "which is not from a passive activity," there is a question whether this language prevents the allowed losses from being treated as "properly allocable deductions" from passive activities for purposes of section 1411.
>
> Commentators recommended that losses allowed under section 469(g) be taken into account in computing net gain under section 1411(c)(1)(A)(iii), and that any net loss in section 1411(c)(1)(A)(iii) resulting from the use of such losses should be treated as a properly allocable deduction under section 1411(c)(1)(B). One commentator suggested that, to the extent a taxpayer has a net loss under section 1411(c)(1)(A)(iii) that is attributable to the allowed loss under section 469(g), the excess section 469(g) loss should continue to be suspended and carried forward to offset future gain resulting from the disposition of other passive assets subject to inclusion in section 1411(c)(1)(A)(iii).
>
> The final regulations provide that section 469(g) losses, which are treated as losses from a nonpassive activity, are taken into account for net investment income purposes in the same manner in which they are taken into account for chapter 1 purposes. As discussed in the context of section 469(f), section 469 does not alter the character or nature of the suspended passive loss. If the suspended losses allowed as a current year deduction by reason of section 469(g)(1) are attributable to operating deductions in excess of operating income, such suspended losses retain that character as, in most cases,

[1686] Reg. § 1.1411-5(c) discusses financial instruments and commodities.

[1687] T.D. 9655. Reg. § 1.1411-4(g)(9) provides:

> *Treatment of section 469(g)(1) losses*. Losses allowed in computing taxable income by reason of section 469(g) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

See Reg. § 1.1411-4(g)(8)(iii), Example (2).

For more about Code § 469(g), see part II.K.1 Passive Loss Rules Generally, especially the text accompanying fns. 2027-2028.

> deductions described in section 62(a)(1) or 62(a)(4). However, to the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character when they are ultimately allowed by section 469. Therefore, losses that are allowed by reason of section 469(g) may constitute properly allocable deductions under section 1411(c)(1)(B) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) in the year they are allowed, depending on the underlying character and origin of such losses. The recommendations proposed by the commentators depart from the general operating principles in chapter 1 and add additional complexity. Therefore, the final regulations do not adopt the positions advanced by commentators that section 469(g)(1) suspended losses should offset the gain first, then be allowed as a properly allocable deduction or that it should continue to be suspended and carried forward.
>
> Furthermore, section 469(g)(1) losses that are allowed by reason of a fully taxable disposition of a former passive activity are also fully taken into account for net investment income. As a result of the ordering rules in sections 469(f)(1) and (g)(1), any nonpassive gain realized on the disposition that causes passive losses to be allowed would be excluded from net investment income under the general former passive activity rules discussed in part 5.E.iv of this preamble. However, to the extent that any of the nonpassive gain is included in net investment income (for example, a portion of the gain remaining after the application of section 1411(c)(4)), the final regulations allow the same amount of suspended losses described in section 469(f)(1)(A) to be included in net investment income to offset the gain. The section 469(g)(1) losses allowed by reason of the disposition of the former passive activity are allowed in full because they relate to a period of time when the activity was a passive activity and represent true economic losses from a passive activity that do not materially differ from other section 469(g)(1) losses from non-former passive activities.

Losses allowed in computing taxable income by reason of Code § 469(g) are taken into account in computing net gain or as properly allocable deductions in the same manner as such losses are taken into account in computing Code § 63 taxable income.[1688]

I do not plan to analyze here the methods of calculating gain excluded from NII under the 2013 proposed regulations. If any reader would like to alert me to planning opportunities, I would be happy to review those ideas.

II.I.8.f. Summary of Business Activity Not Subject to 3.8% Tax

This part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax hits some of the highlights of part II.I.8 Application of 3.8% Tax to Business Income but is not intended to be comprehensive. Also consider part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, especially part II.K.3.b Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year.

[1688] Reg. § 1.1411-4(f)(9).

If a trade or business is not a long-term rental activity, then the activity is not NII if:

- During the taxable year, the owner spends more than 100 hours in the business' daily operations (a significant participation activity),[1689]

- The activity is a personal service activity, and the individual materially participated in the activity for any 3 taxable years (whether or not consecutive) preceding the taxable year,[1690] or

- For either the current year or any five out of the past ten years, the owner spent more than 500 hours in the business' daily operations (a material participation activity).[1691]

Note, however, that significant participation activities may be aggregated to constitute material participation, moving one from a significant participation paradigm to a material participation paradigm, so be sure you know which paradigm applies.[1692]

The significant participation activity exception covers many situations but is not a panacea:

- Various credits arising from significant participation activities might be suspended.[1693]

- From an income tax perspective, consider that losses from a significant participation activity offset regular income only in certain situations.[1694]

- The self-charged rental and interest exception described below apply only if the recipient materially participates in the payer activity. For example, if a taxpayer rents real estate to an S corporation in which the taxpayer materially participates, then the rental meets the self-charged rental exception. If the taxpayer's participation in the S corporation is "significant" but not "material" (see text accompanying fn. 1692 above), then the S corporation's income is nonpassive but the rental activity is passive investment income (subject to exclusions for real estate professionals).

- If a taxpayer works for more than 500 hours for five years, the activity continues to be nonpassive under the 5-out-of-the-last-10-years rule. Working for more than 100 hours but not more than 500 hours does not trigger the 5-out-of-the-last-10-years rule. The same idea also applies to the 3-year personal service activity rule.

[1689] See parts II.I.8.a.i Passive Activity Recharacterization Rules, II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, II.K.1.a.vi Proving Participation, and II.K.1.a.v What Does Not Count as Participation.
[1690] See part II.K.1.a.ii Material Participation, including fn. 2050, referring to activity that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, or is a trade or business in which capital is not a material income-producing factor.
[1691] See parts II.I.8.a General Application of 3.8% Tax to Business Income and II.K.1.a Counting Work as Participation.
[1692] See fns. 2047-2048 and accompanying text, found in part II.K.1.a.ii Material Participation.
[1693] See part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.
[1694] See part II.K.1.a Counting Work as Participation.

Rental income and part or all of interest income paid to an owner of a business in which the landlord or lender, respectively, materially participate is not NII.[1695]

Rental not protected by the self-rental exception is not NII under either of the following situations:

- The taxpayer is a real estate professional and the rental activity rises to the level of being a trade or business or is not a trade or business but is grouped with a rental trade business.[1696]

- Any gain from the property's sale is included in the taxpayer's income for the taxable year, the property's rental began less than 12 months before the property was sold, and the taxpayer materially participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the property's value.[1697]

See also part II.G.25 Real Estate Dealer vs. Investor.

II.I.8.g. Structuring Businesses in Response to 3.8% Tax

What might be an ideal structure for a new business entity is described in part II.E Recommended Structure for Entities.

When structuring to avoid this 3.8% tax, be careful to avoid triggering another 3.8% tax: FICA (self-employment tax). Part II.L Self-Employment Tax (FICA) describes these rules, with specific structures illustrated in parts II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker and II.L.6 SE Tax N/A to Nongrantor Trust; see also part II.E Recommended Structure for Entities. If one has to choose between the 3.8% tax on net investment income and self-employment tax, consider not only the thresholds for applying them but also the fact that the employer's 1.45% share is deductible against business income,[1698] whereas none of the 3.8% tax on net investment income is deductible.

Structuring a trust to characterize its income as nonpassive income might not be quite as easy as one might think. See part II.K.2.b Participation by an Estate or Nongrantor Trust. For other considerations regarding trusts and net investment income tax, see part II.J.3.a Who Is Best Taxed on Gross Income, especially the text accompanying fns. 1725-1729.

Note that participation by an ESBT is based on its trustee's actions, whereas participation by a QSST is based on its beneficiary's actions:

- Although switching to a QSST might facilitate participation regarding the S Corporation's income, it might complicate qualifying for the self-rental exception that avoids the 3.8% tax on rental income. The self-rental exception requires the

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[1695] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent.

[1696] See parts II.I.8.c.ii Real Estate Classified as Nonpassive for Real Estate Professionals and II.I.8.c.iii Rental as a Trade or Business.

[1697] For details and nuances, see fn. 2210 in part II.K.1.e Rental Activities.

[1698] Code § 164(f)(1).

landlord to materially participate in the tenant's business.[1699] Material participation in the tenant's business includes owning an interest in the tenant's business.[1700] Suppose a nongrantor trust owns the real estate and the S corporation stock. If and to the extent that the QSST election is made, the beneficiary, not the trust, is deemed to own the stock. A solution might be to place most of the stock into a QSST, keeping some in an ESBT. The portion that is in the ESBT would qualify that trust for the self-rental exception. The governing regulations[1701] do not impose a minimum ownership requirement, so it appears that any ownership of stock by the ESBT would suffice; I leave it to the reader to decide whether leaving more than a peppercorn is advisable.

- A trust that has only one current beneficiary might be able to switch back and forth every 36 months. See part III.A.3.e.iv Flexible Trust Design.

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

Also, one might consider selling S corporation stock to a QSST that a third party (perhaps the client's parent) creates for the client. For a discussion of how this avoids income tax on the sale but also might require the equivalent of paying for the stock twice, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. After the note is repaid (or 36 months, whichever occurs last), perhaps part or all of the trust would be switched to an ESBT, as discussed in part III.A.3.e.iv Flexible Trust Design.

II.I.9. Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII

Elections to consider to minimize the tax apply to:[1702]

- Regrouping passive activities.[1703]
- Pre-2013 installment sales that might generate net investment income in 2013 and later years.
- Controlled foreign corporation and qualified electing fund stock.
- Married taxpayers, in which one spouse is a nonresident alien. Nonresident aliens are not subject to the tax.[1704]

[1699] See part II.I.8.a.iii Qualifying Self-Charged Interest or Rent Is Not NII, especially fn. 1610, and part II.K.1.e.ii Self-Rental Converts Rental to Nonpassive Activity, especially fn. 2170-2171.

[1700] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[1701] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.

[1702] Nadeau and Ellis, "The Net Investment Income Tax: Elections to Start Thinking About Now," *T.M. Memorandum* (BNA), Vol. 54, No. 07 (4/8/2013). This article's Appendix contains a handy chart.

[1703] See parts II.K.1.b.i Grouping Activities – General Rules and II.K.1.b.iii Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income.

Because the tax applies only if modified adjusted gross income (MAGI) exceeds various thresholds, consider accelerating next year's income or deferring the current year's income so that either this year or next year has MAGI below the threshold. For example:

- Accelerate or defer retirement plan distributions or change the mix between Roth and traditional IRA distributions, to the extent permitted without violating the rules requiring minimum distributions to be taken.[1705] Even though retirement plan distributions are not NII, income from distributions increases MAGI.

- Time capital gains and losses which might include, if spreading out the gain will keep MAGI below the threshold, engaging in installment sales.[1706]

II.J. Fiduciary Income Taxation

Generally, a "trust" is:[1707]

[1704] Code § 1411(e)(1).

[1705] Code §§ 401(a)(9), 403(b)(10), 408(a)(6), 408(b)(3).

[1706] Code § 453, which is subject to Code §§ 453A and 453B.

[1707] Reg. § 301.7701-4(a), which further provides:

> Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

That a beneficiary provided consideration for the trust's establishment does not prevent the trust from being classified as such. *Hanover Bank v. Commissioner*, 40 T.C. 532 (1963), *acq.* 1964-2 C.B. 5, which further held:

> There does not appear to be any ambiguity in the agreement concerning the creation of the trust and, in fact, all the parties to that agreement, including Frances, have long treated the agreement as creating a valid trust. Petitioners Strong reported as trust income in 1953 and 1954 most of the amounts paid to them by the trustee. Long-standing interpretations should be given consideration and will not lightly be set aside even when there is ambiguity in the instrument, *Babette B. Israel*, 11 T.C. 1064 (1948). Furthermore, the Supreme Court of New York previously construed the agreement as creating a valid trust and the material parts of that judgment are set forth in our Findings of Fact. Judicial constructions by State courts are conclusive as to the legal extent and character of the interests created under such an agreement, *Louise Savage Knapp Trust A*, 46 B.T.A. 846 (1942).
>
> The situation here is distinguishable from cases such as *Lyeth v. Hoey*, 305 U.S. 188, and *Chase National Bank et al., Executors*, 40 B.T.A. 44 (1939). In each of those cases the taxpayer threatened to take contrary to a will and in each case compromised his claims. The Courts determined that the property received in compromise was the substitute for an inheritance. In the instant case, Frances did not contest the disposition and the amounts she received were not in compromise of any claim she may have had.

> an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.

A life estate might create a relationship that rises to the level of a trust.[1708]

However, a mere agency agreement does not constitute a trust.[1709] Nor does a court-supervised guardianship or conservatorship for a minor or other incapacitated person.[1710]

See also part II.D Special Purpose Trusts.

This part II.J tends to focus on estates and nongrantor trusts and often refers to such entities when referring to trust. In many ways, estates are taxed as nongrantor trusts that are not required to distributed all of their income, so a reference to such a trust tends to apply to an estate as well; however, as with anything in these materials, a tax professional should apply independent judgment to any such inference.

For a focus on grantor trusts, see part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust, especially parts III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment and III.B.2.h How to Make a Trust a Grantor Trust.

II.J.1. Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries

Our fiduciary income tax system, generally computes taxable income as if the trust were an entity, then allocates taxable income between the trust and its beneficiaries.[1711]

A trust, all of the accounting income of which is required to be distributed currently to one or more noncharitable beneficiaries, deducts the lesser of its accounting income or distributable net income (DNI).[1712] It also deducts any other amounts of DNI that are

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[1708] Taxpayers sought that conclusion in fn. 4466 (found in part III.A.3.e.i QSSTs) to confirm treatment as a QSST.

[1709] Rev. Rul. 76-265 held:

> In the instant case, the bank trustee will not take title to the property for the purpose of protecting or conserving it for beneficiaries, but will be acting as an agent of the United States and in that capacity will receive moneys, hold assets, and make payments on behalf of the United States for the purposes of constructing public buildings and satisfying the obligation of the United States to holders of the participating certificates.
>
> Accordingly, the arrangement is not a trust for Federal income tax purposes, but is a security arrangement with the bank trustee acting as an agent on behalf of the United States.

Letter Ruling 200227012 followed Rev. Rul. 76-265.

[1710] Reg. § 1.6012-3(b)(3).

[1711] Technically, the trust allocates distributable net income to the trust and beneficiaries, then takes into account other items in computing the trust's taxable income. The text in the body is a convenient way to describe the system to clients.

[1712] Code § 651 and Code § 661(a)(1), (c). Code § 643(a) defines DNI, and Code § 643(b) defines accounting income. For more on accounting income, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which generally covers the area of accounting income, with extra attention paid to capital gains.

"properly paid or credited or required to be distributed" for the taxable year.[1713] Thus, a mandatory income feature is simply a proxy for other distributions, without the requirement that the distribution be made during the year or within 65 days thereafter.[1714] The beneficiary includes in income the amount of the trust's deduction for DNI.[1715]

The above is a simplistic explanation. Among omissions are the treatment of tax-exempt income, the separate share rule,[1716] and charitable deductions.[1717]

II.J.2. Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended

Code § 663(b) allows distributions in the first 65 days of the taxable year to count as distributions in the current or prior year's tax return.

Thus, the trustee can count distributions from January 1, 2016 through and including March 5, 2016 as 2015 or 2016 distributions or a combination thereof.

When in doubt, distribute more rather than less (if distributions are appropriate).[1718] The tax return, including extensions, will determine how much of the distribution counts as a distribution for the year just ended or for the year in which the distribution is made, but the distribution needs to be made within the 65-day period.

This tactic can carry out capital gains, without regard to any prior year election regarding distributing capital gains.[1719]

1713 Code § 661(a)(2), (c). A beneficiary's use of a residence generally should not constitute a deemed distribution unless the trust is a foreign trust and the beneficiary is a US person. For the latter rule, see Code § 643(i). For various cases analyzing the former issue, see *DuPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976), *aff'd* 574 F.2d 1332 (5th Cir. 1978); *Commissioner v. Plant*, 76 F.2d 8 (2nd Cir. 1935); TAM 8341005 (following *Plant* - real property taxes and the cost of the caretaker were carrying costs allocable to corpus, and income used to pay those expenses were not deemed distributed to the beneficiary who used the house; the beneficiary paid for electricity, heating and personal expenses); *Commissioner v. Lewis*, 141 F.2d 221 (3rd Cir. 1944) (carrying charges and depreciation were chargeable to trust accounting income under local law and deductible in computing amounts taxable to the mandatory income beneficiaries). *Moreell v. U.S.*, 221 F.Supp. 864 (W.D. Pa. 1963), is a sloppy, confusing, unreasoned opinion involving a mandatory income trust that was partly a grantor trust. I have not read but have seen cited *Fuller v. Commissioner*, 9 T.C. 1069 (1947), *aff'd* 171 F.2d 704 (3rd Cir. 1948); *Prince v. Commissioner*, 35 T.C. 974, 978 (1961).

1714 Part II.J.2 Tactical Planning Shortly After Yearend describes the 65-day rule.

1715 Code §§ 651, 652.

1716 See part II.J.9.a Separate Share Rule.

1717 As described in part II.J.4.c Charitable Distributions, Code § 642(c) generally governs charitable deductions. Among other issues, see part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity, which also covers how a trust's income from business or certain other activities affects the charitable deduction.

1718 See part II.J.3 Strategic Fiduciary Income Tax Planning for tax and nontax issues to consider in deciding whether to make distributions.

1719 See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.

II.J.3. Strategic Fiduciary Income Tax Planning

Planning for fiduciary income tax is a matter of comparing taxation at the trust level, beneficiary level, or deemed owner level, including the following issues:

- Who is best taxed on gross income?[1720]

- Who benefits most from deductions?[1721]

- Consider not only the effect of federal tax but also state and local income tax.[1722]

- Does the method of shifting the incidence of taxation undermine any material purpose of the trust?

- Do decisions made for the current taxable year affect taxation in future years?

- How much flexibility does a trustee have for currently irrevocable trusts, and can this flexibility be enhanced?

- How should one draft to provide more flexibility?

For distributing capital gain, see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

Also note that beneficiaries who are trustees can reduce income subject to the net investment income tax by taking reasonable trustee fees; however, this strategy is not a good idea if the trust has any significant tax-exempt income (because the deduction would be disallowed to the extent allocable to tax-exempt income,[1723] but the entire fee income would still be recognized) or if and to the extent the deduction would offset income (such as qualified dividends or long-term capital gain) taxable at a lower rate. For other aspects of the NII tax, see parts II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles and II.I.9 Elections or Timing Strategies to Consider to Minimize the 3.8% Tax on NII.

II.J.3.a. Who Is Best Taxed on Gross Income

Increased adjusted gross income (AGI) might cause a beneficiary to lose tax benefits, effectively increasing the beneficiary's marginal income tax rate. Therefore, even if the trust and beneficiary have the same nominal rate, the beneficiary might have a higher effective tax rate. Increased beneficiary AGI can cause the following tax detriments:

- <u>Reduction of Overall Itemized Deductions</u>. Generally, itemized deductions are reduced by 3% of the extent to which AGI exceeds certain thresholds. If the

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1720 See parts II.J.3.a Who Is Best Taxed on Gross Income and II.J.3.b Effect of Kiddie Tax on Rates.
1721 See part II.J.3.d Who Benefits Most from Deductions.
1722 See part II.J.3.e State and Local Income Tax.
1723 See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 1916.

itemized deductions offset ordinary income, this effectively imposes an additional tax of approximately 1.2% on AGI.

- Reduction in Particular Itemized Deductions. Itemized deductions such as medical expenses, miscellaneous itemized deductions, and casualty losses are reduced as AGI increases.

- Phase Out of AMT Exemption. The alternative minimum tax exemption is phased out and eventually eliminated once income exceeds certain limits.

- Phase Out of Personal Exemption. The regular tax personal exemption is phased out and eventually eliminated once income exceeds certain limits.

- Net Investment Income (NII) Tax.

  - Once an individual's income exceeds certain thresholds, NII tax applies.[1724] Although a trust's income quickly becomes subject to the NII tax, the threshold for an individual is much higher.

  - NII tax applies to passive income.[1725] The trustee of a nongrantor trust might not be a suitable person to participate sufficiently to avoid the income being characterized as passive, and the rules governing whether a trustee's work constitutes participation are challenging to apply.[1726] If the trust is a grantor trust, the deemed owner's work is what counts while that person is the deemed owner,[1727] although the trustee's work might be important to set the stage for future nonpassive treatment.[1728] For a nongrantor trust, beneficiary's participation should count for depreciation but does not count for other items of business income.[1729]

  - If the beneficiary is charitably inclined, the trust and beneficiary can avoid NII tax by the trust instead of the beneficiary making charitable contributions.[1730]

[1724] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[1725] See part II.I.8 Application of 3.8% Tax to Business Income.
[1726] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[1727] See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 1555.
[1728] The trust will cease to be a grantor trust when the deemed owner dies, if the grantor trust powers are not turned off before then. If a QSST sells its S corporation stock, the sale is taxed to the trust rather than to the beneficiary. Consider having the trustee work in the business to try to establish participation, looking toward those events. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax), II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.
[1729] See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules.
[1730] Individuals cannot deduct charitable contributions against NII (the charitable deduction is not listed in part II.I.6 Deductions Against NII), but trusts can. See part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, especially fn. 1561.

Also, consider whether the trust or the beneficiary has capital loss (or, less likely but still possible, net operating loss) carryovers against which to offset trust income.

II.J.3.b. Effect of Kiddie Tax on Rates

Code § 1(g) requires the tax of certain children, including certain students who have not attained age 24 as of the close of such calendar year, to compute their income tax based on their parents' rates.

However, no comparable rule applies to computing children's 3.8% net investment income tax.[1731]

Thus, shifting income to children subject to the kiddie tax can still result in tax savings.

II.J.3.c. Who Is Benefits the Most from Losses

See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important.

II.J.3.d. Who Benefits Most from Deductions

Consider that generally[1732] the fiduciary income tax system allows nongrantor trusts[1733] to net deductions against income before allocating income to beneficiaries. Thus, incurring expenses at the trust level provides benefits similar to trapping income inside trusts described in part II.J.3.a Who Is Best Taxed on Gross Income. Furthermore, favorable treatment is provided deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.[1734]

Charitable deductions often produce more benefit to a trust than to an individual.[1735]

Certain losses from the sale of small business stock[1736] are not available to nongrantor trusts,[1737] so grantor trust planning might be considered for that asset. Similarly, depreciation deductions allocated to the remaindermen of a nongrantor trust that is

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[1731] For thresholds, see part II.I.3 Tax Based on NII in Excess of Thresholds.
[1732] Depreciation and similar deductions are an exception to this rule. See part II.J.11.a Depreciation Advantages and Disadvantages.
[1733] Reg. § 1.67-2T(g)(1) prevents grantor trusts from netting deductions.
[1734] Code § 67(e)(1), which regulations narrow the definition more than one might have otherwise thought.
[1735] See part II.J.4.c Charitable Distributions.
[1736] See part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.
[1737] See part II.J.11.b Code § 1244 Treatment Not Available for Trusts.

included in the grantor's or beneficiary's estate reduce the basis step-up; presumably this rule would not apply to a grantor trust.[1738]

II.J.3.e. State and Local Income Tax

II.J.3.e.i. Residence Generally

Consider whether income trapped inside a trust might be taxed at a lower state and local income tax rate (or entirely exempt from such tax) than income reported on a beneficiary's income tax return.

Generally, states do not tax nonbusiness income earned by a nonresident trust. Some high income-tax states fail to tax income earned by trusts set up by their residents that are administered in other jurisdictions, which has led to the creation of incomplete gift nongrantor trusts to cause capital gain from investments to avoid state income tax.[1739]

Consider whether:

- The trustee could have minimized tax by moving the trust.
- By changing residence, the trustee has subjected the trust to income tax. Sometimes a trustee moves, doesn't realize that the move subjects the trust to fiduciary income tax, fails to file, then makes the trust liable for not only tax but also interest and penalties.

Consider preparing and updating a contacts list for the trust to see what contacts the trust has with which states and whether that can generate state income tax liability or whether contacts can be changed to reduce or eliminate state income tax.

Before making a Code § 645 election to treat a revocable trust as an estate, consider whether that will subject the trust (and trusts created upon its funding) to state income tax.[1740]

If a state that imposes income tax follows the federal rules, exercising a general power of appointment might shift the grantor.[1741] If such a shift is undesirable, see

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[1738] See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

[1739] "Incomplete nongrantor" is abbreviated ING, so one often hears of DING (Delaware ING) or NING (Nevada ING) trusts, even though the strategy is available for trusts established in other states (including Missouri). Private letter rulings approving such trusts treat certain trustees as adverse for income tax but not gift tax purposes without explaining how those conditions can coexist.

Now I have some silly comments to add spice to your day:

- Suppose your DING also has some asset protection features. It might be a bankruptcy avoidance trust (BAT). Being a DING-BAT, it was referred to frequently on the TV series, "All in the Family."
- Suppose you have a Missouri ING, and to the extent the grantor allocates GST exemption at death it terminates in favor of a perpetual trust. This MING Dynasty Trust might be appropriate to hold 13th century Chinese artifacts.

[1740] See fn. 1837, found in part II.J.7 Election to Treat a Revocable Trust as an Estate.

part II.H.2.k Taxable Termination vs. General Power of Appointment vs. Delaware Tax Trap.

II.J.3.e.ii. Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence

A state might ignore a trust's existence while the trust is a grantor trust.[1742] On the other hand, some states do not recognize grantor trust status of irrevocable trusts.[1743]

Given that clients often retire to jurisdictions that are not subject to income tax, keeping the trusts as grantor trusts until the clients move to those jurisdiction might mean that the state in which the trust was created will not treat the trust as a resident trust, because for income tax purposes the trust was deemed not to exist until the grantor was not a resident.

See also part II.J.15.b QSSTs and State Income Tax Issues.

II.J.3.f. Consider Trust Purposes

If shifting the incidence of taxation requires making distributions, consider whether distributions are appropriate. Consider whether distributions undermine the following nonexclusive list of concerns:

[1741] Reg. § 1.671-2(e)(5). Connecticut Ruling 2005-2 held:

> The residency status of an appointive trust created by the exercise of a power of appointment that is not a general power of appointment is to be determined by the residency of the donor of the power of appointment. The residency status of an appointive trust created by the exercise of a general power of appointment is to be determined by the residency of the donee of the power of appointment.

By "donor," the ruling was referring to the settlor. The ruling is my doc. no. 6517233.

[1742] For example, in defining what is a trust, Illinois disregards the existence of a grantor trust. 35 ILCS 5/1501(a)(20)(D) and 86 Ill. Admin. Code § 100.3020(a)(4) refer to grantor trusts under Code §§ 671-678.

[1743] Nenno, 869 T.M. II.A. states:

> As noted above, if a trust is treated as a grantor trust for federal and for state income-tax purposes, all income (including accumulated ordinary income and capital gains) is taxed to the trustor, making planning difficult if not impossible while that status continues. Nevertheless, where the federal and state grantor-trust rules are not identical, it might be possible to structure a trust to be a grantor trust for federal purposes but to be a nongrantor trust for state purposes and to arrange matters so that the trust is not subject to that state's tax. For instance, Pennsylvania and Tennessee don't have grantor-trust rules for irrevocable trusts; Arkansas, the District of Columbia, Louisiana, and Montana tax the grantor only in limited circumstances;[21] and Massachusetts classifies a trust as a grantor trust based on §§ 671–678 only, so that a trust that falls under § 679 will be a grantor trust for federal but not for state purposes. Unfortunately, a number of those states tax individuals based on federal taxable income,[22] which captures all federal grantor-trust income,[23] making the foregoing planning option unavailable.
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> [21] Ark. Inc. Tax Reg. § 4.26-51-102; D.C. Code §§ 47-1809.08–47-1809.09; La. Rev. Stat. Ann. § 47:187; Mont. Code Ann. § 15-30-2151(5).
>
> [22] § 63.
>
> [23] § 671.

Instructions to Pennsylvania's fiduciary income tax returns explain that they respect the grantor trust rules only for revocable trusts.

- Supplemental needs trusts designed to protect the flow of governmental benefits
- Protection from tort creditors
- Protection from business creditors
- Protection from spouses or ex-spouses
- Otherwise keeping funds inside the family
- Poor spending habits
- Inability to handle money
- Discouraging undue influence
- Funding addictive behavior
- Protecting from estate tax
- Other spendthrift concerns

II.J.3.g. Effect on Future Years

The first time a distribution of principal is made from principal without referring to or actually distributing capital gain proceeds, the trustee is essentially electing for that year and all future years whether such distributions will carry out capital gains.[1744]

Causing a trust to be taxed to the grantor can be turned on or off by the presence or absence of a swap power or other powers.[1745]

However, turning off the powers that make a trust deemed owned by one or more beneficiaries is more challenging.[1746] If one wants flexibility in turning on or off beneficiary grantor trust treatment, consider using QSST strategies (which can cause difficulty splitting up trust assets if more than one person is a remainderman).[1747]

II.J.3.h. Drafting for Flexibility in Trust Income Taxation

When drafting using an ascertainable standard for distributions ("support" in my documents),[1748] one can give the trustee the flexibility to consider or ignore the

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[1744] See part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.
[1745] See part III.B.2.h How to Make a Trust a Grantor Trust.
[1746] See generally part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.
[1747] See parts III.A.3.e.vi QSST (including part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts) and III.A.3.e.iv Flexible Trust Design.
[1748] See Reg. §§ 1.674(b)-1(b)(5)(i) (grantor trust income tax rules), 20.2041-1(c)(2) (exception to estate tax general power of appointment) and 25.2511-1(g)(2) (gift tax ascertainable standard – reproduced in fn. 1881).

beneficiary's other resources. If the trustee has a legal duty to support one or more beneficiaries, consider using "reasonable support and comfort"[1749] to emphasize that distributions are more than just the minimum that is required to discharge a support obligation.[1750]

I also like to include standards that are not ascertainable ("welfare" in my documents). To avoid the IRS alleging adverse estate/gift tax consequences, the trustee either cannot have been appointed by the beneficiary or was appointed by the beneficiary but is not a related or subordinate party (as defined in Code § 672(c))[1751] with respect to the beneficiary.[1752]

When drafting, consider including an annually lapsing withdrawal right to make the trust deemed owned in part by the beneficiary;[1753] one twist on the power would be giving the trustee or a trust protector the power to turn off the power for a year (or range of years) before the year starts, allowing the power to be turned off if creditors are hovering. Absent such a provision, one might convert a trust to a partial beneficiary grantor trust by exercising one of the standards described above with respect to the lesser of $5,000 or 5% of the trust's assets and giving the beneficiary the power to withdraw the declared

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Some documents include a statement that the trustee's determination is conclusive and binding on all parties. Reg. § 25.2511-1(g)(2) takes the position that such language undermines the ascertainable standard exception, but the other two regulations are silent on the issue. Those regulations were promulgated before the Uniform Trust Code ("UTC"), section 814(s) of which provides:

> Notwithstanding the breadth of discretion granted to a trustee in the terms of the trust, including the use of such terms as "absolute", "sole", or "uncontrolled", the trustee shall exercise a discretionary power in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

UTC §§ 1002(b), 1008(a)(1) (see also the sections to which the Comments to Section 103(8) refer) provide similar references to good faith and the beneficiaries' interests in determining whether a trustee is liable. Thus, the assumption that "conclusive and binding" language makes the trustee's discretion unreviewable might be incorrect. I would not use such language in connection with trying to establish an ascertainable standard, but generally I would not urge reformation of an irrevocable trust merely for using that language. *Jennings v. Smith*, 161 F2d 74 (2nd Cir. 1947), upheld as not causing estate inclusion an ascertainable standard that included some language about the trustee's "absolution discretion."

1749 As defined in Reg. §§ 25.2511-1(g)(2) and 1.674(b)-1(b)(5)(i).

1750 Generally, a legal support obligation encompasses a much more narrow view of support than does what is permitted for an ascertainable standard, but one would want to check state law to verify. Also, if a trust makes distributions for items encompassed by a support obligation, query whether the trust has a claim against the person who has the support obligation. Finally, state laws prohibiting trustees from discharging their legal obligations, as well as any such prohibitions in the trust instrument itself, should reinforce the idea of the trust having a claim against the beneficiary. Nevertheless, many estate planners prefer to have other mechanisms for getting distributions to dependent children.

1751 See Rev. Rul. 66-160 (director of a corporation is not an "employee" under Code § 672(c)); Letter Rulings 9842007 and 9841014.

1752 For the latter, see fn. 5062.

1753 See part III.B.2.i.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

amount or portion.[1754] In either case, such treatment generally has a permanent effect.[1755]

If locking in the beneficiary as the deemed owner is unattractive, the trust can dump its assets in an S corporation, make a QSST election when taxing the beneficiary is attractive,[1756] and convert to an ESBT when trapping income in the trust (primarily when the trust is not subject to state income tax but the beneficiary is) is more attractive.[1757] However, planning using S corporations involves additional long-term planning.[1758]

Also, to promote flexibility in including capital gains in distributable net income that the trustee can elect to carry out to the beneficiaries, consider using flexible language regarding allocating receipts between income and principal.[1759]

II.J.3.i. Planning for Excess Losses

Generally, an estate or nongrantor trust cannot pass losses (other than depreciation)[1760] to beneficiaries except in the year of termination. Also consider the points made in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good in light of planning a trust's and its beneficiaries' income and losses.

If the trust is not terminating by the end of the calendar year, consider accelerating income (perhaps selling appreciated assets, among other items) or deferring deductions if and to the extent that the trust's deductions otherwise would exceed its income.

On the final termination of an estate or a nongrantor trust, it can pass to its beneficiaries a net operating loss carryover under Code § 172, a capital loss carryover under Code § 1212, or for the last taxable year of the estate or trust deductions (other than the exemption and charitable deduction) in excess of gross income for such year, all to the extent provided in regulations.[1761] These carryovers and excess deductions are allocated among the beneficiaries succeeding to the property proportionately according to the share of each in the burden of the loss or deductions, which can include those receiving specific bequests that are abated.[1762] A person who qualified as a beneficiary

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[1754] See text accompanying fns. 1567-1569.
[1755] For flexibility regarding beneficiary grantor trust status, see fn. 1747.
[1756] See part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs, which is part of the larger part III.A.3.e QSSTs and ESBTs.
[1757] See parts III.A.3.e.ii.(c) When ESBT Income Taxation Might Help and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.
[1758] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).
[1759] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1878.
[1760] See part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss.
[1761] Code § 642(h); Reg. § 1.642(h)-2.
[1762] Reg. § 1.642(h)-4, which concludes with an example:

> A decedent's will leaves $100,000 to A, and the residue of his estate equally to B and C. His estate is sufficient to pay only $90,000 to A, and nothing to B and C. There is an excess of deductions over gross income for the last taxable year of the estate or trust of $5,000, and a capital loss carryover of $15,000, to both of which section 642(h) applies. A is a beneficiary succeeding to the property of the estate to the extent of $10,000, and since the total of the excess of deductions and the loss carryover

succeeding to the property with respect to one amount and does not qualify with respect to another amount is a beneficiary succeeding to the property as to the amount with respect to which the beneficiary qualifies.[1763]

A trust will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary).[1764]

II.J.4. Tips for Fiduciary Income Tax Preparers

The IRS' web page for fiduciary income tax returns is https://www.irs.gov/uac/about-form-1041.

Income tax preparers might consider the following:

II.J.4.a. Distributions after Yearend to Carry Out Income to Beneficiaries

Prepare a rough draft of the income tax return in February and compare it to the beneficiaries' income tax rates.

If distributions are appropriate, make them by March 5 or 6.

For details, see part II.J.2 Tactical Planning Shortly After Yearend to Save Income Tax for Year That Ended.

II.J.4.b. Capital Gain Elections

Tax return preparation software automatically treats capital gains as trapped in the trust.

Consider whether current or future capital gains should be shifted to the beneficiaries.[1765]

Although a prior year return might have constituted an election not to distribute capital gains under one particular option, the tax laws are much more flexible than might appear at first. See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

II.J.4.c. Charitable Distributions

Even more generous than the 65-day rule mentioned in part II.J.4.a, a charitable contribution made any time in the current year can count for the current or immediately preceding year.[1766] For example, a contribution made December 31, 2017 can count as a 2016 contribution for a calendar year fiduciary taxpayer.

is $20,000, A is entitled to the benefit of one half of each item, and the remaining half is divided equally between B and C.

[1763] Reg. § 1.642(h)-4.

[1764] Reg. § 1.641(b)-3(b), incorporated by reference by Reg. § 1.642(h)-1(a).

[1765] See part II.J.3 Strategic Fiduciary Income Tax Planning.

[1766] Code § 642(c)(1); Reg. § 1.642(c)-1(b)(1). Although an estate can deduct any amounts set aside and paid any time before termination, that election can be fraught with danger. See

A nongrantor trust or estate's charitable deduction reduces adjusted gross income distributed to the beneficiaries and is the only way a charitable deduction can reduce net investment income subject to the 3.8% tax.[1767] However, the Code § 642(c) charitable deduction does not reduce the amount of the DNI allocated to a mandatory income beneficiary.[1768] If the trust is mandatory income as to a portion and discretionary as to a portion, the beneficiary receiving discretionary distributions may benefit from the charitable deduction and may receive a windfall,[1769] but these rules may also cause

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part II.J.7 Election to Treat a Revocable Trust as an Estate, with the caution described in fn. 1834.

[1767] See fn. 1561.

[1768] Code § 651(b), as explained by Reg. § 1.651(a)-4(a), prevents trusts that make charitable distributions from being treated as simple trusts. Code § 662(a)(1), which applies to trusts other than simple trusts, provides:

> *Amounts required to be distributed currently*. The amount of income for the taxable year required to be distributed currently to such beneficiary, whether distributed or not. If the amount of income required to be distributed currently to all beneficiaries exceeds the distributable net income (computed without the deduction allowed by section 642(c), relating to deduction for charitable, etc., purposes) of the estate or trust, then, in lieu of the amount provided in the preceding sentence, there shall be included in the gross income of the beneficiary an amount which bears the same ratio to distributable net income (as so computed) as the amount of income required to be distributed currently to such beneficiary bears to the amount required to be distributed currently to all beneficiaries. For purposes of this section, the phrase "the amount of income for the taxable year required to be distributed currently" includes any amount required to be paid out of income or corpus to the extent such amount is paid out of income for such taxable year.

F. Ladson Boyle & Jonathan G. Blattmachr, §3:5.2 Tier System, *Blattmachr on Income Taxation of Estates and Trusts* (PLI 16th ed. 2016), explains:

> ... trust-accounting income (required to be distributed currently) may exceed DNI. In effect, charitable distributions of income are in a middle category: available income is first treated as going to first-tier beneficiaries; then, to the extent that income is distributed to charity, there is a charitable deduction. As a result, only the residue of income is taxed to the second-tier beneficiaries.

[1769] See Code § 662(a)(1), reproduced in fn. 1768. In applying this rule, Reg. § 1.662(b)-2 provides that:

> for the purpose of allocating items of income and deductions to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently.

Reg. § 1.662(b)-2, Example (1), illustrates this rule, with paragraph (e) of the example providing the discretionary beneficiary with the windfall of receiving:

> (a) A trust instrument provides that $30,000 of its income must be distributed currently to A, and the balance may either be distributed to B, distributed to a designated charity, or accumulated. Accumulated income may be distributed to B and to the charity. The trust for its taxable year has $40,000 of taxable interest and $10,000 of tax-exempt income, with no expenses. The trustee distributed $30,000 to A, $50,000 to charity X, and $10,000 to B.
>
> (b) Distributable net income for the purpose of determining the character of the distribution to A is $30,000 (the charitable contributions deduction, for this purpose, being taken into account only to the extent of $20,000, the difference between the income of the trust for the taxable year, $50,000, and the amount required to be distributed currently, $30,000).

more K-1 income for the mandatory income beneficiary than the trust would have had if the trust had been able to accumulate the income.[1770] I have not explored the interaction of this rule with the fact that unrelated business income generally moves the charitable deduction from Code § 642(c) to Code § 170.[1771]

For the requirement that the contribution be paid from gross income and complexity that applies when the trust has S corporation, business, or debt-financed income, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. Special rules apply to electing small business trusts owning S corporations that make charitable contributions, which disallow the charitable contribution regarding any donations that the ESBT portion of the trust makes and essentially apply the individual contribution limits rather than Code § 642(c) to any contributions flowing through the K-1 that the ESBT receives.[1772]

(c) The charitable contributions deduction taken into account, $20,000, is allocated proportionately to the items of income of the trust, $16,000 to taxable interest and $4,000 to tax-exempt income.

(d) Under section 662(a)(1), the amount of income required to be distributed currently to A is $30,000, which consists of the balance of these items, $24,000 of taxable interest and $6,000 of tax-exempt income.

(e) In determining the amount to be included in the gross income of B under section 662 for the taxable year, however, the entire charitable contributions deduction is taken into account, with the result that there is no distributable net income and therefore no amount to be included in gross income.

(f) See subpart D (section 665 and following), part I, subchapter J, chapter 1 of the Code for application of the throwback provisions to the distribution made to B.

[1770] F. Ladson Boyle & Jonathan G. Blattmachr, §3:5.2 Tier System, *Blattmachr on Income Taxation of Estates and Trusts* (PLI 16th ed. 2016), suggests:

> **Example**: A complex trust has $65,000 of taxable dividend income. Annually, the trust is required to distribute the first $10,000 of income to a qualified charity, C, and the balance of its accounting income to an individual, A. In addition, the trustee is authorized to invade principal for the benefit of a second individual, B, and distributes $10,000 to B. The trust pays $10,000 in trustee fees that are chargeable one-half to income and one-half to principal. The accounting income for the trust is $60,000 ($65,000 less $5,000 (one-half of the trustee's fee)). Thus, the amount distributable to A is $50,000 ($60,000 less $10,000 due the charity).
>
> The trust's taxable income [ignoring the distribution deduction and exemption] is $45,000 ($65,000 less $10,000 trustee fee and less $10,000 charitable deduction). The DNI for the trust is $45,000. Because distributions to A and B exceed DNI, the trust's distribution deduction is limited to $45,000.
>
> When the amount of income A must report is computed, DNI is recomputed without a charitable deduction. Thus, DNI is $55,000 for this purpose and A has $50,000 of taxable income under section 662. Note that the amount of income A must report is less than the recomputed DNI by $5,000.
>
> Nevertheless, B has no income on the distribution of principal as the DNI for purposes of the tier 2 distribution is the original $45,000 and that amount is not in excess of the tier 1 distribution to A.

B's windfall comes at the expense of A paying tax on more income ($50,000) than the net of the trust's taxable items ($45,000).

[1771] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[1772] Under 2017 tax reform, Code § 642(c) does not apply to an ESBT; see fn 4529 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview and also note that fn 4528 allows an ESBT

But for these limitations, generally a nongrantor trust's charitable deduction is not subject to the limitations that would apply to a beneficiary. Nongrantor trusts and estates may deduct charitable contributions made during the taxable year or in the next taxable year, [1773] whereas generally individuals may deduct contributions made during the taxable year. Furthermore, charitable gifts from nongrantor trusts and estates do not appear to be subject to the strict substantiation[1774] and appraisal[1775] rules that apply to

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to deduct charitable contributions against its S corporation income only to the extent they are on the K-1 from the S corporation

[1773] See fn. 1766.

[1774] Code § 170(f)(8) disallows contributions under Code § 170(a) if certain substantiation requirements are not met but does so without referring to Code § 642(c). Also, Code § 642(c) says that the deduction is "in lieu of the deduction allowed by section 170(a)," further disconnecting Code § 642(c) for Code § 170(f)(8). Note also that Reg. § 1.170A-13(f)(13) provides:

> Section 170(f)(8) does not apply to a transfer of property to a trust described in section 170(f)(2)(B), a charitable remainder annuity trust (as defined in section 664(d)(1)), or a charitable remainder unitrust (as defined in section 664(d)(2) or (d)(3) or § 1.664-3(a)(1)(i)(b)). Section 170(f)(8) does apply, however, to a transfer to a pooled income fund (as defined in section 642(c)(5)); for such a transfer, the contemporaneous written acknowledgment must state that the contribution was transferred to the donee organization's pooled income fund and indicate whether any goods or services (in addition to an income interest in the fund) were provided in exchange for the transfer. The contemporaneous written acknowledgment is not required to include a good faith estimate of the income interest.

[1775] Code § 170(f)(11) imposes requirements for various noncash contributions, depending on the nature and size of the gift. Reg. § 1.170A-13(c)(3) and Notice 2006-96 govern qualified appraisals; Prop. Reg. § 1.170-17 would apply only to contributions made after it is finalized (see subsection (c)) and therefore is not a consideration until then. Reg. § 1.170A-13(c)(3)(ii)(E), which is cross-referenced by Reg. § 1.170A-13(c)(4)(ii)(I), requires that the appraiser supply an EIN if required by Code § 6109 and the regulations thereunder; however, no formal guidance of which I am aware says whether this is required. However, the preamble to Prop. Reg. § 1.170-17, [REG-140029-07] (8/7/2008), expresses the IRS view:

> Expressing concerns about identity theft, some commenters requested elimination of the requirements of supplying the appraiser's taxpayer identification number on Form 8283 and in the appraisal, as currently required under §§ 1.170A-13(c)(3)(ii)(E) and 1.170A-13(c)(4)(ii)(I). The concern arises from appraisers who do not have a taxpayer identification number other than a social security number. The proposed regulations continue to require this information because, pursuant to § 301.6109-1(a)(1)(ii)(D) of the Procedure and Administration Regulations, an appraiser may obtain an employer identification number even if the appraiser does not have employees. This number may be obtained by completing Form SS-4, "Application for Employer Identification Number." See Pub. 1635, "Understanding Your Employer Identification Number." If an appraiser is employed by a firm, the firm's employer identification number should be used.

Relaxing the appraisal rules a bit, *Cave Buttes L.L.C. vs. Commissioner*, 147 T.C. No. 10 (2016), included in its official syllabus:

> *Held*: C's appraisal report substantially complied with the requirements of sec. 1.170A-13(c)(5)(iii), Income Tax Regs., by including one of the two appraisers' signatures on Form 8283, Noncash Charitable Contributions.
>
> *Held, further*, a description of the appraised property by address and characteristics is sufficient to strictly comply with sec. 1.170A-13(c)(3)(ii)(A), Income Tax Regs.
>
> *Held, further*, the wording in the appraisal report that it was conducted to value the property for "filing with the IRS" at least substantially, if not strictly, complied with sec. 1.170A-13(c)(3)(ii)(G), Income Tax Regs.

individuals, partnerships, and corporations and appear to be more liberal as to who the donee is.[1776] The substantiation rules can knock out contributions that qualify but for having timely documentation,[1777] and lack of a good appraisal may add valuation penalties[1778] even if the deduction is knocked out.[1779]

> *Held, further*, a difference between the date of valuation and the date of contribution of at least 11 days and at most 21 days, without any significant events' affecting the land during that time, substantially complies with sec. 1.170A-13(c)(3)(ii)(I), Income Tax Regs.
> *Held, further*, R conceded that the appraisal report's definition of fair market value, while not in strict conformity with the one in sec. 1.170A-1(c)(2), Income Tax Regs., substantially complied with it.

[1776] Code § 170(c) provides that "the term 'charitable contribution' means a contribution or gift to or for the purpose specified in section 170(c) (determined without regard to section 170(c)(2)(A))."
[1777] A reviewed decision, *15 West 17th Street LLC v. Commissioner*, 147 T.C. No. 19 (2016), disallowed a $64 million charitable deduction. The charity's acknowledgement of the gift failed to recite, as required by Code § 170(f)(8)(B)(ii), whether the charity provided any goods or services to the donor. The taxpayer lost even though the charity later filed an amended Form 990 stating the gift's value. Because no regulations implement Code § 170(f)(8)(D), taxpayers cannot rely on a charity's filing with the IRS as an exception to Code § 170(f)(8)(B)(ii).
However, *Big River Development, L.P. v. Commissioner*, T.C. Memo. 2017-166, held:

> LP did not receive from the donee organization a timely letter of the sort that normally acts as a "contemporaneous written acknowledgment" (CWA) within the meaning of section 170(f)(8)(B)…. We have previously held that a deed of easement may constitute a CWA. See *310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164; *RP Golf, LLC v. Commissioner,* T.C. Memo. 2012-282, 104 T.C.M. (CCH) 413; *Averyt v. Commissioner*, T.C. Memo. 2012-198, 104 T.C.M. (CCH) 65. We conclude that the deed of easement in this case qualifies as a CWA under the logic of these cases.

See fn. 1779 for a case that knocked out the charitable deduction for omitting its cost or other adjusted basis from its Form 8283.
[1778] See Code § 6664(c) and *Kaufman v. Commissioner*, 784 F.3d 56 (1st Cir. 2015), *aff'g* T.C. Memo. 2014-52. In affirming the imposition of penalties, the First Circuit reasoned:

> The Tax Court did not purport to equate "good faith investigation" with "exhaustive investigation." It merely required that the Kaufmans do some basic inquiry into the validity of an appraisal whose result was squarely contradicted by other available evidence glaringly in front of them.

[1779] *Partita Partners LLC v. U.S.*, 120 A.F.T.R.2d 2017-XXXX (D.C. NY 7/10/2017), which is consistent with another decision issued just a week before that one, *Reri Holdings I, LLC v. Commissioner*, 149 T.C. No. 1 (2017), the Official Tax Court Syllabus to which states:

> PS, a partnership, paid $2.95 million in March 2002 to acquire a remainder interest in property. The agreement that created the remainder interest provided covenants intended to preserve the value of the subject property but also limited the remedy available to the holder of the remainder interest for a breach of those covenants to immediate possession of the property; in no event would the holder of the corresponding term interest be liable for damages to the holder of the remainder interest. On Aug. 27, 2003, PS assigned the remainder interest to U, a university. On its 2003 Form 1065, U.S. Return of Partnership Income, PS claimed a deduction under sec. 170(a)(1) of $33,019,000. The Form 8283, Noncash Charitable Contributions, that PS attached to its return provides the date and manner of its acquisition of the contributed remainder interest but left blank the space for the "Donor's cost or other adjusted basis".
> *Held*: PS' omission from its Form 8283 of its cost or other adjusted basis in the contributed remainder interest violated the substantiation requirement of sec. 1.170A-13(c)(4)(ii)(E), Income Tax Regs.

However, rules requiring nongrantor trusts and estates to use gross income to make contributions can be tricky,[1780] especially when a nongrantor trust has unrelated business income.[1781]

A trust claiming a charitable deduction must identify the "governing instrument," show that the charitable contributions were paid "pursuant to" the terms of that instrument as required by Code § 642(c)(1), and demonstrate that each contribution was paid for a

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> *Held*, *further*, because PS' disclosure of its cost or other basis in the contributed property would have alerted R to a potential overvaluation of that property, omission of that information prevented the Form 8283 from achieving its intended purpose; the omission thus cannot be excused on the grounds of substantial compliance.
>
> *Held*, *further*, PS' failure to comply, either strictly or substantially, with the requirements of sec. 1.170A-13(c)(2), Income Tax Regs., requires denial in full of its claimed charitable contribution deduction.
>
> *Held*, *further*, because of the limitation on remedies available to the holder of the remainder interest for breaches of protective covenants, the agreement that created that interest did not provide adequate protection to its holder, for purposes of sec. 1.7520-3(b)(2)(iii), Income Tax Regs.; the standard actuarial factors provided under sec. 7520 thus do not apply in valuing the remainder interest; instead, the value of that interest is its "actual fair market value", determined without regard to sec. 7520, on the basis of all of the facts and circumstances. Sec. 1.7520-3(b)(1)(iii), Income Tax Regs.
>
> *Held*, *further*, on the basis of all of the facts and circumstances, the remainder interest that PS assigned to U on Aug. 27, 2003, had a fair market value on that date of $3,462,886.
>
> *Held*, *further*, because the $33,019,000 value that PS assigned to the remainder interest it transferred to U is more than 400% of that interest's actual fair market value, PS' claimed charitable contribution deduction resulted in a gross valuation misstatement. sec. 6662(e)(1)(A), (h)(2).
>
> *Held*, further, any underpayment resulting from the disallowance of PS' claimed charitable contribution deduction would be "attributable to" a gross valuation misstatement to the extent the underpayment relates to the disallowance of that portion of the deduction that exceeds $3,462,886. *AHG Invs., LLC v. Commissioner*, 140 T.C. 73 (2013). *885 Inv. Co. v. Commissioner*, 95 T.C. 156 (1990), overruled.
>
> *Held*, *further*, PS did not make a good-faith investigation of the value of the property subject to the remainder interest and thus did not have reasonable cause for, or act in good faith with respect to, its claim of a charitable contribution deduction that resulted in a gross valuation misstatement. sec. 6662(c)(2)(B).

As applied to each owner of the LLC (partner for income tax purposes):

> Although the liability of a particular partner for the gross valuation misstatement penalty will depend on the arithmetic threshold provided in section 6662(e)(2), no partner will be able to avoid the penalty on the basis of the reasonable cause exception provided in section 6664(c).

The Tax Court did not refer to an argument previously made about whether the donor should have listed the single-member LLC it contributed instead of the underlying assets, which argument was described in fn. 284 in part II.B Limited Liability Company (LLC).

[1780] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 3533-3534.

[1781] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 3545-3551, which impose individual percentage limitations in lieu of Code § 642(c) and seem to undo the benefits described above in the text accompanying fns. 1773 1776. This rule does not apply to estates. See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 3557-3558.

charitable purpose under Code § 170(c).[1782] Trustee discretion to distribute to charity satisfies the "pursuant to" standard;[1783] however, the trustee relevant documents must authorize the distributions.[1784] Payments an estate made to charity out of estate income attributable to that part of the estate transferred to charity, under the terms of a settlement agreement resulting from a will contest, qualify for a Code § 642(c) deduction;[1785] absent an actual dispute, the IRS has questioned the deduction.[1786] When a charitable lead annuity trust distributed more to charity than its annuity amount and that distribution was not clearly authorized, the trust received neither a charitable nor an income distribution deduction for those excess distributions.[1787] When a surviving spouse who had a general power of appointment over the marital trust created for her, exercised that power in favor of her estate, and left her estate to charity, the marital trust was not entitled to a charitable income tax deduction.[1788] When a trust gave a

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[1782] *Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67, citing *Brownstone v. United States*, 465 F.3d 525, 529 (2nd Cir. 2006).

[1783] *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), construing the predecessor to Code § 642(c), rejecting the IRS' narrow construction and adopting a broad definition of "pursuant to":

> We are asked to hold that the words "pursuant to" mean directed or definitely enjoined. And this notwithstanding the admission that Congress intended to encourage charitable contributions by relieving them from taxation. *Lederer, Collector, v. Stockton*, 260 U.S. 3, 43 S.Ct. 5, 67 L.Ed. 99; *United States v. Provident Trust Co., Administrator*, 291 U.S. 272, 285, 54 S.Ct. 389, 392, 78 L.Ed. 793.
>
> "Pursuant to" is defined as "acting or done in consequence or in prosecution (of anything); hence, agreeable, conformable; following; according."[3]
>
> [3] *Webster's New International Dictionary, Unabridged* (2d Ed.) 1935.

[1784] In rejecting a Code § 642(c) deduction when a pour-over revocable trust distributed to a charity that was a beneficiary under the grantor-decedent's will, *Love Charitable Foundation v. Commissioner*, 710 F.2d 1316 (8th Cir. 1983), reasoned:

> *Old Colony* stands for the proposition that a trust is entitled to a deduction when a trustee who is authorized but not required to make charitable contributions under the trust instrument does in fact make charitable contributions. We do not believe, however, that the *Old Colony* case and the definition of "pursuant to" given in that case should be read so broadly as to entitle a trust to a charitable deduction when a trustee, acting without any authority under the trust instrument, distributes the Trust assets to charity. Rather, as stated earlier, we believe it is necessary that a trust instrument authorize the trustee to make charitable contributions if it is to be said that the charitable contributions were made "pursuant to the terms of" the Trust instrument.

[1785] Rev. Rul. 59-15, which was followed by Letter Ruling 9044047 regarding the settlement of a dispute among all interested parties, including the state attorney general.

[1786] CCA 200848020.

[1787] *Crown Income Charitable Fund v. Commissioner*, 98 T.C. 327 (1992), *aff'd* 8 F.3d 571, 573 (7th Cir. 1993). In denying the income distribution deduction as an alternative when the charitable deduction was disallowed, the Tax Court referred to Reg. § 1.663(a)-2, which provides:

> Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c).

[1788] *Brownstone v. U.S.*, 465 F.3d 525 (2nd Cir. 2006). Instead of claiming the charitable deduction, the trust should have taken an income distribution deduction and the estate then taken the charitable deduction. Thus, the court was correct to deny the charitable deduction. However, rather than saying the above, the court used the following reasoning:

> Appellant's arguments are equally unavailing. Appellant asks us to consider Ethel's power of appointment and Lucien's will together as the governing instrument, but as the district court noted on the record, the statute refers to "governing instrument" in the

beneficiary an inter vivos power of appointment in favor of charity that the beneficiary

singular. To combine Ethel's power of appointment with Lucien's will and deem the resultant agglomeration the "governing instrument" strains the statute's text. We agree with appellant that ordinarily "governing" can imply a broader subject-object relationship than does "creating." Nevertheless, we find that the implication is neutralized by the statute's legislative history, which deems the current statute and its predecessor "comparable." We also agree with the district court that "the legislative history doesn't suggest that there is any attempt to broaden the prior law...."

In construing the statute, however, we do not go so far as to equate "governing instrument" with "will or deed creating the trust." Instead, we note "[i]t is a common principle of taxation that where doubt exists, courts should resolve deductions in favor of the government: 'Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.'" *Holmes v. United States*, 85 F.3d 956, 961 n.3 (2d Cir. 1996) (quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)). Here, Congress has not made clear provision that an instrument subsequent to the creating instrument, such as Ethel's exercise of the power of appointment, in Article Third of her will, when combined with the "creating" deed or will, such as Lucien's will, could qualify as a "governing instrument." Under this rule of construction, because there is no such clear provision, Ethel's appointment, combined with Lucien's will, cannot qualify as a governing instrument under § 642(c)(1). Indeed, were the Tax Code to permit a trustee to agglomerate the separately manifested intents of diverse testamentary instruments so as to create a single, chimerical "governing instrument," it would greatly enhance the ability of trusts to obtain income tax deductions. For this, Congress has not made clear provision. We hold, therefore, that the governing instrument in this case is not a combination of two separate instruments. It is Lucien's will alone.

The second step in our inquiry leads us to determine whether Ethel's distribution was made "pursuant to" the governing instrument, Lucien's will. In *Old Colony*, the U.S. Supreme Court held: "'Pursuant to' is defined as 'acting or done in consequence or in prosecution (of anything); hence, agreeable; conformable; following; according.'" 301 U.S. at 383-84. This standard is permissive, but it "still conveys more than 'not in violation of'." *Weir Foundation*, 362 F.Supp. at 939. Therefore, "the instrument must be shown to possess some positive charitable intent or purpose of the settlor–not merely that the settlor did not exclude charity from all the possible beneficiaries of his bounty." *Id.* Ethel's will, in exercising the power of appointment, did not make the charitable distribution "pursuant to" the terms of Lucien's will because Lucien's will does not express sufficient charitable intent with respect to the Trust principal. In Article Seventh of his will, Lucien established the Trust for the support and maintenance of his wife. Article Seventh also gave Ethel a power of appointment that allowed her to distribute the Trust principal in any manner she saw fit. Only if she did not validly exercise that power would the Trust principal pass to a charitable organization. By the terms of Lucien's will, Ethel could have distributed the Trust principal entirely to private individuals. Just as easily, she could have distributed the Trust principal entirely to charity. But the choice was Ethel's alone, and Lucien's will expressed no preference. Indeed, Lucien's will necessarily abandoned all charitable intent with respect to the Trust principal in creating the power of appointment; if it had not, the Trust could not have taken advantage of the marital deduction. See 26 U.S.C. § 2056(b)(5). Once Ethel received the power of appointment, Lucien's will could not bind her to any course of action, charitable or otherwise. We agree with the district court: "She was not compelled to give one penny to charity. The governing instrument did not govern her free exercise of her discretion in any way, shape or form." Thus, Ethel did not make her distribution "pursuant to" the terms of the governing instrument.

The above analysis went way beyond what was necessary to resolve the case.

exercised to direct charitable distributions, Letter Ruling 201225004 allowed the charitable deduction. However, CCA 201651013 asserted no charitable deduction and no income distribution deduction when a court order gave a beneficiary an inter vivos power to appoint to charity and the beneficiary exercised it.[1789] Furthermore, the "pursuant to" requirement was not met when a court modified a trust to add charities as income beneficiaries when only individuals were beneficiaries and the charities did not become beneficiaries until a later taxable year, even though the court action purported to be a construction and not a modification.[1790] To avoid controversy, consider expressly authorizing the trustee to make charitable distributions or a beneficiary to exercise an inter vivos power of appointment in favor of charity. Also, consider having the trust participate in a partnership that makes the donation, which may avoid needing to satisfy the "pursuant to" requirement.[1791]

A trust claiming Code § 642(c) charitable deduction may have additional filing requirements. Split-interest trusts described in Code § 4947(a)(2) have their own filing

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[1789] The CCA, which was issued in the name of Brad Poston, a well-respected senior IRS official, reasoned:

> In the current case, the taxpayer makes a summary argument that the payments qualify under § 642(c) because they are pursuant to the governing instrument, citing to *Old Colony*. They do not address the authorities concerning deductions under modified trust instruments. Here there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The trust terms were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believe they will receive from the modification of the Parent Trust. Neither Rev. Rul. 59-15 nor *Emanuelson* hold that a modification to a governing instrument will be construed to be the governing instrument in situations where the modification does not stem from a conflict of some sort. Additionally, both *Crown* and *Brownstone* have a narrow interpretation of what qualifies as pursuant to a governing instrument. Therefore, any payments to Foundation 1 and Foundation 2 after the modification of Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).

In denying the income distribution deduction, the CCA looked at Reg. § 1.663(a)-2, reproduced in fn. 1787, but took a much closer look at the issues that it said that the regulation definitively resolved. However, the CCA failed to consider Rev. Rul. 73-142, which would seem to resolve the issue in favor of the taxpayer; see fn. 4777, in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers, giving <u>prospective</u> effect to a court modification. Following up on this and other issues, CCA 201747005 discussed Rev. Rul. 73-142; however, the CCA's arguments focused on will/trust construction cases being retroactive under *Bosch* and did not distinguish that in its reasoning from the much lower hurdle of merely needing a final court decree required for respecting court action prospectively. For example, the CCA cited *Hubbell* (see fn. 1790) as favoring the CCA's position when *Hubbell* addressed only an attempt to apply a decree retroactively.

[1790] *Hubbell Trust v. Commissioner*, T.C. Summ. Op. 2016-67. The probate court order stated:

> The language of the Will, as written, providing for the administration of the Trust, authorizes, and has from the inception of the Trust authorized, the Trustees of the Trust to make distributions of income and principal for charitable purposes specified in Internal Revenue Code section 170(c), or the corresponding provision of any subsequent federal tax law, both currently and upon termination of the Trust.

The Tax Court rejected the purposed construction, holding that the will did not provide for charitable contributions during that time period and that there was no ambiguity about that. Note that Rev. Rul. 73-142, referred to in fn. 1789, provides relief prospectively only.

[1791] See fn. 3534, in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

requirements.[1792] Other trusts claiming Code § 642(c) deductions have certain filing requirements (Form 1041-A)[1793] unless "all the net income for the year, determined under the applicable principles of the law of trusts, is required to be distributed currently to the beneficiaries,"[1794] or the trust is described in Code § 4947(a)(1).[1795]

Charitable contributions are merely deductions and do not trigger issuing a K-1 to the charity.[1796]

II.J.4.d. Possible Change in Beneficiary's Residence

A beneficiary changing residence might change the beneficiary's income tax posture and possibly the trust's residence. See part II.J.3.e State and Local Income Tax.

II.J.4.e. Material Participation for Business or Rental Activities

The 3.8% tax on net investment income[1797] applies to passive activities a trust holds.[1798] However, if the business has enough potential for ups and downs in its taxable income that planning for a potential significant loss becomes important, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, discussing a trade-off between NII tax and regular income.

Special rules apply to trusts when determining whether an activity is passive.[1799]

Consider how to document[1800] the trustee's participation as trustee in business activities,[1801] whether the trust should be converted to a beneficiary grantor trust to use

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[1792] Code § 6034(a). Code § 4947(a)(2) describes:

> … a trust which is not exempt from tax under section 501(a), not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 ….

[1793] Code § 6034(b)(1).

[1794] Code § 6034(b)(2)(A). Form 1041-A instructions refer to Code § 643(b) income. For more on Code § 643(b) income, see parts II.J.8.c.i.(a) Power to Adjust, II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[1795] Code § 6034(b)(2)(B). Code § 4947(a)(1) describes:

> … a trust which is not exempt from taxation under section 501(a), all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522 (or the corresponding provisions of prior law)….

[1796] See fn. 3561, found in part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

[1797] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[1798] See part II.I.8 Application of 3.8% Tax to Business Income, especially part II.I.8.g Structuring Businesses in Response to 3.8% Tax.

[1799] See part II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business.

[1800] See part II.K.1.a.vi Proving Participation.

[1801] The IRS argues that the trust does not get credit for work a trustee does as an individual. See part II.K.2.b.i Participation by a Nongrantor Trust: Authority. Although the IRS has lost in court, one might consider avoiding being a test case. Accordingly, for steps one might consider the beneficiary's work rather than the trustee's work,[1802] and the effect of the beneficiary's participation on any depreciation deductions.[1803]

II.J.4.f. Making Trust a Partial Grantor Trust as to a Beneficiary

If the trustee believes that a permanent change to the trust's income tax posture shifting income to the beneficiary would be helpful,[1804] the trustee might try to convert a trust to a partial beneficiary grantor trust[1805] by exercising discretion to declare a distribution. However, rather than make an actual distribution, with respect to the lesser of $5,000 or 5% of the trust's assets the trustee grants the beneficiary the power to withdraw the declared amount or portion.[1806] When the withdrawal right lapses, presumably Code § 678(a)(2) would make the beneficiary a deemed owner as to that portion.

Over time, the portion deemed owned by the beneficiary increases.

II.J.4.g. Making the Trust a Complete Grantor Trust as to the Beneficiary

If the beneficiary being taxed on the trust's income is desirable, whether because of rates or a desire to accumulate funds in the trust, then consider converting the trust to a qualified subchapter S trust (QSST).[1807]

The trust forms an S corporation, the trust is modified as needed to be eligible for a QSST election, and the beneficiary makes a QSST election.

The beneficiary is taxed on the trust's distributive share of the S corporation's income.

Although the trust must distribute all of its income, income generally means distributions from the S corporation, and the trustee as the sole shareholder can control how much the S corporation distributes.[1808] Note that the trust can continue to be a discretionary trust as to income if all of the income is actually distributed.[1809] Mandatory income is safer in that it prevents a misstep in not distributing enough income, but in some cases the flexibility is more important (in a mandatory income trust, the beneficiary might pressure the trustee to distribute more from the S corporation).

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to comply with the IRS' position, see part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

1802 See parts II.K.2.c Participation When Grantor Trusts Are Involved; Effect of Toggling and III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

1803 As described in part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses), depreciation deductions often pass through to the income beneficiaries, bypassing the usual fiduciary income tax filter. Therefore, the beneficiary's work is the only counted as participation in deciding whether the deductions are allowable.

1804 See part II.J.3 Strategic Fiduciary Income Tax Planning.

1805 See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts, especially part III.B.2.i.vi.(b) Determining Portion Owned When Trust Is Only a Partial Grantor Trust.

1806 See text accompanying fns. 1567-1569.

1807 See parts III.A.3.e.i.(a) QSSTs Generally and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

1808 See part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries and III.A.4 Trust Accounting Income Regarding Business Interests.

1809 See parts III.A.3.e.i.(a) QSSTs Generally (especially fn. 4468) and III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

Unlike the partial grantor trust strategy mentioned above, this trust's beneficiary grantor status can be toggled off, with income being accumulated in the trust.[1810]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[1811]

II.J.4.h. Trapping Income in Trust Notwithstanding Distributions – ESBT

Just as in the above strategy, the trust forms an S corporation, only this time makes an electing small business trust (ESBT) election[1812] or creates another trust.

The trust's distributive share of S corporation income is taxed to the trust, even if distributed to the beneficiary.

To better control the effect of distributions, if the trust reinvests its distributions in taxable investments then it should divide and put those assets in a separate trust.[1813]

If circumstances change, the trust could toggle to being taxed to the beneficiaries.[1814]

Before engaging in this approach, be careful to plan an exit strategy upon termination.[1815]

II.J.4.i. Modifying Trust to Make More Income Tax Efficient

In some states, the settlor and all beneficiaries may amend a noncharitable irrevocable trust, even if the modification or termination is inconsistent with a material purpose of the trust.[1816]

Also, depending on the distribution standard and state law, the trustee might be able to change a trust using decanting.[1817] Decanting might be done by merely amending the trust rather than by actually transferring assets to another trust.[1818] If the trust's situs has

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1810 See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.
1811 See parts III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made) and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.
1812 See part III.A.3.e.ii ESBTs.
1813 See part III.A.3.e.ii.(c) When ESBT Income Taxation Might Help.
1814 See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.
1815 See parts III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made) and III.A.3.e.i.(b) QSST Issues When Beneficiary Dies.
1816 Uniform Trust Code § 401, found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.4A-411, found at http://www.moga.mo.gov/mostatutes/stathtml/45604A04111.html.
1817 Uniform Trust Decanting Act, found at http://www.uniformlaws.org/Act.aspx?title=Trust Decanting, with the drafting committee's work found at http://www.uniformlaws.org/Committee.aspx?title=Trust%20Decanting; R.S.Mo. § 456.4-419, found at http://www.moga.mo.gov/mostatutes/stathtml/45600404191.html. Before considering decanting a QSST, see fn. 4463, found in part III.A.3.e.i.(a) QSSTs Generally.
1818 Uniform Trust Decanting Act (fn. 1817) § 2(23)(A), authorizes amending a trust without transferring assets. The official Comments state:

> Thus the authorized fiduciary may exercise the decanting power by modifying the first trust, in which case the "second trust" is merely the modified first trust. The decanting

moved since inception, the trust's situs (not the substantive law of the original state) determines authority to decant through merger.[1819] If decanting is done using asset transfers to a new trust, see part II.G.1.c How and When to Obtain or Change an Employer Identification Number (EIN)How and When to Obtain or Change an Employer Identification Number (EIN), fn. 784. The private letter rulings that fn. 784 cited treated the new trusts as continuation of the old trust rather than treating the transfers as distributions from the old trust to the new trusts.

See also part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner, especially fns 5269-5270.

II.J.4.j. Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure

II.J.4.j.i. Need to Provide Notices

In Missouri and many other states, a beneficiary can sue a trustee any time before five years after the first to occur of the trustee's removal, resignation, or death of the trustee, the termination of the beneficiary's interest in the trust, or the trust's termination.[1820]

However, a beneficiary may not sue a trustee more than one year after the last to occur of the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential claim for breach of trust and the date the trustee informed the beneficiary of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.[1821]

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instrument can, when appropriate, merely identify the specific provisions in the first trust that are to be modified and set forth the modified provisions, much like an amendment to a revocable trust. If the decanting power is exercised by modifying the terms of the first trust, the trustee could either treat the second trust as a new trust or treat the second trust as a continuation of the first trust. If the second trust is treated as a continuation of the first trust, there should be no need to transfer or retitle the trust property. Further, subject to future tax guidance, if the second trust is a continuation of the first trust, there may be no need to treat the first trust as having terminated for income tax purposes and no need to obtain a new tax identification number.

[1819] Letter Ruling 201711002.

[1820] Section 1005(c) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provides:

(c) If subsection (a) does not apply, a judicial proceeding by a beneficiary against a trustee for breach of trust must be commenced within five years after the first to occur of:
  (1) the removal, resignation, or death of the trustee;
  (2) the termination of the beneficiary's interest in the trust; or
  (3) the termination of the trust.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[1821] Section 1005(a) and (b) of the Uniform Trust Code (http://www.uniformlaws.org/Act.aspx?title=Trust Code), provide:

(a) A beneficiary may not commence a proceeding against a trustee for breach of trust more than one year after the date the beneficiary or a representative of the beneficiary was sent a report that adequately disclosed the existence of a potential

A report adequately discloses the existence of a potential claim if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.[1822] The trustee may choose to disclose less than complete information; in that case, the trustee is protected only with respect to the information that is disclosed.

The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it. Given that a beneficiary's failure to bring a claim might constitute a gift,[1823] allowing any disputes to settle annually might minimize gift tax issues.

Each year, after a tax return preparer's peak period ends, the preparer might consider suggesting that the trustee contact counsel and obtain help in putting together an annual notice. The tax return preparer can compile the information, especially given that many preparers keep records in PDFs and can easily burn them to a CD. Part II.J.4.j.ii provides an example of what that might look like.

Every trustee should consider following this procedure:

- <u>Litigious Beneficiaries</u>. Having as few years as possible open will help reduce the stakes and make it less worthwhile for them to spend money to take legal action. Annual notices require them to state their concerns now, rather the criticizing many years in the future – put up or shut up. And, if the trustee has made a mistake (nobody's perfect), the trustee is in a better position to rectify it now than after the mistake's effects have been compounded for many years.

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claim for breach of trust and informed the beneficiary of the time allowed for commencing a proceeding.

(b) A report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.

Missouri's version is R.S.Mo. § 456.10-1005, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[1822] Uniform Trust Code § 1005(b), found at http://www.uniformlaws.org/Act.aspx?title=Trust Code; R.S.Mo. § 456.10-1005.2, found at http://www.moga.mo.gov/mostatutes/stathtml/45601010051.html.

[1823] The failure to assert a claim is a gift when the right to assert the claim becomes foreclosed, Rev. Rul. 84-105, which is described in fn. 4779, which is found in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers. Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> … the right in a beneficiary of a trust to assent to a periodic accounting, thereby relieving the trustee from further accountability, is not a power of appointment if the right of assent does not consist of any power or right to enlarge or shift the beneficial interest of any beneficiary therein.

If somehow the consent does somehow consist of any power or right to enlarge or shift a beneficial interest, note that a principal/income allocation generally is only a few percent, and a beneficiary's failure to object to an accounting – if somehow characterized as a lapse of a general power of appointment - might very well be less than the 5% lapse of a general power of appointment that, under Code § 2514(e), does not constitute a gift. Having an annual report keeps the grievances within the 5% range.

- One Big Happy Family. Sure, everyone's happy now. But relationships can change overnight – a beneficiary gets divorced, has a business failure, becomes addicted to drugs, is struck by physical or mental illness that changes his or her outlook on life, undergoes other financial or emotional stress, or simply starts disliking the trustee. Provide notices now, while everyone is happy and unlikely to complain. Besides, the trustee generally should be keeping beneficiaries informed anyway. Notices now can prevent a big claim later if a blow-up occurs.

Generally, a trustee may use the trust's resources to provide notices, respond to questions, provide distributions to some beneficiaries to adjust for perceived unfairness in distributions to other beneficiaries, and defend lawsuits (so long as the trustee did not engage in bad faith or reckless indifference to the beneficiaries' interests).

Countervailing this recommendation are concerns about the effect of notices on the beneficiaries themselves. The trustee might be concerned that knowing that a pool of funds is available for a beneficiary might change the beneficiary's behavior – make the beneficiary more interested in draining the trust than earning a living, generate a sense of entitlement, or encourage the beneficiary to ask the grantor or the grantor's surviving spouse for money. The trustee will need to weigh those concerns against the trustee's legal exposure and general duties to provide information and might even decide that serving as trustee is too thankless a task. Better to think about these issues now and with eyes opened than to encounter a surprise.

II.J.4.j.ii. Sample Notice

After this paragraph, the rest of this part II.J.4.j.ii is a shell of a notice I have used. The trustee should consult with the trustee's own legal counsel to determine the advisability and sufficiency of such a notice under the circumstances.

Re: Trustee's Notice re: [trust's name]

As you know, the [trust's name] (the "Trust") was created by the [name of trust agreement].

As a beneficiary of the Trust, and on behalf of any other current or future beneficiaries of the Trust, you have the right to request a copy of the [name of trust agreement] and to receive information about the Trust's investments and other activity.

[Disclose any related party transactions.]

The enclosed CD-ROM contains the following information for the Trust for the period of January 1, 20xx, through December 31, 20xx:

1. [any trust accounting regularly prepared]

2. [brokerage statements]: January 1, 20xx, through December 31, 20xx

3. 20xx Fiduciary Income Tax Return for the Trust

4. Investment policy for [brokerage account or for trust as a whole]

If you have any questions with respect to this letter and the information contained on the enclosed CD-ROM, or if you have any difficulty accessing the information, please contact me. If you want to make a claim that I, as trustee, have breached any duty with respect to the Trust, you have one (1) year from the last to occur of (i) the date on which you (or your representative) were sent a report that adequately disclosed the existence of potential claim for breach of trust, and (ii) the date you were informed of the time allowed for commencing a proceeding with respect to any potential claim adequately disclosed on the report.

Attached you will find an Acknowledgement confirming receipt of this information. Please sign and date the acknowledgement and return it via fax or email to my attention.

Thank you.

[closing]

[page break]

ACKNOWLEDGEMENT

On my behalf and on the behalf of any other current or future beneficiaries, I hereby acknowledge receipt of the Trustee's Notice to the beneficiaries of the [trust's name], which includes reports relating to the trust's activities for the period January 1, 20xx, through December 31, 20xx.

[signature line and date blank]

II.J.5. Issues Arising with Mandatory Income Trusts

For very important limitations on the use of the Code § 642(c) charitable deduction, see fns. 1768-1769 in part II.J.4.c Charitable Distributions.

Some of the interplay between entities and trusts is described in parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.

Also consider what happens when a trust holds only illiquid business assets and the trust needs to pay the trustee fee. Generally, one-half of trustee fees and certain other administrative expenses is allocated to income and one-half to principal.[1824] Using the trust's income to pay trustee fees, etc. attributable to would be problematic. Consider:

- Draft into the trust agreement language flexible enough to opt out of this general rule.[1825]

- Consider exercising a power to adjust, reclassifying some of the entity's distributions from income to principal, if the income that the business generates after the

[1824] Section 501 of the Uniform Principal & Income Act.

[1825] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1878.

adjustment fairly balances the interests of the income beneficiary and remaindermen.[1826]

- Consider that the trustee might not have any significant activities directly on behalf of the trust and might instead spend most of his or her time running the business entity. This would especially be true if the entity was formed to hold investment assets. Perhaps the business entity should pick up a large majority of the burden of compensating the trustee, so that the above two recommendations are more palatable?

- Have the entity make noncash distributions, which generally are treated as principal.[1827] The trust can then sell those assets and use the proceeds to pay trustee fees. Note that a distribution of property is a recognition event for corporations[1828] and might be a recognition event for partnerships,[1829] so consider distributing high basis assets (which the entity might need to purchase).

Also consider whether the trustee needs to sell part of the unmarketable asset or planning to avoid this issue.[1830]

II.J.6. Income Allocation on Death of a Beneficiary

If income is required to be distributed currently to a beneficiary, by a trust for a taxable year which does not end with or within the last taxable year of a beneficiary (because of the beneficiary's death), the extent to which the income is included in the gross income of the beneficiary for the beneficiary's last taxable year or in the gross income of the beneficiary's estate is determined by the computations under Code § 652 for the taxable year of the trust in which his last taxable year ends.[1831] Consider whether income should be expressly payable or not payable to the beneficiary's estate.

If an amount is paid, credited, or required to be distributed by an estate or trust for a taxable year which does not end with or within the last taxable year of a beneficiary

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[1826] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text in fn. 1863.

[1827] Section 401(c)(1) of the Uniform Principal & Income Act.

[1828] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[1829] See part II.Q.8.b.i Distribution of Property by a Partnership.

[1830] See parts III.A.4.c.iii.(b) What The Trustee Must Do To Alter The Trust's Investments If The Trust Agreement Does Not Address The Issue and III.A.4.c.iii.(c) How To Minimize Disputes About What The Trustee Should Do.

[1831] Reg. § 1.652(c)-2, which further provides:

> Thus, the distributable net income of the taxable year of the trust determines the extent to which the income required to be distributed currently to the beneficiary is included in his gross income for his last taxable year or in the gross income of his estate. (Section 652(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the decedent's death. If the trust does not qualify as a simple trust for the taxable year of the trust in which the last taxable year of the beneficiary ends, see section 662(c) and § 1.662(c)-2.

(because of the beneficiary's death), the extent to which the amount is included in the gross income of the beneficiary for his last taxable year or in the gross income of his estate is determined by the computations under Code § 662 for the taxable year of the estate or trust in which his last taxable year ends.[1832]

Both of these rules are subject to part II.J.9.a Separate Share Rule.

II.J.7. Election to Treat a Revocable Trust as an Estate

An election under Code § 645, filing IRS Form 8855, causes a qualified revocable trust[1833] to be taxed as part of an estate. The form is due by the time of the first income tax return filed for the grantor's estate (or grantor's revocable trust, if no probate estate exists). Although the form allows the trust to simply use the estate's EIN, consider whether the trust might not be distributed past the "applicable date" described below and therefore should obtain its own EIN so that accounts do not need to be changed after the "applicable date."

Among benefits are an unlimited charitable set-aside (which is not always beneficial)[1834] and UBTI not reducing the charitable deduction,[1835] deducting losses on funding pecuniary bequests, more favorable time deadlines for holding or making elections with respect to stock in an S corporation, and being able to deduct losses from certain active

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[1832] Reg. § 1.662(c)-2, which further provides:

> Thus, the distributable net income and the amounts paid, credited, or required to be distributed for the taxable year of the estate or trust, determine the extent to which the amounts paid, credited, or required to be distributed to the beneficiary are included in his gross income for his last taxable year or in the gross income of his estate. (Section 662(c) does not apply to such amounts.) The gross income for the last taxable year of a beneficiary on the cash basis includes only income actually distributed to the beneficiary before his death. Income required to be distributed, but in fact distributed to his estate, is included in the gross income of the estate as income in respect of a decedent under section 691. See paragraph (e) of § 1.663(c)-3 with respect to separate share treatment for the periods before and after the death of a trust's beneficiary.

[1833] "Qualified revocable trust" means any trust treated under Code § 676 as owned by the decedent by reason of a power in the grantor, determined without regard to Code § 672(e). Code § 645(b)(1).

[1834] Code § 642(c)(1) and the regulations thereunder allow trusts to deduct gross income paid to charity during the taxable year and the following taxable year. Code § 642(c)(2) and the regulations thereunder (as well as Reg. § 1.645-1(e)(2)(i) and(e)(3)(i)) authorize estates to deduct gross income permanently set aside; however, contingent claims, regardless of size, might disallow the entire set-aside deduction. *Belmont v. Commissioner*, 144 T.C. No. 6 (2015). Reg. § 1.642(c)-2(d) provides, "No amount will be considered to be permanently set aside, or to be used, for a purpose described in paragraph (a) or (b)(1) of this section unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible." *Estate of John D. DiMarco v. Commissioner*, T.C. Memo. 2015-184, citing *Belmont*, concerned with the uncertainty of administrative expenses in light of litigation, disallowed the charitable set-aside, holding, "By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed its income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible."

[1835] See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, especially fn. 3557.

real estate rental.[1836] However, beware state income results – it might be easier for a state to claim jurisdiction over an estate than a trust, so making the Code § 645 election might convert a nonresident trust to a resident estate;[1837] note that this result might be better if the trust would be taxed in a high-tax state and the estate taxed in a low-or-no-tax state. Also, if the trust owns stock in an S corporation that makes material charitable contributions, an ESBT election may facilitate deducting the charitable contribution deduction.[1838]

This treatment expires on the "applicable date." If no estate tax return is required to be filed, the "applicable date" is two years after the date of the decedent's death;[1839] otherwise, it is six months after the date of the final determination of estate tax liability.[1840] Final determination of estate tax liability is the earliest of the following:[1841]

(A) The date that is six months after the issuance by the Internal Revenue Service of an estate tax closing letter, unless a claim for refund with respect to the estate tax is filed within twelve months after the issuance of the letter;

(B) The date of a final disposition of a claim for refund, as defined in paragraph (f)(2)(iii) of this section, that resolves the liability for the estate tax, unless suit is instituted within six months after a final disposition of the claim;

(C) The date of execution of a settlement agreement with the Internal Revenue Service that determines the liability for the estate tax;

(D) The date of issuance of a decision, judgment, decree, or other order by a court of competent jurisdiction resolving the liability for the estate tax unless a notice of appeal or a petition for certiorari is filed within 90 days after the issuance of a decision, judgment, decree, or other order of a court; or

(E) The date of expiration of the period of limitations for assessment of the estate tax provided in section 6501.

The IRS might not issue a closing letter until the estate requests one, thereby extending the time that a Code § 645 might continue to apply under (A) above.[1842]

After receiving a closing letter, the estate might try to extend the Code § 645 election by filing a claim for refund for expenses in administering the Code § 6166 election.[1843]

[1836] See part II.K.1.e.iv Active Rental Subject to AGI Limits, especially fn. 2209.

[1837] See part II.J.3.e.i Residence Generally. For example, RSMo § 143.331 (http://www.moga.mo.gov/mostatutes/stathtml/14300003311.html) treats an estate as a resident merely if the decedent was domiciled in Missouri, whereas a trust is not a resident unless not only was the settlor a resident but also the trust has at least one income beneficiary who, on the last day of the taxable year, was a resident of Missouri.

[1838] See part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income, fn 3538 and the text preceding it.

[1839] Code § 645(b)(2)(A).

[1840] Code § 645(b)(2)(B).

[1841] Reg. § 1.645-1(f)(2)(ii).

[1842] See fn. 5458, found in part III.B.5.d.iv.(g).

II.J.8. Allocating Capital Gain to Distributable Net Income (DNI)

Although the discussion below generally refers to trusts, generally it applies to estates as well. If a trustee has discretion to make an election regarding that trust, the election does not affect the choices available regarding other trusts the trustee manages.[1844]

II.J.8.a. Capital Gain Constitutes DNI Unless Excluded

Taxable income is DNI unless expressly excluded.[1845]

Code § 643(a)(3) provides:[1846]

[1843] Reg. § 1.645-1(f)(2)(ii). Jonathan Blattmachr suggested this idea. Note that Rev. Rul. 76-23 held that, "where the sole purpose for retaining stock of a small business corporation in an estate of a deceased shareholder is to facilitate the payment of the estate tax under section 6166 of the Code, the administration of the estate will not be considered unreasonably prolonged for purposes of section 641(a)(3), and thus the estate will continue to be an eligible shareholder within the meaning of section 1371(a) for the period during which the estate complies with the provisions of section 6166." Contrast this to an estate, for which Reg. § 1.641(b)-3(a) discusses whether administration is unduly prolonged:

> The income of an estate of a deceased person is that which is received by the estate during the period of administration or settlement. The period of administration or settlement is the period actually required by the administrator or executor to perform the ordinary duties of administration, such as the collection of assets and the payment of debts, taxes, legacies, and bequests, whether the period required is longer or shorter than the period specified under the applicable local law for the settlement of estates. For example, where an executor who is also named as trustee under a will fails to obtain his discharge as executor, the period of administration continues only until the duties of administration are complete and he actually assumes his duties as trustee, whether or not pursuant to a court order. However, the period of administration of an estate cannot be unduly prolonged. If the administration of an estate is unreasonably prolonged, the estate is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the performance by the executor of all the duties of administration. Further, an estate will be considered as terminated when all the assets have been distributed except for a reasonable amount which is set aside in good faith for the payment of unascertained or contingent liabilities and expenses (not including a claim by a beneficiary in the capacity of beneficiary). Notwithstanding the above, if the estate has joined in making a valid election under section 645 to treat a qualified revocable trust, as defined under section 645(b)(1), as part of the estate, the estate shall not terminate under this paragraph prior to the termination of the section 645 election period. See section 645 and the regulations thereunder for rules regarding the termination of the section 645 election period.

[1844] Reg. § 1.643(a)-3(e), Example (14).

[1845] Code § 643(a) provides:

> For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications….

[1846] Code § 643(a)(3) further provides:

> Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The exclusion under section 1202 shall not be taken into account.

> *Capital gains and losses*. Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c).

Thus, to be excluded, the gains must:

- Arise from the sale or exchange of capital assets,
- Be allocated to corpus, and
- Not be actually or deemed to be distributed.

The rest of this part II.J.8.a Capital Gain Constitutes DNI Unless Excluded focuses on the first two prongs.

II.J.8.a.i. Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset

Only gains from the sale of capital assets are ordinarily excluded from DNI.[1847]

For example, "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business" is not a capital asset.[1848] Therefore, the sale of such property would constitute DNI, although it would not constitute trust accounting income.[1849] Whether other real estate is a capital asset depends on various facts.[1850]

However, "any recognized gain on the sale or exchange of property used in the trade or business" often receives capital gain treatment[1851] to the extent it does not constitute certain depreciation recapture.[1852] Goodwill that has not been amortized is a capital asset, but goodwill that is being amortized is not a capital asset.[1853] Thus, because

[1847] Code § 643(a)(3); Reg. § 1.643(a)-3(a).

[1848] Code § 1221(2).

[1849] Section 401(c)(1) of the Uniform Principal & Income Act.

[1850] See part II.G.12 Future Development of Real Estate, especially fn. 1042.

[1851] Code § 1231(a)(3)(A)(i). See part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business.

[1852] Depreciation recapture on the sale of tangible personal property is taxed as ordinary income; see fn. 965. Depreciation recapture on the sale of real property tends to be taxed as a capital gain but at a higher rate; see fn. 966. Note that cost segregation studies might break out building components as tangible personal property, so be sure to ask about this possibility when advising on the sale of a building. For various tips under regulations that applied starting in 2014, see Wood and Abdoo, "Applying the Final Tangible Property Regulations to Tenant Fit-Ups," *TM Real Estate Journal* (BNA) (9/2/2015); Atkinson and Afeman (KPMG), "The Tangible Property Regulations: Considerations For the Real Estate Industry," *TM Memorandum* (BNA) (9/7/2015). In October 2016, the IRS made major revisions to its Cost Segregation Audit Techniques Guide, found at https://www.irs.gov/businesses/cost-segregation-audit-techniques-guide-table-of-contents.

[1853] Letter Ruling 200243002. For more discussion of goodwill, see fns. 1306, 2997, and 3034 (especially the latter).

such assets are not capital assets, such capital gains generally would be included in DNI.

II.J.8.a.ii. Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus

I am unaware of any authority defining "allocated to corpus" as used in Code § 643(a)(3). Presumably it means receipts by the trust that are allocated to principal.

Does the statute mean that capital gain are automatically included in DNI unless they are affirmatively allocated to principal and certain other conditions exist? Reg. § 1.643(a)-3(a) might overrule that requirement, providing (highlighting added):

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

This regulation essentially has three parts:

- Reg. § 1.643(a)-6 deals with foreign trusts.

- Reg. § 1.643(a)-3(b) explains when capital gains from the sale or exchange of an asset are included in DNI and does not include a requirement that the capital gain be allocated to principal.[1854] In fact, one of the prongs discusses the treatment when capital gains are allocated to income.[1855]

- Depending on the meaning one gives to "ordinarily," this regulation might dispense with the statutory requirement that capital gains be allocated to corpus. The regulation does not explain when it says "ordinarily" what the exceptions might be, other than Reg. §§ 1.643(a)-6 and 1.643(a)-3(b). There would appear to be substantial authority for saying that an affirmative allocation of capital gains to principal is or is not required.

This issue seems to be most important for the trust's gross income that does not take the form of receipts of cash or other property. For example, a trust might invest in a partnership, S corporation, or other flow-through entity that does not distribute all of its taxable income. How should one treat capital gain from a flow-through entity's sale of a capital asset, when the entity distributes less than all of its taxable income? Should the undistributed capital gain be included in DNI?

- With respect to the accumulated capital gain, the trust has no receipts and therefore is not allocated to corpus. Arguably, the capital gain is not excluded from DNI and therefore constitutes DNI.

[1854] See part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal, which quotes the regulation.

[1855] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law and the various subparts thereunder.

- On the other hand, the accumulated capital gain benefits the trust's corpus. Should it be treated as if it had been allocated to corpus? In that case, should it be trapped inside the trust, given that it was accumulated inside the entity and not distributed to the beneficiary?

- Given this uncertainty, would the trustee have discretion to take a different position each year? In Reg. § 1.643(a)-3(b), the Treasury generally agreed that the trustee would not be required to take a consistent position year-by-year, except for capital gain allocated to corpus and treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. Given that this gross income was not allocated corpus (because it was never physically received), perhaps the trustee has discretion to vary the treatment from year to year? Another approach might be to say that, because the undistributed capital gain was not allocated to principal, the regulations might presume that the undistributed capital gain is allocated to income and can be included in DNI inconsistently from year to year under Reg. § 1.643(a)-3(b)(1).

If all of a flow-through entity's K-1 items taxable to the trust are included in DNI, then part II.J.8.c Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal might cause ordinary income to be trapped at the trust level if the flow-through entity distributes cash in an amount less than all of these K-1 items; see part II.J.8.f Consequences of Allocating Capital Gain to DNI. In light of the consequences described there, the most taxpayer-favorable reading would be that capital gain is ordinarily excluded from DNI.

I leave it to the reader to decide which approach is "better" or perhaps to make that decision on a trust-by-trust basis.

For more on using flow-through entities, see part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries.

II.J.8.b. Should Capital Gain Be Allocated to DNI?

Often beneficiaries have income below the thresholds that cause the 3.8% tax and the additional 5% capital gain tax to be incurred, whereas trusts start paying those taxes at relatively modest income levels. Therefore, distributing capital gains to beneficiaries might be beneficial – at least from an income tax viewpoint.

Consider various factors described in part II.J.3 Strategic Fiduciary Income Tax Planning.

II.J.8.c. Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal

Generally, gains from the sale or exchange of capital assets, net of losses,[1856] are excluded from distributable net income (DNI).[1857]

[1856] Reg. § 1.643(a)-3(d) provides:

Reg. § 1.643(a)-3(b) provides:

> *Capital gains included in distributable net income*. Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law) -
>
> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Note that (b)(1) relates to determining whether capital gain has been allocated to income for state law purposes, and (b)(2) and (b)(3) relate to distributing capital gains that have been allocated to corpus.

Before its amendment by T.D. 9102 (12/30/2003), Reg. § 1.643(a)-3 made it more difficult to include capital gain in DNI.[1858]

> *Capital losses*. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary. See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

See part II.J.3.i Planning for Excess Losses.

[1857] Reg. § 1.643(a)-1(a) provides:

> *In general*. Except as provided in § 1.643(a)-6 and paragraph (b) of this section, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

Reg. § 1.643(a)-6 refers to DNI of a foreign trust (as defined in Code § 7701(a)(31)).

[1858] Former Reg. § 1.643(a)-3(a) provided:

> Except as provided in § 1.643(a)-6, gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income, and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary unless they are:
>
> (1) Allocated to income under the terms of the governing instrument or local law by the fiduciary on its books or by notice to the beneficiary,
>
> (2) Allocated to corpus and actually distributed to beneficiaries during the taxable year, or

II.J.8.c.i. Capital Gain Allocated to Income Under State Law

Most states have adopted the Uniform Principal and Income Act.[1859]

Generally, any capital gain included as the distributive share of income from a partnership or S corporation and distributed from the entity to the trust will constitute income under the Act, making the rest of this part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI) be moot.[1860]

Generally, the Act allocates capital gains to principal.[1861] The main exceptions are the power to adjust, unitrust distributions, and exceptions in the governing instrument; the power to adjust and power to convert to a unitrust followed adoption of the prudent investor rule.[1862] Following a discussion of each of these is a discussion of the respect fiduciary income tax law gives them.

II.J.8.c.i.(a). Power to Adjust

A trustee may adjust between principal and income to the extent the trustee considers necessary if:[1863]

- The trustee invests and manages trust assets as a prudent investor,
- The trust's terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and
- The trustee determines that the adjustments is necessary to fulfill the trustee's duty of impartiality between the beneficiaries.

The impartiality component recognizes that an income beneficiary would want the trustee to invest for income and the remaindermen want the trustee to invest for growth.

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(3) Utilized (pursuant to the terms of the governing instrument or the practice followed by the fiduciary) in determining the amount which is distributed or required to be distributed.

However, if capital gains are paid, permanently set aside, or to be used for the purposes specified in section 642(c), so that a charitable deduction is allowed under that section in respect of the gains, they must be included in the computation of distributable net income.

See Zaritsky, Lane & Danforth, ¶3.03. Capital Gains and Losses, *Federal Income Taxation of Estates and Trusts* (WG&L).

[1859] See http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act (2000) (as amended in 2000) and http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) (as amended in 2008), the latter being referred to as the "Act" in the footnotes in this part II.J.8.c.i Capital Gain Allocated to Income Under State Law. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

[1860] See part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries.

[1861] Act § 401.

[1862] For an analysis of how these ideas interact, see Sager, "Litigation and the Total Return Trust," *ACTEC Journal*, vol. 35, no. 3, p. 206 (Winter 2009).

[1863] Act § 104(a).

A prudent investor would tend to invest for both income and growth and make fair distributions of total return to the income beneficiary. The power to adjust authorizes the trustee to invest for total return and allocate part of the growth component to the income beneficiary. If the trustee is actually distributing the capital gain to the income beneficiary as part of a fair sharing of the trust's total return, then it would seem fair to tax the income beneficiary on the capital gain that the income beneficiary receives. Depending on the overall situation, it might also be fair to include in that adjustment compensation for the taxes the income beneficiary pays on those capital gains.[1864] Often, the trustee couches the power to adjust in terms of a target percentage of the trust's value; however, the trustee might vary the target percentage as the trustee deems appropriate.

The Act prescribes a number of the factors the trustee should consider[1865] and circumstances that limit or prevent the exercise of this power.[1866] Illinois has a more concise power to adjust that is in some ways more flexible and in some ways less flexible than the Act.[1867]

This power to adjust would not apply when the same standards apply to the distribution of income and principal.

II.J.8.c.i.(b). Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation

It is not uncommon for partnerships and S corporations to reinvest part of their annual income; indeed, to facilitate growth or simply a stronger capital structure (which lenders might require), many distribute only enough to pay their owners' income taxes (commonly referred to as a "tax distribution") plus a modest bonus (referred to below as a "bonus distribution").

Taxes on this reinvested income are charged against the income of a trust that owns such an entity.[1868] This is the only practical solution to the trust's obligation to pay its taxes, because the taxing authorities' claims against the trustee are much more pressing than the beneficiaries' claims. (Note that the income beneficiary of a Qualified Subchapter S Trust pays this tax – part III.A.3.e QSSTs and ESBTs – which has an effect similar to charging the trust's income.)

The Uniform Principal and Income Act includes a remedy for the income beneficiary that had to pay the tax on the entity's accumulated income that has been inherently baked into principal. Section 506(a)(3) authorizes a fiduciary to "make adjustments between

[1864] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.
[1865] Act § 104(b).
[1866] Act § 104(c).
[1867] 760 ILCS 15/3(b)(2) authorizes the trustee to use discretion in allocating receipts to income or principal:

> if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal.

[1868] See part III.A.4 Trust Accounting Income Regarding Business Interests.

principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from … the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary." This specific provision supplements any power to adjust that might generally apply.[1869]

Thus, when an interest in a partnership or an S corporation is sold, the trustee should consider whether to allocate some of the sale proceeds to income. However, it's not at all obvious that the trustee should make an adjustment; consider that:

- The entity made distributions specifically to pay this tax, so the trust or income beneficiary was not really "out of pocket" for this tax.

- If the entity had been a C corporation, the entity would have paid the tax itself. Its dividend would have equaled the bonus distribution, and this issue would never have arisen.

- The true issue is whether the bonus distribution was sufficient. Was the decision to accumulate income fair – a sound exercise of the business judgment of those who run the entity? Did those who control the entity promise a make-up distribution at some point because of a special project, or was the accumulation merely part of a solid plan to grow the business, which presumably would result in increased income and increased bonus distributions? Were those who control the entity running it just to benefit themselves (and, if owners, trying to extract more benefits as owners than the inactive owners received)? I have probably left out many other relevant considerations, but hopefully I have communicated why this decision is not easy.

See part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets for important tactical issues in implementing these ideas.

If the trustee is concerned that the income beneficiary might spend a perceived windfall unwisely, the trustee might consider using the power to adjust[1870] to spread distributions over an appropriate period of time. Such a spread over time might be more palatable if, instead of labelling the adjustment to sale proceeds as a tax reimbursement, the trustee labelled it as a make-up for insufficient bonus distributions, taking the position that future distributions to beneficiaries might be loosened because of a prior conservative distribution policy.[1871] The bonus distributions might have been sufficient from the viewpoint of what the entity should have distributed but might have been insufficient from

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[1869] See part II.J.8.c.i.(a) Power to Adjust.

[1870] Part II.J.8.c.i.(a) Power to Adjust.

[1871] "Conservative" does not necessarily equate with "stingy." Paying fixed (or inflation-adjusted) amounts that exceed net cash income can cause a trust's net asset value to decline, causing future income to decline, or might simply cause the principal not to grow sufficiently, causing the remaindermen's interests not to keep up with inflation. Using the power to adjust to make up for peaks and valleys would seem wiser than paying fixed (or inflation-adjusted) amounts. Generally, trustees should fairly and impartially balance the beneficiaries' interests under the trust agreement and might consider additional communication to those currently receiving distributions about the peaks and valleys and provide to the beneficiaries (or encourage them to obtain) advice about how to manage these peaks and valleys.

the viewpoint of how much income the trustee should have tried to generate. As mentioned in part III.A.4.c.iii Advising Clients about the UPAIA Section 505 Changes (discussing conflicts with beneficiaries that might arise when an entity makes tax distributions but little or no bonus distributions), these issues have no easy answer.

See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.

II.J.8.c.i.(c). Unitrust

A unitrust is a trust that distributes fixed amounts, redetermined annually as a fixed percentage of the value of the trust's value, which value is redetermined annually but might be based on an average of values, such as the average value of the trust's assets for the past three years. Computing this average adds to the trustee's recordkeeping burden, although the calculation itself might or might not be simple. For a trust holding marketable securities, the calculation might not take very long. On the other hand, for a trust with closely-held business interests or real estate, the calculation might impose additional costs on the trust; in such a case, one might draft a trust applying the unitrust only to easy-to-value assets and using either more traditional principal and income concepts or the power to adjust for difficult-to-value assets.

Beyond practical valuation issues, the main conceptual difference between a unitrust and a power to adjust is that the trustee might vary the percentage applied to the value, whereas a unitrust uses a percentage that never changes.

Providing a fixed unitrust percentage allows the trustee to avoid fights with the income beneficiary and remaindermen over what percentage to use. However, it also can cause the trust to sell assets in a down year. For example, if the trust provides a 3% unitrust and interest and dividends are 2%, the trustee needs to raise the 1% difference by selling assets. That's fine when asset values increase, but it can cause the trust to be depleted if trust values have not increased, especially if the trust has several down years. Using a power to adjust, the trustee might distribute only interest and dividends in down years and distribute capital gains in up years, perhaps making extra distributions in up years to make up for decreased distributions in down years. The problem is that the income beneficiary might rely on a particular level of distributions, and distributing less in a down year might not be acceptable. Using a unitrust based on an average of the past few years' value would help smooth fluctuations, giving the beneficiary time to adjust spending habits when notified that values are down but that the decrease will be spread over time. When assets appreciate, the trustee might consider taking some of those gains and reserving them for down years, so that a unitrust will not have to sell assets in a down market.

Reg. § 1.643(a)-3(e) provides the following examples regarding unitrusts:

> *Example (11)*. The applicable state statute provides that a trustee may make an election to pay an income beneficiary an amount equal to four percent of the fair market value of the trust assets, as determined at the beginning of each taxable year, in full satisfaction of that beneficiary's right to income. State statute also provides that this unitrust amount shall be considered paid first from ordinary and tax-exempt income, then from net short-term capital gain, then from net long-

term capital gain, and finally from return of principal. Trust's governing instrument provides that A is to receive each year income as defined under state statute. Trustee makes the unitrust election under state statute. At the beginning of the taxable year, Trust assets are valued at $500,000. During the year, Trust receives $5,000 of dividend income and realizes $80,000 of net long-term gain from the sale of capital assets. Trustee distributes to A $20,000 (4% of $500,000) in satisfaction of A's right to income. Net long-term capital gain in the amount of $15,000 is allocated to income pursuant to the ordering rule of the state statute and is included in distributable net income for the taxable year.

Example (12). The facts are the same as in Example 11, except that neither state statute nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating principal, other than capital gain, as distributed to the beneficiary to the extent that the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by not including any capital gains in distributable net income on Trust's Federal income tax return so that the entire $80,000 capital gain is taxed to Trust. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently follow this treatment of not allocating realized capital gains to income.

Example (13). The facts are the same as in Example 11, except that neither state statutes nor Trust's governing instrument has an ordering rule for the character of the unitrust amount, but leaves such a decision to the discretion of Trustee. Trustee intends to follow a regular practice of treating net capital gains as distributed to the beneficiary to the extent the unitrust amount exceeds Trust's ordinary and tax-exempt income. Trustee evidences this treatment by including $15,000 of the capital gain in distributable net income on Trust's Federal income tax return. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must consistently treat realized capital gain, if any, as distributed to the beneficiary to the extent that the unitrust amount exceeds ordinary and tax-exempt income.

A right to income expressed initially solely as a unitrust interest may qualify for the QTIP marital deduction.[1872]

[1872] Letter Ruling 201117005 approved a unitrust expressly authorized by state law:

State Statute provides that the grantor of a trust may create an express total return unitrust which will become effective as provided in the trust document without requiring a conversion of an income trust to a total return unitrust under the provisions of State Statute. An express total return unitrust created by the grantor of the trust shall be treated as a unitrust under State Statute only if the terms of the trust document contain all of the following provisions: (a) that distributions from the trust will be unitrust amounts and the manner in which the unitrust amount will be calculated and the method in which the fair market value of the trust will be determined; (b) the percentage to be used to calculate the unitrust amount, provided the percentage used is not greater than 5 percent nor less than 3 percent; (c) the method to be used in determining the fair market value of the trust; and (d) which assets, if any, are to be excluded in determining the unitrust amount.

II.J.8.c.i.(d). Exceptions in the Governing Instrument

Although the Act provides general rules, it also allows trust agreements to override those rules:[1873]

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and
>
> (4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

II.J.8.c.i.(e). Fiduciary Income Tax Recognition of the Trust Agreement and State Law

Code § 643(b) generally defers to the trust agreement and applicable state law.[1874] The Uniform Principal and Income Act authorizes the trust agreement to override the Act.[1875]

[1873] Act § 103(a).

[1874] Code § 643(b) provides:

> For purposes of this subpart and subparts B, C, and D, the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

[1875] Section 103(a) of the act provides:

> In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:
>
> (1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];
>
> (2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];
>
> (3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

However, Reg. § 1.643(b)-1[1876] does not recognize trust agreements that depart too far from the usual rules:

> Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.

The regulation respects variations provided under applicable state law:

> However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. Similarly, a state statute that permits the trustee to make adjustments between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries is generally a reasonable apportionment of the total return of the trust. Generally, these adjustments are permitted by state statutes when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding the allocation of receipts and disbursements to income and principal, is unable to administer the trust impartially. Allocations pursuant to methods prescribed by such state statutes for apportioning the total return of a trust between income and principal will be respected regardless of whether the trust provides that the income must be distributed to one or more beneficiaries or may be accumulated in whole or in part, and regardless of which alternate permitted method is actually used, provided the trust complies with all requirements of the state statute for switching methods.[1877]

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(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

[1876] This version of the regulation applies to taxable years of trusts and estates ending after January 2, 2004.

[1877] The regulation sets forth parameters for switching methods:

> A switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries. A switch to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event

Circling back to the Act's authorizing trust agreements to depart from traditional principles, Reg. § 1.643(b)-1 concludes with:

> In addition, an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.

Section 103(b) of the Uniform Principal and Income Act addresses the "reasonable and impartial exercise" requirement:

> In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

I often use a clause providing that the trustee has wide discretion but must reasonably and fairly balance the interests of the income and remainder beneficiaries.[1878] That

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> to the trust or its beneficiaries for purposes of section 1001 and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

[1878] As with everything else, the reader must exercise independent legal judgment (or, if the reader is not an estate planning lawyer, retain one) before using the language reproduced below:

> The trustee is authorized to apportion any receipt or disbursement between principal and income, notwithstanding the apportionment that would apply under [applicable state law] apart from this provision; to determine the depletable, depreciable or amortizable interest of the principal and income in any property included among the trust estate subject to being depleted, depreciated or amortized, and to apportion the amount received from such property between principal and income; to maintain reasonable reserves for depletion, depreciation, amortization and obsolescence; to allocate to income or principal of the trust estate any gains or losses realized upon the sale or disposition of any part of the trust estate; to determine what part, if any, of the actual income received upon a wasting investment or upon any security purchased or acquired at a premium shall be returned and added to principal to prevent a diminution of principal upon exhaustion or maturity thereof; and to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income; provided, however, that the trustee, in taking any action under this Section, must reasonably and fairly balance the interests of the income and remainder beneficiaries.

For an example of how the clause, "to determine what payment, if any, should be made to any income beneficiary as compensation for losses of income due to the acquisition or retention of property returning no income or slight income," can come in handy, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets, especially fn. 2012.

language comes from the marital deduction regulations.[1879] Generally, the trustee's authority to allocate between income and principal does not trigger grantor trust status,[1880] does not constitute a power of appointment,[1881] and does not have

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[1879] Reg. § 20.2056(b)-5(f)(1), which governs general power of appointment marital deduction trusts under Code § 2056(b)(5), looks to whether:

> the spouse is entitled to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of § 1.643(b)-1 of this chapter.

Reg. § 20.2056(b)-5(f)(4) elaborates:

> Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus….

For QTIP (qualified terminable interest property) trusts, Reg. § 20.2056(b)-7(d)(1) provides:

> A power under applicable local law that permits the trustee to adjust between income and principal to fulfill the trustee's duty of impartiality between the income and remainder beneficiaries that meets the requirements of §1.643(b)-1 of this chapter will not be considered a power to appoint trust property to a person other than the surviving spouse.

Reg. § 20.2056(b)-7(d)(2) also circles back to the general power of appointment marital deduction rules:

> *Entitled for life to all income*. The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.

[1880] Code § 674(b)(8); Reg. § 1.674(a)-1(b)(1)(iv).

[1881] Reg. §§ 20.2041-1(b)(1) (estate tax) and 25.2514-1(b)(1) (gift tax) provide:

> The mere power of management, investment, custody of assets, or the power to allocate receipts and disbursements as between income and principal, exercisable in a fiduciary capacity, whereby the holder has no power to enlarge or shift any of the beneficial interests therein except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment.

Although a trustee's allocations to income and principal ordinarily will not cause gift tax issues, other decisions that affect distributions might cause gift tax issues if the trustee is also a beneficiary. Reg. § 25.2511-1(g)(2) provides a safe harbor:

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living; or to meet an emergency, would be such a standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not such a standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no such standard exists.

See fn. 1748 for additional authority on ascertainable standards.

Letter Ruling 8908032 recognized that Reg. §§ 20.2041-1(b)(1) generally prevents administrative powers from creating a general power of appointment:

…. Although the amount of income that A may receive each year is generally limited, the trust provides that any income from real estate must be distributed first and that all the income from real estate be distributed to A even if such distribution exceeds the annual limitation. Thus, if the trust had substantial income from real estate, it is possible for A to receive distributions in excess of the annual limitation imposed by the trust.

Where the holder of a power is not completely free from legal control or restraint in the disposition of property, a power held by the holder would not be a general power of appointment. Such legal control or restraint exists when the holder is legally accountable for its exercise. fiduciary duties imposed by local law are always subject to the control of the courts and the holder is always under a legal duty to account. See *Security-Peoples Trust Company v. United States*, 238 F.Supp. 40 (W.D. Pa. 1965). The initial step in determining whether a decedent has a general power of appointment is to determine, in light of local law, the interest conveyed to the decedent under trust; *i.e.*, the extent to which consonant with testamentary trust provisions, the decedent could invade and consume the principal. See *Morgan v. Commissioner*, 309 U.S. 78 (1940).

It is necessary to look to the law of State X to determine whether A has the power to alter the beneficial interest under the trust. If A appointed herself trustee, A, as the trustee, would have the authority under the trust to sell trust assets and to invest the proceeds in real estate. Thus, A could cause trust income from real estate to exceed the limitation set forth in the trust for income distributions from other sources and, consequently, increase the total income distributions to A. Such investment policy and actions by A as the trustee would result in a shift of the beneficial interest of the trust. However, A would not have complete freedom to set investment policy for the trust. The statutory law of State X requires that a trustee consider the relative interests of both income and remainder beneficiaries in determining the prudence of any investment and imposes a duty on the trustee to administer the trust with due regard to the respective interests of income beneficiaries and remainderpersons in accordance with the terms of the trust. In addition, the highest court in State X has addressed the responsibilities of the trustee and stated that:

> It is the duty of the trustees to preserve the corpus of the trust for the remaindermen and to secure the usual rate of income upon safe investments for the life tenant, and to use a sound discretion in reference to each of those objectives. They cannot postpone the yielding of income for the increase of capital, nor select a wasting or hazardous investment for the sake of greater present income.

Congdon v. Congdon, 160 Minn. 343, 200 N.W. 76 (1924).

Moreover, *In re Clarke's Will*, 204 Minn. 574, 284 N.W. 876 (1939), addressed a situation where the trustee, who was also the income beneficiary, treated trust property incorrectly as "income" rather than "capital" and made erroneous distributions to herself. The court held that the trustee-income beneficiary had a duty to distinguish between the rights of the life tenant and those of the remaindermen with meticulous care. The court found that, although there had been no intentional wrong, there was an invasion of the rights of the remaindermen by the trustee-income beneficiary that amounted to fraud, irrespective of intention.

The law of State X clearly imposes a strong fiduciary duty on a trustee to protect the interests of all beneficiaries of the trust. While A, as the trustee, may invest trust assets in real estate that may produce sufficient income resulting in an increase in distributions to A, A cannot adopt an investment policy that would be detrimental to the interests of the remaindermen. Neither Trust 1 nor Trust 2 gives A, as the income beneficiary, any control over investment policy or income withdrawal. Due to the restrictions imposed by both the law of State X and the trust instruments, A does not have an unfettered right to change the interests of the beneficiaries.

Accordingly, A's power to remove the current trustee and appoint anyone, including A, as the trustee is not a general power of appointment as described in section 2041 of the Code.

generation-skipping transfer tax implications.[1882] The trustee might want to consider providing accountings or other notices to the beneficiaries that would start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile this one on top of it, which procedure might help minimize any gift tax consequences to failing to make a claim.[1883]

How does one draw the line between what departs "fundamentally from traditional principles of income and principal" and what is "a reasonable and impartial exercise of a discretionary power granted to the fiduciary" under Reg. § 1.643(b)-1?

Presumably, the trustee should be on solid ground in allocating to income capital gains such that the total amount of all receipts allocated to income does not exceed 5%, given that the regulations expressly approve unitrusts in the 3%-5% range. The trusts should also be on solid ground in allocating to income capital gains generated by a partnership that the settlor intended to distribute to the income beneficiary.[1884]

Beyond that, it's a matter of facts and circumstances and judgment. However, Reg. § 1.643(a)-3(e), Example (4) respected a mandatory allocation of capital gain to income where a trust had $5,000 of dividends and $10,000 of capital gains, and the trustee distributed $17,000 to the beneficiary.

II.J.8.c.i.(f). Conclusion Regarding Allocating Capital Gain to Income

Reg. § 1.643(a)-3(b)(1) requires a consistent practice for unitrusts. Considering that the unitrust recipient is receiving cash and presumably would have the liquidity to pay tax on any capital gains distributed to the beneficiary, in many cases it would be fair to allocate capital gain to DNI to the extent that the unitrust amount exceeds the income that would apply under the Act's general rules. Given that one provides for a unitrust when tension between the income beneficiary and remaindermen might be high, the tension created by this tax issue would be high to the same degree. Consider providing a firm rule in the trust agreement regarding the allocation of capital gain to DNI. If one is concerned that shifting tax rates might create an unfair tax result, consider providing a clause reimbursing the unitrust beneficiary for taxes paid on the unitrust and on the reimbursement; this requires cooperation between the trustee's income tax preparer and the beneficiary's income tax preparer, but the calculation should be relatively mechanical.

For trusts that are not unitrusts, Reg. § 1.643(a)-3(b)(1) provides significant flexibility, allowing the trustee discretion whether to allocate capital gain to income for fiduciary

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[1882] Reg. § 26.2601-1(b)(4)(i)(D)(2) provides:

> … administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

[1883] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

[1884] See fn. 1907.

accounting purposes (if the trust agreement and state law permit) and also whether to include in DNI the capital gain that was allocated to income.

II.J.8.c.ii. Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary

Reg. § 1.643(a)-3(e) helps guide our application of Reg. § 1.643(a)-3(b)(2):

> *Example (1)*. Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.
>
> *Example (2)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.
>
> *Example (3)*. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of investments. This treatment of capital gains is a reasonable exercise of Trustee's discretion.

The all-or-nothing approach taken by Examples (1) and (2) is not very attractive, but we need to deal with it. Let's consider some fact patterns:

1. <u>The beneficiary needs regular annual distributions that cannot be made using a power to adjust</u>. Generally, distributions in excess of what can made using a power to adjust would not be sustainable. A power to adjust typically adjusts to a 3%-5% distribution, and most models suggest that distributions in excess of that will lead to a trust being depleted. Thus, a more likely scenario is that a power to adjust is not available, because state law prevents using the power to adjust in particular situations (unless the trust agreement overrides it). In such a case, the beneficiary's federal and state/local income tax bracket for capital gains needs to be compared to the trust's federal and state/local income tax bracket for capital gains. Note that a

nonresident trust would have a zero state/local income tax bracket, to the extent that the trust does not have income from a business sourced to the state/local jurisdiction.

2. The beneficiary's need for distributions in excess of income is sporadic. It's difficult to predict how the beneficiary's federal and state/local income tax bracket for capital gains compares to the trust's federal and state/local income tax bracket for capital gains, given that rates will change and the trust's and its beneficiaries' circumstances might change over time. In such a case, consider whether the distribution might be phrased as "allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary." If that is likely to be the case, then consider not electing to carry out capital gain automatically under (b)(2) but rather deciding to rely on (b)(3), because (b)(3) is flexible whether to allocate capital gain to income, allowing the decision to made separately each year on a case-by-case basis.

Generally, trustees would not be likely to take advantage of the discretion that Example (3) provides to allocate to income only capital gain from the sale of certain specified assets or a particular class of investments, because such an election requires additional recordkeeping.

Some people point to the word "deem" in Example (1) and emphasize the need for such authority in the trust agreement or applicable state law. Uniform Trust Code § 816 generally authorizes trustees to make tax elections,[1885] so the authority to "deem" distributions to be capital gains is inherently authorized in UTC states, as well as any other state where a trustee generally has the authority to make tax elections.

II.J.8.c.iii. Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary

Reg. § 1.643(a)-3(b)(3) might seem confusing at first, but it actually has very practical use.

First, let's look at some examples that Reg. § 1.643(a)-3(e) provides:

> Example (5). The facts are the same as in Example 1, except that Trustee decides that discretionary distributions will be made only to the extent Trust has realized capital gains during the year and thus the discretionary distribution to A is $10,000, rather than $12,000. Because Trustee will use the amount of any realized capital gain to determine the amount of the discretionary distribution to the beneficiary, the $10,000 capital gain is included in Trust's distributable net income for the taxable year.

[1885] Paragraph (16) of that section authorizes the trustee to "exercise elections with respect to federal, state, and local taxes." The official Comment provides:

> Paragraph (16) authorizes a trustee to make elections with respect to taxes. The Uniform Trust Code leaves to other law the issue of whether the trustee, in making such elections, must make compensating adjustments in the beneficiaries' interests.

Example (6). Trust's assets consist of Blackacre and other property. Under the terms of Trust's governing instrument, Trustee is directed to hold Blackacre for ten years and then sell it and distribute all the sales proceeds to A. Because Trustee uses the amount of the sales proceeds that includes any realized capital gain to determine the amount required to be distributed to A, any capital gain realized from the sale of Blackacre is included in Trust's distributable net income for the taxable year.

Although Reg. § 1.643(a)-3(b)(3) is viewed generally as discretionary, note that Example (6) is mandatory: if the trustee is required to distribute sale proceeds to a beneficiary, the capital gain from the sale is included in the DNI that the distribution carries out the beneficiary. Example (7) similarly requires all capital gain recognized in the trust's final taxable year to be included in the DNI that the distribution carries out the beneficiary.

The practical application is based on the ability to count as prior year distributions those distributions made in the first 65 days of the current year.[1886] For example, any distribution made on or before March 6, 2018 can be treated as a 2017 or 2018 distribution.[1887] This election applies to the greater of accounting income under Reg. § 1.643(b)-1 or DNI under Reg. §§ 1.643(a)-1 through 1.643(a)-7.[1888] By completing the line on the trust's income tax return, Form 1041, page 2, Part B, showing amounts (other than income required to be distributed currently) paid, credited, or otherwise required to be distributed and checking the Code § 663(b) box in "Other Information" at the bottom of Form 1041, page 2, the trustee decides how much of a current year distribution is allocated to the prior year; the balance would then be credited to the current year.[1889]

The practical application based on the 65-day rule would generally occur during February after the year ends and applies only if the trustee has discretion to distribute corpus.[1890] The regulations do not specify any particular trust records regarding the election, so do whatever seems best to evidence the intent. Perhaps the income tax return preparer emails the trustee recommending how much of a distribution be made to distribute income and capital gain under the 65-day rule (erring on the side of distributing

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[1886] Code § 663(b).

[1887] In a leap year, the deadline is March 5; in other years, the deadline in March 6.

[1888] Reg. § 1.663(b)-1(a)(2)(i).

[1889] Reg. § 1.663(b)-1(a)(2)(ii). The election may be made on an extended return but not on an amended return filed after the (extended) due date. Reg. § 1.663(b)-2(a)(1). If no return is required to be filed for the taxable year of the trust for which the election is made, the election shall be made in a statement filed with the internal revenue office (under Code § 6091 and the regulations thereunder) with which a return by such trust would be filed if such trust were required to file a return for such taxable year. Reg. § 1.663(b)-2(a)(2).

[1890] The authority to distribute principal for welfare would be helpful, but the trustee should not be a related or subordinate party. See Code § 2041(b)(1), absent the application of Code § 2041(b)(1)(A) and the other exceptions, combined with Rev. Rul. 95-58 and a variety of private letter rulings applying that Rev. Rul. to Code § 2041, found in fn. 5062. Alternatively, suppose the trustee has the authority to distribute under ascertainable standards, but the trustee has the discretion to consider or ignore the beneficiary's other resources. The trustee might have considered the other resources and taken a minimalist approach to distributions throughout the year; but, when doing 65-day-rule planning, the trustee might chooses to ignore other resources and take an expansive view of the authority to make distributions.

too much), then the trustee makes the distribution, and the tax return carries through the intent. As long as the distribution is made timely, the tax return can treat none, part, or all of the distribution as a distribution of the taxable year's income. In a manner similar to Example (5), the trustee has referred to the capital gain itself in determining how much to distribute. Unlike Reg. § 1.643(a)-3(b)(3), Reg. § 1.643(a)-3(b)(2) allows one to carry out discretionary distributions of capital gain inconsistently from one year to another.

If the beneficiary does not require monthly or quarterly cash flow, the trustee can simply each February make a big distribution and apply it to the prior or current year for tax return preparation purposes. If the beneficiary does require monthly cash flow but is willing to accept informal constraints, the trustee makes the big distribution into an investment account that the beneficiary owns, and the account makes monthly transfers to the beneficiary's checking account. Obviously this would not work for a beneficiary who cannot exercise discipline, but there is a good segment of beneficiaries for whom it would work.

An alternative approach is to distribute an asset to a beneficiary before the asset is sold. Generally, the beneficiary will receive a carryover basis and then be taxed on the gain.[1891]

As with all tax planning, the strategies described in this part II.J.8.c.iii may be unavailable (based on the trust terms), inadvisable (based on sound financial planning), or stupid (giving money to a drug addict just to save taxes).

II.J.8.c.iv. Conclusions Regarding the Basic Framework on Allocating Capital Gains to DNI

Often, one cannot predict whether the combination of federal, state, and local income tax rates will be higher inside or outside of the trust.

Quite frankly, I keep changing my mind regarding the best income tax elections as I encounter new situations. If the document is flexible as to distributions and distributions are appropriate, then I would lean toward:

- Flexible language allowing the trustee to allocate capital gains to income, so long as the trustee must reasonably and fairly balance the interests of the income and remainder beneficiaries.

- Using the 65-day-rule to distribute large capital gains to the beneficiary as DNI.

- Electing <u>not</u> to establish a practice of carrying out capital gain to beneficiaries under Reg. § 1.643(a)-3(b)(2) <u>unless</u> it appears that the above two approaches will not suffice to minimize overall income taxes. However, it is not uncommon for me to decide that the above. two approaches will not suffice to minimize overall income taxes. On the other hand, if the situation involves enough money, the trustee can covert capital gain that would otherwise be trapped inside the trust to trust

[1891] Code § 643(e)(2).

accounting income, using the tool described in part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries.

Consider adding a withdrawal right of up to 5% of the trust's value. The beneficiary will be deemed to be the owner of the part that the beneficiary can withdraw and perhaps continue to be deemed the owner with respect to the lapsed portion. However, note that withdrawal rights can increase exposure to creditors to the extent of the withdrawal right and perhaps even after a lapse. For details on all of the ideas mentioned in this paragraph, see part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts. If one is concerned about the withdrawal right itself becoming a bad idea, consider using a provision along the following the lines:

> In addition to the distributions authorized by the preceding sentence, subject to the following sentence the trustee shall distribute to the beneficiary so much of the principal of the trust as the beneficiary, while at least __ years of age, may request once between February 23 and March 5 of every calendar year, on a noncumulative basis, up to five percent (5%) of the aggregate value, as of the time of such request by the beneficiary, of the principal of the trust. The trustee may, by instrument placed in the trust's records, provide that the preceding sentence shall not apply during any period (including the beneficiary's remaining life), which period shall begin no earlier than the January 1 following the date of the instrument.

This allows the trustee to turn off the withdrawal rights for any future year(s) without impeding the beneficiary's absolute right to withdraw during the current year.

II.J.8.c.v. Fairness of Taxing Capital Gain to Beneficiaries; Need for Tax Distributions Here and Other Areas

Our income tax system taxes income to whoever receives it, subject to certain exceptions not relevant to this part II.J.8.c.v. Therefore, it is fair to tax the beneficiaries.

However, when a distribution is made for a particular purpose and the money is spent, the beneficiary will get upset when handed a tax bill for which the beneficiary did not plan. Therefore, one might need to make a supplemental distribution to pay tax on the original distribution. The supplemental distribution would also need to be enough to pay tax on the supplemental distribution itself. This supplemental distribution is often referred to as "grossing up the distribution" to pay taxes.

This issue applies to more than just capital gains. Clients who leave residences in trust often wish to have the trust pay expenses that a life tenant would ordinarily pay. Distributions by the trust for those purposes run into the same problem – the money is spent for the intended purpose and not available to pay taxes. These distributions also need to be grossed up to pay taxes.

II.J.8.d. Distribution in Kind; Specific Bequests

II.J.8.d.i. Distribution in Kind - Generally

Except as provided below and except to the extent that it carries out DNI [1892] or constitutes a bequest of income,[1893] a distribution is a nontaxable gift[1894] (unless the recipient assumes liabilities, in which case it is taxed as a bargain sale).[1895]

When a trust distributes property to satisfy a pecuniary obligation, the trust recognizes gain on the deemed sale,[1896] even if the trust's residue is less than the pecuniary obligation.[1897] If a trust makes a non-pro rata distribution of residue without either the

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[1892] Reg. § 1.102-1(d).

[1893] Reg. §§ 1.102-1(b), (c) and 1.663(a)-1(b)(2)(i).

[1894] Reg. § 1.102-1(a), (d).

[1895] See part III.B.1.c Gifts With Consideration – Bargain Sales.

[1896] Reg. § 1.661(a)-2(f) provides:

> Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently. In addition, gain or loss is realized if the trustee or executor makes the election to recognize gain or loss under section 643(e).

[1897] Rev. Rul. 66-207 included the following facts and conclusion:

> By the terms of the decedent's will he made a bequest of a specific sum of money in the amount of 250x dollars to be used to create a trust for the benefit of a designated beneficiary. After payment of all debts, costs of administration, claims, and specific bequests, other than the sum of 250x dollars, the executor finds that all he has left in the estate are assets now having a fair market value of 200x dollars and an aggregate basis to the estate of 150x dollars. Included among these assets is cash in the amount of 10x dollars. All of these assets will be transferred in trust to the designated trustee in accordance with the terms of the will….
>
> Section 1.661(a)-2(f) of the regulations provides, in part, that no gain or loss is realized by the trust or estate by reason of the distribution of property in kind unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount. Under this provision of the regulations whenever property other than money is distributed by an estate to any beneficiary, including a trust, in satisfaction of a cash bequest the estate realizes gain or loss measured by the difference between the amount of the bequest satisfied and the basis to the estate of the property so distributed. See *William R. Kenan, Jr., et al. v. Commissioner*, 114 F.2d 217 (1940); and *Sarah P. Suisman v. Eaton*, 15 F.Supp. 113 (1935), *affirmed per curiam*, 83 F.2d 1019, *certiorari denied*, 299 U.S 573.
>
> When the executor of this estate distributes the property remaining in the estate to the designated trustee in creation of the trust the estate will realize a gain of 50x dollars. This is the difference between the amount of the bequest satisfied by distribution of property other than cash (200x dollars less 10x dollars cash, or 190x dollars) and the basis (150x dollars less 10x dollars cash or 140x dollars) to the estate of the assets other than cash distributed in satisfaction of the bequest of a specific sum of money. The effect of the distribution will be the same as if the executor sold the remaining assets of the estate and distributed the proceeds to the trustee in trust.
>
> No amount is deductible by the estate under section 661 of the Code or includible in gross income of the trust under section 662 of the Code since the distribution will be in satisfaction of a bequest of a specific sum of money, as defined by section 1.663(a)-1(b) of the regulations.

trust instrument or local law authorizing a non-pro rata distribution, each beneficiary may be treated as having received a pro rata distribution and exchanged it with the other beneficiaries.[1898] Otherwise, the trust does not recognize any gain or loss unless the trust elects[1899] to treat the distribution as a sale, and the beneficiaries receive the same basis as the trust's.[1900]

The amount deemed distributed is the lesser of the property's basis or fair market value,[1901] unless gain was recognized, in which case it is the property's value. [1902]

Distributing an unmarketable partnership interest would carry out DNI without giving the beneficiary cash. However, valuation adjustments might depress the amount of the deemed distributions, and the beneficiary would be entitled to a proportionate share of future distributions from the partnership. However, if the trustee controls the partnership, the trustee can also control the distribution spigot.

II.J.8.d.ii. Specific Bequest

A gift or bequest of a specific sum of money or of specific property, which is required by the specific terms of the will or trust instrument and is properly paid or credited to a beneficiary, is not allowed as a deduction to an estate or trust under Code § 661 and is not included in the gross income of a beneficiary under Code § 662, unless under the terms of the will or trust instrument the gift or bequest is to be paid or credited to the recipient in more than three installments.[1903]

II.J.8.e. Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries

Generally, K-1 income from a passthrough business entity will carry out any income (including capital) distributed to the trust and then to the trust's beneficiaries. This section focuses on nongrantor trusts holding partnerships rather than S corporations, because generally a trust can hold S corporation stock that is not a grantor trust, QSST, or ESBT only during a relatively limited amount of time.[1904] (Although the principles in this part II.J.8.e would apply to a net income with make-up charitable remainder unitrust

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> Accordingly, a final distribution by the executor of an estate of appreciated property, in order to satisfy a pecuniary legacy, will result in a gain to the estate, although such distribution is of an insufficient amount to completely satisfy such bequest.

[1898] Rev. Rul. 69-486. See Zaritsky, Lane & Danforth, ¶2.19. Gain on the Division, Termination, or Reformation of a Trust, *Federal Income Taxation of Estates and Trusts* (WG&L).

[1899] Code § 643(e)(3).

[1900] Rev. Rul. 69-486.

[1901] Code § 643(e)(2).

[1902] Code § 643(e)(3).

[1903] Reg. § 1.663(a)-1(a), which provides further:

> Thus, in order for a gift or bequest to be excludable from the gross income of the recipient, (1) it must qualify as a gift or bequest of a specific sum of money or of specific property (see paragraph (b) of this section), and (2) the terms of the governing instrument must not provide for its payment in more than three installments (see paragraph (c) of this section). The date when the estate came into existence or the date when the trust was created is immaterial.

[1904] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

– a NIMCRUT – the IRS has concerns about that application and might shut it down at some point.)[1905]

Also, if one elected not to carry out capital gains under Reg. § 1.643(a)-3(b)(2) and later decides that all capital gain should be included in DNI going forward (or does not want to take a risk that the IRS will not respect deviations from general rules of the Uniform Principal and Income Act,[1906] consider forming an entity taxed as a partnership. Capital gains earned through a partnership generally constitute trust accounting income.[1907]

The Uniform Principal and Income Act provides that, generally, all cash distributions from an entity (including a partnership) are considered trust accounting income.[1908] Only the following distributions from an entity are not considered trust accounting income:[1909]

[1905] Rev. Proc. 2015-3, Section 4.01(36) identifies as an area in which rulings or determination letters will not ordinarily be issued:

> Whether a trust that will calculate the unitrust amount under § 664(d)(3) qualifies as a § 664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under § 643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient.

Check the most recent year's Rev. Proc. 20xx-3 [where "xx" represents the last two digits of the year] to see whether this remains on the list. For further discussion, see Fox, ¶ 25.20[5] NIMCRUTs—Where Timing of Trust Income Is Controlled by Grantor, Trustee, or Related or Subordinate Person, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L).

When administering any partnership, be careful to avoid any direct or indirect violation of the prohibition against counting precontribution gain as income found in Reg. § 1.664-3(a)(1)(i)(b)(3):

> For purposes of this paragraph (a)(1)(i)(b), trust income generally means income as defined under section 643(b) and the applicable regulations. However, trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to trust income at least to the extent of the trust's purchase price of those assets. Except as provided in the two preceding sentences, proceeds from the sale or exchange of any assets contributed to the trust by the donor or purchased by the trust may be allocated to income, pursuant to the terms of the governing instrument, if not prohibited by applicable local law. A discretionary power to make this allocation may be granted to the trustee under the terms of the governing instrument but only to the extent that the state statute permits the trustee to make adjustments between income and principal to treat beneficiaries impartially.

[1906] See http://www.uniformlaws.org/Act.aspx?title=Principal and Income Act (2000) (as amended in 2000) and http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) (as amended in 2008), the latter being referred to as the "Act" in the footnotes in this part II.J.8.e Partnerships and S Corporations Carry Out Income and Capital Gain to Beneficiaries. However, because the 2008 amendments changed only sections 409 and 505, generally a reference to the Act in this part is the same whether it is the 2000 version or 2008 version.

[1907] In *Crisp v. U.S.*, 76 A.F.T.R.2d 95-6261, 34 Fed. Cl. 112 (1995), the Court of Claims held that capital gain distributed in the ordinary course of a partnership's operations was allocated to income (because the settlor intended to distribute it) and therefore was includible in DNI.

[1908] Act § 401(b).

- property other than money;
- money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
- money received in total or partial liquidation of the entity; and
- money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

Thus, a partnership's capital gains recognized in the ordinary course of managing and re-balancing a portfolio would constitute fiduciary accounting income to the extent distributed from the partnership in cash and therefore would be includible in DNI under (1) above.

To keep control of the partnership, consider having the trust be a 1% general partner and 98% limited partner, and the beneficiary or someone else might contribute 1% as a limited partner. Distributing a limited partnership interest to a beneficiary can carry out income and perhaps capital gain while at the same time not giving the beneficiary cash to spend (but be sure to distribute enough cash so that the beneficiary can pay tax on the distribution). Be careful to avoid the gain on formation that applies when a contributing partner diversifies the partner's holdings by forming the partnership.[1910] If the trust holds not only marketable securities but also investments in businesses, consider setting up one partnership for the business investments and another partnership for the marketable securities, which would help facilitate allocating trust assets on termination or any other trust division.[1911] Also consider whether a state with jurisdiction over the trust might subject the partnership itself to state income tax.[1912]

Complexity might arise if a partnership distributes less than all of its taxable income to a mandatory income trust. It is unclear whether all of the trust's distributive share of capital gain is DNI.[1913] Furthermore, interrelated calculations might be required for a mandatory income trust.[1914] Generally, we should look to see whether planning under part II.J.8.c.i Capital Gain Allocated to Income Under State Law or II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is sufficient before recommending a partnership solely to address the issues described in part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[1909] Act § 401(c).
[1910] See part II.M.3.b Exception: Diversification of Investment Risk.
[1911] See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
[1912] Although Illinois subjects partnerships to an income tax called the "replacement tax," it does not tax investment partnerships. See fn. 3879.
[1913] See part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary.
[1914] Part III.A.4 Trust Accounting Income Regarding Business Interests describes trust accounting income, income tax, and some tough fiduciary issues that arise when a mandatory income trust owns an business interest. See also part III.D.2 Trust Accounting and Taxation.

II.J.8.f. Consequences of Allocating Capital Gain to DNI

II.J.8.f.i. General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income (and General Retention of the Character of DNI Distributed to Beneficiaries)

This part II.J.8.f.i first discusses netting deductions against income then discusses allocating that income.

II.J.8.f.i.(a). Allocating Deductions to Various Income Items

Rules for allocating deductions include:

- All deductible items directly attributable to one class of income are allocated to that class.[1915] To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income as described above except that any excess deductions attributable to tax-exempt income may not be offset against any other class of income.[1916]

- Deductions not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but Code § 265 requires a portion of such indirect expenses to be allocated to non-taxable income.[1917] Such indirect expenses include trustee fees, the rental of safe deposit boxes, and state income and personal property taxes.[1918] Once one has allocated expenses to tax-exempt income, how does one choose to which items of taxable income to allocate deductions? One would consider allocating to those income items that are most highly taxed, considering federal and state income tax

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[1915] Reg. § 1.652(b)-3(a).

[1916] Reg. § 1.652(b)-3(d).

[1917] Reg. § 1.652(b)-3(b) provides:

> The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to non-taxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instances, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

An expense allocated to tax-exempt income and therefore disallowed for income tax purposes may be deductible for estate tax purposes. Rev. Rul. 59-32, which Rev. Rul. 63-27 clarifies as showing just one among the acceptable methods of such a calculation.

[1918] Reg. § 1.652(b)-3(c).

and the 3.8% tax on net investment income.[1919] For example, interest income is taxed at the highest rates, whereas qualified dividends are taxed at long-term capital gain rates. Within interest income, consider whether the interest is from U.S. obligations exempt from state income tax. Although distributions from qualified retirement plans and IRAs are taxed at the highest regular tax rate, they are exempt from the 3.8% tax on net investment income. See part II.I.6 Deductions Against NII (especially the text accompanying fns. 1544-1545).

- If a charitable deduction under Code § 642(c) is involved, any allocations of taxable income between the charitable deduction and the beneficiaries must have substantial economic effect.[1920]

[1919] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[1920] Reg. § 1.642(c)-3(b)(2) provides:

> *Determination of the character of an amount deductible under section 642(c)*. In determining whether the amounts of income so paid, permanently set aside, or used for a purpose specified in section 642(c)(1), (2), or (3) include particular items of income of an estate or trust, whether or not included in gross income, a provision in the governing instrument or in local law that specifically provides the source out of which amounts are to be paid, permanently set aside, or used for such a purpose controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or in local law, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. See § 1.643(a)-5(b) for the method of determining the allocable portion of exempt income and foreign income. This paragraph (b)(2) is illustrated by the following examples:
>
> Example (1). A charitable lead annuity trust has the calendar year as its taxable year, and is to pay an annuity of $10,000 annually to an organization described in section 170(c). A provision in the trust governing instrument provides that the $10,000 annuity should be deemed to come first from ordinary income, second from short-term capital gain, third from fifty percent of the unrelated business taxable income, fourth from long-term capital gain, fifth from the balance of unrelated business taxable income, sixth from tax-exempt income, and seventh from principal. This provision in the governing instrument does not have economic effect independent of income tax consequences, because the amount to be paid to the charity is not dependent upon the type of income from which it is to be paid. Accordingly, the amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the trust as the total of each class bears to the total of all classes.
>
> Example (2). A trust instrument provides that 100 percent of the trust's ordinary income must be distributed currently to an organization described in section 170(c) and that all remaining items of income must be distributed currently to B, a noncharitable beneficiary. This income ordering provision has economic effect independent of income tax consequences because the amount to be paid to the charitable organization each year is dependent upon the amount of ordinary income the trust earns within that taxable year. Accordingly, for purposes of section 642(c), the full amount distributed to charity is deemed to consist of ordinary income.

Reg. § 1.643(a)-5(b) provides:

> If the estate or trust is allowed a charitable contributions deduction under section 642(c), the amounts specified in paragraph (a) of this section and § 1.643(a)-6 are reduced by the portion deemed to be included in income paid, permanently set aside, or to be used for the purposes specified in section 642(c). If the governing instrument or local law specifically provides as to the source out of which amounts are paid, permanently set

- Special rules apply to depreciation deductions.[1921]

II.J.8.f.i.(b). Allocating Income Items Among Those Receiving It

In allocating income between the trust and the beneficiary (or beneficiaries), the amounts of DNI distributed to the beneficiaries:[1922]

> shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the estate or trust as the total of each class bears to the total distributable net income of the estate or trust in the absence of the allocation of different classes of income under the specific terms of the governing instrument.

However, this proportionate rule is subject to specific provisions in the governing instrument for the allocation of different classes of income or different allocations under local law,[1923] subject to tax-exempt income being allocated in a manner that does not allow it to be deducted.[1924]

Thus, except for tax-exempt income and allocations between the charitable and noncharitable shares (and any special rules regarding depreciation deductions),[1925] it appears that a trust agreement may create ordering provisions between which items of

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> aside, or to be used for such charitable purposes, the specific provision controls for Federal tax purposes to the extent such provision has economic effect independent of income tax consequences. See § 1.652(b)-2(b). In the absence of such specific provisions in the governing instrument or local law, an amount to which section 642(c) applies is deemed to consist of the same proportion of each class of the items of income of the estate or trust as the total of each class bears to the total of all classes. For illustrations showing the determination of the character of an amount deductible under section 642(c), see Examples 1 and 2 of § 1.662(b)-2 and § 1.662(c)-4(e).

[1921] See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[1922] Code § 661(b).

[1923] Reg. § 1.661(b)-1.

[1924] Code § 661(c). Reg. § 1.661(c)-1, which was adopted 12/19/56 and amended 12/15/64, provides:

> An estate or trust is not allowed a deduction under section 661(a) for any amount which is treated under section 661(b) as consisting of any item of distributable net income which is not included in the gross income of the estate or trust. For example, if in 1962, a trust, which reports on the calendar year basis, has distributable net income of $20,000, which is deemed to consist of $10,000 of dividends and $10,000 of tax-exempt interest, and distributes $10,000 to beneficiary A, the deduction allowable under section 661(a) (computed without regard to section 661(c)) would amount to $10,000 consisting of $5,000 of dividends and $5,000 of tax-exempt interest. The deduction actually allowable under section 661(a) as limited by section 661(c) is $4,975, since no deduction is allowable for the $5,000 of tax-exempt interest and the $25 deemed distributed out of the $50 of dividends excluded under section 116, items of distributable net income which are not included in the gross income of the estate or trust.

[1925] See fn. 1920.

DNI the trust retains and which items of DNI the trust distributes to beneficiaries. However, such a provision might encounter significant resistance from the IRS.[1926]

Once one decides which items of DNI the trust distributes to beneficiaries, generally distributions to each beneficiary carry out a pro rata portion of ordinary income and capital gain items allocated to the beneficiaries, and any other characteristic of the income at the trust level retains its status in the beneficiary's hands[1927] (which, among other things, is important for net investment income tax purposes).[1928]

[1926] In adopting Reg. § 1.642(c)-3(b)(2), which is quoted in fn. 1920, T.D. 9582 rebuffed criticism of the regulation, saying:

> Permitting an ordering rule with no economic effect independent of income tax consequences to supersede the pro rata allocation rule generally applicable under Subchapter J would, in effect, permit taxpayers to deviate at will from the general rule imposed throughout Subchapter J in the case of all kinds of complex trusts.

[1927] Code § 652(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary.

Code § 662(b) provides that amounts included in the beneficiary's income for regular income tax purposes:

> … shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income (including the deduction allowed under section 642(c)) shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary. In the application of this subsection to the amount determined under paragraph (1) of subsection (a), distributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year.

Reg. § 1.662(b)-1 provides:

> In determining the amount includible in the gross income of a beneficiary, the amounts which are determined under section 662(a) and §§ 1.662(a)-1 through 1.662(a)-4 shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The amounts are treated as consisting of the same proportion of each class of items entering into the computation of distributable net income as the total of each class bears to the total distributable net income of the estate or trust unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For this purpose, the principles contained in § 1.652(b)-1 shall apply.

Reg. § 1.652(b)-1 provides:

This proportionate requirement applies "unless the terms of the governing instrument specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation."[1929]

> In determining the gross income of a beneficiary, the amounts includible under § 1.652(a)-1 have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts specified in § 1.652(a)-1 consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hands for purposes of determining the availability to the beneficiary of the dividends received credit under section 34 (for dividends received on or before December 31, 1964) and the dividend exclusion under section 116…. Similarly, to the extent such amounts consist of an amount received as a part of a lump sum distribution from a qualified plan and to which the provisions of section 72(n) would apply in the hands of the trust, such amount shall be treated as subject to such section in the hands of the beneficiary except where such amount is deemed under section 666(a) to have been distributed in a preceding taxable year of the trust and the partial tax described in section 668(a)(2) is determined under section 668(b)(1)(B). The tax treatment of amounts determined under § 1.652(a)-1 depends upon the beneficiary's status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includibility of such income in his gross income depends upon his taxable status with respect to that income.

[1928] See fn. 1564, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

[1929] Reg. § 1.662(b)-1, which is quoted in fully in fn. 1927. Furthermore, Reg. § 1.652(b)-2(a) provides:

> The amounts specified in § 1.652(a)-1 which are required to be included in the gross income of a beneficiary are treated as consisting of the same proportion of each class of items entering into distributable net income of the trust (as defined in section 643(a)) as the total of each class bears to such distributable net income, unless the terms of the trust specifically allocate different classes of income to different beneficiaries, or unless local law requires such an allocation. For example: Assume that under the terms of the governing instrument, beneficiary A is to receive currently one-half of the trust income and beneficiaries B and C are each to receive currently one-quarter, and the distributable net income of the trust (after allocation of expenses) consists of dividends of $10,000, taxable interest of $10,000 and tax-exempt interest of $4,000. A will be deemed to have received $5,000 of dividends, $5,000 of taxable interest, and $2,000 of tax-exempt interest; B and C will each be deemed to have received $2,500 of dividends, $2,500 of taxable interest, and $1,000 of tax-exempt interest. However, if the terms of the trust specifically allocate different classes of income to different beneficiaries, entirely or in part, or if local law requires such an allocation, each beneficiary will be deemed to have received those items of income specifically allocated to him.

When allocating among beneficiaries:[1930]

> The terms of the trust are considered specifically to allocate different classes of income to different beneficiaries only to the extent that the allocation is required in the trust instrument, and only to the extent that it has an economic effect independent of the income tax consequences of the allocation.

II.J.8.f.ii. How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary

If the amount of DNI is less than the amount distributed to the beneficiary, the issues described in this part II.J.8.f.ii How Undistributed Capital Gains Being Allocated to DNI Affects Character of Income Trapped Inside of Trust Compared to Distributed to the Beneficiary become important.

Some income might be inadvertently trapped in the trust if the allocation rules of part II.J.8.f.i General Rules of the Proportion of DNI Constitutes Capital Gain Compared to Other Income apply without being modified by any special ordering rule in the trust agreement and if all of a pass-through entity's capital gain constitutes DNI under an approach described in part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus That's because looking exclusively at those two factors bypasses the analysis of part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal.

For example, trust has $10,000 of interest income. Trust's distributive share of partnership's income is $20,000 of dividend income and $70,000 of long-term capital gains. If the rules described in the preceding paragraph apply, then 10% of all distributions constitute interest income, 20% constitute dividend income, and 70% constitute long-term capital gains. Trust distributes $50,000 to the beneficiary. Therefore, each of the beneficiary and the trust has $5,000 of interest income, $10,000 of dividend income, and $35,000 of long-term capital gains.

Contrast that to an approach under which the trustee is able to control how much capital gain is included in DNI, under part II.J.5.c.i Basic Framework for Allocating Capital Gain to DNI If Allocated to Income or Principal. On a year-by-year basis, the trustee can selectively include capital gain in DNI to the extent that one or both of part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a

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[1930] Reg. § 1.652(b)-2(a). Reg. § 1.652(b)-2(b) provides the following:

> (1) Allocation pursuant to a provision in a trust instrument granting the trustee discretion to allocate different classes of income to different beneficiaries is not a specific allocation by the terms of the trust.
>
> (2) Allocation pursuant to a provision directing the trustee to pay all of one income to A, or $10,000 out of the income to A, and the balance of the income to B, but directing the trustee first to allocate a specific class of income to A's share (to the extent there is income of that class and to the extent it does not exceed A's share) is not a specific allocation by the terms of the trust.
>
> (3) Allocation pursuant to a provision directing the trustee to pay half the class of income (whatever it may be) to A, and the balance of the income to B, is a specific allocation by the terms of the trust.

Distribution to a Beneficiary or part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary is available. By including in DNI just enough capital gain to cause the DNI to match the cash distributed to the beneficiary, the trustee can ensure that all of the ordinary income is distributed to the beneficiary.

II.J.8.g. Effectuating Allocation of Capital Gain to DNI

Form 1041 (Schedule D), Part III, column (1) allocates the beneficiaries' shares. Once one separates that, the rest should flow naturally.

II.J.9. Separate Share Rule; Trust Divisions

II.J.9.a. Separate Share Rule

In addition to its significance for fiduciary income tax purposes, the separate share rule can be critically important for determining a trust's eligibility for QSST treatment[1931] and for certain nonqualified deferred compensation plans.[1932]

"A separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists," [1933] which really means that "distributions of the trust are to be made in

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[1931] See part III.A.3.e.i.(a) QSSTs Generally, especially fns. 4475-4477.

[1932] Reg. § 1.404(a)-12(b)(3).

[1933] Reg. § 1.663(c)-2(a), which applies to trusts other than qualified revocable trusts within the meaning of Code § 645(b)(1). For estates and such qualified trusts:

> The applicability of the separate share rule provided by section 663(c) to estates and qualified revocable trusts within the meaning of section 645(b)(1) will generally depend upon whether the governing instrument and applicable local law create separate economic interests in one beneficiary or class of beneficiaries of such estate or trust. Ordinarily, a separate share exists if the economic interests of the beneficiary or class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries.

Reg. §§ 1.663(c)-3(c) and 1.663(c)-4(c) discuss this economic interest:

> A share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

Reg. § 1.663(c)-3(b) explains how rights to distributions need to be separated:

> Separate share treatment will not be applied to a trust or portion of a trust subject to a power to:
>
> (1) Distribute, apportion, or accumulate income, or
>
> (2) Distribute corpus
>
> to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist.

substantially the same manner as if separate trusts had been created."[1934] If a trust (or estate) has separate and independent shares, such treatment "must prevail in all taxable years of the trust (or estate) unless an event occurs as a result of which the terms of the trust instrument and the requirements of proper administration require different treatment."[1935] This rule applies "even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust (or estate), and even though no physical segregation of assets is made or required."[1936] Special rules apply to specific bequests, trusts with Code § 645 elections, and elective shares;[1937] also see part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

Reg. § 1.663(c)-3(d) explains that remote possibilities of distributions outside the separate share's targeted beneficiaries will not ruin separate share treatment:

> Separate share treatment may be given to a trust or portion of a trust otherwise qualifying under this section if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

However, such remoteness is not permitted for a QSST. See part III.A.3.e.i.(a) QSSTs Generally, fn. 4475.

[1934] Reg. § 1.663(c)-3(a), which explains:

> Thus, if an instrument directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the instrument provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

[1935] Reg. § 1.663(c)-1(d).

[1936] Reg. § 1.663(c)-1(c).

[1937] Reg. § 1.663(c)-4(a) provides:

> Separate shares include, for example, the income on bequeathed property if the recipient of the specific bequest is entitled to such income and a surviving spouse's elective share that under local law is entitled to income and appreciation or depreciation. Furthermore, a qualified revocable trust for which an election is made under section 645 is always a separate share of the estate and may itself contain two or more separate shares. Conversely, a gift or bequest of a specific sum of money or of property as defined in section 663(a)(1) is not a separate share.

Reg. § 1.663(c)-4(b) provides:

> Notwithstanding the provisions of paragraph (a) of this section, a surviving spouse's elective share that under local law is determined as of the date of the decedent's death

If different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income (DNI) allocable to the respective beneficiaries under Code §§ 661 and 662.[1938] Any separate share's DNI is computed as if each share constituted a separate trust or estate:[1939]

- Gross income includible in DNI that is fiduciary accounting income "is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law."[1940]

- Gross income includible in DNI that is income in respect of a decedent under Code § 691(a) and is not fiduciary accounting income "is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts."[1941]

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and is not entitled to income or any appreciation or depreciation is a separate share. Similarly, notwithstanding the provisions of paragraph (a) of this section, a pecuniary formula bequest that, under the terms of the governing instrument or applicable local law, is not entitled to income or to share in appreciation or depreciation constitutes a separate share if the governing instrument does not provide that it is to be paid or credited in more than three installments.

[1938] Reg. § 1.663(c)-1(a). Reg. § 1.663(c)-1(b) elaborates:

The separate share rule does not permit the treatment of separate shares as separate trusts (or estates) for any purpose other than the application of distributable net income. It does not, for instance, permit the treatment of separate shares as separate trusts (or estates) for purposes of:

(1) The filing of returns and payment of tax,

(2) The deduction of personal exemption under section 642(b), and

(3) The allowance to beneficiaries succeeding to the trust (or estate) property of excess deductions and unused net operating loss and capital loss carryovers on termination of the trust (or estate) under section 642(h).

[1939] Reg. § 1.663(c)-2(b)(1), which further provides:

Accordingly, each separate share shall calculate its distributable net income based upon its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses.

[1940] Reg. § 1.663(c)-2(b)(2).

[1941] Reg. § 1.663(c)-2(b)(3). Reg. § 1.663(c)-5, Example (9), provides:

The will of Testator, who dies in 2000, directs the executor to divide the residue of the estate equally between Testator's two children, A and B. The will directs the executor to fund A's share first with the proceeds of Testator's individual retirement account. The date of death value of the estate after the payment of debts, expenses, and estate taxes is $9,000,000. During 2000, the $900,000 balance in Testator's individual retirement account is distributed to the estate. The entire $900,000 is allocated to corpus under applicable local law. This amount is income in respect of a decedent within the meaning of section 691(a). The estate has two separate shares, one for the benefit of A and one for the benefit of B. If any distributions are made to either A or B during the year, then, for purposes of determining the distributable net income for each separate share, the $900,000 of income in respect of a decedent must be allocated to A's share.

- Gross income includible in DNI "that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items) … is allocated among the separate shares in the same proportion as [fiduciary accounting] income from the same source would be allocated under the terms of the governing instrument or applicable local law."[1942]

- "Any deduction or any loss which is applicable solely to one separate share of the trust or estate is not available to any other share of the same trust or estate."[1943] It is unclear whether (a) this merely keeps the deduction within its share to offset its share's income but allows a net loss from a separate share might lower the trust's and therefore the other shares' tax liability, or (b) it completely prevents the loss generated by one share from reducing the amount included in the income of the other shares' beneficiaries.[1944] I believe that the former is the better view,[1945]

The Example is troubling, in that the allocation of the IRA does not have economic effect under the actual facts. However, if the residue is less than $1.8 million, then A gets $900,000 and B gets the balance, which would be less than what A received. The fact that the estate was more than that does not change the possible economic effect, because one never knew how large the IRA or the estate would be.

[1942] Reg. § 1.663(c)-2(b)(4).

[1943] Reg. § 1.663(c)-2(b)(5).

[1944] Although the above allocations govern the allocation of DNI, Code §§ 661 and 662 govern how much income the trust can deduct and consequently include in a beneficiary's income. That amount is the lesser of DNI or the sum of income required to be distributed for a taxable year and any other amounts properly paid or credited or required to be distributed for such taxable year. Code § 661(a). These amounts are allocated to the beneficiaries and included in their income. Code § 662(a).

However, because the only mechanism for a beneficiary to deduct a loss is either depreciation deductions (see part II.J.11.a.ii.(b) Beneficiary's Ability to Deduct Depreciation That Generates Net Loss) or loss on termination (Code § 642(h)), a beneficiary cannot deduct a loss and the trust cannot carry over a loss other than one generated by a business (Code § 642(d)) or a capital loss (Code § 1212). Thus, if a separate share has a net loss, the beneficiary(ies) will not deduct that loss. See part II.J.3.i Planning for Excess Losses.

Consider the following scenario: Trust has $10,000 of taxable interest income, allocated to share A, and $10,000 of state income tax liability, attributable to taxes on the prior year's municipal bond interest earned by share B earned before the bonds were sold at no gain or loss. The trust distributes $10,000 to A and $10,000 to B, each out of her own share. The trust's taxable income, ignoring exemptions, is zero. Applying Reg. § 1.663(c)-2(b)(5) to disallow the state income tax deduction would result in A including $10,000 in income and the trust having a $10,000 loss ($10,000 interest income minus the $20,000 sum of the $10,000 income distribution deduction and the $10,000 state income tax liability). Which is correct: zero taxable income for everyone, or $10,000 taxable income to A and the trust has a $10,000 loss that benefits nobody? In other words, does the trust's overall DNI of zero control, or do A's DNI of $10,000 and B's DNI of negative $10,000 control?

Consider another scenario: share A has $10,000 of dividends and $10,000 of capital gain through a partnership that distributes $20,000 as a distribution of operating income (and not a distribution in partial liquidation), and share B has no dividends and $10,000 of capital loss through a partnership that distributes $20,000 of cash as a distribution of the prior year's operating income. On Form 1041, Schedule D, the capital gain and loss offset. We know that the separate share rule prevents B from reporting any of A's income. However, does the separate share rule tax $20,000 ($10,000 of dividends and $10,000 of capital gain) or $10,000 (dividends only, because capital gains were offset by capital loss) to A? If the former, what mechanism is there for although when taking that position one might attach IRS Form 8275-R because on its face that position appears to contradict Reg. § 1.663(c)-2(b)(5).[1946] If one or more separate shares benefit from the overall ceiling of tax liability, then the trustee should consider making an equitable adjustment to compensate the share that generated the loss for the benefit that the other share(s) received – especially because that loss is probably reflected in lower tax basis of assets held by the share that generated the loss. If one is doing an interim division of a trust, holding some back in the general residue but opening up a separate account within a trust to represent a separate share for each beneficiary or group of beneficiaries, one might consider raising this issue and clarifying the approach to be taken if one share generates a loss.

In making the above allocations to separate shares, "the fiduciary must use a reasonable and equitable method to make the allocations, calculations, and valuations…."[1947] For example, a principal distribution from one share that is disproportionately larger than a principal distribution from another share should affect the relative allocation of income between those shares.[1948]

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preserving the $10,000 capital loss allocated to B? Nowhere do the Instructions for Schedule D (Form 1041) address this issue; even if one allocated share B's capital loss to the trust instead of to the beneficiaries, neither the tax return nor the Capital Loss Carryover Worksheet in the Instructions provides a mechanism that prevents netting the beneficiaries' capital gain against the trust's capital loss in a manner that would generate a capital loss carryover for share B.

[1945] Yu, "Deductions in a Proposed Calculation and Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate," 5 Pitt. Tax Rev. 123 (2008) (saved as my document no. 6167169), reviews the two approaches to resolve the issue raised in fn. 1944 and the accompanying text and states that the view I adopted is the better approach. Footnote 93 in Yu's article cited F. Ladson Boyle & Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (15th ed. 2008), as saying on pages 3-104 to 3-105 the following about Reg. § 1.663(c)-2(b)(5):

> Notwithstanding this rule [that any deduction or loss that is applicable solely to one separate share is not available to any other share], when a net loss in one share results in the DNI of an entire trust being less than the potential DNI of a different share (computed as though it was a separate trust), the DNI of the share with net income should not exceed the DNI of the trust. The effect of limiting the DNI of the profitable, second share to the trust's DNI is to give the second share the benefit of the net loss in the first share.

Informal email conversations with Lad and Jonathan in April 2015 confirmed that they had not changed their view on this issue.

Reg. § 1.663(c)-1(a) explains the philosophy of the separate share rules, applying them to an example, and concludes, "In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B." Yu's preferred approach that I adopted does not cause any income to be shifted from one beneficiary to another; it merely limits the estate's deduction consistent with the overall DNI limitation of Code § 661(a).

[1946] Such an explanation is saved as my document no. 6149985.

[1947] Reg. § 1.663(c)-2(c).

[1948] Reg. § 1.663(c)-5, Example (3) provides:

> The facts are the same as in Example 2, except that in 2000 the executor makes the payment to partially fund the children's trust but makes no payment to the surviving spouse. The fiduciary must use a reasonable and equitable method to allocate income and expenses to the trust's share. Therefore, depending on when the distribution is made to the trust, it may no longer be reasonable or equitable to determine the

However, the amount the trust deducts[1949] and the amount each separate share includes in income[1950] is the lesser of the DNI allocated to[1951] or the amount actually distributed to that separate share.

The charitable deduction reduces the amount allocable to DNI.[1952] After separate shares are determined, the charitable deduction reduces the amount of DNI allocated to each separate share.[1953] Furthermore, generally the charitable deduction proportionately reduces the other deductions allocable to each share.[1954]

If a beneficiary dies, to the extent that this part II.J.9.a does not apply, see part II.J.6 Income Allocation on Death of a Beneficiary.

II.J.9.b. Trust Divisions

If a trust is divided so that each trust has the same beneficial interests but different assets and trustees, the division itself will not carry out income from one trust to the other.[1955] If one trust later distributes to another trust as a conduit to make distributions to the beneficiaries, the distribution will carry out DNI; however, if the distribution is just

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> distributable net income for the trust's share by allocating to it 40% of the estate's income and expenses for the year. The computation of the distributable net income for the trust's share should take into consideration that after the partial distribution the relative size of the trust's separate share is reduced and the relative size of the spouse's separate share is increased.

T.D. 8849 added this example December 27, 1999, presumably superseding the approach taken in Letter Ruling 9644057, which ruling approved disproportionate distributions of principal without changing the distribution of income.

[1949] Code § 661(a).

[1950] Code § 662(a).

[1951] Code § 663(c) allocates DNI and therefore is a factor the determining, rather than the sole determinant of, the amount deducted by the trust or estate and included in the beneficiary's income.

[1952] Code § 663(a)(2) and Reg. § 1.663(a)-2, the former which is incorporated by reference into Reg. § 1.661(a)-1. For the charitable fiduciary income tax deduction, see part II.J.4.c Charitable Distributions.

[1953] Reg. § 1.663(c)-5, Example (11) provides:

> The will of Testator, who dies in 2000, provides that after the payment of specific bequests of money, the residue of the estate is to be divided equally among the Testator's three children, A, B, and C. The will also provides that during the period of administration one-half of the income from the residue is to be paid to a designated charitable organization. After the specific bequests of money are paid, the estate initially has three equal separate shares. One share is for the benefit of the charitable organization and A, another share is for the benefit of the charitable organization and B, and the last share is for the benefit of the charitable organization and C. During the period of administration, payments of income to the charitable organization are deductible by the estate to the extent provided in section 642(c) and are not subject to the distribution provisions of sections 661 and 662.

[1954] See part II.J.8.f.i.(a) Allocating Deductions to Various Income Items, especially fn. 1920.

[1955] Letter Ruling 201642028. For a similar result for decanting, see part II.J.4.i Modifying Trust to Make More Income Tax Efficient.

to shift funds between with the trusts without the shift being related to distributions, the shift does not carry DNI.[1956]

Whether a trust division shifts the grantor does not affect whether the division constitutes a distribution that carries out DNI.[1957]

II.J.10. Consider Extending Returns for Year of Death and Shortly Thereafter

If an estate tax audit results in higher values and therefore higher basis, the related fiduciary income tax return might need to be amended to take advantage of higher basis to reduce gain on sale of assets or increase depreciation deduction.

II.J.11. Trust Business Income Tax Nuances

II.J.11.a. Depreciation Advantages and Disadvantages

II.J.11.a.i. Code § 179 Disallowance for Nongrantor Trust

Code § 179 allows businesses to expense depreciable personal property within certain limits, which limits have become much more generous in recent years.[1958] However, a trust cannot deduct this special Code § 179 expense that flows through on its K-1 from a partnership or S corporation.[1959] The business entity does not reduce its basis in, and may depreciate, this depreciable property to the extent that this deduction is

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[1956] Letter Ruling 201642028.

[1957] T.D. 8831 (8/6/1999), provides:

> Commenters also questioned a provision in the proposed regulations that treated a distribution from one trust to another trust that is a beneficiary of the first trust as a gratuitous transfer, with the result that the first trust was a grantor of the second trust. Under the temporary regulations, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, such person is treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Code. (These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.)

See parts II.D.3 Trust as Grantor of a Trust and III.B.2.h.i Who Is the Grantor, the latter including fns. 4990-4993.

[1958] See Stevens, "Section 179's Special Pass-Through Entity Rules," *Business Entities* (WG&L) (July/August 2010).

[1959] Code § 179(d)(4).

disallowed.[1960] Presumably, this complexity would be avoided by using a grantor trust.[1961]

II.J.11.a.ii. Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses)

II.J.11.a.ii.(a). Separate Reporting of Depreciation Deductions Allocable to Beneficiary

When a depreciation deduction of a trust is allocable to its beneficiaries, and where such deductions if separately taken into account by the trust would result in an income tax liability for the trust different from that which would result if the trust did not take such deductions into account separately, then the partnership's depreciation must be separately reported on the K-1 that the trust receives; a similar rule applies to depreciation allocated between a life tenant and the remaindermen or between an estate and its beneficiaries.[1962]

The allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each;[1963] however, if the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve is apportioned between the income

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[1960] Reg. § 1.179-1(f)(3). Because the regulation specifically refers to S corporations, presumably this regulation overrides the general rule that all S corporation shareholders are taxed the same; the only way to give effect to this regulation would appear to make a special allocation of depreciation expense (including bonus depreciation – see part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation) to the trust or estate. Presumably, an S corporation or partnership would allocate the asset's inside basis, depreciation expense, and other tax attributes to the trust, including not reducing the basis of the trust's interest in the business until depreciation expense is incurred.

[1961] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially fn. 4914, for the proposition that the grantor of a grantor trust is deemed to own directly any asset owned by that trust.

[1962] Rev. Rul. 74-71. See 2013 Form 1041, Schedule K-1, line 9. Code § 167(d) provides:

> *Life tenants and beneficiaries of trusts and estates*. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust, the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. In the case of an estate, the allowable deduction shall be apportioned between the estate and the heirs, legatees, and devisees on the basis of the income of the estate allocable to each.

See Ransome, "Allocating Partnership Depreciation Between Trusts and Beneficiaries,"

For an elaboration on rules governing estates, see *Estate of Nissen v. Commissioner*, 345 F2d 230 (4th Cir. 1965), *rev'g* 41 T.C. 522 (1964); *Lamkin v. U.S.*, 533 F2d 303 (5th Cir. 1976).

[1963] Code § 642(e) provides:

> An estate or trust shall be allowed the deduction for depreciation and depletion only to the extent not allowable to beneficiaries under sections 167(d) and 611(b) .

beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each,[1964] and the trust agreement may not override this rule.[1965] No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument.[1966] I am unaware of any guidance how to allocate in a sprinkle trust; presumably, those beneficiaries who tend to receive distributions would be the ones entitled to the depreciation deductions.

If a trust holds mortgaged property and the trustee charges payments of mortgage principal against trust income in determining the amount to be distributed to the trust's beneficiaries, depreciation must be allocated to the trust, by multiplying the total allowable depreciation by a fraction, the numerator of which is the amount of income accumulated and the denominator of which is the total trust income computed under Code § 643(b).[1967]

For an in-depth discussion of allocating depreciation, see Lawson, "Tax Planning for Rental Real Estate Owned by a Trust," *Estate Planning Journal* (Vol. 40, No. 9, Sept. 2013).

II.J.11.a.ii.(b). Beneficiary's Ability to Deduct Depreciation That Generates Net Loss

Although the depreciation and depletion deductions are apportioned on the basis of the income of the estate or income of the trust allocable to each of the parties (without regard to any depreciation or depletion allocable to them), they are not limited by the amount of such income.[1968]

Therefore, a fiduciary might be able to allocate depreciation and depletion deductions between an estate and its heirs, legatees, and devisees or between a trust and its beneficiaries in amounts that are greater than their pro rata shares of the income of the estate or income of the trust.[1969]

See also part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

[1964] Reg. § 1.167(h)-1(b), incorporated by reference by Reg. § 1.642(e)-1, the latter of which (not yet amended to reflect changes made by P.L. 101-508, P.L. 97-34, P.L. 94-455) provides:

> An estate or trust is allowed the deductions for depreciation and depletion, but only to the extent the deductions are not apportioned to beneficiaries under sections 167(h) and 611(b). For purposes of sections 167(h) and 611(b), the term "beneficiaries" includes charitable beneficiaries. See the regulations under those sections.

[1965] *Dusek v. Commissioner*, 376 F.2d 410 (10th Cir. 1967).

[1966] Reg. § 1.167(h)-1(b).

[1967] Rev. Rul. 90-82.

[1968] Rev. Rul. 74-530.

[1969] Rev. Rul. 74-530.

II.J.11.a.ii.(c). Trust vs. Separately Recognized Business Entity Holding Depreciable Property

If the trust holds depreciable property through a partnership, the trustee might not be making any decision regarding depreciation reserve, if the trustee is counting on the partnership to make any appropriate reserve.[1970] In that case, presumably the depreciation deduction would be allocated solely to the beneficiaries who do or may receive current distributions. Furthermore, passing the deductions through to any beneficiaries who participate in the business would simplify any passive loss issues (if and to the extent that the passive loss rules do not supersede this part II.J.11.a.ii),[1971] because the rules for determining an individual's participation are more well-defined and easier to apply than determining a trust's participation.[1972]

If a trust holds depreciable property through an S corporation, consider the following:

- If a nongrantor trust is permitted to hold the stock without making an ESBT or a QSST election,[1973] then see the discussion above regarding partnerships.

- If and to the extent an ESBT is a nongrantor trust, the depreciation deductions are trapped inside the trust.[1974] (This is a bad result if the trust is included in a person's estate.)[1975]

1970 Query whether the aggregate theory of partnership taxation affects this analysis any.

1971 See part II.K.2.b.iv Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary.

1972 See part II.K.2.b Participation by an Estate or Nongrantor Trust.

1973 See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation and III.A.3.e QSSTs and ESBTs.

1974 See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, which generally traps in a trust all items on an S corporation's K-1. Reg. § 1.641(c)-1 does not expressly discuss the depreciation issue, the only authority being Reg. § 1.641(c)-1(d)(2)(i):

> (i) *In general*. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. [then discusses ESBT elections for a partial year]

The second sentence tends to suggest applying this part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses) would apply to S corporation K-1 items. However, in requiring breaking out separately stated items, Code § 1366(a)(1)(A) cross-references Code § 702(a)(4), (6), but depreciation deductions under this this part II.J.11.a.ii would fall under Code § 702(a)(7) by reason of Reg. § 1.702-1(a)(8)(ii). On the other hand, fiduciary income tax return form instructions refer to items under this part II.J.11.a.ii from a pass-through; by not specifying the type of pass-through, do these instructions suggest that S corporation items would fall under this part II.J.11.a.ii? Ultimately, the issue appears decided in favor of trapping these deductions in the trust by the language at the end of Code § 641(c)(2)(C), "…no item described in this paragraph shall be apportioned to any beneficiary," which per Code § 641(c)(2)(C)(i) includes any item described in Code § 1366.

1975 See part II.H.2.d Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate.

- If and to the extent the trust is grantor trust deemed owned by the grantor or the beneficiary (the latter including QSSTs), the deemed owner (including the deemed owner of an ESBT)[1976] would be allocated the depreciation deductions, because the grantor trust rules supersede everything.

II.J.11.b. Code § 1244 Treatment Not Available for Trusts

Individuals may deduct as an ordinary a loss incurred on the first $50,000 or $100,000 on the sale of small business corporation stock under Code § 1244.[1977]

Trusts and estates are not entitled to this treatment.[1978]

Note that, for S corporations, trusts can deduct losses as the S corporation incurs them if they have sufficient basis,[1979] so that the S corporation's ordinary losses will provide current annual benefit to the trust, and the trust's basis in the stock would be correspondingly reduced, which reduces the chance of the trust having a capital loss on disposition of the S corporation stock. Therefore, this issue is much more of concern for trusts owning C corporation stock than for trusts owning S corporation stock.

II.J.12. Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act

Articles by Dobris (1979)[1980] and Blattmachr (1984)[1981] seem to be the leading authority in this area. In exercising tax elections, trustees may have these duties:[1982]

(1) the duty to minimize the overall tax burden on the estate and its beneficiaries;

(2) the duty of impartiality; and

(3) the duty to abstain from self-dealing.

Harris Trust & Sav. Bank v. MacLean, 542 N.E.2d 943 (1st Dist. Ill. 1989), involved a common situation: Trust recognizes big capital gain and pays federal and state capital gain tax. Both taxes are charged to principal. However, the income beneficiaries

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[1976] Reg. § 1.641(c)-1(c).
[1977] Part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation.
[1978] Code § 1244(d)(4).
[1979] See part II.G.3.c.i Basis Limitations for S Corporation Owners.
[1980] "Equitable Adjustments in Postmortem Income Tax Planning: An Unremitting Diet of Warms," 65 *Iowa L. Rev.* 103 (1979), saved as Thompson Coburn doc. no. 6174776.
[1981] "The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey," *18th University of Miami (Heckerling) Estate Planning Institute ¶ 1400* (1984).
[1982] *Estate of Rappaport*, 467 N.Y.S.2d 814 (N.Y. 1983), citing Carrico and Bondurant, "Equitable Adjustments: A Survey and Analysis of Precedents and Practice," 36 The Tax Lawyer, 545–6. Earlier the opinion discussed with approval Dobris, "Limits on the Doctrine of Equitable Adjustment in Sophisticated Post-mortem Tax Planning," 66 Iowa L. Rev., 273, 297–8. When administrative expenses are not needed to be deducted on an estate tax return to save estate tax, consider deducting them for income tax purposes. *Matter of Ettinger*, 564 N.Y.S.2d 691 (1990). When fiduciaries have conflicts of interest in exercising tax elections, a court may resolve the issue. *Matter of Estate of Spear*, 553 N.Y.S.2d 985 (1990).

benefitted the following year by deducting the state capital gain tax. The court held that the trustee could not reduce the beneficiaries' income account by the tax benefit they received, because a trustee should be able to make an equitable adjustment only for inequities resulting from a trustee's discretionary decisions.[1983] The court viewed the tax benefit from the deduction of state income taxes to be very small compared to the sales proceeds that benefitted the principal beneficiaries, even though the benefit was probably hundreds of thousands of dollars. Blattmachr had indicated mixed results on this issue before this case was decided.[1984]

The Uniform Principal & Income Act, which has not been enacted in Illinois,[1985] takes the following approach:[1986]

[1983] The court reasoned and held:

> The question of whether a trustee is required to make an equitable adjustment between the trust's income and principal accounts where inequitable consequences result from the mandatory application of tax laws is one of first impression in Illinois. Several courts in other jurisdictions have addressed this issue. Some courts have suggested that an equitable adjustment should only be applied in response to a trustee's election or discretionary decision (*In re Dick's Estate* (1961), 29 Misc.2d 648, 218 N.Y.S.2d 182; *In re Kent's Estate* (1964), 23 Fla. Supp. 133), while one court has approved an adjustment to correct inequities not caused by any discretionary decision of the trustees (*Rice Estate* (1956), 8 Pa. D & C 2d 379) and another has rejected a distinction between discretionary decisions and mandatory applications (*In re Holloway's Estate* (1972), 68 Misc.2d 361, 327 N.Y.S.2d 865).
>
> We believe the better view is that equitable adjustments should be applied only in response to inequities resulting from a trustee's discretionary decisions which favor one beneficiary or class of beneficiaries over another. We agree with the trustees' position that the common law doctrine of equitable adjustments should only be employed in such circumstances because this concept is grounded in the fiduciary duty of a trustee not to be partial in making decisions or elections impacting on successive beneficiaries. (See *In re Warms' Estate* (Surr. Ct. 1955), 140 N.Y.S.2d 169; *In re Bixby's Estate* (1956), 140 Cal.App.2d 326, 295 P.2d 68.) The fiduciary should not be required to cure the inequities resulting from the application of mandatory tax laws; rather, any corrective action is more properly left for the legislature. *In re Dick's Estate*, 29 Misc.2d 648, 218 N.Y.S.2d 182; accord *In re Kent's Estate*, 23 Fla. Supp. 133.

I have been told that a Massachusetts court reached the same result.

[1984] See fn. 1981, ¶ 1403.3 Corpus Expenses Benefit Income and Not Corpus but Not as a Result of Fiduciary Election, fns. 30-33. A leading case he cited, *In re Holloway's Estate*, 68 Misc.2d 361, 327 N.Y.S.2d 865 (1972), held:

> It is this court's considered opinion, however, that the *Dick* case rationale lacks the requisite equitable approach. As one writer observed: "Sections of the 1954 Code dealing with estate and trusts yield other examples directly contrary to both estate and trust law and common sense. For example, subchapter J, part I, was apparently drawn by tax lawyers not entirely familiar with trust concepts or fiduciary accounting principles. *The fiduciary and the court must be free in such cases to repair the damage by equitable adjustment*" (Browning, Problems of Fiduciary Accounting, 36 N.Y.U.L.Rev. 931, p. 953 [1961]). (Italics supplied.)

[1985] However, 760 ILCS 15/3(b)(2) allows a trustee to reallocate receipts "if the trustee in the trustee's discretion determines that application of the provisions of this Act would result in a substantial inequity to either the income beneficiaries or the remaindermen, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as those entitled to principal." The statute enacting the quoted provision was included in 1991 Ill. Legis. Serv. P.A. 87-714 (S.B. 717) (WEST).

Section 506. Adjustments Between Principal And Income Because Of Taxes.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

The official Comments include:

Discretionary adjustments. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain.

[1986] http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

See also part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation.

Settlement of an ambiguous provision allocating capital gain tax between income and principal should not carry with it any gift, GST, or income tax consequences (except, of course, to the extent that they modify cash distributions that carry out DNI).[1987] Similarly, when a trust erroneously reported capital gain as taxable to the beneficiary instead of to the trust, reimbursing the beneficiary for tax paid on the capital gain did not have gift, estate, or GST tax consequences.[1988]

[1987] Letter Ruling 201528024, addressing construction of a provision directing the trustee to collect all the income and out of such income pay or provide for "all proper taxes."

[1988] Letter Ruling 201735005, involving a QSST that sold its S corporation stock. Fir the income tax consequences of such a transaction, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). in the ruling:

> On or about Date 2, Trustee sold Trust's share of stock in Corporation in a transaction that resulted in capital gain to Trust for federal and state tax purposes. Pursuant to State law, the capital gains should have been allocated to Trust principal and all income taxes due on the capital gains were required to be paid from Trust principal. However, Trustee in connection with Trust's Form 1041, U.S. Fiduciary Income Tax Return, erroneously issued Daughter a K-1, Beneficiary's Share of In-come, Deductions, Credits, Etc., which treated the capital gain as a taxable distribution to Daughter for both federal and state tax purposes. As a result of receiving the K-1 Daughter reported the entire amount of the capital gain on her individual Federal and state income tax returns which she jointly filed with Spouse. The errors on the Schedules K-1 were in Year 1. Trustee distributed $A to Daughter in Year 2 as a partial reimbursement for the income taxes erroneously paid by Daughter and Spouse. Daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.
>
> Trustee prepared a draft of its first accounting as Trustee on Date 3. Upon receipt of the draft accounting, Daughter became aware that she was due an additional reimbursement from Trustee for the income taxes paid by Daughter and Spouse in connection with the sale of S Corporation stock.
>
> On or about Date 4, Trustee filed a Petition for Adjudication with Court seeking judicial approval of its first intermediate accounting (Accounting) from Date 5 to Date 6. On Date 7, Daughter, through her counsel, filed an objection (Objection) to the Accounting alleging that it failed to provide for the additional reimbursement to Daughter from Trust for state income taxes in the amount of $B, together with interest on the unreimbursed

When an estate deducted administrative expenses on its income tax return and reimbursed the principal for the income tax saved, the estate was allowed an estate tax deduction for the increased residue passing to charity (even though post-mortem actions normally do not affect the charitable deduction).[1989]

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taxes at a specified rate, and reimbursement of Daughter's attorney's fees incurred in connection with the Accounting and Objection.

On Date 8, Court entered an order (Order) ruling that the statute of limitations remains open for Daughter to object to any and all matters disclosed in the Accounting; and that the Accounting fails to provide for an additional reimbursement from Trust to Daughter for the unreimbursed taxes, interest and attorney's fees associated with the Accounting and Objection. Trustee intends, in accordance with the Order, to reimburse Daughter for the amount of the unreimbursed taxes, interest, and attorney's fees due for the erroneous payment of income taxes by Daughter and Spouse in Year 1.

The ruling held:

1. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not constitute a constructive addition by Daughter and Spouse to Trust under § 26.2601-1(b)(1)(v)(C).
2. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust and the subsequent reimbursement to them of the income taxes paid, together with interest and attorney's fees, does not cause any portion of Trust to become subject to chapter 13.
3. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with the taxable income of Trust does not constitute a gift to Trust for federal gift tax purposes where Daughter and Spouse have a right of recovery from Trust, they have exercised their rights, and Trustee, in fact, has previously reimbursed Daughter and Spouse a portion of the income taxes, and will further reimburse Daughter and Spouse the balance of income taxes together with, interest and attorney's fees.
4. The inadvertent payment by Daughter and Spouse of federal, State 1 and State 2 income taxes in connection with taxable income of Trust does not cause any portion of Trust to be includible in Daughter's gross estate.

[1989] Rev. Rul. 78-445, reasoning:

In *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), *acq*. and *nonacq.*, page 3, this Bulletin, the decedent bequeathed a remainder interest in the residuary trust to charity. The court, in effect, concluded that a reimbursement paid pursuant to section 11-1.2(A) of the Estates, Powers and Trusts Law (which actually codified the New York case law relied upon by the court) should be included in determining the amount passing to charity for purposes of section 2055(a).

The court determined that the purpose of such reimbursement (under section 11-1.2(A)) is to ensure that the amount passing to the residuary legatees in accordance with the decedent's will is not diminished by the additional estate tax payable as a result of the estate's election under section 642(g). To accomplish this, the statute requires a reimbursement, which effectively limits the amount of estate tax charged against the residue to the tax that would have been due had the administration expenses been deducted from the federal gross estate. The reimbursement is not properly characterized as an additional gift to the residuary legatees from the income recipient. Rather, the reimbursement ensures that the residuary legatees receive the amount they are otherwise entitled to receive under the terms of the decedent's will. The Service's acquiescence in Britenstool related to this issue.

Similarly, in the instant case, for purposes of section 2055(a), the value of the charitable deduction should be computed based on a residue of $825x, and not $800x. In

II.J.13. Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not

A nongrantor trust's NII passes through to beneficiaries as NII.

For a nongrantor trust, the determination of whether business income is passive and therefore constitutes NII is made at the trust level.

If the beneficiary is active but the trustee is not, considering doing the following:

1. The trust contributes its interest in the partnership or sole proprietorship into one or more S corporations.

2. The trust converts into a trust eligible to be subjected to a QSST election.

3. The beneficiary makes a QSST election.

For cautions in applying this strategy, see part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

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accordance with the court's decision in Britenstool, $825x represents the amount passing to the residuary trust from D, under the terms of D's will. The $25x reimbursement, which was paid pursuant to state law, merely ensured that this $825x amount would not be diminished as a result of the executor's section 642(g) election.

Reg. § 20.2055-3(b)(2)-(4) provide:

(2) *Effect of transmission expenses*. For purposes of determining the charitable deduction, the value of the charitable share shall be reduced by the amount of the estate transmission expenses paid from the charitable share.

(3) *Effect of management expenses attributable to the charitable share*. For purposes of determining the charitable deduction, the value of the charitable share shall not be reduced by the amount of the estate management expenses attributable to and paid from the charitable share. Pursuant to section 2056(b)(9), however, the amount of the allowable charitable deduction shall be reduced by the amount of any such management expenses that are deducted under section 2053 on the decedent's federal estate tax return.

(4) Effect of management expenses not attributable to the charitable share. For purposes of determining the charitable deduction, the value of the charitable share shall be reduced by the amount of the estate management expenses paid from the charitable share but attributable to a property interest not included in the charitable share.

II.J.14. Application of 3.8% Tax to ESBTs

Electing small business trusts (ESBTs)[1990] are separated into S and non-S portions[1991] and subjected to the NII tax as follows:[1992]

1. The S portion and non-S portion computes each portion's undistributed net investment income as separate trusts[1993] and then combine these amounts to calculate the ESBT's undistributed net investment income.

2. The ESBT calculates the non-S portion's-adjusted gross income,[1994] increased or decreased by the S portion's net income or net loss, after taking into account all the S portion's deductions, carryovers, and loss limitations, as a single item of ordinary income (or ordinary loss).

3. The ESBT will pay tax on the lesser of (a) the ESBT's total undistributed net investment income, or (b) the excess of the ESBT's adjusted gross income[1995] over the dollar amount at which the highest fiduciary income tax bracket begins.

Beyond the 3.8% tax on NII, consider parts II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good, particularly noting the IRS' position on NOLs incurred by an ESBT when the S corporation stock it owns generates losses.[1996]

[1990] See part III.A.3.e.ii ESBTs.

[1991] Reg. § 1.1411-3(c)(1) provides:

> The S portion and non-S portion (as defined in § 1.641(c)-1(b)(2) and (3), respectively) of a trust that has made an ESBT election under section 1361(e)(3) and § 1.1361-1(m)(2) are treated as separate trusts for purposes of the computation of undistributed net investment income in the manner described in paragraph (e) of this section, but are treated as a single trust for purposes of determining the amount subject to tax under section 1411. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion (as defined in § 1.641(c)-1(b)(1)) are included in the grantor's calculation of net investment income and are not included in the ESBT's computation of tax described in paragraph (c)(1)(ii) of this section.

[1992] Reg. § 1.1411-3(c)(2). Reg. § 1.1411-3(c)(3) provides an example.

[1993] In the manner described in Reg. § 1.1361-3(e).

[1994] As defined in Reg. § 1.1361-3-(a)(1)(ii)(B)(1).

[1995] As calculated under Reg. § 1.1361-3(c)(2)(ii).

[1996] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 4524.

II.J.15. QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items

II.J.15.a. QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax)

The preamble to the 2013 proposed regulations for net investment income tax generally explains the regular income tax treatment of sales involving QSSTs when discussing how the proposed regulations would treat the sales for net investment income tax purposes:[1997]

> H. Qualified subchapter S trusts (QSSTs)
>
> The preamble to the 2012 Proposed Regulations requested comments on whether special coordination rules are necessary to address dispositions of stock in an S corporation held by a QSST. Specifically, the request for comments deals with the application of section 1411(c)(4) to the existing QSST stock disposition mechanics in § 1.1361-1(j)(8).
>
> In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361-1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST. Section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8) provide that, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST is treated as a disposition by the income beneficiary. However, in this special case, the QSST beneficiary, for chapter 1 purposes, does not have any passive activity gain from the disposition. Therefore, the entire suspended loss (to the extent not allowed by reason of the beneficiary's other passive net income in the disposition year) is a section 469(g)(1) loss, and is considered a loss from a nonpassive activity.
>
> For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469. However, because gain or loss resulting from the sale of S corporation stock by the QSST will be reported by the QSST and taxed to the trust by reason of § 1.1361-1(j)(8), it is not clear whether the beneficiary's section 469 status with respect to the S corporation is attributed to the trust.
>
> One commentator recommended that the disposition of S corporation stock by a QSST should be treated as a disposition of the stock by the income beneficiary for purposes of determining material participation for purposes of section 1411. In addition, the commentator recommended that the final regulations confirm that

[1997] REG-130843-13.

> the special rule stated in the last sentence of § 1.1361-1(j)(8) applies for purposes of section 1411 as it does for section 469 and 465.
>
> After consideration of the comments, these proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level.
>
> This treatment is consistent with the chapter 1 treatment of the QSST by reason of § 1.1361-1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons.
>
> First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust. As discussed in part 4.F of the preamble to the 2013 Final Regulations, the Treasury Department and the IRS believe that the issue of material participation by estates and trusts, including QSSTs, is more appropriately addressed under section 469.
>
> Additionally, one commentator noted that the IRS has addressed the treatment of certain asset sales as the functional equivalent of stock sales for purposes of § 1.1361-1(j)(8) in a limited number of private letter rulings. In these cases, the private letter rulings held that gain from the sale of assets, which was followed by a liquidation, would be taxed at the trust level under § 1.1361-1(j)(8) rather than being taxed at the beneficiary level. The commentator recommended that an asset sale followed by a liquidation, within the context of § 1.1361-1(j)(8), should have a similar result under section 1411(c)(4). Similar to the issue of material participation by QSSTs discussed in the preceding paragraph, the Treasury Department and the IRS believe that the issue of whether an asset sale (deemed or actual) is the equivalent of a stock sale for purpose of the QSST rules should be addressed under the § 1.1361-1(j) QSST regulations, rather than in § 1.1411-7. However, the Treasury Department and the IRS believe that proposed § 1.1411-7(a)(4)(i), which provides that asset sales followed by a liquidation is a disposition of S corporation stock for purposes of section 1411(c)(4), address the commentator's QSST issue.
>
> Second, with respect to the section 1411 treatment of the disposition by the beneficiary by reason of section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8), the Treasury Department and the IRS believe that the general administrative principles enumerated in § 1.1411-1(a), when combined with the general treatment of section 469(g) losses within § 1.1411-4, provide an adequate framework for the treatment of QSSTs beneficiaries without the need for a special computational rule within § 1.1411-7.

For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs [1998] and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

[1998] Particularly the text accompanying fns. 4480-4482, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional

For planning issues relating to the dispositions described in this part II.J.15.a, see part II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets.

II.J.15.b. QSSTs and State Income Tax Issues

As a grantor trust with respect to S corporation items, the trust is not subjected to state income tax on those items; instead, the beneficiary is.

A state might even treat the trust as not existing while it is a grantor trust, providing the opportunity to treat the trust as a nonresident trust if the grantor moves to another state (for example, a state with no income tax).[1999] Thus, if a QSST holds only S corporation stock, then the QSST election might allow the trust's residency to be determined at a later, perhaps more favorable date.[2000]

Some trust agreements provide that any S corporation will be held in a separate QSST, leaving the original trust undisturbed as to any provisions that might be consistent with QSST status. This approach would appear to maximize the possibility of the delayed residence determination described above.

Of course, one would also want to consider the other factors mentioned in part II.J.3 Strategic Fiduciary Income Tax Planning rather than focusing exclusively on this issue.

II.J.16. Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets

Consider the following:

- The sale of ownership of a business entity is allocated to principal. Assuming the business interest is a capital asset, any capital gain is included in DNI only if certain exceptions are satisfied[2001] and any ordinary income[2002] is automatically included in DNI.[2003]

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planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). See also part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs, especially part III.A.3.e.v.(b) Implementation and, within that, the paragraph that includes a reference to fn. 4568.

[1999] See part II.J.3.e.ii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence.

[2000] Illinois Schedule K-1-P, which partnerships and S corporations use to report K-1 income includible in their owners' income, has a separate line, line 9b, which was "expanded to allow grantor trusts and other federally disregarded entities to identify the taxpayer that will report the income or loss shown on the Schedule K-1-P…." See Illinois Dept. of Rev. Info. Bulletin, No. FY 2013-09, 01/01/2013. That line was also on 2014 returns.

[2001] See part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI).

[2002] For example, the sale of a partnership interest might generate ordinary income from the sale of "hot assets" – see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest.

[2003] Code § 643(a).

- A flow-through entity might sell its assets, or a sale of S corporation stock might be taxed to the shareholders as a sale of the entity's assets followed by the corporation liquidating.[2004] Generally, assets used in business activities do not constitute capital assets, so capital gain from their sale is included in DNI without needing to apply the special rules for gain from the sale of a capital asset,[2005] and of course any ordinary income generated by depreciation recapture is included in DNI as well. Goodwill is a capital asset unless it has been subject to any amortization.[2006] Because this gain/income is included in DNI, the allocation of such gains to principal does not cause any particular limits to be placed on shifting them to beneficiaries if they are properly paid, credited, or required to be distributed.[2007] However, if and to the extent that they are not paid or credited during the year or within 65 days thereafter[2008] and are not required to distributed, consider whether they can be allocated to income if the trust is a mandatory income trust.[2009]

- State and local income taxes are not deductible in determining alternative minimum tax (AMT).[2010] Often the best way to prevent these items from triggering AMT is to pay them in the year in which the income that generated them is recognized. Given that a state might allow one to use the prior year's income tax as a safe harbor or might not require estimated tax payments at all, one might easily overlook the need to pay state income tax in the year of the sale (or other major income recognition event).

Although items on a K-1 from an S corporation generally are taxed the beneficiary as if the QSST were a grantor trust, gain from sale of the stock and gain from the sale or deemed sale of the corporation's assets (even if reported on a K-1) are taxed to the trust, not as part of the grantor trust portion.[2011] However, if the beneficiary's federal and state/local income taxation (including the 3.8% tax net investment income) are more favorable than the trust's and a distribution form the trust would not frustrate the trust's objectives, consider using the ideas in the bullet points above to shift taxation on any items otherwise taxable to the trust. It is not unusual for an income tax preparer to be unfamiliar with the QSST rules regarding taxation of the sale or deemed sale of the corporation's assets and not to plan for the correct taxation, so be sensitive to this issue up front and also consider reallocating principal to income if the trust is a mandatory

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[2004] See parts II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items and II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[2005] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.
[2006] See fns. 3030-3034.
[2007] Code § 661(a)(1), (c).
[2008] See part II.J.2 Tactical Planning Shortly After Yearend.
[2009] See parts II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation and II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act.
[2010] Code § 56(b)(1)(A)(ii).
[2011] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). For more information on the taxation of QSSTs, see parts III.A.3.e.i QSSTs (particularly the text accompanying fns. 4480-4482, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale) and III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs. If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result.

income trust.[2012] Although one might initially view the election to tax a stock sale as a sale of the business' assets (followed by liquidation) as merely substituting gain on the sale of assets for gain on the sale of stock, note that state income taxation might also generate surprising results; see part II.H.8.a.ii State Income Tax Disconnect.

For an ESBT, consider allocating administrative expenses and state income taxes to the S portion as much as is reasonable to do.[2013] Allocating administrative expenses to the non-S portion might create a loss that is not deductible unless the trust is terminating,[2014] making an allocation to the S portion even more desirable. In addition to that concern, allocating state income tax to the non-S portion might generate a large alternative minimum tax bill,[2015] which would not be owed if allocated to the S portion and paid in the year of sale.

If the trust is a QSST or if the trust is a grantor trust that would be converted to an ESBT shortly before the sale, consider making the trustee active in the business to maximize opportunities to avoid the 3.8% tax on net investment income and, in the case of a grantor trust, converting it to an ESBT far enough in advance of the sale for the trustee to accumulate sufficient hours of participation. See generally part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

If the trustee mistakenly taxes the sale to the beneficiary, reimbursing the beneficiary should not generate any transfer tax consequences.[2016]

II.J.17. Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax

This part II.J.17 assumes that avoiding NII characterization is the most important objective. Before making that assumption, see part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.[2017]

[2012] See part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation. In a QSST, one might be able to allocate principal to income to make up for expenses ordinarily allocated to principal that were allocated to income as an adjustment needed due to cash flow issues; see text accompanying fns. 4471-4474 in part III.A.3.e.i.(a) QSSTs Generally. For form language that might facilitate this allocation, see fn. 1878, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[2013] For ESBT tax issues, see parts II.J.14 Application of 3.8% Tax to ESBTs and III.A.3.e.ii.(b) ESBT Income Taxation - Overview, the latter especially including fns. 4526-4527.

[2014] Code § 642(h). See part II.J.3.i Planning for Excess Losses.

[2015] Code § 56(b)(1)(A)(ii).

[2016] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act, especially fn. 1988.

[2017] Particularly note the IRS' position on NOLs incurred by an electing small business trust (ESBT) when the S corporation stock it owns generates losses part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 4524.

Making income from operations and gain on sale be nonpassive income is the key to avoiding NII characterization:

- Generally, income from a trade or business is exempt from the 3.8% tax if it is nonpassive income.[2018]

- Gain on the sale of assets used in a nonpassive trade or business (or from the part of the sale of a partnership interest or S corporation stock allocable to such assets) is exempt from the 3.8% tax.[2019]

- The taxpayer needs to sufficiently participate in a business to make it nonpassive.[2020]

Consider the following:

- In an ESBT, the trust is the taxpayer.

- In a QSST, for normal operations, the beneficiary, as deemed owner under the grantor trust rules, is the taxpayer.

- In a QSST, when the business is sold, generally the trust will be the taxpayer.[2021]

- In a grantor trust, the deemed owner is the taxpayer, but the deemed owner might turn off the grantor trust powers before selling the business, generally making the trust the taxpayer, whether the trust is an ESBT or a QSST (or the business is taxed as partnership).

Thus, even when a trust is taxable to the grantor or beneficiary under the grantor trust rules, one might consider establishing the trustee's material participation at least a year before the business might be sold;[2022] whether this would count given the trust's being disregarded for income tax purposes has never been addressed, but, with rules regarding trust material participation so uncertain, these extra precautions might be worthwhile if the tax at risk is significant enough. This might require jumping through extra hoops if the entity was formed as a state law corporation, because a traditional corporate structure does not lend itself to the type of participation the IRS seeks.[2023]

For more discussion of QSSTs and ESBTs, see generally part III.A.3.e QSSTs and ESBTs, which compares and contrasts those types of trusts and discusses strategies for switching back and forth.

II.J.18. Other Special Purpose Trusts

See part II.D Special Purpose Trusts.

[2018] See part II.I.8 Application of 3.8% Tax to Business Income.
[2019] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[2020] See part II.K.1.a Counting Work as Participation.
[2021] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[2022] See part II.K.2.b Participation by an Estate or Nongrantor Trust.
[2023] See part II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.

II.K. Passive Loss Rules

II.K.1. Passive Loss Rules Generally

Although owners of partnerships and S corporations[2024] generally can deduct losses, subject to various basis and at-risk limitations, a passive loss from a trade or business[2025] is deductible only against other passive income[2026] or when the activity that generated the loss is sold;[2027] when a taxpayer disposes of a passive activity with current and suspended passive losses that exceed the gain on disposition, the net passive income and net passive losses from all of the taxpayer's other passive activities should be netted before any excess passive income is applied against the current and suspended passive losses from the disposed of activities, and any excess losses from

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[2024] *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016) ("In conclusion, we AFFIRM the decision of the Tax Court essentially for the reasons set out therein."), rejected a shareholder's argument that S corporation income is not subject to the passive losses because Code § 469 does not directly apply to S corporations, holding:

> Since S corporations and other passthrough entities do not pay tax, section 469 need not identify them as "taxpayers" to whom it applies, because the individual shareholders of an S corporation are the taxpayers to whom section 469 applies. The Court has previously recognized that income and losses from passthrough entities are subject to section 469, even though passthrough entities are not specifically included in the list of "taxpayers" to whom section 469 is applicable. See, *e.g.*, *Harnett v. Commissioner*, T.C. Memo. 2011-191 (applying section 469 to losses attributable to rental properties owned by an S corporation), *aff'd*, 496 Fed. Appx. 963 (11th Cir. 2012); *Dunn v. Commissioner*, T.C. Memo. 2010-198 (analyzing the grouping rules of section 469 with respect to various entities, including an S corporation); *Shaw v. Commissioner*, T.C. Memo. 2002-35 (applying section 469 and section 1.469-2(f)(6), Income Tax Regs., in various contexts, including the context of property leased by an S corporation); *Sidell v. Commissioner*, T.C. Memo. 1999-301 (holding income received via grantor trusts and reported as a passthrough item on taxpayers' Federal income tax returns was subject to section 469). The law is well settled in this area, and in numerous cases the Court has applied the passive loss limitations of section 469 to individuals who receive income from passthrough entities.

[2025] A mortgage or banking activity is a trade or business subject to the passive loss rules. INFO 2009-0229.

[2026] Code § 469(d)(1)(B).

[2027] Code § 469(g)(1), (3). Worthless stock is considered disposed of for purposes of this rule. See fn. 811. A foreclosure on real property subject to recourse debt comprising a taxpayer's entire interest in a passive (or former passive) activity qualifies as a fully taxable disposition for purposes of Code § 469(g)(1)(A), even if the foreclosure triggers cancellation of indebtedness (COD) income that is excluded from gross income under Code § 108(a)(1)(B). CCA 201415002. However, if partnership property is foreclosed upon, the partnership lists the property as an asset on its tax returns, and the partnership is pursuing counterclaims, the foreclosure does not constitute a disposition. *Herwig v. Commissioner*, T.C. Memo. 2014-95 (accuracy-related penalties imposed when taxpayer did not introduce evidence of reasonable cause for taking the position).
Although a QSST's disposition of stock is taxable to the trust (see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets), the trust's disposition is treated as a disposition by the beneficiary for purposes of Code §§ 465 and 469. Code § 1361(d)(1)(C).

the disposed of activity are treated as nonpassive under Code § 469(g)(1)(A).[2028] Losses disallowed by the passive loss rules are suspended and carried into future years.[2029] If the business interest is transferred by gift, any suspended passive losses are permanently lost but added to basis;[2030] for disposition by death, see part II.K.2.d Effect of Death of an Individual or Termination of Trust on Suspended Losses.

Passive income does not include gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business.[2031]

The material participation rules are based on the number of hours the taxpayer participates in the activity[2032] and therefore encourage taxpayers to group businesses together as one activity (so that the hours from various activities can be aggregated to meet the necessary threshold).[2033] On the other hand, the complete allowance of a loss on the sale of an activity discourages grouping, since selling only part of the grouped activity will not be a complete disposition.

A passive income generator tends to be viewed favorably, in that it allows passive losses to be deducted. However, given the 3.8% tax on passive investment for high-income taxpayers and trusts,[2034] generating passive income in excess of losses might lead to unfavorable tax results. Thus, taxpayers might seek to transform passive income into nonpassive income, if they can do so without disallowing passive losses or triggering self-employment tax.[2035] Further below is a discussion of when passive income would

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2028 TAM 9742002. For the impact of Code § 469 on the 3.8% net investment income tax, see part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation, particularly the text accompanying fn. 1687.

2029 IRS Publication 925 explains the passive loss and at-risk rules generally. The IRS' "Passive Activity Loss Audit Technique Guide is at http://www.irs.gov/pub/irs-mssp/pal.pdf, which can also be viewed through http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-Audit-Technique-Guide-ATG-Table-of-Contents.

2030 Code § 469(j)(6).

2031 Code § 469(e)(1)(A)(i)(I).

2032 See part II.K.1.a Counting Work as Participation.

2033 See part II.K.1.b Grouping Activities.

2034 See part II.I 3.8% Tax on Excess Net Investment Income.

2035 See part II.L.1 FICA: Corporation

For corporations, compensation, including any distributions re-characterized as salaries, is subject to income tax and FICA tax. Income retained by the corporation and not paid as compensation is not subject to FICA tax.

If all of the remuneration to an individual from related corporations is disbursed through the common paymaster, the total amount of FICA imposed on the employer and employee is determined as though the individual has only one employer (the common paymaster). The common paymaster is responsible for filing information and tax returns and issuing Forms W-2 with respect to wages it is considered to have paid under this rule.

For S corporations, shareholders' health insurance is deductible to the S corporation and considered compensation to owners. However, it is subject to FICA only if offered in a plan that discriminates in favor of owners. The owners may deduct health insurance subject to the same rules as partners and sole proprietors.

be recharacterized as nonpassive income, in the IRS' efforts to minimize passive income against which passive losses can be deducted.[2036]

Conversely, although limitations on using net passive losses might not save regular income tax on nonpassive income, an abundance of passive losses can be helpful to the extent that they prevent passive business income from being subjected to the 3.8% tax on net investment income.[2037]

II.K.1.a. Counting Work as Participation in Business under the Passive Loss Rules

II.K.1.a.i. Taxpayer Must Own an Interest in the Business to Count Work in the Business

An individual needs to own an interest in an activity for the individual's work to count as participation.[2038] When counting hours that a taxpayer performs services in real property

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Income Subject to Self-Employment Tax, including the exclusion of certain types of income from SE tax.

[2036] See part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

[2037] See generally part II.I 3.8% Tax on Excess Net Investment Income (NII).

[2038] Reg. § 1.469-5(f)(1) provides:

> *In general*. Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

Neither the final regulation nor Reg. § 1.469-5T(f) promulgate other paragraphs that qualify this rule.

The parentheticals at the end of Reg. § 1.469-5T(a)(2), (3) imply that participation is done only by an owner.

To drive home the ownership requirement, Reg. § 1.469-5T(k), Example (6) provides:

> The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own an interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example (5) to which this example refers is Reg. § 1.469-5(k), Example (5):

> In 1993, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of § 1.469-1(e)(2)). For every taxable year from 1993 through 1997, D is treated as materially participating (without regard to § 1.469-5T(a)(5)) in the activity. D retires from the activity at the beginning of 1998, and would not be treated as materially participating in the activity for 1998 and subsequent taxable years if material participation for those years were determined without regard to § 1.469-5T(a)(5). Under § 1.469-5T(a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1998 through 2003 because D materially participated in the activity (determined without regard to § 1.469-5T(a)(5) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under § 1.469-5T(a)(5) as materially participating in the activity for taxable years beginning after 2003 because for those years D has not materially

trades or businesses during a taxable year, personal services performed as an employee count only if the employee is a 5% owner.[2039]

A taxpayer's activities include those conducted through C corporations that are subject to Code § 469, S corporations, and partnerships.[2040]

The owner in an interest in an organization may materially participate in the activities of a wholly owned subsidiary of the organization.[2041]

II.K.1.a.ii. Material Participation

An individual shall be treated as materially participating in an activity for the taxable year if and only if:[2042]

(1) The individual participates in the activity for more than 500 hours during such year;[2043]

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year, <u>if the owner is not a limited partner</u>;[2044]

> participated in the activity (determined without regard to § 1.469-5T(a)(5) for five of the last ten immediately preceding taxable years.

2039 *Calvanico v. Commissioner*, T.C. Summary Opinion 2015-64, citing Code § 469(c)(7)(D)(ii) and Reg. § 1.469-9(c)(5), cross-referencing Code § 416(i)(1)(B).

2040 Reg. § 1.469-4(a). *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), held that this regulation is valid and applied it to count activity through a C corporation that was subject to Code § 469 even though the regulation was promulgated in the context of grouping activities together. Presumably it reached that result because grouping of activities is mandatory to a certain extent; see Reg. § 1.469-4(d)(5)(i), which provides:

> *In general*. A C corporation subject to section 469, an S corporation, or a partnership (a section 469 entity) must group its activities under the rules of this section....

Williams v. Commissioner, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), reaffirmed the *Schwalbach* holding that Reg. § 1.469-4(a) is valid.

2041 Letter Ruling 201029014.

2042 Reg. § 1.469-5T(a). *Mordkin v. Commissioner*, T.C. Memo. 1996-187, rebuffed a taxpayer's claim that the quantitative tests in the following bullet points are invalid.

2043 Reg. § 1.469-5T(a)(1).

2044 Reg. § 1.469-5T(a)(2). *Windham v. Commissioner*, T.C. Memo. 2017-068, found that the taxpayer satisfied this test:

> Petitioner ran her rental real estate activities by herself. She handled all aspects of the business from collecting rent to overseeing the work of repairmen. She also met prospective buyers and handled problems with utility and service companies. While petitioner did not physically perform all of the repairs that were necessary at each of those rental properties, she hired multiple contractors and repairmen to handle those repairs. With the repairs made and the number of different individuals involved in those repairs, no one individual participated in the rental real estate activities to the extent petitioner did. The Court is satisfied by petitioner's testimony and other evidence that her participation in each of those activities constituted substantially all of the participation in each.

However, that taxpayer did not fare quite as well for a vacant lot:

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year,[2045] if the owner is not a limited partner;[2046]

(4) The activity is a significant participation activity[2047] for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours, if the owner is not a limited partner;[2048]

(5) The individual materially participated in the activity (determined without regard to this bullet point) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;[2049]

(6) The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year;[2050] or

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The Lynn Haven property was a vacant lot in which petitioner had a 50% ownership interest. She spent approximately 12 hours meeting with an attorney and the other owner of the vacant lot discussing whether to develop or sell the vacant lot. There is nothing in the record about the participation hours of the other owner of the vacant lot. Petitioner has failed to prove that her participation constituted substantially all of the participation in the activity.

[2045] Hiring a management company undermines this test if any management company employee works more than the owner, as was the case in *Schumann v. Commissioner*, T.C. Memo. 2014-138. The taxpayer satisfied this test in *Kline v. Commissioner*, T.C. Memo. 2015-144; having a variety of employees (and documenting the hours they worked) helped assure that no employee's work exceeded the work of the taxpayer and spouse (see part II.K.1.a.iii Spousal Participation).

[2046] Reg. § 1.469-5T(a)(3).

[2047] Reg. § 1.469-5T(c) provides that an activity is a significant participation activity of an individual if and only if such activity is a trade or business activity (within the meaning of Reg. § 1.469-1T(e)(2)) in which the individual participates for more than 100 hours during the taxable year and would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to the significant participation activity rules.

[2048] Reg. § 1.469-5T(a)(4). To better understand how to apply the significant participation test, consider the following: Assume T, an individual, has $500,000 in taxable income for the taxable year, and is the sole owner of S corporations 1, 2, and 3, which are engaged in trade or business Activities 1, 2, and 3 respectively. Business 1 has at least one full-time employee. T participates 400 hours in Activity 1, 90 hours in Activity 2, and 90 hours in Activity 3, which is the same kind of trade or business as Activity 2, but is a different business. If T does not group Activity 2 with Activity 3, then the material participation test is not satisfied, and the net income from Activity 1 is nonpassive (see part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, particularly fns. 2224-2229) and the net loss from Activity 1 and net income or loss from Activities 2 and 3 are passive. If T groups Activity 2 with Activity 3, then the significant participation activity is satisfied, and all of the income or loss from Activities 1, 2, and 3 is nonpassive.

[2049] Reg. § 1.469-5T(a)(5).

[2050] Reg. § 1.469-5T(a)(6) refers to Reg. § 1.469-5T(d), which provides:

(7) Based on all of the facts and circumstances,[2051] the individual participates in the activity on a regular, continuous, and substantial basis during such year, <u>if the owner is not a limited partner</u>.[2052]

Note that some of the tests above apply only if the owner is not a limited partner.[2053] These differences arise from the statutory prohibition against limited partners being treated as materially participating except as provided in regulations.[2054] A member in an

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Personal service activity. An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in-

(1) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or

(2) Any other trade or business in which capital is not a material income-producing factor.

[2051] The rule incorporated by reference here, Reg. § 1.469-5T(b)(2), does not specify the facts and circumstances but applies the following rules in determining the facts and circumstances: The fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision other than the passive loss rules shall not be taken into account in determining whether such individual materially participates for purposes of the passive loss rules. Furthermore, an individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under this "facts and circumstances" rule unless, for such taxable year:

- no person (other than such individual) who performs services in connection with the management of the activity receives prohibited compensation (wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered) in consideration for such services, and
- no individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

Finally, the individual must participate in the activity for more than 100 hours during the taxable year. Grouping may push the taxpayer over this threshold. *Wade v. Commissioner*, T.C. Memo. 2014-169, is a great example of the founder letting others run the business on-site, yet continuing to participate:

> With Ashley [taxpayer's son] there to handle day-to-day management, Mr. Wade became more focused on product and customer development. He did not have to live near business operations to perform these duties, so petitioners moved to Navarre, Florida. After the move he continued to make periodic visits to the facilities in Louisiana and regularly spoke on the phone with plant personnel.
>
> In 2008 TSI and Paragon began struggling financially as prices for their products plummeted and revenues declined significantly. Mr. Wade's involvement in the businesses became crucial during this crisis. To boost employee morale, he made three trips to the companies' industrial facility in DeQuincy, Louisiana, during which he assured the employees that operations would continue. He also redoubled his research and development efforts to help TSI and Paragon recover from the financial downturn. During this time Mr. Wade invented a new technique for fireproofing polyethylene partitions, and he developed a method for treating plastics that would allow them to destroy common viruses and bacteria on contact. In addition to his research efforts, Mr. Wade ensured the companies' financial viability by securing a new line of credit. Without Mr. Wade's involvement in the companies, TSI and Paragon likely would not have survived.

[2052] Reg. § 1.469-5T(a)(7).

[2053] Reg. § 1.469-5T(e) defines a "limited partnership interest" and allows limited partners to be treated as materially participating if they qualify under Reg. § 1.469-5T(a)(1), (5), or (6).

[2054] Code § 469(h)(2).

LLC is not inherently a limited partner.[2055] Proposed regulations would treat an interest in an entity as an interest in a limited partnership as a limited partner if:[2056]

- The entity in which such interest is held is classified as a partnership for Federal income tax purposes under the check-the-box regulations; and
- The holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement.

Furthermore, an individual is not treated as holding an interest in a limited partnership as a limited partner for the individual's taxable year if that individual also holds an interest in the partnership that is not an interest as a limited partner, such as a state-law general partnership interest, at all times during the entity's taxable year;[2057] thus, being a general partner and a limited partner causes the partner's entire partnership interest to be treated as a general partner for purposes of the passive loss rules but does not *per se* subject the person's interest as a limited partner to self-employment tax.[2058]

II.K.1.a.iii. Spousal Participation

Any participation by a person's spouse in an activity (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) is considered participation by that person in that activity.[2059] A taxpayer may spend zero time in the activity and be deemed to participate solely by reason of the spouse's participation.[2060]

However, working to help a spouse's business does not establish the taxpayer as engaging in his own trade or business.[2061] Accordingly, consider documenting and compensating the spouse's services or making the spouse a co-owner.

[2055] A member in an LLC is not treated as a limited partner merely by reason of having limited liability. *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Ore. 2000); *Garnett v. Commissioner*, 132 T.C. 368 (2009); *James R. Thompson v. U.S.*, 87 Fed. Cl. 728, 734 (2009), *acq.* in result only, AOD 2010-002; *Hegarty v. Commissioner*, T.C. Summary Opinion 2009-153. *Newell v. Commissioner*, T.C. Memo. 2010-23 reasoned:

> … [T]he parties stipulated that petitioner husband handled the day-to-day operations of Pasadera, including hiring and firing employees, negotiating loan agreements and other contracts, overseeing construction, administering membership programs, and reviewing, approving, and signing all checks. As the managing member of the L.L.C., petitioner husband functioned as the substantial equivalent of a general partner in a limited partnership.

[2056] Prop. Reg. § 1.469-5(e)(3)(i).

[2057] Prop. Reg. § 1.469-5(e)(3)(ii).

[2058] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, especially fn. 2409.

[2059] Reg. § 1.469-5T(f)(3), authorized under Code § 469(h)(5).

[2060] *Zarrinnegar v. Commissioner*, T.C. Memo. 2017-34, described in fn 2069 of part II.K.1.a.vi Proving Participation and fn. 2181 of part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception.

[2061] *DeGuzman v. U.S.*, 147 F. Supp. 2d 274 (D. N.J. 2001). The husband attempted to prove that he was a real estate professional and asserted that time he spent cleaning his wife's office should count toward that. Given that neither of them owned the property (she was leasing it form

Finally, although spousal attribution applies with respect to the material participation requirements even if they do not file a joint return,[2062] they do not allow for spousal attribution for purposes of meeting the other requirements to be treated as a "real estate professional" that a taxpayer perform more than one half of his or her personal services and more than 750 hours in real estate trades or businesses if they file separate returns.[2063]

II.K.1.a.iv. Period of Participation

A taxpayer's participation in a partnership or S corporation is determined for the taxable year of the entity (and not the taxpayer's taxable year).[2064]

II.K.1.a.v. What Does Not Count as Participation

However, not all work counts as participation for purposes of the material participation test:

- Work done in connection with an activity is not treated as participation in the activity if not only that work is not of a type that is customarily done by an owner of such an activity but also one of the principal purposes for the performance of such work is to avoid the disallowance, under Code § 469 and its regulations, of any loss or credit from such activity.[2065]

- Work done by an individual in the individual's capacity as an investor in an activity is not treated as participation in the activity unless the individual is directly involved in the activity's day-to-day management or operations.[2066] "Investor" work includes:[2067]

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an unrelated third party), his hours could not count as participation generally (see part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business); furthermore, his not having been hired by the landlord undermined his claim that his work was part of a trade or business of providing real estate services.

[2062] Reg. § 1.469-5T(f)(3), authorized under Code § 469(h)(5).

[2063] *Oderio v. Commissioner*, T.C. Memo. 2014-39. See Reg. § 1.469-9(c)(4) and the flush language at the end of Code § 469(c)(7)(B). See part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception, especially fn. 2175.

[2064] Reg. § 1.469-2T(e)(1). The same test applied to determine whether a partner is treated as a general partner or a limited partner; see text accompanying fn. 2057.

[2065] Reg. §§ 1.469-5T(f)(2)(i) and 1.469-5T(k), Example (7) (work as an office receptionist did not count because that was not the type of work typically done by the owner of the business, which was a football team). Note that the regulations do not expressly exclude the work from material participation if the performance of such work is to avoid the characterization of the income as net investment income under Code § 1411. Therefore, it appears that work that is not of a type that is customarily done by an owner of such an activity does count towards material participation, even if its principal purpose is to avoid the characterization of the income as net investment income under Code § 1411, so long as no principal purpose is to avoid the passive loss rules. Reg. § 1.1411-5 refers to Reg. § 1.469-5T(a) but does not say that the application of Reg. § 1.469-5T(f)(2)(i) is to be modified.

[2066] Reg. § 1.469-5T(f)(2)(ii)(A) provides:

> *In general*. Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section

- Studying and reviewing financial statements or reports on operations;
- Preparing or compiling summaries or analyses of the finances or operations for the individual's own use; and
- Monitoring the finances or operations in a non-managerial capacity.

- Providing legal, tax, or accounting services as an independent contractor (or as an employee thereof), or that the taxpayer commonly provides as an independent contractor, would not ordinarily constitute material participation in an activity other than the activity of providing these services to the public. Thus, for example, a member of a law firm who provides legal services to a client regarding a general partnership engaged in research and development, is not, if he invests in such partnership, treated as materially participating in the research and development activity by reason of such legal services.[2068]

> unless the individual is directly involved in the day-to-day management or operations of the activity.

When an individual is involved in day-to-day management or operations, does investor work done in furtherance of such management/operations count, or does all of the investor work count, without needing to differentiate between work done purely as an investor from investor work done to conduct such management/operations? All the investor work counts, once the court finds that the individual is involved in day-to-day management or operations. *Assaf v. Commissioner*, T.C. Memo. 2005-14; *Tolin v. Commissioner*, T.C. Memo. 2014-65; and *Lamas v. Commissioner*, T.C. Memo. 2015-59.

[2067] Reg. § 1.469-5T(f)(2)(ii)(B). *Lapid v. Commissioner*, T.C. Memo. 2004-222, held:

> While Mrs. Lapid testified that she spent many hours every night studying and tracking her investments, the evidence she submitted shows that she was actually just reviewing financial statements and reports on operations. Because the regulation specifically defines such monitoring as investment activity, we cannot include that time in calculating whether she met the material participation standard in three of the safe harbors she is aiming for. This is true despite our belief that Mrs. Lapid did indeed spend a lot of time tracking her properties….
>
> Unable to count the hours that Mrs. Lapid spent on investment activity, the petitioners' claim to the loss on their hotel condos quickly collapses. Though we believe that the Lapids did at least occasionally visit the condos, the record is devoid of any evidence that they spent anywhere near 500 hours doing so. That the hotels did the routine onsite work of property management undermines the Lapids' ability to show any significant amount of time that would count as "participation" in the activity. And they completely failed to compare the time they spent with the time spent by individuals actually onsite.

[2068] Committee Reports for Senate Bill 99-313, P.L. 99-514.

II.K.1.a.vi. Proving Participation

One needs to use reasonable means to establish participation:[2069]

- "Reasonable means" may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

- Although contemporaneous daily time reports, logs, or similar documents are preferable,[2070] they are not required if the extent of participation may be established

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[2069] Reg. § 1.469-5T(f)(4). Part VIII of T.D. 8175 provides:

> H. *No Recordkeeping Requirements*
>
> Notwithstanding the quantitative tests set forth in the regulations, § 1.469-5T(f)(4) expressly provides that taxpayers need not keep contemporaneous records of their hours of participation in each activity. The Service recognizes that, while lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days, most individuals do not customarily maintain such records. Accordingly, under the regulations, taxpayers will be allowed to prove the requisite number of hours by any reasonable means, including, but not limited to, appointment books, calendars, and narrative summaries.

Zarrinnegar v. Commissioner, T.C. Memo. 2017-34, shows an ideal way to prove one's case:

> To establish the hours petitioner husband spent each year on his real estate business, petitioners offered petitioner husband's testimony and logs of hours for 2010, 2011, and 2012; each log showed that petitioner husband spent more than 1,000 hours per year on real estate activities.[11] Petitioner husband testified credibly that the logs had been prepared contemporaneously. He also testified credibly and at great length about the logs' contents; he was able to recall extensive details relating to the entries. Petitioners also offered the testimony of several other witnesses, including petitioner wife. All this testimony was credible and tended to corroborate petitioner husband's logs and testimony. We therefore find that petitioner husband worked more than 1,000 hours per year at the real estate business.
>
> [11] Petitioner husband testified that throughout the years at issue he had high hopes for the brokerage side of the business, despite the financial malaise burdening the housing market. Undaunted despite earning only $8,500 in brokerage fees during the years at issue, petitioner-husband testified that he poured hundreds of hours each year into broker's tours, listing searches, open houses, property viewings, client meetings, and other related activities, likening his efforts to the early labors of Bill Gates and Mark Zuckerberg, who toiled in obscurity and relative poverty before reaping fabulous profits.

The finding of over 1,000 hours per year was important because he was also a dentist and proved that he worked less than 1,000 hours per year, the proportions being important to satisfying the real estate professional test. See part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception, especially fn 2181.

However, the cases below impose a heavy burden of proof on those who do not keep contemporaneous records and impose penalties if recordkeeping is inadequate.

[2070] *Schumann v. Commissioner*, T.C. Memo. 2014-138, held that, while not necessarily required:

> … we cannot overemphasize the importance of keeping thorough, contemporaneous time records rather than making estimates after the fact.

If one reconstructs time, the reconstruction needs to include details, as that court pointed out:

> Petitioner did not keep a contemporaneous log or an appointment calendar tracking his real estate activities, but he prepared a narrative summary of his activities. The summary, however, provides a broad description of the work performed at each property rather than a detailed description of the work that petitioner performed personally.

by other reasonable means;[2071] however, failure to keep good records can lead to penalties.[2072] Note, however, that reconstructing participation[2073] might lead one to

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[2071] *Montgomery v. Commissioner*, T.C. Memo. 2013-151. In holding for the taxpayer, *Leland v. Commissioner*, T.C. Memo. 2015-240, included the following footnote 3:

> Respondent's main objection to petitioner's reconstructed logs was that they were not prepared contemporaneously with the activity. Sec. 1.469-5T(f)(4), Temporary Income Tax Regs., 53 Fed. Reg. 5727 (Feb. 25, 1988), does not require contemporaneous records, and we are satisfied that petitioner has established material participation through other reasonable means. Respondent did not dispute petitioner's inclusion of travel time in his reconstructed logs. The facts of this case establish that petitioner's travel time was integral to the operation of the farming activity rather than incidental. *See Shaw v. Commissioner*, T.C. Memo. 2002-35. We are also satisfied that petitioner's purpose in traveling long distances to and from Turkey, Texas, was not to avoid the disallowance, under sec. 469 and the regulations thereunder, of any loss or credit from the farming activity. *See* sec. 1.469-5T(f)(2)(i), Temporary Income Tax Regs., *supra*.

Hailstock v. Commissioner, T.C. Memo. 2016-146, approved the full-time efforts of a taxpayer who did not engage in any other work, cautioning that the taxpayer should keep better records for future audits:

> Petitioner satisfies the facts and circumstances test in section 1.469-5T(a)(7), Temporary Income Tax Regs., *supra*, because of her credible testimony and the substantial amount of money and time devoted to each rental property. Petitioner testified credibly and in detail about her duties in operating her real estate rental business. We find petitioner's narrative summary convincing because she owned numerous rental properties and conducted her business as a "one-man operation" without being otherwise employed. As previously discussed, petitioner spent well in excess of 40 hours each week doing work related to numerous rental properties (i.e., researching prospective properties, maintaining properties, supervising work orders, finding tenants, securing leases, and continuing education related to rental real estate). The record before the Court indicates that petitioner received sizable amounts of rental income during the taxable years in issue and used substantial amounts of her own resources to facilitate the rental operation. Petitioner's testimony is further buttressed by respondent's concession that she "rented and incurred expenses in connection with the parcels of real property located at 1515 Ruth Avenue, 1516 Ruth Avenue, 1809-1811 Fairfax Avenue, 1805-1807 Fairfax Avenue, 1112 Race Street, 1619 Fairfax Avenue, 2541 Hemlock Street, 1923 Dana Avenue, 1517 Ruth Avenue, 140 Mulberry Avenue, 1668 California Street, 1729 Kinney Avenue, 1823 Fairfax Avenue and 1407 Race Street." Although we caution petitioner to construct contemporaneous time logs for her future real estate endeavors, we find her detailed and credible testimony to be a "reasonable means" of proof. See sec. 1.469-5T(f)(4), Temporary Income Tax Regs. On the basis of petitioner's testimony and the record as a whole, we conclude that petitioner did materially participate in each rental property reported on her reconstructed Schedule E for the taxable years in issue.[5] Because she has proven that she "materially participated" in operating each of her rental properties from 2005 to 2009, petitioner easily meets the 750-hour requirement of section 469(c)(7)(B)(ii). Accordingly, petitioner qualifies for the real estate professional exception under section 469(c)(7) for each of the taxable years in issue, and therefore her Schedule E losses are not subject to the passive loss limitations imposed by section 469.
>
> [5] As held above, 201 Mulberry Avenue and 9103 Brehm Road do not qualify as rental properties for any of the taxable years in issue and therefore are not aggregated to meet the 750-hour requirement of sec. 469(c)(7)(B)(ii).

[2072] *Williams v. Commissioner*, T.C. Memo. 2014-158 (taxpayer "made no attempt to keep contemporaneous records showing what amount of time he spent on the airplane, nor did he provide any appointment books, calendars, or narrative summaries corroborating such time"). *Schumann v. Commissioner*, T.C. Memo. 2014-138, imposed 20% negligence penalties:

make serious flaws in compiling the documentation.[2074] The court will not respect a "postevent 'ballpark guesstimate.'"[2075] However, reconstructing participation is

> Petitioner did not call either of his tax return preparers to testify. Petitioner did not keep books and records adequate to substantiate his status as a real estate professional. We think petitioner acted without reasonable cause and did not act in good faith.

[2073] Reconstructing hours spent includes correcting or supplementing a log. *Flores v. Commissioner*, T.C. Memo. 2015-9, found a lack of credibility when the taxpayer admitted that various calendar entries overstated time spent. The taxpayer claimed to have a second calendar but did not produce it early enough in the proceedings to have it admitted into evidence. The court upheld a 20% accuracy-related penalty.

[2074] For example, a taxpayer, who claimed as a contemporaneous record a 2008 calendar printed in 2009, incurred a 20% accuracy-related penalty. *Hassanipour v. Commissioner*, T.C. Memo. 2013-88. Another taxpayer's attempt to reconstruct activity led to contradictions about when he worked where, again incurring a 20% accuracy-related penalty. *Bartlett v. Commissioner*, T.C. Memo. 2013-182, pointing out:

> While the regulations permit some flexibility with respect to the evidence required to prove material participation, we are not required to accept post-event "ballpark guesstimates," nor are we bound to accept the unverified, undocumented testimony of taxpayers. See, e.g., *Lum v. Commissioner*, T.C. Memo. 2012-103; *Estate of Stangeland v. Commissioner*, T.C. Memo. 2010-185.

Similarly, *Adeyemo v. Commissioner*, T.C. Memo. 2014-1, characterized an after-the-fact spreadsheet reconstruction of time spent as an impermissible "ballpark guesstimate":

> The first problem is that the times and activities listed in the spreadsheet are not consistent with either the Adeyemos' testimony or their documentary evidence. Mr. Adeyemo testified that the activities listed in the spreadsheet were derived from his memory as well as from documentary evidence such as receipts, phone bills, the logbook, and newspaper ads. To the extent that the spreadsheet entries are purportedly derived from documentary evidence, the record does not establish a credible link between the spreadsheet and the underlying documents. For example, most entries include a general reference to a batch of receipts or phone bills. However, the references are too vague and the receipts too disorganized for us to trust that the spreadsheet is corroborated by the underlying documents….

Harnett v. Commissioner, T.C. Memo. 2011-191, in which the taxpayer claimed to spend at least 750 hours and more than half of his time managing real estate, illustrates some issues:

> Petitioner did not maintain a contemporaneous log of time spent participating in his real estate activities. In 2008, in preparation for respondent's audit, he attempted to reconstruct the time he spent in his real estate activities. He claims to have spent months going through his records to arrive at these reconstructed estimates, but petitioners have not demonstrated the evidentiary basis or methodology for these reconstructions. At trial petitioner testified that on the basis of these reconstructions he estimated spending 1,270 hours managing his real estate properties in 2003, 1,421 hours in 2004, and 1,648 hours in 2005. As discussed in more detail below, the contemporaneous records that petitioners have offered into evidence do not credibly support these estimates....
>
> Although petitioner spent some time dealing with his various properties during the years at issue and attempting to sell some of them, primarily through agents and brokers, we are not convinced that he performed more than 750 hours of services with respect to these properties during any year at issue. By 2003 petitioner had ceased to rent these properties to any significant extent and was looking to liquidate at least some of them. He was in ill health and had important duties at the bank. The properties were widely dispersed geographically. To a great extent he relied upon various agents, brokers, lawyers, and contractors as well as his wife, Robert Goldie, and Jeana Hopkins to deal with these properties.

> Petitioners suggest that because petitioner owned so much real estate, which they say was worth over $30 million, he necessarily must have spent at least 750 hours each year managing these properties. Yet petitioner also testified that during the years at issue he spent only about 10 hours a month working at the bank. Considering that for most of this period he was both chairman of the board and CEO of the bank, with wide-ranging responsibilities and six-figure compensation, this testimony strains credibility. But if this testimony is to be believed, we see no reason to think that managing his mostly dormant real estate holdings would have required petitioner to spend anywhere near 750 hours each year. And if the testimony is not to be believed, petitioner's lack of credibility on this score further erodes his credibility about the hours he claims to have spent on his real estate activities.

Almquist v. Commissioner, T.C. Memo. 2014-40 rejected calendars allegedly compiled from an original notebook where the taxpayer could not find the original notebook:

> Petitioners contend that this Court should look past the fact that petitioners did not provide any supporting documentation of the hours Mr. Almquist worked, should ignore petitioners' calendar and first log, and should look only to the second log in determining whether Mr. Almquist is a real estate professional. We again emphasize that the Court was not provided any of the purported supporting documentation or email and was provided only petitioners' self-serving testimony.
>
> We are not required to accept such self-serving testimony, and we are not willing to rely on that testimony to establish petitioners' position. See *Tokarski v. Commissioner*, 87 T.C. 74, 76-77 (1986); see also *Chapman Glen Ltd. v. Commissioner*, 140 T.C. __ (slip op. at 45 n.24) (May 28, 2013). Without any supporting documentation, the second log, created by petitioners over a year after the work was completed, is nothing more than "a postevent 'ballpark guesstimate". See *Moss v. Commissioner*, 135 T.C. at 369.

[*Chapman Glen Ltd. v. Commissioner* is found at 140 T.C. 294.]

Makhlouf v. Commissioner, T.C. Summary Opinion 2017-1, held:

> We conclude that the hours shown on the Weston spreadsheet are inflated, duplicative, and implausible on their face. Few if any entries are supported by contemporaneous record-keeping.

Penley v. Commissioner, T.C. Memo. 2017-65, expressed the skepticism usually shown when people with full-time jobs claim that they spent more than half their working time doing real estate work (and concluding later a 20% penalty):

> Petitioners claim Mr. Penley worked 2,520 hours on his real estate activities. To do so he would have had to work a total 4,714 hours (*i.e.*, 2,194 for HHS + 2,520 on his real estate activities) in 2012. That means if he worked every day, he would need to have averaged 12.88 total hours per day (**i.e.**, 4,712 ÷ 366 = 12.88). We conclude the calendar is untrustworthy, and we will not naively accept it to reach the result petitioners seek.
>
> Virtually all of the entries are rounded to the nearest hour or half-hour, do not specify a start or end time for the work, include the time spent driving to and from the property, and do not separate out any time for meals or other breaks. See *Merino v. Commissioner*, T.C. Memo. 2013-167, at *8-*12; *Rapp v. Commissioner*, 78 T.C.M. (CCH) at 177-178 (discounting testimony that lacked specifics about time work was performed); *Pohoski v. Commissioner*, T.C. Memo. 1998-17, 75 T.C.M. (CCH) 1574, 1579 (1998) (noting that the large number of hours claimed seemed implausible, especially given that the calendar did not contain breaks for meals or leisure time with family).
>
> Corroborating evidence, such as credit card statements, phone bills, and emails relating to the purchase of Evergreen Park, demonstrates meaningful real estate activity by petitioners during 2012. However, petitioners have not provided the Court with a sufficient explanation to reconcile this documentary evidence of their activities such as a brief email, a phone call, or a hardware store purchase with the large blocks of time (often 4 hours to 14 hours) shown on the calendar. See *Hill v. Commissioner*, T.C. Memo. 2010-200, 100 T.C.M. (CCH) 220, 223 (2010) (finding that the excessive hours claimed by the taxpayer, relative to the tasks performed, diminished the credibility of the

acceptable when corroborated by phone records, third-party witness testimony, the parties' comprehensive stipulations of fact, and other contemporaneous materials.[2076]

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taxpayer's estimates), *aff'd*, 436 F.App'x 410 (5th Cir. 2011). We find that petitioners' calendar does not fall within the regulation's "any reasonable means". See sec. 1.469-5T(f)(4), Temporary Income Tax Regs., *supra*.

[2075] *Hudzik v. Commissioner*, T.C. Summary Opinion 2013-4, which also imposed penalties:

> Petitioner's counsel contended that petitioner acted with reasonable cause and in good faith by listing both properties on Schedules E, following the instructions on TurboTax, and reading and attempting to follow IRS publications. While section 469 and its regulations cover a highly complex area of the tax code, petitioner's recordkeeping seems to have greatly inflated the number of hours spent in the activity in order to satisfy the statute and the regulations. We conclude that petitioner did not act with reasonable cause and in good faith and that petitioner is liable for accuracy-related penalties under section 6662(a) for taxable years 2006, 2007, and 2008.

Calvanico v. Commissioner, T.C. Summary Opinion 2015-64 (sloppy contemporaneous notes led to reconstruction efforts that were not credible and more like ballpark estimates; penalty imposed).

Finding a ballpark estimate (and imposing penalties), *Syed v. Commissioner*, T.C. Memo. 2017-226, ruled:

> Petitioners created this list during the IRS examination or before trial with an end result in mind: to show a certain number of hours of time devoted to rental properties. We have previously found such lists unpersuasive, and our conclusion is the same here. See, *e.g.*, *Mowafi v. Commissioner*, T.C. Memo. 2001-111; *Goshorn*, T.C. Memo. 1993-578.

[2076] *Tolin v. Commissioner*, T.C. Memo. 2014-65. In setting the stage for its ultimate conclusion that the taxpayer materially participated, the court described the taxpayer's efforts and IRS' response:

> At trial petitioner introduced a narrative summary in which he describes the work he performed in connection with the thoroughbred activity and estimates the time he spent performing such work for each of the years at issue. He prepared the summary with the assistance of his attorney in preparation for trial, using telephone records, credit card invoices, and other contemporaneous materials. For each year petitioner claims time for the following work done in connection with the thoroughbred activity: preparing and distributing promotional materials; telephone conversations with his associates, advisors, and potential customers; business trips to Louisiana; registering his horses for State and national awards; reviewing and placing mortality insurance on [the horse]; reviewing and paying bills; recordkeeping; and continuing education. [footnote omitted] Cumulatively, petitioner contends that he participated in the thoroughbred activity for 891 hours in 2002, 862 hours in 2003, and 937.5 hours in 2004.
>
> While the narrative summary is a postevent review of petitioner's claimed participation in the thoroughbred activity, the parties stipulated his performance of many of the activities described therein, and a significant amount of credible third-party witness testimony and objective evidence indicates that it is an accurate depiction of his thoroughbred activity during the years at issue. [citations omitted] Respondent primarily disputes the time petitioner claims he spent performing the activities described in his narrative summary, arguing that his estimates are unreliable because the summary was prepared solely for purposes of litigation and is based in large part on petitioner's "unreliable memory". Respondent further argues that a substantial amount of petitioner's work was undertaken in his capacity as an investor in the thoroughbred activity and thus does not qualify as participation. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., supra.
>
> …we conclude that petitioner participated in the thoroughbred activity for more than 500 hours in each year.

Hiring a management company tends to undermine one's own participation.[2077]

II.K.1.b. Grouping Activities

For more insight, see Hamill, "Group Passive Activities to Achieve Best Tax Treatment," *Estate Planning Journal* (Dec. 2016).

II.K.1.b.i. Grouping Activities – General Rules

When grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of Code § 469, a taxpayer's activities include those conducted through C corporations that are subject to Code § 469, S corporations, and partnerships.[2078]

> ….
>
> The remaining hours of participation petitioner needs to satisfy the "more than 500 hours" test … are easily accounted for by his preparation and mailing of the promotional breeding packages (the voluminous contents of which were stipulated by the parties) and the miscellaneous administrative tasks he completed. See *Harrison v. Commissioner*, T.C. Memo. 1996-509.
>
> Respondent nevertheless argues that a great deal of the work upon which petitioner relies to satisfy the "more than 500 hours" test should not qualify as participation because petitioner performed it in his capacity as an investor in the thoroughbred activity. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., *supra*. We reject this argument. Petitioner was directly involved in the day-to-day management and operations of the thoroughbred activity; therefore, any investor work he completed qualifies as participation for purposes of section 469. See sec. 1.469-5T(f)(2)(ii), Temporary Income Tax Regs., *supra*; see also *Assaf v. Commissioner*, T.C. Memo. 2005-14. On the basis of his satisfaction of the more-than-500-hours test of section 1.469-5T(a)(1), Temporary Income Tax Regs., *supra*, we conclude that petitioner was a material participant in the thoroughbred activity in 2002.

Note that the tax and penalties at stake were under $60,000; it seems that the taxpayer needed to go to a lot of effort to fight that. However, the taxpayer was a practicing lawyer (1,000-1,200 hours per year) and might have needed the win to protect his credibility.

[2077] *Schumann v. Commissioner*, T.C. Memo. 2014-138 ("In addition, petitioner's use of several rental agencies to help find prospective tenants, show his properties, and market his properties suggests that he did not materially participate in the rental of his properties."). In rejecting a taxpayer's claim of material participation, *Madler v. Commissioner*, T.C. Memo. 1998-112 commented:

> Petitioners have offered no evidence to indicate that they personally approved of tenants, decided rental terms, approved of expenditures for repairs and capital improvements, or in any way participated in the management of the unit in a significant and bona fide sense. It appears that VDS, rather than petitioners, performed all significant management activities. Moreover, we do not consider petitioner's ability to terminate the contract with VDS as active participation per se; the legislative history of section 469 explains that taxpayers must themselves genuinely exercise independent discretion and judgment.

However, continuous, active marketing (including booking reservations) and spending a block of 10 days annually was enough to establish material participation for condominiums in Hawaii, even though a local property manager checked in customers and managed maid service. *Pohoski v. Commissioner*, T.C. Memo. 1998-17.

[2078] Reg. § 1.469-4(a). *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), held that this regulation is valid.

To meet these participation rules, one or more trade or business activities[2079] or rental activities[2080] may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules.[2081] A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities.[2082] The factors listed below, not all of which are

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[2079] Reg. § 1.469-4(b)(1) provides that, for purposes of the grouping rules, "trade or business activities" are activities, other than rental activities or activities that are treated as incidental to an activity of holding property for investment, that:

(i) Involve the conduct of a trade or business (within the meaning of section 162);
(ii) Are conducted in anticipation of the commencement of a trade or business; or
(iii) Involve research or experimental expenditures that are deductible under section 174 (or would be deductible if the taxpayer adopted the method described in section 174(a)).

For purposes of the 3.8% tax on net investment income, the IRS takes the position that grouping cannot transform an investment activity into a trade or business. See text accompanying fn. 1644.

[2080] Reg. § 1.469-4(b)(2) provides that, for purposes of the grouping rules, one refers to the definition of rental activities under Reg. § 1.469-1T(e)(3). Reg. § 1.469-1T(e)(3)(i) provides that, generally, an activity is a rental activity for a taxable year if:

(A) During such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and
(B) The gross income attributable to the conduct of the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

However, Reg. § 1.469-1T(e)(3)(ii) provides that an activity involving the use of tangible property is not a rental activity for a taxable year if, for such taxable year:

(A) The average period of customer use for such property is seven days or less;
(B) The average period of customer use for such property is 30 days or less, and significant personal services (within the meaning of paragraph (e)(3)(iv) of this section) are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;
(C) Extraordinary personal services (within the meaning of paragraph (e)(3)(v) of this section) are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);
(D) The rental of such property is treated as incidental to a nonrental activity of the taxpayer under paragraph (e)(3)(vi) of this section;
(E) The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or
(F) The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section.

[2081] Reg. § 1.469-4(c)(1). The IRS' checklist for grouping entities is at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Exhibit-8-1-Activities-Grouping-Entities. Its Audit Techniques Guide explains the grouping rules at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-8-Activities-Grouping-Rules.

[2082] Reg. § 1.469-4(c)(2). In TAM 201634022, a surgeon did not group with his medical practice his interest in a surgical center. The TAM permitted the non-grouping:

necessary to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules:[2083]

- Similarities and differences in types of trades or businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Total lack of interdependence precludes grouping.[2084]

In determining groupings, generally all the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests; the reality of control, not its form or mode of exercise, is determinative.[2085] In applying this rule:

- Two or more undertakings of a taxpayer are part of the same common-ownership group for purposes of this rule if and only if the sum of the common-ownership percentages of any five or fewer persons (not including pass-through entities) with respect to such undertakings exceeds 50%; the common-ownership percentage of a

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> We conclude that the facts and circumstances of this case, as presented and analyzed under the five-factor test of § 1.469-4(c), suggest that there may be more than one reasonable method for grouping the taxpayers' activities into appropriate economic units. We also conclude that the facts and circumstances, as presented, do not support a determination that the taxpayers' grouping of the interests in X, Y, and P as separate activities is clearly inappropriate for purposes of either § 1.469-4(e)(2) or § 1.469-4(f). We further conclude that the facts as presented do not support a determination that H acquired his interest in P and treated it as a separate activity apart from X and Y with a principal purpose of circumventing the underlying purpose of § 469, for purposes of § 1.469-4(f). Therefore, we conclude that the Commissioner does not have authority to regroup the taxpayers' interests in X, Y, and P as a single activity under § 1.469-4(f) to prevent tax avoidance.

Hardy v. Commissioner, T.C. Memo. 2017-16, refused to allow the IRS to regroup the taxpayer's reasonable decision not to group; the IRS had argued that Reg. § 1.469-4(f)(2) applied. Reg. § 1.469-4(f)(2) provides that the IRS may regroup a partnership's activity leasing equipment to the partners' medical practices where the partners had passive losses. The taxpayer also successfully analogized his situation to the TAM in showing that his decision not to group was reasonable.

[2083] Reg. § 1.469-4(c)(2). *Lamas v. Commissioner*, T.C. Memo. 2015-59, held that all five factors were satisfied when two businesses with similar ownership operated from the same office.

[2084] *Williams v. Commissioner*, T.C. Memo. 2014-158.

[2085] Reg. § 1.469-4T(j)(1).

person with respect to such undertakings is the person's smallest ownership percentage in any such undertaking.[2086]

- If, without regard to this sentence, an undertaking of a taxpayer is part of two or more common-ownership groups, any undertakings of the taxpayer that are part of any such common-ownership group shall be treated for purposes of this test as part of a single common-ownership group in determining the activities of such taxpayer.[2087]

- A person's ownership percentage in an undertaking or in a pass-through entity shall include any interest in such undertaking or pass-through entity that the person holds directly and the person's share of any interest in such undertaking or pass-through entity that is held through one or more pass-through entities (but a beneficiary does not get included by reason of a trust's ownership).[2088]

- A person's ownership percentage in a pass-through entity or in an undertaking shall be determined by treating such person as the owner of any interest that a person related person (applying Code § 267(b) or 707(b)(1)) owns (determined without regard to this sentence) in such pass-through entity or in such undertaking;[2089] however, the common-ownership percentage of five or fewer persons with respect to two or more undertakings shall be determined, in any case in which, after the application of the preceding sentence, two or more such persons own the same interest in any such undertaking (the "related-party owners") by treating as the only owner of such interest (or portion thereof) the related-party owner whose ownership of such interest (or a portion thereof) would result in the highest common-ownership percentage.[2090]

Grouping is subject to the following limitations:[2091]

- A rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit and:[2092]

  - The rental activity is insubstantial in relation to the trade or business activity;

[2086] Reg. § 1.469-4T(j)(2)(ii).

[2087] Reg. § 1.469-4T(j)(2)(iii).

[2088] Reg. § 1.469-4T(j)(3)(i). In applying this pass-through test, Reg. § 1.469-4T(j)(3)(ii) provides that:

- A partner's interest in a partnership and share of any interest in a pass-through entity or undertaking held through a partnership shall be determined on the basis of the greater of such partner's percentage interest in the capital (by value) of such partnership or such partner's largest distributive share of any item of income or gain (disregarding Code § 707(c) guaranteed payments) of such partnership.
- A shareholder's interest in an S corporation and share of any interest in a pass-through entity or undertaking held through an S corporation shall be determined on the basis of such shareholder's stock ownership.
- A beneficiary's interest in a trust or estate and share of any interest in a pass-through entity or undertaking held through a trust or estate shall not be taken into account.

[2089] Reg. § 1.469-4T(j)(3)(iii)(A), (C).

[2090] Reg. § 1.469-4T(j)(3)(iii)(B).

[2091] Reg. § 1.469-4(d).

[2092] Reg. § 1.469-4(d)(1).

- The trade or business activity is insubstantial in relation to the rental activity;[2093] or

- Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.[2094]

- An activity involving the rental of real property and an activity involving the rental of personal property (other than personal property provided in connection with the real property or real property provided in connection with the personal property) may not be treated as a single activity.[2095]

- Generally, a taxpayer that owns an interest as a limited partner or a limited entrepreneur,[2096] in certain activities described in the at-risk rules,[2097] may not group that activity with any other activity. A taxpayer that owns an interest as a limited partner or a limited entrepreneur in an activity described in the preceding sentence may group that activity with another activity in the same type of business if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules.[2098]

[2093] *Stanley v. U.S.*, 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), held that running golf courses provided as an amenity to apartment complexes, but open to the public for a fee, constituted an insubstantial activity, even though golf revenue might have approached 20% of revenue from operations. The golf courses facilitated apartment rentals and sometimes helped overcome neighborhood opposition to the apartments being built.

[2094] If this proportionality cannot be achieved, consider using the structure provided in part II.E Recommended Structure for Entities, especially part II.E.9 Real Estate Drop Down into Preferred Limited Partnership, assigning disproportionate preferred profits interest related to the disproportionate ownership of the real estate.

[2095] Reg. § 1.469-4(d)(2)

[2096] As used here, a limited entrepreneur is a person does not actively participate in the management of a farm. Code § 464(e)(2).

[2097] Code § 465(c)(2)(A) treats as a separate activity under the at-risk rules: film or video tape, Code § 1245 property which is leased or held for leasing, a farm, oil and gas property (as defined under Code § 614), or geothermal property (as defined under Code § 614). However, Code § 465(c)(2)(B)(i) treats as a single activity all of a partnership's or S corporation's activities with respect to Code § 1245 (generally depreciable personal property) properties that are leased or held for lease and are placed in service in any taxable year of the partnership or S corporation. Also, Code § 465(c)(2)(B)(ii) treats as a single activity a trade or business (i) in which the taxpayer actively participates, or (ii) that is carried on by a partnership or an S corporation if 65% or more of the entity's losses for the taxable year are allocable to persons who actively participate in the management of the trade or business. This is a general overview, and one needs to look to the regulations under Code § 465 for a more accurate description.

[2098] Reg. § 1.469-4(d)(3). The IRS audit guide at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-8-Activities-Grouping-Rules described the rule as follows (emphasis in original):

> Limited partners involved in motion pictures, videotapes, farming, exploring or exploiting oil and gas, and exploring or exploiting geothermal deposits may group with another activity **only if it is in the same line of business**.

- The IRS may issue additional guidance prohibiting grouping.[2099]

The undertaking is generally the smallest unit that can constitute an activity, and it may include diverse business and rental operations.[2100] Note that:

- Business and rental operations conducted at the same location and owned by the same person are generally treated as part of the same undertaking; conversely, business and rental operations generally constitute separate undertakings to the extent that they are conducted at different locations or are not owned by the same person.[2101]

- However, operations that are not conducted at any fixed place of business or that are conducted at the customer's place of business are treated as part of the undertaking with which the operations are most closely associated; and operations, that are conducted at a location but do not relate to the production of property at that location or to the transaction of business with customers at that location, are treated as part of the undertaking or undertakings that the operations support.[2102]

- Furthermore, if the undertaking includes both rental and nonrental operations, the rental operations and the nonrental (including short-term rentals of real property, such as hotel-room rentals) operations generally must be treated as separate undertakings, unless more than 80% of the income of the undertaking determined under the usual rule is attributable to one class of operations (i.e., rental or nonrental) or if the rental operations would not be treated as part of a rental activity because of certain exceptions.[2103]

- Also, oil and gas wells that are subject to a certain working-interest exception as separate undertakings.[2104]

- The IRS would likely treat a portfolio of mortgages as a single trade or business activity which includes making, holding, or servicing the portfolio of mortgages, so that fact that one or more of the mortgages go into foreclosure likely will not allow the company to deduct its passive losses.[2105]

2099 Reg. § 1.469-4(d)(4). Rev. Proc. 2007-65, Sec. 4.09, treats certain wind farms as separate activities. The last time I checked, treatises had not mentioned any other guidance issued under this regulation.

2100 Reg. § 1.469-4T(a)(3)(i). Reg. § 1.469-4T(b)(2)(ii)(A) defines "business and rental operations" as all endeavors that are engaged in for profit or the production of income and satisfy one or more of the following conditions for the taxable year:

- Such endeavors involve the conduct of a trade or business (within the meaning of Code § 162) or are conducted in anticipation of such endeavors becoming a trade or business;
- Such endeavors involve making tangible property available for use by customers; or
- Research or experimental expenditures paid or incurred with respect to such endeavors are deductible research or experimental expenditures.

2101 Reg. § 1.469-4T(a)(3)(ii).

2102 Reg. § 1.469-4T(a)(3)(iii).

2103 Reg. § 1.469-4T(a)(3)(iv).

2104 Reg. § 1.469-4T(a)(3)(v).

2105 INFO 2009-0229.

When separate entities are involved:[2106]

- A C corporation subject to Code § 469, an S corporation, or a partnership (a "section 469 entity") decides how to group its activities.

- Once the section 469 entity groups its activities, a shareholder or partner may group those activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other section 469 entities. For example, an owner may group an activity conducted through one entity with an activity conducted through another entity.[2107]

- A shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

Although generally each undertaking in which a taxpayer owns an interest is treated as a separate activity of the taxpayer, additional rules may either require or permit the aggregation of two or more undertakings into a single activity, if the activity is a trade or business, professional service, or rental real estate undertaking:[2108]

- Trade or business undertakings include all nonrental undertakings other than certain oil and gas undertakings and certain professional service.[2109]

- An aggregation rule treats trade or business undertakings that are both similar and controlled by the same interests as part of the same activity, except for small interests held by passive investors in such undertakings, unless such interests are held through the same pass-through entity.[2110]

- Undertakings are similar for purposes of this rule if more than half (by value) of their operations are in the same line of business or if the undertakings are vertically integrated.[2111]

- All the facts and circumstances are taken into account in determining whether undertakings are controlled by the same interests for purposes of the aggregation rule; however, if each member of a group of five or fewer persons owns a substantial interest in each of the undertakings, the undertakings may be rebuttably presumed to be controlled by the same interests.[2112]

- However, professional service undertakings (nonrental undertakings that predominantly involve the provision of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) are similar, however, if more than 20% (by value) of their operations are

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[2106] Reg. § 1.469-4(d)(5)(i).
[2107] Reg. § 1.469-4(c)(3), Example (2).
[2108] Reg. § 1.469-4T(a)(4)(i).
[2109] Reg. § 1.469-4T(a)(4)(ii)(A).
[2110] Reg. § 1.469-4T(a)(4)(ii)(B). "Pass-through entity" means a partnership, S corporation, estate, or trust. Reg. § 1.469-4T(b)(2)(i).
[2111] Reg. § 1.469-4T(a)(4)(ii)(B).
[2112] Reg. § 1.469-4T(a)(4)(ii)(B).

in the same field, and two professional service undertakings are related if one of the undertakings derives more than 20% of its gross income from persons who are customers of the other undertaking.[2113]

- Also, the rules for aggregating rental real estate undertakings are generally elective, permitting taxpayers to treat any combination of rental real estate undertakings as a single activity or to divide their rental real estate undertakings and then treat portions of the undertakings as separate activities or recombine the portions into activities that include parts of different undertakings.[2114]

- Taxpayers may also elect to treat a nonrental undertaking as a separate activity even if the undertaking would be treated as part of a larger activity under the aggregation rules applicable to the undertaking, subject to certain consistency requirements; moreover, if a taxpayer elects to treat a nonrental undertaking as a separate activity, the taxpayer's level of participation (i.e., material, significant, or otherwise) in the separate activity is the same as the taxpayer's level of participation in the larger activity in which the undertaking would be included but for the election.[2115]

For business and rental operations of consolidated groups of corporations and publicly traded partnerships, a consolidated group is treated as one taxpayer in determining its activities and those of its members, and business and rental operations owned through a publicly traded partnership cannot be aggregated with operations that are not owned through the partnership.[2116]

Subject to certain exceptions,[2117] business and rental operations that constitute a separate source of income production are required to be treated as a single undertaking that is separate from other undertakings.[2118] For this purpose, business and rental operations shall be treated as a separate source of income production if and only if such operations are conducted at the same location[2119] and are owned by the same

[2113] Reg. § 1.469-4T(a)(4)(iii).
[2114] Reg. § 1.469-4T(a)(4)(iv).
[2115] Reg. § 1.469-4T(a)(4)(v).
[2116] Reg. § 1.469-4T(a)(5).
[2117] Notwithstanding that a taxpayer's interest in leased property would be treated as used in a single rental real estate undertaking under this rule, the taxpayer may, in certain circumstances, treat a portion of the leased property as a rental real estate undertaking that is separate from the undertaking or undertakings in which the remaining portion of the property is treated as used. Reg. § 1.469-4T(k)(2)(iii). Also, special rules apply to an oil or gas well. Reg. § 1.469-4T(e).
[2118] Reg. § 1.469-4T(c)(1).
[2119] For this purpose, Reg. § 1.469-4T(c)(2)(iii) provides:

(A) The term "location" means, with respect to any business and rental operations, a fixed place of business at which such operations are regularly conducted;

(B) Business and rental operations are conducted at the same location if they are conducted in the same physical structure or within close proximity of one another;

(C) Business and rental operations that are not conducted at a fixed place of business or that are conducted on the customer's premises shall be treated as operations that are conducted at the location (other than the customer's premises) with which they are most closely associated;

(D) All the facts and circumstances (including, in particular, the factors listed in paragraph (c)(3) of this section) are taken into account in determining the location with which business and rental operations are most closely associated; and person[2120] and income-producing operations[2121] owned by such person are conducted at such location.[2122] If the rule described in this paragraph would require treatment as a single undertaking that is separate from other undertakings, generally its rental operations[2123] and its operations other than rental operations are treated as two separate

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(E) Oil and gas operations that are conducted for the development of a common reservoir are conducted within close proximity of one another.

In determining whether a location is the location with which business and rental operations are most closely associated for purposes of (D) above, Reg. § 1.469-4T(c)(3) provides the following relationships between operations that are conducted at such location and other operations are generally the most significant:

(i) The extent to which other persons conduct similar operations at one location;
(ii) Whether such operations are treated as a unit in the primary accounting records reflecting the results of such operations;
(iii) The extent to which other persons treat similar operations as a unit in the primary accounting records reflecting the results of such similar operations;
(iv) The extent to which such operations involve products or services that are commonly provided together;
(v) The extent to which such operations serve the same customers;
(vi) The extent to which the same personnel, facilities, or equipment are used to conduct such operations;
(vii) The extent to which such operations are conducted in coordination with or reliance upon each other;
(viii) The extent to which the conduct of any such operations is incidental to the conduct of the remainder of such operations;
(ix) The extent to which such operations depend on each other for their economic success; and
(x) Whether such operations are conducted under the same trade name.

[2120] For this purpose, Reg. § 1.469-4T(c)(2)(v) provides that business and rental operations are owned by the same person if and only if one person is the direct owner of such operations. "Person" means and includes an individual, a trust, estate, partnership, association, company or corporation. Code § 7701(a)(1). In applying this rule, two partnerships owned by the same individuals are considered separate persons. Reg. § 1.469-4T(d)(4), Example (5)(ii).

[2121] For this purpose, Reg. § 1.469-4T(c)(2)(iv) provides that "income-producing operations" means business and rental operations that are conducted at a location and relate to (or are conducted in reasonable anticipation of):

(A) The production of property at such location;
(B) The sale of property to customers at such location;
(C) The performance of services for customers at such location;
(D) Transactions in which customers take physical possession at such location of property that is made available for their use; or
(E) Any other transactions that involve the presence of customers at such location.

[2122] Reg. § 1.469-4T(c)(2)(i).

[2123] Generally, such an undertaking's rental operations are all of the undertaking's business and rental operations that involve making tangible property available for use by customers and the provision of property and services in connection therewith. However, the undertaking's operations that involve making short-term real property available for use by customers and the provision of property and services in connection therewith are not treated as rental operations if such operations, considered as a separate activity, would not constitute a rental activity. Also, such an undertaking's operations that involve making tangible property available during defined business hours for nonexclusive use by various customers are not treated as rental operations. Reg. § 1.469-4T(d)(3).

undertakings,[2124] the income and expenses that are reasonably allocable to an undertaking is taken into account in determining the income or loss from the activity or activities that include such undertaking,[2125] and an undertaking is treated as a rental undertaking if and only if such undertaking, considered as a separate activity, would constitute a rental activity.[2126]

Finally, grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity, although those rules do provide a separate aggregation election.[2127]

II.K.1.b.ii. How to Report Grouping

Generally, a taxpayer must file a written statement with its original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity.[2128] Even before the rule became effective, merely reporting an activity is nonpassive when the taxpayer has another activity that is nonpassive does not support an inference of grouping.[2129]

If a taxpayer adds a new trade or business activity or a rental activity to an existing grouping for a taxable year, the taxpayer shall file a written statement with the taxpayer's original income tax return for that taxable year.[2130] If it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities.[2131] Until the taxpayer makes a change to the

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[2124] Reg. § 1.469-4T(d)(1)(i). However, this rule requiring treatment as separate undertaking does not apply for any taxable year in which the rental operations, considered as a separate activity, would not constitute a rental activity, less than 20% of the gross income of the overall undertaking is attributable to rental operations, or less than 20% of the gross income of the overall undertaking is attributable to operations other than rental operations. Reg. § 1.469-4T(d)(2).

[2125] Reg. § 1.469-4T(d)(1)(ii), which is applied after considering the text accompanying fn. 2124.

[2126] Reg. § 1.469-4T(d)(1)(iii), which is applied after considering the text accompanying fn. 2124.

[2127] See fns. 2176-2177.

[2128] Rev. Proc. 2010-13, Section 4.02, which further provides:

> This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.

[2129] *Hardy v. Commissioner*, T.C. Memo. 2017-16.

[2130] Rev. Proc. 2010-13, Section 4.03, which provides reporting requirements similar to those of Section 4.02.

[2131] Rev. Proc. 2010-13, Section 4.04, which provides reporting requirements similar to those of Section 4.02, but also provides:

> If two or more activities are regrouped into a single activity, the statement reporting a regrouping must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469. Furthermore, the statement reporting a regrouping must contain an explanation of why the taxpayer's original grouping was determined to be clearly

grouping as described in the preceding sentences of this paragraph, a taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that have been made before taxable years beginning on or after January 25, 2010.[2132]

If a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity as described in any of the above paragraphs, then each trade or business activity or rental activity will be treated as a separate activity.[2133] However, a timely disclosure is deemed made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer.[2134]

Partnerships and S corporations are not subject to the above requirements:[2135]

> Instead, partnerships and S corporations must comply with the disclosure instructions for grouping activities provided for on Form 1065, U.S. Return of Partnership Income and Form 1120S, U.S. Income Tax Return for an S Corporation, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1. The partner or shareholder is not required to make a separate disclosure of the groupings disclosed by the entity under §§ 4.02, 4.03, and 4.04 of this revenue procedure unless the partner or shareholder (1) groups together any of the activities that the entity does not group together, (2) groups the entity's activities with activities conducted directly by the partner or shareholder, or (3) groups the entity's activities with activities conducted through other section 469 entities. Pursuant to § 1.469-4(d)(5)(i), a shareholder or partner may not treat activities grouped together by a section 469 entity as separate activities.

The instructions to Form 1120S seem to me to be quite vague.[2136] All I can discern is:[2137]

> inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate.

[2132] Rev. Proc. 2010-13, Sections 4.06 and 5.

[2133] Rev. Proc. 2010-13, Section 4.07.

[2134] Rev. Proc. 2010-13, Section 4.07. Furthermore:

> If the failure to disclose is first discovered by the Service, however, the taxpayer must also have reasonable cause for not making the disclosures required by this revenue procedure. Although the default rule established by this section 4.07 will generally result in unreported activities being treated as separate activities, the Commissioner may still regroup a taxpayer's activities to prevent tax avoidance pursuant to § 1.469-4(f). This revenue procedure provides alternative relief for untimely filing of the disclosures required by this revenue procedure; therefore, relief for untimely disclosures under § 301.9100 of the Procedure and Administration Regulations is not available pursuant to § 301.9100-1(d)(2).

[2135] Rev. Proc. 2010-13, Section 4.05.

[2136] Page 10 of the 2014 instructions discusses grouping but don't say how to do it.

[2137] Page 11 of the 2014 instructions, heading, "Passive Activity Reporting Requirements."

> To allow shareholders to correctly apply the passive activity loss and credit limitation rules, the corporation must do the following.
>
> 1. If the corporation carries on more than one activity, provide an attached statement for each activity conducted through the corporation that identifies the type of activity conducted (trade or business, rental real estate, rental activity other than rental real estate, or investment)….

The instructions do not address the consequences of the corporation's failing to attach such a statement.[2138] Has the S corporation implicitly elected to group if it fails to attach such a statement? Or has it failed to comply with the instructions and deemed not to have grouped?[2139] An S corporation that discovers that it has not addressed this issue should be able to cure it, if it makes the required disclosure on the income tax return for the year in which the S corporation first discovers the failure to disclose.[2140]

II.K.1.b.iii. Regrouping Activities Transitioning into 3.8% Tax on Net Investment Income

The enactment of the 3.8% tax on net investment income provides an opportunity for taxpayers to revisit their groupings. The preamble to the proposed regulations under Code § 1411 provides:[2141]

> Section 1.469-4(e)(1) provides that, except as provided in §§ 1.469-4(e)(2) and 1.469-11, once a taxpayer has grouped activities, the taxpayer may not regroup those activities in subsequent taxable years. The Treasury Department and the IRS have determined on prior occasions that taxpayers should be given a "fresh start" to redetermine their groupings. The enactment of section 1411 may cause taxpayers to reconsider their previous grouping determinations, and therefore the Treasury Department and the IRS have determined that taxpayers should be given the opportunity to regroup. Thus, the proposed regulations provide that taxpayers may regroup their activities in the first taxable year beginning after December 31, 2013, in which the taxpayer meets the applicable income threshold in proposed § 1.1411-2(d) and has net investment income (as defined in proposed § 1.1411-4). The determination in the preceding sentence is

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[2138] Nor did the IRS' Audit Guide for grouping, which pre-dates Rev. Proc. 2010-13, last time I looked. The Audit Guide was at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-8-Activities-Grouping-Rules and http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Exhibit-8-1-Activities-Grouping-Entities.

[2139] Rev. Proc. 2010-13, Section 4.07 provides:

> Except as provided in § 4.05, if a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity in accordance with this revenue procedure, then each trade or business activity or rental activity will be treated as a separate activity for purposes of applying the passive activity loss and credit limitation rules of section 469.

Section 4.05 is what provides that partnerships and S corporations must comply with the disclosure instructions for grouping activities provided for on Form 1065 or 1120S. If the partnership or S corporation does not comply with the instructions, does that kick the entity out of the safe harbor and require treatment as separate activities?

[2140] See fn. 2134.

[2141] Part 6.B.1.(b)(4) of the preamble.

made without regard to the effect of the regrouping. Taxpayers may regroup their activities in reliance on this proposed regulation for any taxable year that begins during 2013 if section 1411 would apply to such taxpayer in such taxable year. A taxpayer may only regroup activities once pursuant to § 1.469-11(b)(3)(iv)(A), and any such regrouping will apply to the taxable year for which the regrouping is done and all subsequent years.

The regrouping must comply with the existing requirements under § 1.469-4. For example, § 1.469-4(e) provides that taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years. On January 25, 2010, the Treasury Department and the IRS published Revenue Procedure 2010-13 (2010-4 IRB 329), which requires taxpayers to report to the IRS their groupings and regroupings of activities and the addition of specific activities within their existing groupings of activities for purposes of section 469 and § 1.469-4. Thus, the disclosure requirements of § 1.469-4(e) and Revenue Procedure 2010-13 require taxpayers who regroup their activities pursuant to proposed § 1.469-11(b)(3)(iv) to report their regroupings to the IRS. See § 601.601(d)(2).

The final regulations[2142] allow an individual, estate, or trust to regroup in the first taxable year beginning after December 31, 2013, in which Code § 1411 would apply to such taxpayer, if the taxpayer has net investment income[2143] and such taxpayer's income exceeds the applicable thresholds.[2144]

The preamble to the final regulations explains:[2145]

The final regulations retain the requirement that regrouping under § 1.469-11(b)(3)(iv) may occur only during the first taxable year beginning after December 31, 2012, in which (1) the taxpayer meets the applicable income threshold under section 1411, and (2) has net investment income. The Treasury Department and the IRS believe that the interaction between section 1411 and section 469 justifies the section 1411 regrouping rule, and that, if a taxpayer does not have a section 1411 tax liability, the reason for allowing the regrouping does not apply. The Treasury Department and the IRS acknowledge that, in the case of regrouping elections by partnerships and S corporations, one commentator's implied assertion is correct that imposition of section 1411 on a passthrough entity's owner(s) is the same change in law that precipitated the proposed regulation's allowance of regrouping in the first instance. However, if the

[2142] Reg. § 1.469-11(b)(3)(iv).
[2143] As defined in Reg. § 1.1411-4.
[2144] Reg. § 1.469-1(b)(3)(iv)(B) refers to the modified adjusted gross income (as defined in Reg. § 1.1411-2(c)) of an individual (as defined in Reg. § 1.1411-2(a)) exceeding the applicable threshold in Reg. § 1.1411-2(d) or the adjusted gross income of an estate or trust (as defined in Reg. § 1.1411-3(a)(1)(i)) exceeding the amount described in Reg. § 1.1411-3(a)(1)(ii)(B)(2).
[2145] T.D. 9644. The first sentence quoted here appears to be erroneous, in that, as fn. 2142 notes, the final regulations allow regrouping in the first taxable year beginning after December 31, 2013, rather than the first taxable year beginning after December 31, 2012. The mention of December 31, 2012 might have been in light of taxpayers being able to rely on the proposed regulations to regroup in their 2013 returns.

> Treasury Department and the IRS were to expand the scope of the regulations to allow regrouping by partnerships and S corporations, then taxpayers with no tax liability under section 1411 indirectly would be allowed to regroup. Accordingly, the final regulations do not adopt this suggestion.
>
> However, after considering the comments, the Treasury Department and the IRS agree with the commentators' concerns regarding the potential unfairness to taxpayers who become subject to section 1411 after adjustments to, for example, income or deduction items after an original return has been filed. Therefore, the final regulations allow a taxpayer to regroup under § 1.469-11(b)(3)(iv) on an amended return, but only if the taxpayer was not subject to section 1411 on his or her original return (or previously amended return), and if, because of a change to the original return, the taxpayer owed tax under section 1411 for that taxable year. This rule applies equally to changes to modified adjusted gross income or net investment income upon an IRS examination.
>
> However, if a taxpayer regroups on an original return (or previously amended return) under these rules, and then subsequently determines that the taxpayer is not subject to section 1411 in that year, such regrouping is void in that year and all subsequent years until a valid regrouping is done. The voiding of the regrouping may cause additional changes to the taxpayer's current year return and may warrant corrections to future year returns to restore the taxpayer's original groupings. The final regulations contain two exceptions to such voided elections. First, the final regulations allow a taxpayer to adopt the voided grouping in a subsequent year without filing an amended return if the taxpayer is subject to section 1411 in such year. Second, if the taxpayer is subject to Section 1411 in a subsequent year, the taxpayer may file an amended return to regroup in a manner that differs from the previous year's voided regrouping. The final regulations provide four new examples on the amended return regrouping rules. Furthermore, § 1.1411-2(a)(2)(iii) of the final section 1411 regulations also contains a similar rule applicable to section 6013(g) elections.

The preamble quoted above acknowledges that, if a passive activity is held through a partnership or an S corporation, any grouping is done first at the entity level, and those entities are not described above.

Practice Tips:

- If a partnership has a bunch of long-term leases, consider converting the partnership into an investment trust,[2146] such as a Delaware statutory trust,[2147] so that each owner can separately engage in regrouping.

[2146] See part II.D.4.a Investment Trusts. For example, all of the partners might contribute their partnership interests into an investment trust, and the partnership would dissolve as a matter of state law (if it is a general partnership) or by the entity that was a partnership filing the appropriate termination documentation. The trust itself would be a limited liability entity. However, it would have to be carefully structured so that the trust's activity does not rise to the level of a partnership. The partners would need to group that activity with other activities in which the partners engaged to satisfy the appropriate tests. When done to avoid the 3.8% tax on net investment income, this would require threading a very fine needle, in that the trust would be

- If it is later determined that a regrouping was invalid because the NII tax would not otherwise have applied, a new election would need to be made on a subsequent return. As noted above, a taxpayer can amend such a subsequent return to make the regrouping election.[2148] Consider whether a regrouping election might be reaffirmed each year in case the initial regrouping was invalid; this would be worthwhile only if reaffirming the regrouping does not take much work.

For more about regrouping, see Kirk and Satchit, "Peeling The Onion: Passive Loss Regrouping in Light of Section 1411," *Business Entities (WG&L)* (March/April 2015).

II.K.1.b.iv. Is Grouping Advisable?

Grouping undertakings together as a single activity means that an undertaking is not treated as disposed of, thereby freeing suspended losses, until all undertakings in that grouped activity are disposed of.[2149]

Also, grouping might dilute the personal service aspects of an undertaking, throwing it out of the favorable rules for material participation that apply to personal services activities.[2150]

Grouping does not help with the real estate professional test under part II.K.1.e.iii Real Estate Professional Converts Rental to Nonpassive Activity.[2151]

II.K.1.c. Attributing Material Participation from Business Entities to Their Employees and Vice Versa (Including Limited Partnership with Corporate General Partner)

When the same individual owns the corporate general partner, is the sole limited partner, and works in the partnership's business as an individual, this work can cause not only the individual but also the corporation to materially participate.[2152] Note that a special provision applying the passive loss rules to certain C corporation owners mandates the result regarding the corporation's participation.[2153]

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taking the position that it is not engaged in a trade or business (to satisfy the requirements described in part II.D.4.a Investment Trusts) and its owners would argue that their interest in the trust, when combined with their other activities, rises to the level of a trade or business (to satisfy the requirements described in part II.I.8.c Application of 3.8% Tax to Rental Income).

[2147] See fn. 547.

[2148] Reg. § 1.469-11(b)(3)(iv)(C)(2).

[2149] For more information on dispositions, see fn. 2027.

[2150] See text accompanying fn. 2050.

[2151] See fn. 2176. Real estate professionals have a separate aggregation election available.

[2152] Reg. § 1.469-5T(k), Example (1).

[2153] Code § 469(h)(4) provides:

> *Certain closely held C corporations and personal service corporations*. A closely held C corporation or personal service corporation shall be treated as materially participating in an activity only if-
>
> (A) 1 or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of such corporation materially participate in such activity, or

When an individual owns the corporate general partner, is the sole limited partner, and works in the partnership's business as an employee of the corporate general partner, this work can cause not only the corporation but also the individual to materially participate.[2154]

When an individual is the sole limited partner and works in the partnership's business as an employee of the corporate general partner, but that individual does not own the corporate general partner, this work can cause the individual to materially participate but will not affect the corporation's material participation.[2155]

These examples are consistent with the idea that an individual receives credit for participation in any capacity.[2156]

II.K.1.d. Applying Passive Loss Rules to a Retiring Partner under Code § 736

Except as described below, any Code § 707(c) payment to a partner for services or the use of capital, including any Code § 736(a)(2) payment (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner), constitutes a payment for services or as the payment of interest, respectively, under the passive loss rules and not as a distributive share of partnership income.[2157]

If any gain or loss is taken into account by a retiring partner or a deceased partner's successor in interest as a result of a Code 736(b) payment,[2158] the gain or loss constitutes passive activity gross income or deduction only to the extent that the gain or loss would have been passive activity gross income or deduction of the retiring or deceased partner if it had been recognized at the time the liquidation of the partner's interest began.[2159]

If a Code § 736(a) payment is made in liquidation of a retiring or deceased partner's interest and that person takes into account any income as a result of the payment that is attributable to the portion (if any) of the payment that is allocable to the partnership's unrealized receivables[2160] and goodwill, the percentage of the income treated as passive shall not exceed the percentage of passive income that would be included in the income that person would have recognized if the unrealized receivables and goodwill had been sold at the time that the liquidation of the partner's interest began.[2161]

(B) in the case of a closely held C corporation (other than a personal service corporation), the requirements of section 465(c)(7)(C) (without regard to clause (iv)) are met with respect to such activity.

See Reg. § 1.469-1T(g).

[2154] Reg. § 1.469-5T(k), Example (2).

[2155] Reg. § 1.469-5T(k), Example (2) (variation mentioned in the final sentence).

[2156] See fn 2038.

[2157] Reg. § 1.469-2(e)(2)(ii). For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

[2158] See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[2159] Reg. § 1.469-2(e)(2)(iii)(A).

[2160] Within the meaning of Code § 751(c).

[2161] Reg. § 1.469-2(e)(2)(iii)(B)(1). For purposes of this test, calculate the portion (if any) of a Code § 736(a) payment allocable to a partnership's unrealized receivables and goodwill using the

For some background, see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

II.K.1.e. Rental Activities

Generally, "passive activity" also includes any rental activity.[2162]

II.K.1.e.i. What Is Rental?

Generally, an activity is a rental activity for a taxable year if:[2163]

- During that taxable year, tangible property is used by customers or held for use by customers, and

- The gross income attributable to the activity during such taxable year represents (or, in the case of an activity in which property is held for use by customers, the expected gross income from the conduct of the activity will represent) amounts paid or to be paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

However, regulations exclude from treatment as rental the use of tangible property for a taxable year if, for that taxable year:[2164]

- The average period of customer use for such property is seven days or less;[2165]

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principles of Reg. § 1.736-1(b) for determining the portion of a payment made under Code § 736 treated as a distribution under Code § 736(b). Reg. § 1.469-2(e)(2)(iii)(B)(2). Reg. § 1.736-1(b)(3) provides:

> To the extent that the partnership agreement provides for a reasonable payment with respect to good will, such payments shall be treated under section 736(b) and this paragraph. Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct.

Recognizing this exception, the Preamble to Prop. Reg. § 1.1411-7 (net investment income tax) (12/02/2013), Fed. Reg. Vol. 78, No. 231, pp. 72451 et seq., provides:

> Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").

[2162] Code § 469(c)(2). An excellent article discussing how the passive loss rules apply to real estate investors and real estate professionals is Panitz and Lubin, "Higher Stakes for Tax Treatment of Rental Real Estate," *Journal of Accountancy*, at 56-62 (Dec. 2013).

[2163] Reg. § 1.469-1T(e)(3)(i).

[2164] Reg. § 1.469-1T(e)(3)(ii).

[2165] To facilitate finding a short rental period, instead of having the lease begin the date of signature or deposit, provide that lease begins with delivery and concludes with the return of the property, the latter which was successfully done in *Moreno v. U.S.*, 113 A.F.T.R.2d 2014-2149 (D. La 5/19/2014).

- The average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers;

- Extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use);[2166]

- The rental of such property is treated as incidental to a nonrental activity of the taxpayer;

- The taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or

- The provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under the following exception:[2167]

    - If the taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture, the provision of such property is not a rental activity.

[2166] Reg. § 1.469-1T(e)(3)(ii)(C), referring to extraordinary personal services under Reg. § 1.469-1T(e)(3)(ii)(C), which provides:

> *Extraordinary personal services*. For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services. For example, the use by patients of a hospital's boarding facilities generally is incidental to their receipt of the personal services provided by the hospital's medical and nursing staff. Similarly, the use by students of a boarding school's dormitories generally is incidental to their receipt of the personal services provided by the school's teaching staff.

In rejecting taxpayers' claim that they provided "extraordinary personal services" under the regulation, *Johnson v. U.S.*, 116 A.F.T.R.2d 2015-5486 (D. N.C. 2015), 117 A.F.T.R.2d 2016-947 (4th Cir. 2016), *cert. den*. 10/3/2016:

> None of the unsubstantiated evidence proffered by plaintiffs would support a finding that their rental homes in either Illinois or South Carolina offered services that were "akin to those services offered by a hospital or school, where the prime concern of the tenants is the receipt of services, whether medical, teaching, or, [this] case, legal[, financial, and psychological]." *Assaf*, 2005 WL 209726 4. The only statement provided by someone other than plaintiffs merely reveals that the "services" promised were provided; such "services" included the provision of continental breakfast items, furniture, and laundry facilities, which, as discussed above, do not constitute extraordinary personal services. The only "services" which would differentiate plaintiffs' rental homes from typical rental properties were the counseling services allegedly provided, and plaintiffs have simply failed to proffer anything more than their own conclusory statements to support a finding that the occupants' use of their property was incidental to their receipt of counseling services provided by Johnson.

[2167] Reg. § 1.469-1T(e)(3)(vii).

- Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a guaranteed payment under Code § 707(c)[2168] is not income from a rental activity under any circumstances.
- The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

II.K.1.e.ii. Self-Rental Converts Rental to Nonpassive Activity

A taxpayer's net rental income for the year from an item of property is treated as nonpassive if the property is rented for use in a trade or business activity in which the taxpayer[2169] materially participates[2170] for the taxable year.[2171]

This test applies to the item of property, ignoring any grouping elections that might apply to that item of property.[2172]

[2168] For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

[2169] *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), held that, if a passthrough entity holds real estate, the passthrough entity's owners, not the passthrough entity itself, must materially participate.

[2170] See parts II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business and II.K.1.a Counting Work as Participation, as well as the rest of part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules. In *Schumann v. Commissioner*, T.C. Memo. 2014-138, a taxpayer who took substantial salary from his operating business could not prove that he did not materially participate in the business (because he wanted his rent to be passive income), despite his testimony that "his income tax reporting for both years was 'tax provisioning' and that he did not actively provide services to either company in exchange for the wages and payments reported on his tax returns."

[2171] Reg. § 1.469-2(f)(6) provides:

> *Property rented to a nonpassive activity*. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property-
>
> (i) Is rented for use in a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer materially participates (within the meaning of § 1.469-5T) for the taxable year; and
>
> (ii) Is not described in § 1.469-2T(f)(5).

The cross-reference to Reg. § 1.469-2(e)(2) is puzzling, because Reg. § 1.469-2(e)(2)(i) is reserved and Reg. § 1.469-2(e)(2)(ii) related to partnership redemptions. *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), ignored this cross-reference when holding that Reg. § 1.469-2(f)(6) is valid and applying it in to treat rental to a professional service corporation as nonrental. *Williams v. Commissioner*, T.C. Memo. 2015-76, *aff'd* 117 A.F.T.R.2d 2016-600 (5th Cir. 2/2/2016), followed *Schwalbach* in holding that Reg. § 1.469-2(f)(6) is valid.

Reg. § 1.469-2T(f)(5) is discussed in part II.K.1.e.v Rental Income Property a Taxpayer Improves, Rents Briefly, and Then Sells Is Nonpassive.

See fns. 1604 and 1644 regarding the interaction of Reg. § 1.469-2(f)(6) with the 3.8% tax on net investment income.

"Rented for use in a trade or business activity" does not include rental to an activity that is itself rental.[2173]

II.K.1.e.iii. Real Estate Professional Converts Rental to Nonpassive Activity

Below is a discussion of the real estate professional exception, followed by certain rules in aggregating real estate activities.

II.K.1.e.iii.(a). Scope and Effect of Real Estate Professional Exception

A real estate activity is not *per se* a passive activity if the taxpayer[2174] is a real estate professional described as follows:[2175]

- more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses[2176] in which the taxpayer materially

[2172] *Carlos v. Commissioner*, 123 T.C. 275 (2004); *Veriha v. Commissioner*, 139 T.C. 45 (2012) (defining "item of property" for purposes of this rule); *Dirico v. Commissioner*, 139 T.C. 396 (2012); see also *Samarasinghe v. Commissioner*, T.C. Memo. 2012-23 (same result, but I'm not sure whether the taxpayer grouped the item with other rental properties or merely tried to use passive loss to offset this income).

[2173] *Dirico v. Commissioner*, 139 T.C. 396 (2012). In approving the deduction of rental losses against rental income, the Tax Court did not hold against the taxpayer the taxpayer's misreporting of rental income as ordinary business income.

[2174] Including a trust, per *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014) (rejecting the IRS' contention that only individuals - not trusts - could be real estate professionals). The petition, reply, and briefs are at http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220.
CCA 201244017 had taken the position that a trust cannot be a real estate professional.

[2175] Each bullet point below requires a finding of material participation in those real property trades or businesses before adding up hours. *Windham v. Commissioner*, T.C. Memo. 2017-068. The taxpayer may use spousal participation to establish material participation in a real property trade or business so that the taxpayer can count hours in that activity, but the taxpayer does not to count spousal hours in the real estate professional test. See part II.K.1.a.iii Spousal Participation, especially fn. 2063. See also Kalfayan and Patterson, "Classifying Taxpayer Business Hours to Determine Qualification as a 'Real Estate Professional' Under the Passive Activity Loss Rules," *Journal of Taxation* (WG&L) 5/2017, saved as Thompson Coburn LLP doc. no. 6561377.

[2176] "Real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Code § 469(c)(7)(C). A holding company that raised capital to invest in real estate projects (owned by other entities) but neither owned any rental real property nor performed any management or operations functions is not considered a Code § 469(c)(7)(C) real property trade or business. *Coastal Heart Medical Group v. Commissioner*, T.C. Memo. 2015-84.

participates (and personal services do not count unless the person is a 5% owner).[2177]

CCA 201504010 held as follows, with the first holding intended to be totally positive:

1. A real estate agent who brings together buyers and sellers of real property may be engaged in a real property brokerage trade or business under § 469(c)(7)(C) [even though the licensed agent was not licensed as a broker].

2. A mortgage broker who is a broker of financial instruments is not in a real property brokerage trade or business within the meaning of § 469(c)(7)(C).

Hickam v. Commissioner, T.C. Summary Opinion 2017-66 held that neither mortgage brokerage services nor loan origination services were performed in a real property trade or business within the meaning of Code § 469(c)(7)(C).[2178]

[2177] Code § 469(c)(7)(B). For purposes of this test, personal services performed as an employee shall not be treated as performed in real property trades or businesses unless (and when) the employee is a 5-percent owner in the employer. Code § 469(c)(7)(D)(ii); Reg. § 1.469-9(c)(5). Both of these provisions refer to Code § 416(i)(1)(B)(i), which defines 5-percent owner to mean:

> (I) if the employer is a corporation, any person who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation, or
>
> (II) if the employer is not a corporation, any person who owns more than 5 percent of the capital or profits interest in the employer.

Stanley v. U.S., 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), held:

> The Court has already set out the evidence of record substantiating Roy's ownership of the stock, and the Court does not find that the word "outstanding" imposes some additional requirement that the stock be readily transferable or not at risk of forfeiture that would operate to prevent Roy from claiming ownership for purposes of 26 U.S.C. § 469(c)(7)(D)(ii).

The IRS nonacquiesced, 2017–42 I.R.B. 311 (10/16/2017), stating in fn. 1:

> Nonacquiescence relating to the holdings that: 1) mere possession of a stock certificate, disregarding other conditions, restrictions or limitations on the possessor's rights regarding the stock, constitutes ownership for purposes of § 469(c)(7)(D)(ii); and 2) work performed by the taxpayer in a rental real estate activity for purposes of § 469(c)(7)(A) may also constitute work performed by the taxpayer in non-rental business activities of the taxpayer for other purposes of § 469.

An excellent article discussing how the passive loss rules apply to real estate investors and real estate professionals is Panitz and Lubin, "Higher Stakes for Tax Treatment of Rental Real Estate," *Journal of Accountancy*, at 56-62 (Dec. 2013). See generally Reg. § 1.469-9.

[2178] The court reasoned:

> Mr. Hickam's argument that his mortgage brokerage services and his loan origination services are performed in trades or businesses in "real property operation" because the underlying assets are real property is too attenuated. His argument ignores the words "real property" that precede the specific activities listed in the statute; those words modify each of those activities, including "operation". Although the loans he brokered and originated were secured by real property, Mr. Hickam's mortgage brokerage services and his loan origination services did not involve operating the real properties that secured those loans.

Note that being a real estate professional merely treats the activity as not *per se* passive; the taxpayer's rental activity still must satisfy the usual nonrental rules for being a nonpassive activity.[2179]

The IRS often succeeds when attacking those who hold full-time jobs (a job is considered a "trade or business")[2180] who claim that they were also real estate professionals, collecting not only tax but also a 20% accuracy-related penalty.[2181] However, a taxpayer who spent her mornings on real estate and her afternoons on her investment advisory business (the latter being her more steady source of income) was able to prove being a real estate professional.[2182]

For more insight into what is a real estate trade or business, see part II.I.8.c.iii Rental as a Trade or Business, in the context of the tax on net investment income (NII), including a detailed excerpt from the preamble to the final NII regulations.

See also part II.G.25 Real Estate Dealer vs. Investor.

II.K.1.e.iii.(b). Aggregating Real Estate Activities for a Real Estate Professional

A qualifying taxpayer may elect to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity, which election may be made in any year and is binding for the taxable year in which it is made and for all future years[2183] in which the taxpayer is a qualifying taxpayer, but which does not have effect in years in which the taxpayer is not a qualifying taxpayer.[2184] Absent such an election, each building would

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> Further, while Mr. Hickam's mortgage brokerage services constitute a "brokerage" trade or business, they does not constitute a "real property brokerage" trade or business. Mr. Hickam did not broker real estate during either year at issue. Rather, he brokered loans between buyers and financial institutions.
>
> The legislative history of the statute supports the consequence of this distinction. Congress considered including "finance operations" in the activities listed in section 469(c)(7)(C) but specifically did not do so. See H.R. 2264, 103d Cong., sec. 13143 (1993); H.R. 1414, 102d Cong. (1991); S. 1257, 102d Cong. (1991); H.R. 3732, 101st Cong. (1989); S. 2384, 101st Cong. (1989).

[2179] *Gragg v. U.S.*, 118 A.F.T.R.2d 2016-5364 (9th Cir. 8/4/2016), citing *Perez v. Commissioner*, T.C. Memo. 2010-232, as confirming its interpretation of Reg. § 1.469-9(e)(1), which provides:

> Section 469(c)(2) does not apply to any rental real estate activity of a taxpayer for a taxable year in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section. Instead, a rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity.

[2180] Reg. § 1.469-9(c)(5).

[2181] See part II.K.1.a.vi Proving Participation. *Zarrinnegar v. Commissioner*, T.C. Memo. 2017-34, was an unusual case described in fn 2069 of that part. The wife and husband shared the dental practice and real estate investments. The wife worked full-time and the husband part-time (less than 1,000 hours) in the dental practice. The wife worked none and the husband worked more than 1,000 hours in the real estate business. The wife was attributed the husband's status as a real estate professional under part II.K.1.a.iii Spousal Participation.

[2182] *Windham v. Commissioner*, T.C. Memo. 2017-068.

[2183] See fn. 2200.

[2184] Reg. § 1.469-9(g)(1) provides:

> *In general*. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election is

constitute a separate activity,[2185] and it might be impossible to prove sufficient participation for each building.[2186]

To be a qualifying taxpayer, a taxpayer must own at least one interest in rental real estate and meet these requirements:[2187]

- The taxpayer must meet the requirements of section 469(c)(7)(B):[2188]

  - more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

  - the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates (and personal services do not count unless the person is a 5% owner).

- A taxpayer must materially participate in a real property trade or business for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the above requirements.[2189]

- Spouses filing a joint return are qualifying taxpayers only if one spouse separately satisfies both requirements of Code § 469(c)(7)(B).[2190]

> binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year. In years in which the taxpayer is not a qualifying taxpayer, the election will not have effect and the taxpayer's activities will be those determined under § 1.469-4. If there is a material change in the taxpayer's facts and circumstances, the taxpayer may revoke the election using the procedure described in paragraph (g)(3) of this section.

[2185] Reg. § 1.469-9(e)(4), subparagraph (i), reproduced further below.

[2186] *Syed v. Commissioner*, T.C. Memo. 2017-226, fn. 5.

[2187] Reg. § 1.469-9(b)(6), (c).

[2188] Reg. § 1.469-9(c)(1), referring to Code § 469(c)(7)(B), which is described (more than what is in the bullet points above) in fn. 2177 in part II.K.1.e.iii.(a) Scope and Effect of Real Estate Professional Exception. Reg. § 1.469-9(c)(2) applies special rules for taxpayers that are closely held C corporations.
This requirement seems like a chicken-and-egg question – how can one prove the participation necessary to aggregate without first combining activities in some way? See fn. 2204 and the accompanying text for an answer.

[2189] Reg. § 1.469-9(c)(3).

[2190] Reg. § 1.469-9(c)(4), which further provides:

> In determining the real property trades or businesses in which a married taxpayer materially participates (but not for any other purpose under this paragraph (c)), work performed by the taxpayer's spouse in a trade or business is treated as work performed by the taxpayer under § 1.469-5T(f)(3), regardless of whether the spouses file a joint return for the year.

See part II.K.1.a.iii Spousal Participation, fn. 2059.

- Work "as an employee" counts only of the taxpayer owns more than 5% of the business.[2191] Presumably (no authority on point of which I am aware), work as a partner, whether compensated directly through Code § 707(c) guaranteed payments or merely through the taxpayer's distributive share, would not be subject to this rule, but work under Code § 707(a)(2) other than as a partner may be subject to this rule.[2192] Therefore, if a partner is compensated for services, consider including the right to payment in the partnership agreement and specify that it will be reported on the partner's K-1 as a Code § 707(c) guaranteed payment; this reporting means that the income will be reported in the year for which the partnership deducts it, rather than the year in which the partner receives the payment.[2193]

A taxpayer may use any reasonable method of applying the facts and circumstances in determining the real property trades or businesses in which the taxpayer provides personal services, and a real property trade or business might consist either of one or more than one such trade or business; a taxpayer's grouping of activities under Reg. § 1.469-4 does not control the determination of the taxpayer's real property trades or businesses for purposes of this test.[2194] Once a taxpayer determines the real property trades or businesses in which personal services are provided for purposes of this test, the taxpayer may not redetermine those real property trades or businesses in subsequent taxable years unless the original determination was clearly inappropriate or there has been a material change in the facts and circumstances that makes the original determination clearly inappropriate.[2195] If a business includes significant activities not defined as real property trades or businesses, the taxpayer will need to segregate the time spent on real property trades or businesses from other activities to determine whether the taxpayer satisfies this test.[2196]

[2191] Reg. § 1.469-9(c)(5), "Employees in real property trades or businesses," provides:

> For purposes of paragraph (c)(1) of this section, personal services performed during a taxable year as an employee generally will be treated as performed in a trade or business but will not be treated as performed in a real property trade or business, unless the taxpayer is a five-percent owner (within the meaning of section 416(i)(1)(B)) in the employer. If an employee is not a five-percent owner in the employer at all times during the taxable year, only the personal services performed by the employee during the period the employee is a five-percent owner in the employer will be treated as performed in a real property trade or business.

[2192] See part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

[2193] See fn. 437, found in part III.B.7.c.viii Creative Bonus Arrangements.

[2194] Reg. § 1.469-9(d)(1). Failure to group under the passive loss general grouping rules constitutes an election not to group - see fns. 2133 (effect failure to group) and 2134 (possible relief) in part II.K.1.b.ii How to Report Grouping - whereas failure to aggregate real estate does not preclude a later aggregation election – see fn. 2184 in this part II.K.1.e.iii.(b).

[2195] Reg. § 1.469-9(d)(2).

[2196] Failure to segregate led to the taxpayer losing *Cantor v. Commissioner*, T.C. Summary Opinion 2014-103 (company installed glass in vehicles and residences, and residential work was not necessarily part of constructing, reconstructing, etc. a home); see also *Langille v. Commissioner*, 108 A.F.T.R.2d 2011-7254 (11th Cir. 2011) (law practice does not count as real estate professional work, and taxpayer failed to even introduce evidence that work done at law firm was real estate work rather than legal work), *aff'g* T.C. Memo. 2010-49.

This election applies to rental real estate interests held through passthrough entities.[2197] Explaining how to make the election, *Shiekh v. Commissioner*, T.C. Memo. 2010-126, pointed out:[2198]

> To make an election, a taxpayer must clearly notify the Commissioner of the taxpayer's intent to do so. See *Knight- Ridder Newspapers, Inc. v. United States*, 743 F.2d 781, 795 (11th Cir. 1984). "[T]he taxpayer must exhibit in some manner … his unequivocal agreement to accept both the benefits and burdens of the tax treatment afforded" by the law. *Young v. Commissioner*, 83 T.C. 831, 839 (1984), *affd.* 783 F.2d 1201 (5th Cir. 1986). A taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return declaring that the election is under section 469(c)(7)(A). *Trask v. Commissioner*, T.C. Memo. 2010-78; sec. 1.469-9(g)(3), Income Tax Regs. A taxpayer has not made an election if it is not clear from the return that an election has been made. See *Young v. Commissioner*, 783 F.2d at 1206.
>
> We have held that aggregating losses from Schedule E on line 17 of Form 1040, U.S. Individual Income Tax Return, is insufficient notice to the Commissioner that the taxpayer intended to elect to treat all his rental properties as a single activity under section 469(c)(7). *Kosonen v. Commissioner*, T.C. Memo. 2000-107. Similarly, a taxpayer's intent to elect, without exhibiting an unequivocal agreement to accept both the benefits and the burdens of such an election, is irrelevant to making a determination of whether he or she has made an election. See *Young v. Commissioner*, 783 F.2d at 1206; *Kosonen v. Commissioner*, *supra.*

The deadline for making the aggregation election may be extended.[2199] An election to treat all of a taxpayer's interests in rental real estate as a single activity is binding for subsequent tax years, absent changed circumstances.[2200]

[2197] Reg. § 1.469-9(h)(1).

[2198] See also *Schumann v. Commissioner*, T.C. Memo. 2014-138, and *Windham v. Commissioner*, T.C. Memo. 2017-68.

[2199] Rev. Proc. 2011-34, § 4.01 may provide relief if the taxpayer meets all of the following requirements:

(1) the taxpayer failed to make an election under § 1.469-9(g) solely because the taxpayer failed to timely meet the requirements in § 1.469-9(g);
(2) the taxpayer filed consistently with having made an election under § 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years;
(3) the taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within 6 months after its due date, excluding extensions;
(4) the taxpayer has reasonable cause for its failure to meet the requirements in § 1.469-9(g).

For purposes of the real estate professional rule described above, if a taxpayer elects to treat all interests in rental real estate as a single rental real estate activity and at least one interest in rental real estate is held by the taxpayer as a limited partnership interest,[2201] the combined rental real estate activity will be treated as a limited partnership interest of the taxpayer for purposes of determining material participation.[2202] However, the preceding sentence does not apply if the taxpayer's share of gross rental income from all of the taxpayer's limited partnership interests in rental real estate is less than 10% of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the taxable year.[2203]

Except for the limited partnership rule provided above, the IRS explained aggregation under the real estate professional rules as follows:[2204]

> [T]he first step here is to determine whether TP is a qualifying taxpayer under section 469(c)(7)(B). Pursuant to § 1.469-9(d), TP has reasonably determined under the particular facts and circumstances that TP has a combined real property trade or business for purposes of Treas. Reg. § 1.469-9(d) that includes Property 1, Property 2, and the real property development trade or business. Under Treas. Reg. § 1.469-5T(a)(1), because TP spends more than 500 qualifying hours on this real property trade or business, TP materially participates in this real property trade or business. Therefore, time spent on Property 1, Property 2, and the real property development trade or business may count towards meeting the qualifications of section 469(c)(7)(B). Because TP owns an interest in rental real estate and more than one-half of the personal services performed in trades or businesses by TP during the taxable year are performed in real property trades or businesses in which TP materially participates, and TP performs more than 750 hours of services during the taxable year in real property trades or businesses in which TP materially participates, TP is a qualifying taxpayer within the meaning of Treas. Reg. § 1.469-9(b)(6). Thus, section 469(c)(2) does not apply to any rental real estate activity of TP. Instead, a rental real estate activity of TP is not a passive activity for the taxable year if TP materially participates in the activity.

[2200] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165, 181 n. 17 (2014).

[2201] Referring to a limited partnership interest within the meaning of Reg. § 1.469-5T(e)(3).

[2202] Reg. § 1.469-9(f)(1), which continues the thought:

> Accordingly, the taxpayer will not be treated under this section as materially participating in the combined rental real estate activity unless the taxpayer materially participates in the activity under the tests listed in § 1.469-5T(e)(2) (dealing with the tests for determining the material participation of a limited partner).

See part II.K.1.a.ii Material Participation for a list of material participation tests, including describing which ones do not apply to limited partners.

[2203] Reg. § 1.469-9(f)(2).

[2204] CCA 201427016. Questions about the CCA are to be directed to Benjamin Weaver or Jaclyn Goldberg of the Office of Associate Chief Counsel (Passthroughs & Special Industries) at (202) 317-6850. For a summary of the CCA, see Miles, "Interplay of the Rental Real Estate Grouping Election and Real Estate Professional Exception," *Journal of Accountancy*, p. 62 12/1/2014. *Stanley v. U.S.*, 116 A.F.T.R.2d 2015-5419 (D. Ark. 11/12/2015), involved successful rental grouping; see fn. 2177 for IRS' nonacquiescence to *Stanley*.

Next, once it is determined that TP is a qualifying taxpayer, we must determine whether TP materially participates in TP's rental real estate activities to determine whether these are passive activities. In accordance with section 469(c)(7)(A)(ii), because TP has not made an election under Treas. Reg. § 1.469-9(g), Property 1 and Property 2 are treated as separate rental real estate activities. Thus, TP must demonstrate material participation in Property 1 and Property 2 separately. In other words, TP must separately meet one of the tests in Treas. Reg. § 1.469-5T(a) for each of Property 1 and Property 2. Further, pursuant to Treas. Reg. § 1.469-9(e)(3), TP's participation in the real property development trade or business is disregarded in determining whether TP materially participates in Property 1 and Property 2.[2205] If, for example, TP meets one of the tests in § 1.469-5T(a) for Property 1, but not for Property 2, Property 1 will be a nonpassive activity for the taxable year, and Property 2 will be a passive activity for the taxable year.

Reg. § 1.469-9(e)(4) provides an example before and after applying Reg. § 1.469-9(e):

(i) Taxpayer B owns interests in three rental buildings, U, V and W. In 1995, B has $30,000 of disallowed passive losses allocable to Building U and $10,000 of disallowed passive losses allocable to Building V under § 1.469-1(f)(4). In 1996, B has $5,000 of net income from building U, $5,000 of net losses from building V, and $10,000 of net income from building W. Also in 1996, B is a qualifying taxpayer within the meaning of paragraph (c) of this section. Each building is treated as a separate activity of B under paragraph (e)(1) of this section, unless B makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. If the buildings are treated as separate activities, material participation is determined separately with respect to each building. If B makes the election under paragraph (g) to treat the buildings as a single activity, all participation relating to the buildings is aggregated in determining whether B materially participates in the combined activity.

(ii) Effective beginning in 1996, B makes the election under paragraph (g) to treat the three buildings as a single rental real estate activity. B works full-

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[2205] [This footnote is not in the CCA.] Reg. § 1.469-9(e)(3), "Grouping rental real estate activities with other activities, provides:

(i) *In general*. For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under § 1.469-5T.

(ii) *Special rule for certain management activities*. A qualifying taxpayer may participate in a rental real estate activity through participation, within the meaning of §§ 1.469-5(f) and 5T(f), in an activity involving the management of rental real estate (even if this management activity is conducted through a separate entity). In determining whether the taxpayer materially participates in the rental real estate activity, however, work the taxpayer performs in the management activity is taken into account only to the extent it is performed in managing the taxpayer's own rental real estate interests.

> time managing the three buildings and thus materially participates in the combined activity in 1996 (even if B conducts this management function through a separate entity, including a closely held C corporation). Accordingly, the combined activity is not a passive activity of B in 1996. Moreover, as a result of the election under paragraph (g), disallowed passive losses of $40,000 ($30,000 + $10,000) are allocated to the combined activity. B's net income from the activity for 1996 is $10,000 ($5,000 − $5,000 + $10,000). This net income is nonpassive income for purposes of section 469. However, under section 469(f), the net income from a former passive activity may be offset with the disallowed passive losses from the same activity. Because Buildings U, V and W are treated as one activity for all purposes of section 469 due to the election under paragraph (g), and this activity is a former passive activity under section 469(f), B may offset the $10,000 of net income from the buildings with an equal amount of disallowed passive losses allocable to the buildings, regardless of which buildings produced the income or losses. As a result, B has $30,000 ($40,000 − $10,000) of disallowed passive losses remaining from the buildings after 1996.

For more insight, see Hamill, "Group Passive Activities to Achieve Best Tax Treatment," *Estate Planning Journal* (Dec. 2016).

II.K.1.e.iv. Active Rental Subject to AGI Limits

A natural person, with adjusted gross income within certain limits,[2206] is not subject to the passive loss rules with respect to that portion of the passive activity loss (or the deduction equivalent of the passive activity credit) for any taxable year, up to $25,000,[2207] which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).[2208]

An estate might receive this benefit for its taxable years ending less than two years after the date of the decedent's death.[2209]

II.K.1.e.v. Rental Income Property a Taxpayer Improves, Rents Briefly, and Then Sells Is Nonpassive

A taxpayer's net rental income for the year from an item of property shall be treated as nonpassive if:[2210]

- Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

[2206] Code § 469(i)(3) includes the limits and which credits are not subject to them.
[2207] Code § 469(i)(2), subject to potential reduction under Code § 469(i)(4) for certain married taxpayers filing separately.
[2208] Code § 469(i)(1) , subject to potential reduction under Code § 469(i)(4) for certain married taxpayers filing separately.
[2209] Code § 469(i)(4); Reg. § 1.645-1(e)(2)(i), (3)(i) (election to treat revocable trust as an estate).
[2210] Reg. § 1.469-2(f)(5), the heading to which reads, "Net income from certain property rented incidental to development activity."

- The taxpayer's use of the item of property in an activity involving the rental of the property began less than 12 months before the date of the disposition of such property;[2211] and

- The taxpayer materially participated or significantly participated for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value[2212] of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

II.K.1.f. Royalty as a Trade or Business

Royalties received by any person with respect to a license or other transfer of any rights in intangible property are considered to be derived in the ordinary course of the trade or business of licensing such property only if that person created such property or performed substantial services or incurred substantial costs with respect to the development or marketing of such property.[2213]

Generally, the determination of whether a person has performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property shall be made on the basis of all the facts and circumstances.[2214] However, a person has performed substantial services or incurred substantial costs for a taxable year with respect to the development or marketing of an item of intangible property if:[2215]

[2211] Reg. § 1.469-2(f)(5)(ii) provides:

(A) *In general*. For purposes of paragraph (f)(5)(i)(B) of this section, a taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which-

(1) The taxpayer owns an interest in the property;

(2) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

[2212] Reg. § 1.469-2(f)(5)(iii) provides:

Services performed for the purpose of enhancing the value of property. For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to-

(A) Construction;

(B) Renovation; and

(C) Lease-up (unless more than 50 percent of the property is leased on the date that the taxpayer acquires an interest in the property).

[2213] Reg. § 1.469-2T(c)(3)(iii)(B)(1).

[2214] Reg. § 1.469-2T(c)(3)(iii)(B)(2)(i).

[2215] Reg. § 1.469-2T(c)(3)(iii)(B)(2)(ii). In applying this test, expenditures in a taxable year include amounts chargeable to capital account for such year without regard to the year or years (if any) in which any deduction for such expenditure is allowed. Reg. § 1.469-2T(c)(3)(iii)(B)(2)(ii). Also, in the case of any intangible property held by a partnership, S corporation, estate, or trust, the determination of whether royalties from such property are derived in the ordinary course of a

- The expenditures reasonably incurred by that person in that taxable year with respect to the development or marketing of the property exceed 50% of the gross royalties from licensing such property that are includible in that person's gross income for the taxable year; or

- The expenditures reasonably incurred by that person in that taxable year and all prior taxable years with respect to the development or marketing of the property exceed 25% of the aggregate capital expenditures (without any adjustment for amortization) made by such person with respect to the property in all such taxable years.

If a taxpayer acquires an interest in an entity after the entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income (but not net royalty loss) for the year from that item of property is nonpassive.[2216]

II.K.1.g. Working Interest in Oil and Gas Property

"Passive activity" does not include any working interest in any oil or gas property which the taxpayer holds directly or through an entity[2217] which does not limit the liability of the taxpayer with respect to such interest.[2218]

If any taxpayer has any loss for any taxable year from a working interest in any oil or gas property which is treated as a nonpassive loss, then any net income from such property (or certain replacement property) for any succeeding taxable year shall be treated as nonpassive income.[2219]

The rules described above apply without regard to whether the taxpayer materially participated in the activity.[2220] On the other hand, if a taxpayer holds the working interest through a limited liability entity, then the exception does not apply, but the working

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trade or business shall be made by applying these rules to such entity and not to any holder of an interest in such entity. Reg. § 1.469-2T(c)(3)(iii)(B)(3)

2216 Reg. § 1.469-2T(f)(7)(i).

2217 Reg. § 1.469-1T(e)(4)(v)(A) precludes holding a working interest in a limited partnership in which the taxpayer is not a general partner, a corporation, or any other entity "that, under applicable State law, limits the potential liability of a holder of such an interest for all obligations of the entity to a determinable fixed amount (for example, the sum of the taxpayer's capital contributions)," which presumably would encompass LLCs and LLPs. Indemnification agreements inside partnership agreements don't count; see Reg. § 1.469-1T(e)(4)(v)(C), Example (1). Being liable for a fractional portion of all liabilities suffices to provide liability, even without joint and several liability; see Reg. § 1.469-1T(e)(4)(v)(C), Example (2). A limited partner who is also a general partner is considered to have liability with respect to the interest as a limited partner as well; see Reg. § 1.469-1T(e)(4)(v)(C), Example (3).
Note that an indemnification agreement, a stop loss arrangement, insurance, or any other combination of contractual rights does not constitute a prohibited entity. Reg. § 1.469-1T(e)(4)(v)(B).

2218 Code § 469(c)(3)(A); see Reg. § 1.469-1T(e)(4) for more details.

2219 Code § 469(c)(3)(B); see Reg. §§ 1.469-2(c)(6) and 1.469-2T(c)(6)(iv), Example (3).

2220 Code § 469(c)(4).

interest might nevertheless be a trade or business in which the taxpayer materially participates or for some other reason is nonpassive.

"Working interest" means a working or operating mineral interest in any tract or parcel of land.[2221]

II.K.1.h. Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income

II.K.1.h.i.(a). Overview of Rules Recharacterizing PIGs as Nonpassive Income

Originally, passive income generators (PIGs) had the favorable characteristic of being able to be sheltered by passive losses without having any unfavorable characteristics. Now, the 3.8% tax makes PIGs unfavorable to the extent that their income exceeds passive losses.[2222] Those seeking to avoid passive income will be happy to learn that the IRS adopted rules limiting PIGs, as described below.

Although significant participation activities can be considered nonpassive, a taxpayer might not meet all of the requirements to make them nonpassive.[2223] If that's the case, but all significant participation passive activities net to become a PIG, a special rule converts the net passive income into nonpassive income for purposes of the passive loss rules[2224] and for purposes of the 3.8% tax on net investment income.[2225] "Significant participation passive activity" means any trade or business activity[2226] in which the

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[2221] Reg. § 1.469-1(e)(4)(iv), referring to Reg. § 1.612-4(a), which addresses intangible drilling and development costs incurred by an operator but does not provide a quick explanation of what a working interest is. CCA 200952054 reasons:

> Section 1.469-1(e)(4)(iv) of the Income Tax Regulations provides that for purposes of § 469 and the regulations thereunder, the term "working interest" means a working or operating mineral interest in any tract or parcel of land (within the meaning of § 1.612-4(a)). Thus, the regulations under § 469 define working interest in oil or gas property, for purposes of § 469(c)(3), by reference to the depletion rules set forth in §§ 611-614 and the regulations thereunder.
>
> In general, § 611 provides for a reasonable allowance for depletion in the case of mines, oil and gas wells, and other natural deposits. Section 614 defines the term "property," for purposes of computing the allowance for depletion, as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land." Section 1.614-1(a)(2) provides that the term "interest" means an economic interest in a mineral deposit. Mineral deposit is defined in § 1.611-1(d)(4) as referring to minerals in place. Section 1.611-1(d)(5) defines minerals to include ores of metals, coal, oil, gas, and all other natural metallic and nonmetallic deposits. That section further states that "minerals" includes all of the minerals and other natural deposits subject to depletion.
>
> Thus, the exception provided by § 469(c)(3) for any working interest in any oil or gas property is limited to a working interest in natural deposits of oil and gas.

[2222] See part II.I 3.8% Tax on Excess Net Investment Income, especially part II.I.8 Application of 3.8% Tax to Business Income.

[2223] See fns. 2047-2048 and accompanying text, found in part II.K.1.a.ii Material Participation.

[2224] Reg. § 1.469-2T(f)(2)(i). The Example at the end of Reg. § 1.469-2T(f)(2) clarifies its application.

[2225] Reg. § 1.1411-5(2)(i).

[2226] Within the meaning of Reg. § 1.469-1T(e)(2), which cross-references to Reg. § 1.469-1(e)(2), which in turn cross-references to Reg. § 1.469-4(b)(1), which is reproduced in fn. 2079 within part II.K.1.b.i Grouping Activities – General Rules. It all boils down to engaging or preparing to taxpayer significantly participates[2227] for the taxable year but in which the taxpayer does not materially participate[2228] for such year.[2229]

Land rentals generally are treated as nonpassive: If less than 30% of the unadjusted basis of the property used or held for use by customers in a rental activity during the taxable year is depreciable, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as nonpassive.[2230]

An amount of the taxpayer's gross income for the taxable year from any equity-financed lending activity shall be considered as nonpassive to the extent of the lesser of the taxpayer's equity-financed interest income[2231] from the activity for such year and the taxpayer's net passive income from the activity for such year.[2232] An activity is an equity-financed lending activity for a taxable year if the activity involves a trade or business of lending money and the average outstanding balance[2233] of the liabilities incurred in the activity[2234] for the taxable year does not exceed 80% of the average outstanding balance of the interest-bearing assets[2235] held in the activity for such year.[2236]

The amount of gross income from an activity that is treated as not from a passive activity for the taxable year under the above bullet points shall not exceed the greatest amount

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engage in a Code § 162 "trade or business" or incurring Code § 174 research or experimental expenditures, but does not include "rental activities or activities that are treated as incidental to an activity of holding property for investment."

2227 Within the meaning of Reg. § 1.469-5T(c)(2), which defines significant participation as more than 100 hours during the taxable year.

2228 Within the meaning of Reg. § 1.469-5T, which is described in part II.K.1.a Counting Work as Participation.

2229 Reg. § 1.469-2T(f)(2)(ii). Reg. § 1.469-2T(f)(2)(iii) provides an example.

2230 Reg. § 1.469-2T(f)(3).

2231 The taxpayer's equity-financed interest income from an activity for a taxable year is the amount of the taxpayer's net interest income from the activity for such year multiplied by the fraction obtained by dividing (a) the excess of the average outstanding balance for such year of the interest-bearing assets held in the activity over the average outstanding balance for such year of the liabilities incurred in the activity, by (b) the average outstanding balance for such year of the interest-bearing assets held in the activity. Reg. § 1.469-2T(f)(4)(iii). The net interest income from an activity for a taxable year is (a) the gross interest income from the activity for such year, reduced by (b) expenses from the activity (other than interest on liabilities used in this test) for such year that are reasonably allocable to such gross interest income. Reg. § 1.469-2T(f)(4)(iv).

2232 Reg. § 1.469-2T(f)(4)(i).

2233 The average outstanding balance of liabilities incurred in an activity or of the interest-bearing assets held in an activity may be computed on a daily, monthly, or quarterly basis at the option of the taxpayer. Reg. § 1.469-2T(f)(4)(vii).

2234 Liabilities incurred in an activity include all fixed and determinable liabilities incurred in the activity that bear interest or are issued with original issue discount other than debts secured by tangible property used in the activity. Reg. § 1.469-2T(f)(4)(vi). In the case of an activity conducted by an entity in which the taxpayer owns an interest, liabilities incurred in an activity include only liabilities with respect to which the entity is the borrower. Reg. § 1.469-2T(f)(4)(vi).

2235 Interest-bearing assets held in an activity include all assets that produce interest income, including loans to customers. Reg. § 1.469-2T(f)(4)(v).

2236 Reg. § 1.469-2T(f)(4)(ii)(A). Liabilities incurred principally for the purpose of increasing the percentage of the average outstanding balance of the interest-bearing assets shall not be taken into account in computing such percentage. Reg. § 1.469-2T(f)(4)(ii)(B).

of gross income treated as not from a passive activity under any one of these bullet points.[2237]

Also, generally, if a taxpayer acquires an interest in a development entity after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property shall be treated as nonpassive income.[2238]

II.K.1.h.i.(b). Tax Trap from Recharacterizing PIGs as Nonpassive Income

The government appears to have whipsawed business owners whose income is recharacterized as nonpassive when the activity itself remains classified as passive. Tax credits that are subject to the passive loss rules do not appear to be creditable against such income. Below is a discussion of which credits are subject to this rule, how these rule works, and planning tips.

A credit is suspended if it "arises in connection with the conduct of an activity that is a passive activity for such taxable year"[2239] and is described in subpart D of part IV of subchapter A or in subpart B (other than Code § 27(a)) of such part IV.[2240] The regulation describing the credits omits credits enacted after the regulations were promulgated, so be careful to focus on the statutory provisions.[2241] Subpart D includes any Code section numbered 38 (general business credit) and higher but is less than 46. Subpart B includes any Code section numbered 27 and higher but is less than 31. At the time I wrote this sentence, Code § 38(b) enumerated 36 credits, so always check Code § 38 in addition to making sure the credit does not fall within Subpart B or D.

Note that the regulation refers to arising "in connection with a passive activity" and does not refer to whether the activity's income is passive. "Passive activity means "a trade or business activity … in which the taxpayer does not materially participate for such taxable year" or certain rental activities.[2242]

An enumerated credit is suspended except to the extent that it is allocable to "regular tax liability"[2243] generated "by the excess (if any) of the taxpayer's passive activity gross income for such year over the taxpayer's passive activity deductions…."[2244]

[2237] Reg. § 1.469-2T(f)(8).
[2238] Reg. § 1.469-2T(f)(7).
[2239] Reg. § 1.469-3T(b)(1)(i)(A).
[2240] Code § 469(d)(2)(A).
[2241] Sutton & Howell-Smith, ¶ 3.01[1] Credits Subject to Limitation, *Federal Income Taxation of Passive Activities* (WG&L) (detailed commentary). For a list of credits subject to this rule, see CCH's *Tax Research Consultant*, BUSEXP: 33,252, Credits Subject to Passive Activity Limitation (simple list).
[2242] Reg. § 1.469-1T(e)(1)(i).
[2243] Reg. § 1.469-3T(d)(2) refers the definition of "regular tax liability" in Code § 26(b), which in turn refers to tax determined under Chapter 1, subject to some exceptions from Chapter 1. Chapter 1 include Code sections numbered at least 1 and less than 1401.
[2244] Reg. § 1.469-3T(d)(1)(ii). Reg. § 1.469-2T(c)(1) provides:

Reg. § 1.469-2T(f):

> sets forth rules that require income from certain passive activities to be treated as income that is not from a passive activity (regardless of whether such income is treated as passive activity gross income under section 469 or any other provision of the regulations thereunder).

Note that the income is recharacterized, but the classification as a "passive activity" is not altered. Thus, an enumerated credit appears to remain passive, even if its income is recharacterized as nonpassive.

This observation holds true for significant participation activities (highlighting added):[2245]

> An amount of the taxpayer's gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer's net passive income from such activity for the taxable year shall be treated as not from a passive activity if the taxpayer's passive activity gross income from all significant participation passive activities for the taxable year … exceeds the taxpayer's passive activity deductions from all such activities for such year.

Thus, any enumerated credit that arises from a purely[2246] significant participation activity would appear to be a passive credit that cannot be used to offset tax on that activity's income that year.

The analysis above appears to be confirmed by reading IRS Form 8582-CR, in which one calculates allowable passive credits, allowing them only against tax on passive income shown on IRS Form 8582. The instructions to IRS Form 8582 say not to report income from significant participation activities on IRS Form 8582.

I have not found any article, treatise, or government pronouncement directly addressing this issue. Until then, I assume the analysis above is correct.

Note, however, that passive credits are suspended, not lost. If a passive credit is not allowable one year, it is suspended and carried to the next year.[2247] Consider a taxpayer

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> Except as otherwise provided in the regulations under section 469, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

[2245] Reg. § 1.469-2T(f)(2)(i).

[2246] Note, however, that significant participation activities may be aggregated to constitute material participation. See fns. 2047-2048 and accompanying text, found in part II.K.1.a.ii Material Participation.

[2247] Code § 469(b). The suspended credit is then re-tested each year. Reg. § 1.469-3T(b)(1)(ii), referring to Reg. § 1.469-1T(f)(4), which refers to Reg. § 1.469-1(f)(4). Reg. § 1.469-1(f)(4)(i) provides:

> (i) ***In general***. In the case of an activity of a taxpayer with respect to which any deductions or credits are disallowed for a taxable year under § 1.469-1T(f)(2) or (f)(3) (the loss activity)—
>
> (A) The disallowed deductions or credits is [sic] allocated among the taxpayer's activities for the succeeding taxable year in a manner that reasonably reflects the extent to which each activity continues the loss activity; and

with income and credits from a significant participation activity. If sufficient amounts of suspended passive credits accumulate, the taxpayer might consider intentionally flunking the significant participation test one year and paying net investment income tax but generating passive income against which current and suspended credits may be taken. Whether such a strategy would work depends on the characteristics of the particular credit and taxpayer's tax posture for that year, factors that would need to be analyzed if the situation arises. In other words, I would not suggest counting on using this strategy but would suggest exploring it when planning to obtain credits that are such to the passive activity rules.

Some credits are in lieu of a deduction. When considering the use of credits, those who run businesses subject to these rules might consider the tax characteristics of each owner to decide whether the owners can actually use the credits.

Note that materially participating would prevent these issues from arising, as well as providing other benefits.[2248] Furthermore, one who significantly participates but cannot work more than 500 hours can avoid this trap by not hiring anyone else who works for more than that person.[2249]

II.K.1.i. Former Passive Activities

The preamble to the final regulations governing the 3.8% tax on net investment income[2250] describe the following regarding former passive activities:[2251]

> Losses disallowed by section 469 stem from (1) expenses incurred in the passive activity or (2) a sale of a portion of the passive activity or property used in the activity, in excess of passive income from any source. Section 1.469-1T(f)(2)(i) and (ii) require taxpayers to trace disallowed losses back to the activities giving effect to the deductions from the activity giving rise to the net loss. When a taxpayer disposes of a partial interest in a passive activity or disposes of assets used within a passive activity, any losses realized from the disposition are treated as arising from the passive activity and are allocated to that activity. Sections 469(b), (g), and § 1.469-1(f)(4) provide that, generally, passive losses that are disallowed in the current year carry forward to the succeeding tax year and remain suspended until the taxpayer has sufficient passive income to offset those losses or otherwise disposes of the entire activity in a fully taxable transaction with an unrelated party.
>
> In cases where a taxpayer materially participates in an activity that was formerly a passive activity, the deductions produced by the activity in the current year are

(B) The disallowed deductions or credits allocated to an activity under paragraph (f)(4)(i)(A) of this section shall be treated as deductions or credits from the activity for the succeeding taxable year.

[2248] Such as allowing losses in a down year or satisfying the rule that treats as materially participating any taxpayer who participating for more than 500 hours in 5 of the most recent 10 years. See parts II.K.1.a.ii Material Participation and II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

[2249] See part II.K.1.a.ii Material Participation, particularly fns. 2045-2046.

[2250] See part II.I 3.8% Tax on Excess Net Investment Income (NII).

[2251] T.D. 9644.

not subject to section 469. However, the carryover (or "suspended") passive losses incurred in prior years when the activity was a passive activity remain disallowed passive losses subject to carryover. Section 469(f)(1)(A) allows the suspended passive losses when the former passive activity produces current-year net income (even though that income is technically from a nonpassive activity). To the extent the taxpayer has passive losses allocable to a former passive activity in excess of the current year nonpassive income from that activity (the section 469(f)(1)(A) amount), section 469(f)(1)(C) allows excess passive losses to offset net passive income from other passive activities of the taxpayer. Any suspended passive losses not allowed by section 469(f)(1)(A) or (C) remain suspended and are carried over to the following year.

Section 469 does not alter the character or nature of the items that make up the suspended passive loss. If the suspended losses are attributable to operating deductions in excess of operating income, such suspended losses retain that character as deductions described in section 62(a)(1) or 62(a)(4) when ultimately allowed by section 469. To the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character as section 165 losses when they are ultimately allowed by section 469.

For special rules that the 3.8% tax on net investment income applies to former passive activities,[2252] see fn. 1624.

II.K.1.j. Publicly Traded Partnerships

The passive loss rules apply separately with respect to items attributable to each publicly traded partnership.[2253]

II.K.1.k. Conclusion Regarding General Rules Relating to Passive Activities

The above discussion is by no means comprehensive. These rules have developed for some 20 years, and there is no substitute for consulting with a CPA who has worked with these rules in preparing tax returns. Even experts need to adjust to a paradigm shift, from PIGs being only good to now looking for a way to avoid PIG status to the extent that income from PIGs exceeds passive losses. The author would welcome comments clarifying the analysis in this part II.K.1 or suggesting any additional points.

II.K.2. Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business

II.K.2.a. Overview of Passive Loss Rules Applied to Trusts or Estates

A trust or estate participating might be important not only to prevent the passive loss rules from suspending a loss but also to prevent the 3.8% tax on net investment income from applying to the trust's business income. For details on the net investment income tax, see part II.I 3.8% Tax on Excess Net Investment Income (NII), especially

[2252] See part II.I.8.a.vii Former Passive Activities.
[2253] Code § 469(k).

part II.I.8 Application of 3.8% Tax to Business Income. See also parts II.J.13 Applying 3.8% Tax to Trusts Owning Businesses Other than S Corporations If the Beneficiary is Active But the Trustee Is Not, II.J.14 Application of 3.8% Tax to ESBTs, and II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

Grantor trusts are taxed to their deemed owners and generally are not cover further in this part II.K.2. Further below are discussions of current law and how to plan for estates and nongrantor trusts in light of it.[2254] Here is an overview of regulatory developments:

From when the Code § 469 passive loss rules were enacted until when the Code § 1411 tax on net investment income (NII) was enacted, the application of the passive loss rules to estates and nongrantor trusts generally was ignored. This idea was ignored because the issues were those of timing of deductions, estates and nongrantor trusts with excess deductions could not use them, and the suspending passive losses until sales occurred generally was favorable. However, the NII tax changed the paradigm, causing taxpayers to ask the government for guidance, to which the government responded by asked for comments on what those rules should look like.

Before discussing the comments, one needs to provide context to the government's general approach. The proposed regulations under Code § 1411 initially addressed the general application of the passive loss rules (not yet focusing on trusts) in a manner biased in favor of the government: the proposed regulations would have left taxpayers with income that was nonpassive for Code § 469 but passive for Code § 1411. This approach was inconsistent with the scant legislative history of Code § 1411, and pressure was applied (in a process in which I was not involved) that caused the final regulations to back away from that approach and simply apply Code § 469 (with certain pro-taxpayer exceptions) and let the Code § 1411 consequences fall where they may.

My understanding is that the government will be looking at comments on trust participation as purely Code § 469 issues and let the Code § 1411 consequences fall where they may. It has been suggested that Code § 469 comments that tend to favor characterizing income as nonpassive in the hands of an estate, nongrantor trust, or beneficiary would be an unwarranted boon for taxpayers. However, my understanding is that the government is concerned about what might if it adopts regulations with Code § 1411 in mind, Code § 1411 later gets repealed, and the government has shot itself in the foot under Code § 469 by making it difficult to characterize income as nonpassive. Thus, regulations under Code § 1411, not Code § 469, would be the appropriate place to address any concerns the government might have about the impact of Code § 469 regulations on Code § 1411.

Making fair rules for how trusts can materially participate will be a complex task. Fiduciary arrangements can be grantor trusts (in which case the trust is disregarded and the deemed owner is taxed), estates, or nongrantor trusts. Trustees can be individuals or entities. A trust might have one trustee or multiple trustees. Each trustee might have different skills or knowledge of the beneficiaries' needs, leading to slicing and dicing of trustees' authority and duties. Furthermore, the level of fiduciary duties varies according to state law and the document that created the trust.

[2254] Part II.K.2.b Participation by an Estate or Nongrantor Trust.

Here is a description of comments by certain major groups, all of which I participated in varying degrees:

- AICPA comments were first.[2255] They pointed to taxpayer-friendly case law.
- The ABA's Section on Taxation submitted highly technical comments, which, among other matters, explored the relationship between the passive loss and the fiduciary income tax system.[2256]
- The American College of Trust & Estate Counsel (ACTEC), whose task force I chaired, focused on the fiduciary nature of a trust and explored how the government might handle the evolving roles of trustees.[2257]

ACTEC proposed that work in a business activity be considered work attributable to a trust in determining its material participation if performed by a person who is a qualifying fiduciary. To qualify under ACTEC's proposal, the person must hold a substantial related fiduciary power and personally owe fiduciary duties to the beneficiaries with respect to the power.

One set of comments (not mentioned above) suggested varying the rules depending on who serves (and perhaps how many people serve) as trustee. Considering those factors would punish trusts that do not conform to those comments' ideas of how trusts should be administered. In contrast, ACTEC's comments treat all trustees and trust arrangements the same, focusing on whether fiduciary duties are owed with respect to the work that is performed.

ACTEC's comments mention what little law there is and recommend changes to the law. When one needs a logical framework for trusts that have more than one trustee, when distributions are made to a beneficiary, or when my planning suggestions do not work out or were not followed, ACTEC's comments would form the basis for a well-reasoned argument about how the passive loss rules should be applied.

II.K.2.b. Participation by an Estate or Nongrantor Trust

II.K.2.b.i. Participation by a Nongrantor Trust: Authority

Regulations do not address participation by a nongrantor trust.[2258] The legislative history provides:[2259]

[2255] Thompson Coburn LLP document number 6252341 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

[2256] Thompson Coburn LLP document number 6252340 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

[2257] Thompson Coburn LLP document number 6252339 or http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023565a83fb62ef7764e56b4689d5629036fc.

> An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.

The legislative history does not state that this is the exclusive test for how fiduciaries may participate. For planning purposes, one should consider assuming that is the exclusive test, because the IRS takes that position. For reporting purposes, however,

"Fiduciary" means a "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."[2260] The term "applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another" and also includes a "committee or guardian of the property of an incompetent person."[2261] A mere agent is not a fiduciary; for example, an "agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary" under this definition.[2262]

The IRS has litigated whether one should test based only on actions directly by the trustee or whether actions by others, such as an agent, should be considered.

In *Mattie K. Carter Trust v. United States*,[2263] the IRS argued that "material participation" should be based on the trustee's actions alone. However, the court agreed with the taxpayer that it should be tested by whoever participates on behalf of the trust, which in this case included two people to whom the trustee delegated functions: (1) a full-time ranch manager whose actions were subject to the trustee's approval, and (2) a beneficiary who supervised the manager and general ranch operations.

TAM 200733023 rejected the taxpayer's reliance on *Mattie Carter* and asserted:

> What is apparent from the line of authority in this area is that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. Although Trust represents that Special Trustees were heavily involved in the operational and management decisions of Business, Special Trustees — like the banks in Revenue Ruling 82-177 and *Anderson* — were ultimately powerless to commit Trust to any course of action or control Trust property without the express

[2258] Note that participation of the activity of the deemed owner of a grantor trust would be a matter if that individual's personal participation. Thus, for example, this discussion in this section would not apply to a revocable trust. The rules for the Code § 1411 tax on passive business income expressly recognize this treatment of grantor trusts; see fn. 1555.
[2259] Committee Reports for Senate Bill 99-313, P.L. 99-514. A footnote in the legislative history provides that one looks to the participation of the deemed owner of a grantor trust rather than to the trust's participation.
[2260] Code § 7701(a)(6), which applies to Code § 469 where not otherwise distinctly expressed or manifestly incompatible with that section's intent.
[2261] Reg. § 301.7701-6(b)(1).
[2262] Reg. § 301.7701-6(b)(2).
[2263] 256 F.Supp.2d 536 (N.D. Tex. 2003).

> consent of Trustees. The contract between Trust and Special Trustees is explicit on this point, and Trust itself has acknowledged that Trustees retained final decision-making authority with regard to all facets of Business. The services performed by Special Trustees appear to be indistinguishable from those that would be expected of other non-fiduciary business personnel. If advisors, consultants, or general employees can be classified as fiduciaries simply by attaching different labels to them, the material participation requirement of § 469 as applied to trusts would be meaningless.

Letter Ruling 201029014 involved a trust that owned a partnership interest. The partnership interest was the sole owner of another entity, which in turn was the sole owner of the ultimate subsidiary. The ruling held that the trust may materially participate in the subsidiary's activities if the trustee is involved in the operations of the subsidiary's activities on a regular, continuous, and substantial basis. The ruling failed to mention the *Mattie K. Carter Trust* case or to address whether any formalities were needed to establish participation as the trustee rather than participation as an individual.

The IRS' Audit Technique Guide discusses the topic as follows:[2264]

> **Trusts Material Participation**
>
> If a business activity is owned by a trust, the examiner will need to determine if the material participation standard is met in order for losses to be fully deductible. Businesses may be conducted via Schedules C or Form, partnerships, S Corporations or LLCs.
>
> The IRC § 469(h) requires regular, continuous and substantial participation in the operations of the business to meet material participation and for losses to be fully deductible. There is no guidance in the regulations at this time for material participation of trusts and estates.[2265]
>
> As an administrative proxy, we look to the seven tests in Reg. § 1.469-5T(a) for material participation, and generally will not raise an issue if the trustee meets one of the tests. However, as a technical matter the tests apply to individuals, not to a trust or trustee. Thus, as a legal matter, the trustee must prove he works on a regular basis in operations, on a continuous basis, and on a substantial basis in operations, i.e. rise to the requirements of IRC § 469(h).
>
> **Grantor Trusts:** Since tax law does not recognize a grantor trust as a separate taxable entity, the examiner should ignore the trust entirely and look to the grantor (individual taxpayer) to determine material participation.

[2264] Chapter 6, found by starting with http://www.irs.gov/pub/irs-mssp/pal.pdf or http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Passive-Activity-Loss-ATG-Chapter-6-Entity-Issues. The footnotes in the excerpt below are direct copies from the IRS' audit guide, although the footnote numbers have been changed from footnote numbers 15-19 to those used below.

[2265] Note that Reg. § 1.469-5T(g) is "Reserved".

Qualified Subchapter S Trust[2266] **(QSST):** The QSSTs are generally grantor trusts in which the grantor is frequently a parent and the beneficiary is a child. The examiner should look to the beneficiary (child) to determine material participation.

Exceptions: There are two major exceptions to the passive loss rules:

1. Partnerships which are traders in stocks and bonds;[2267] and,

2. Working interests in oil and gas activities.[2268] Losses or income from these activities are excepted from the passive loss limitations and are not entered on Form 8582.

Issue Identification: Does the trustee materially participate in the following:

- Schedule C or F activities with losses.

- Partnership or S corporation with losses.

- Entity with an EIN and address a long distance from the trust or trustee.

- Entity in which the trust is a limited partner or the ownership percentage is low.

Examination Techniques:

- Secure the trust instrument or will and read it.

- Determine who the trustee is and what his other responsibilities are. If the trustee is a busy bank officer or attorney, material participation may be questionable in businesses or entities in which the trust owns an interest.

Documents to Request:

- Trust instrument or will including any amendments and codicils.

- Copies of Schedule K-1s from related entities.

- Detailed description of business activities conducted on Schedule C or F or by any partnerships, or S Corporations.

- Explanation of the duties and responsibilities of the trustee for each business, whether conducted as a Schedule C, partnership or S Corporation.

[2266] See IRC § 1361(d) where the beneficiary elects to be treated as the owner of the trust for purposes of IRC § 678.
[2267] Reg. § 1.469-1T(e)(6).
[2268] IRC § 469(c)(3), Reg. § 1.469-1T(e)(4)(v).

- Completion of the log at the end of Chapter 4 for any activity in which material participation is questioned.

Supporting Law:

- The **Senate Report**[2269] clearly provides that an estate or trust would be treated as materially participating if the executor or fiduciary/trustee materially participates.

- **Reg. § 1.469-1T(b)(2)** Passive loss rules apply to trusts other than trusts described in IRC § 671 (grantor trusts). Also see Rev. Rul. 85-13, 1986-1 CB 184.

- **QSSTs:** The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, Note 33, page 242, explains, "Similarly, in the case of a qualified electing Subchapter S trust (§ 1361(d)(1)(B)) that is treated as a grantor trust (i.e., the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S Corporation's activity is a passive activity with respect to the beneficiary."

In its April 5, 2013 comments to the proposed regulations under Code § 1411, the American Bar Association's Section on Taxation said:[2270]

> Because of the uncertainty of current law under chapter 1, we recommend that the Service issue guidance regarding material participation for a trust or estate for purposes of section 1411. We recommend that this guidance be issued as a new proposed regulation package rather than including these rules in these final Regulations.
>
> In this regard, we recommend that the new proposed regulation package would provide that material participation by a trust or estate can be accomplished through meeting at least one of three tests:
>
> > (a) The fiduciary materially participates under the standards that apply to individuals under previously promulgated Regulations.[2271]
> >
> > (b) The fiduciary, based on all of the facts and circumstances, participates in the activity on a regular, continuous and substantial basis during the year.[2272]

[2269] S. Rep. No. 313, 99th Cong., 2d Sess., Reprinted in 1986-3 C.B. (Vol. 3) 1, at 735.
[2270] The footnotes below use my numbering rather than the numbering used in the report. The report is at http://www.regulations.gov/contentStreamer?objectId=090000648127f7c2&disposition=attachment&contentType=pdf.
[2271] See Temp. Reg. § 1.469-5T(a)(1)-(5).
[2272] See Temp. Reg. § 1.469-5T(a)(7).

> (c) The fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity.[2273]

It explained its recommendations as follows:

> The recommended alternative tests for material participation by a trust take into account the hybrid nature of a trust by allowing it to qualify based on the actions of the fiduciary (individual tests) and also those employed by the fiduciary in certain circumstances (similar to a closely held C corporation). When considering the efforts of the fiduciary, any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation.
>
> Applying only the standards for an individual to be a material participant in an activity would ignore the obvious differences between individuals and trusts. In what is apparently the only court case to address the issue to date, the court in *Mattie K. Carter Trust*[2274] found the trust to be analogous to a closely held C corporation and concluded that "the material participation of the Carter Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on Carter Trust's behalf, including [the trustee]." The Service took the position that when determining active and passive activities under section 469, only the activities of the fiduciary are to be considered when meeting the standard of regular, continuous, and substantial participation. The taxpayer argued that the participation of the trust's other employees and agents also should be included since the trust could only participate in an activity through its fiduciaries, agents and employees much like a corporation.
>
> The court held for the taxpayer, finding that a trust was most analogous to a corporation and that the acts of its agents would be deemed acts of the taxpayer. Based on the activities of the trust through its trustee, fiduciaries, employees, and agents, the material participation requirement was satisfied. The Court noted that it had studied the "snippet" of legislative history purporting to provide insight on how Congress intended section 469 to apply to a trust's participation in a business, including the Senate Finance Committee Report and the footnote in the Joint Committee on Taxation's Explanation, but did not find it helpful.
>
> In private rulings, the Service has taken the position that it is appropriate in the trust context to look only to the activities of the fiduciary to determine material participation.[2275] The IRS Audit Technique Guide for Passive Activity Loss (the

[2273] Based upon Temp. Reg. § 1.469-1T(g) (rules for C corporations). This regulation was in turn based on I.R.C. § 469(c)(7)(C).
[2274] *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).
[2275] In TAM 200733023 (Aug. 17, 2007), the Service took the position that a trust satisfies the material participation test only if the fiduciaries (i.e., the trustee or trustees) are involved in the operations of the trust's business activities on a regular, continuous, and substantial basis. See

"ATG"), addresses material participation by trusts. The ATG states that the Service will generally not raise an issue if the trustee meets one of the material participation tests included in Regulation section 1.469-5T(a). We view this position as too restrictive given the hybrid nature of trusts and estates.[2276]

> The approach outlined above would maintain the approach outlined in private rulings requiring material participation by the fiduciary, but would also allow certain trusts which meet the requirements to be treated analogous to a closely held C corporation and apply similar standards to qualify for active treatment.

Although neither the Audit Technique Guide nor the above comments focus on whether the trustee's participation is in the trustee's fiduciary capacity, TAM 201317010 did focus on that issue, finding no material participation:

> Notwithstanding the decision in *Mattie K. Carter*, the Service believes that the standard annunciated in the legislative history is the proper standard to apply to trusts for purposes of § 469(h). Thus, the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis.
>
> A fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. *United States v. Anderson*, 132 F.2d 98 (9th Cir. 1942). Although the Trusts represent that A was involved in the day-to-day operations and management decisions of Company X and Company Y, A's powers as Special Trustee were restricted by Article XI of the trust agreements. As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not

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also PLR 201029014 (July 23, 2010). A person "required to hold and conserve the property, or the proceeds of the sale thereof, for future distribution" to others is a trustee. Rev. Rul. 61-102; see also Rev. Rul. 74-273. So is a person with "certain discretionary powers of administration and management with regard to the property ….[who] could vote at any stockholders' meeting; approve or oppose any reorganization or refinancing proposal; invest earnings in government obligations; retain counsel; exercise or sell conversion or subscription rights; hold the property in its own name or in a street name; and petition the court with respect to any other disposition concerning the property it considered to be in the best interest of the unknown owner." Rev. Rul. 69-300. A bank was not a fiduciary when it held an estate's money during litigation over the estate, paid interest, but performed no administrative duties for the estate. Rev. Rul. 82-177.

[2276] TAM 200733023 (Aug. 17, 2007).

> participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

Because this issue has a big impact on the 3.8% tax on net investment income,[2277] the Treasury Department and IRS are considering whether issue formal guidance at some point, even though they did not issue guidance when they finalized the regulations they issued in December 2012.[2278]

Meanwhile, the Tax Court held that, when a nongrantor trust created its own LLC to manage a business and the trustees themselves were paid by the LLC for managing the

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[2277] See part II.I 3.8% Tax on Excess Net Investment Income (NII), particularly part II.I.8 Application of 3.8% Tax to Business Income.

[2278] The preamble to the final regulations issued in T.D. 9644 stated:

> F. Material participation of estates & trusts
>
> Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.
>
> Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.
>
> A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which § 1.469-5T(g) has been reserved.
>
> The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

business, the trust was able to count the trustees' participation.[2279] However, rather than simply disregarding the LLC (which was a disregarded entity for income tax purposes) and holding that the trustees were working for the trust (for income tax purposes), instead the court focused on the trustee's duty to the trust when working for the LLC.[2280] That focus might open the door for an attack on the premise of TAM 201317010 that a trustee who acts as an individual is not also serving as a trustee.

Since then, the AICPA,[2281] ABA Section on Taxation,[2282] and ACTEC[2283] have made formal comments to the government.

[2279] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014). The petition, reply, and briefs are at http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220. CCA 201244017 had taken the position that a trust cannot be a real estate professional.

[2280] The court said:

> Even if the activities of the trust's non-trustee employees should be disregarded,[15] the activities of the trustees--including their activities as employees of Holiday Enterprises, LLC--should be considered in determining whether the trust materially participated in its real-estate operations. The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also *In re Estate of Butterfield*, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302). Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. *Cf. In re Estate of Butterfield*, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy."). Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.[16]
>
> [15]We need not and do not decide whether the activities of the trust's non-trustee employees should be disregarded.
>
> [16]We need not consider the effect of sec. 469(c)(7)(D)(ii), which provides that for purposes of sec. 469(c)(7)(B) personal services performed as an employee are generally not treated as performed in real-property trades or businesses. This rule has no application to the resolution of this case because, as we explain *infra*, the IRS has confined its challenges to the trust's qualification for sec. 469(c)(7) treatment to two challenges: (1) that trusts are categorically barred from sec. 469(c)(7) treatment, and (2) the trust did not materially participate in real-property trades or businesses. Thus, we need not, and do not, determine how many hours of personal services were performed by the trust in real-property trades or businesses. We also note that the IRS does not cite sec. 469(c)(7)(D)(ii) in its brief.

[2281] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicUrc/OGHGu+qSyFQIHlSrV/Yyi63VldeR&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

[2282] http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicikIVHHCCawA0JoSeWnL+iQcx1y1EIbsot+x1JadeV10=&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

II.K.2.b.ii. Participation by a Nongrantor Trust: Planning Issues

Some have suggested that the trustee's participation in the business will cause the trust to be taxed as a business entity. For trusts created for traditional estate planning purposes, that concern is not justified. See part II.K.2.b.iii Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity.[2284]

Consider giving a beneficiary who participates in the activity a role as a trustee, whose authority is limited to acting on behalf of the trust with respect to investments that need to be tested under the passive activity rules. Depending on the state, one might be able to use a nonjudicial settlement agreement to not only add a special trustee for this purpose but also protect the trustee from liability.[2285] Note that the legislative history refers to ***an*** executor or fiduciary, not ***the*** executor or fiduciary, implying that material participation by any one co-trustee will cause a trust to be treated as materially participating in an activity.

At first glance, it might seem an easy matter simply to designate as a special trustee an employee of the business. Note, however, that the special trustee must be participating on behalf of the trust and not merely on his or her own behalf. The trustee's work on behalf of the trust as an investor in an activity is not treated as participation in the activity unless the trustee is directly involved – on behalf of the trust - in the day-to-day management or operations of the activity.[2286] Consider these issues:

- What activities would an owner of that entity typically perform?
- Does the company want the individual to be protecting the trust's interests rather than the company's?[2287]
- As an active participant in running the business, the trust might have fiduciary duties to the other owners that it might not have as a passive owner. The trust might already have duties to other owners if the trust has a controlling interest, but being active in the business would tend to strengthen these duties to others. If the business entity is an LLC, these duties to other owners might be more

2283 http://tcinstitute.com/collect/click.aspx?u=/G1GTPto3VXI/DpFcjQL1otq3HrOC9ELmHwOC+4laW5pGgh0FR5yZJDEt8ehQMicxjC0od0egqdZH1P8mlbZQ43UvnjYGixP&rh=ff0023c897e8a4321085e24d8c4387625763f0f4.

2284 Particularly fn. 2302.

2285 Section 111 of the Uniform Trust Code, found at www.uniformlaws.org/shared/docs/trust_code/utc_final_rev2010.pdf; RSMo § 456.1-111. Subsection 4 authorizes a nonjudicial settlement agreement to interpret the terms of the trust, approve a trustee's report/accounting, direct a trustee to refrain from performing a particular act, grant a trustee any necessary or desirable power, accept a trustee's resignation, appoint a trustee, determine a trustee's compensation, transfer a trust's principal place of administration, and resolve the liability of a trustee for an action relating to the trust.

2286 See part II.K.1.a.v What Does Not Count as Participation.

2287 See part III.A.4.c.iii Advising Clients about the UPAIA Section 505 Changes regarding the trustee's fiduciary duties to beneficiaries when the trustee is active in the business.

easily reduced than perhaps for other types of entities, depending on applicable state law.

- Because the trustee is participating on behalf of the trust rather than for his or her own benefit, should the trust be compensated for the trustee's services and then pay the trustee itself, rather than the trustee receiving compensation directly from the company? If so, then the trustee needs to consider whether the trustee is an employee or independent contractor (generally the latter) and the related employment taxes and insurance.

- Because the trust itself is participating in a trade or business, it might subject itself to Form 1099 filing requirements for payments it makes.

- A very significant purpose of using a business entity is to protect its owners from liability. However, to the extent that the trust is directly involved in the business activity, it would subject itself to liability for the trustee's actions or omissions as the trust's agent. The trust may form an LLC that it wholly owns to provide those services and have the trustees provide those services through the LLC;[2288] if run in a financially responsible manner, the LLC might shield the trust from liability for managing the business.

Additionally, consider the trust's legal rights as an owner. If the entity is a corporation, to what course of action could a trustee commit a trust with respect to stock the trust owns other than voting it and selling it? Note that the trustee's actions as an investor do not count in determining material participation.[2289]

Generally, under corporate law a shareholder cannot act on behalf of a corporation. All the shareholders can do is elect directors. Directors then make strategic decisions (often not more than 100 or 500 hours' worth) and delegate the daily running to the officers (who are by definition employees). So generally a trust as a shareholder in a corporation has no authority to participate in the business' affairs. TAM 201317010 does not seem to understand this inherent limitation and appears geared toward businesses that are wholly owned by trusts.

Given that the IRS is reading the legislative history in a manner that makes it difficult for a trust to materially participate in its role as a shareholder, one might consider the following if the entity is an S corporation:

- Many states have "close corporation" statutes or other statutes that allow shareholders to directly run a corporation, much like an LLC is run by its members.[2290] They also have built-in buy-sell provisions, some of which might protect a corporation's S election (once in place).

[2288] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).

[2289] See part II.K.1.a.v What Does Not Count as Participation.

[2290] See fn 776 and accompanying text regarding close corporation statutes as providing protection against creditors. Such statutes are in the minority. Of the states that do not have close corporation statutes, almost all of them have buried in their corporate law provisions allowing the shareholders to bypass the board of directors and directly run part or all of the business. A chart of states in an article co-authored with Richard Barnes was published

- Consider an LLC or limited partnership taxed as an S corporation,[2291] with an operating agreement or partnership agreement that has distributions following S corporation single-class-of-stock rules rather than capital accounts, and either a limited liability partnership registration in place to protect the general partner (making the partnership an LLLP)[2292] or having the limited partnership do business through an LLC subsidiary. Generally, for an existing corporation, a merger into the new entity (LLLP or the LP's LLC subsidiary) would be required.[2293]

In either case, if all the S corporation stock the trust has is old-and-cold nonvoting stock, do a Code § 1036 tax-free swap for voting stock, giving enough voting stock to constitute adequate and full consideration (using a formula transfer). The holder of the voting stock would file a gift tax return adequately disclosing the transaction as a non-gift.

Also, consider having the entity pay the trust for services rendered managing the business, issuing IRS Form 1099-MISC to the trust.[2294] The trust would report the management income and expense on Schedule C or C-EZ.[2295] Trusts do not pay self-employment tax. After taking a reasonable profit on the payment, the trust would compensate the trustee for services rendered. Unlike most trusts, because the trust is now engaging in a trade or business, the trust would issue IRS Form 1099-MISC to the trustee for those services, and the trustee would report the income in his/her Form 1040, Schedule C, and pay self-employment tax;[2296] however, the IRS did not object when a

March/April 2015 in *Probate & Property*, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/6131013_1.pdf; links supporting this chart were prepared by a summer associate in 2014 and are found in my firm's internal document number 5977514, which is reproduced at http://www.thompsoncoburn.com/Images/Newsletters/5977514_7.pdf.

[2291] As described in part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election, certain regulations might lead one to believe that an S election does not shield LLC owners from self-employment tax; however, those regulations appear to be obsolete. For those who are concerned about those regulations, a limited partnership would be the preferred state law entity, to obtain the self-employment tax exclusion available to limited partners, which is described in part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

[2292] See parts II.C.11 Limited Partnership and II.C.12 Limited Liability Partnership Registration.

[2293] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[2294] For Thompson Coburn LLP personnel – see document number 5879530.

[2295] For an ESBT, management fee income is not part of the S portion, because it is not a K-1 item. Reg. § 1.641(c)-1(d)(1), (2). The same answer applies to QSSTs. Reg. § 1.1361-1(j)(7), (8).

[2296] Generally, nonprofessional trustees do not pay self-employment tax. Rev. Rul. 58-5, reproduced in large part in fn. 1572, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles. However, the Rev. Rul. modifies that position when the trustees carry on a trade or business:

> *Example (1). Executor who receives a flat fee for administering the estate*. A, a nonprofessional fiduciary, receives a flat $10,000 for administering the estate of B. B's gross estate is valued at $150,000 and includes a trade or business which A manages for the period of time required to distribute the assets of the estate. Under the laws of the State in which B's estate is probated, an executor is entitled to a five percent commission based upon the value of the assets distributed. Since A distributed the entire estate worth $150,000 he would have been entitled to $7,500 executor's commissions, based upon the statutory five percent allowance. Inasmuch as A, pursuant to court order, actually received $10,000 instead of $7,500 in commissions, the excess, or $2,500, is

trust formed its own LLC (disregarded for income tax purposes) to manage the business, which LLC reported on Forms W-2 (instead of Form 1099-MISC) compensation that the LLC paid the trustees.[2297]

Does changing the individual's participation from being a direct employee to serving as a trustee affect that person's material participation as an individual? No – although the IRS takes the position that work a trustee's work as an individual does not count as participation by the trust, work done as a trustee apparently counts towards the trustee's participation as an individual.[2298] Consider, however, any impact on employee benefits.

Finally, to avoid the 3.8% tax on net investment income, consider converting an ESBT into one or more QSSTs[2299] if the beneficiary works for the business (or could do so in any capacity for more than 100 hours per year)[2300] and a QSST's mandatory income

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regarded as being attributable to the operation of the trade or business of the estate. A must therefore treat this $2,500 as earnings from self-employment. The remaining $7,500 is regarded as being attributable to the normal fiduciary duties of marshalling the assets of the estate and should not be treated as trade or business income. On the other hand, if A's total fee for administering the estate was equal to or less than $7,500 (the statutory executor's allowance in this case), and if nothing was said in the court order with respect to allocation of the fee, the entire fee would be regarded as being attributable to A's fiduciary activities and no part of the fee would be treated as trade or business income to A.

Example (2). Executrix who receives a special fee for handling the estate's business. C, the sole executrix of the estate of her husband, operates a drugstore belonging to the estate, pending dissolution of the estate. As her commission for handling the estate, C receives, pursuant to court order, $5,125 (based upon a percentage of the value of the assets distributed) and $500, in addition, for the operation of the drugstore. Under these circumstances, only the $500 commission for the operation of the drugstore constitutes earnings from self-employment. The $5,125 commission, based upon the value of the assets distributed is not related to the operation of the trade or business, and, accordingly, does not constitute earnings from self-employment.

Example (3). Coexecutor who does not participate in the operation of the estate's business. D and E are coexecutors of an estate which includes a trade or business. D is totally unfamiliar with the operation of the business and leaves the entire management of the business to E. Under these circumstances, D, who does not participate in the operation of the business, cannot be treated as being in a trade or business. The fees received by D do not constitute net earnings from self-employment. E, however, actively participates in the operation of the business and the compensation received by him for the management of the estate's trade or business constitutes net earnings from self-employment.

2297 *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (2014). The court did not mention this nuance, but the facts described somewhere in the petition, reply, and briefs mentioned that Forms W-2 were issued; see http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220.

2298 See fn. 2038 in part II.K.1.a.ii Material Participation.

2299 See part III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSST.

2300 Because a QSST is a grantor trust deemed owned by the beneficiary, the beneficiary's participation, not the trustee's, is what counts. See text accompanying fns. 1555-1556. Although normally participating in owner-type activities is required to avoid the passive loss rules, regulations governing the 3.8% tax do not mention this issue and therefore do not appear to impose that requirement for avoiding the 3.8% tax. See part II.K.1.a.v What Does Not Count as Participation. For more planning tips involving how to meet the participation requirements and requirement does not do violence to the estate planning goals. However, the trustee's participation will become important again if the stock or business assets are sold.[2301] See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

II.K.2.b.iii. Participating in Business Activities Does Not Convert a Trust Created by Only One Grantor into a Business Entity, But Be Wary If Multiple Grantors

If the beneficiaries are associates in a joint enterprise for the conduct of business for profit, then the trust might be characterized as a business entity. See part II.D.1 Trust as a Business Entity.

However, if the beneficiaries did not create the trust, the trust will not be considered a business entity merely because the trustee engages in business operations.[2302]

II.K.2.b.iv. Character of Passive Activities Flowing from Nongrantor Trust to a Beneficiary; Interaction with Special Depreciation Rules

Generally, income retains its character when flowing from a nongrantor trust to a beneficiary.[2303] Therefore, income's character as passive or nonpassive at the trust level also controls at the beneficiary's level.

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qualify for an exclusion from the 3.8% tax, see part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.

2301 See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax. This is important only for net investment income tax purposes, as a complete disposition of a passive activity removes the passive loss restrictions for that activity. Code § 469(g).

2302 I am unaware of any case addressing this issue after the adoption of Reg. § 301.7701-4(a). The regulation's preamble, T.D. 8697, provides:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

The last major pre-1997 case, *Bedell Trust v. Commissioner*, 86 T.C. 1207 (1986), *acq*. 1987-2 C.B. 1, held:

> We cannot find, where one person has created an entity, unilaterally distributed interests in it to others, and then restricted their ability to transfer their interests, that there exists "a voluntary association of individuals for convenience and profit", which characteristic is the very essence of an association. *Blair v. Wilson Syndicate Trust*, 39 F.2d 43, 46 (5th Cir. 1930)….
>
> We conclude that the beneficiaries, who neither created nor contributed to the trust, whose interests in the trust are not transferable, and only a few of whom participate in the trust affairs, are not associates and their trust is not an association.

The court further commented:

> We understand that the Government regarded this case as a test case in respect of testamentary trusts and trusts engaged in the conduct of a business, and that high levels in the IRS were active in pressing the matter. It is difficult to imagine a more unsuitable vehicle than this case for any such purpose, and we think it regrettable that extensive misguided efforts were exerted to such a fruitless end in this litigation.

2303 See fn. 1564, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles, and fns. 1927-1928, found in part II.J.8.f.i.(b) Allocating Income Items Among Those Receiving It.

In support of this, note that private letter rulings have held that passive rental income earned by a pooled income fund was passive income in the hands of its beneficiaries.[2304]

In grouping passive activities, a beneficiary's beneficial interest in a trust's ownership of an activity cannot be grouped; all grouping is done at the trust level.[2305]

Regarding applying the passive loss rules to the beneficiary's share of directly apportionable deductions (such as depreciation, depletion, and amortization), the IRS instructs taxpayers:[2306]

> Any directly apportionable deduction, such as depreciation, is treated by the beneficiary as having been incurred in the same activity as incurred by the estate or trust. However, the character of such deduction may be determined as if the beneficiary incurred the deduction directly.
>
> To assist the beneficiary in figuring any applicable passive activity loss limitations, also attach a separate schedule showing the beneficiary's share of directly apportionable deductions derived from each trade or business, rental real estate, and other rental activity.

However, some commentators suggest that depreciation deductions flow through to the beneficiaries separately only to the extent allowed after applying the passive loss rules at the trust level.[2307] The best reconciliation I can come up with is the following example: Suppose the trust has $100 rental income before depreciation and $60 depreciation, for $40 net income; therefore, the depreciation is fully deductible under the passive loss rules applied at the trust level. The rental income and depreciation deductions are separately stated on the trust's K-1s to beneficiaries.

[2304] Letter Rulings 200608002 and 200608003 held:

> … the rental of land and buildings by the Fund to X will be a passive activity under § 469(c). Because the excess of aggregate income from all passive activities over the aggregate losses from all passive activities will enter into the computation of DNI, then the characterization rule of § 662(b) will apply. Thus, if the Fund's gross income in any year from rental of the land and buildings exceeds its losses (including a ratable portion of the Fund's indirect expenses) in that year from rental of the land and buildings, amounts distributed from the Fund that are includible in the gross income of an income beneficiary for that year will be income to that beneficiary from a passive activity, within the meaning of § 469, in the same proportion as the Fund's net income from that rental that enters into the computation of the Fund's DNI for that year bears to the Fund's entire DNI for that year.

Letter Ruling 8806065 took a similar position.

[2305] See fn. 2088.

[2306] 2013 Form 1041 Instructions, page 38, explaining how to prepare line 9 of Schedule K-1 issued to the beneficiaries. The instructions also refer to depletion and amortization. See part II.J.11.a.ii Allocating Depreciation to Beneficiaries (Including Surprising Result Regarding Losses).

[2307] Sutton & Howell-Smith, ¶ 15.03 Application of Passive Loss Limitations at the Entity Level, *Federal Income Taxation of Passive Activities* (WG&L) (referring to the position the AICPA took in the late 1980s); Schmolka, "Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King)," *N.Y.U. Tax Law Review*, vol. 58, p. 191 (2005).

On the other hand, a source that CPAs often use for tax preparation states:[2308]

> When net passive income less depreciation results in a net passive loss, a PAL limitation applies at either the trust or beneficiary level, or both. If the depreciation is required to be distributed to the beneficiary, the PAL limitation occurs at the beneficiary level. If a depreciation reserve is required and maintained by the fiduciary and the depreciation allocated to the trust exceeds the passive income, the PAL limitation occurs at the trust level. If a depreciation reserve is not required and the fiduciary does not distribute all fiduciary accounting income, the PAL limitations occur at both the trust and beneficiary level if the allocated depreciation exceeds the income at both the trust and beneficiary levels.

It appears that more than one approach might be defensible. Consider the strategic consequences:

- If the beneficiary can deduct the depreciation currently, then separately applying the passive loss rules based on the beneficiary's participation seems beneficial. However, if the deduction does not offset net investment income, query whether it would have been better to deferred the deduction until it can be deducted against NII.

- If the beneficiary cannot deduct the depreciation currently, consider the effect of suspending the passive losses. When can one credit the beneficiary for a disposition of the passive activity, freeing that activity's losses from suspension?[2309] If the trust sells the asset, incurs gain because depreciation reduced the trust's basis in the property, and the gain is trapped inside the trust, then the depreciation deductions (suspended or not) do not offset the gain.[2310]

II.K.2.b.v. Electing Small Business Trusts (ESBTs) and the Passive Loss Rules

Electing small business trusts have a special tax regime that divides the trust into a grantor trust portion, a nongrantor trust S corporation portion, and a nongrantor trust non-S corporation portion.[2311]

I am unaware of any guidance directly addressing how the passive loss rules interact with these separate portions.

I believe that all portions should be combined in determining whether income or loss is active or passive. The grouping rules[2312] allow an individual and a C corporation that the

[2308] Key Issue 7E: Reporting Passive Activity Information to a Beneficiary, *1041 Deskbook* (PPC) (2015). See also Key Issue 7D: Passive Loss Limitations Generally Determined at the Entity Level, *1041 Deskbook* (PPC) (2015).
[2309] Code § 469(g). For more about Code § 469(g), see fn. 2027.
[2310] For further discussion of mismatches along these lines, see Abbin (WTAS), § 811 Real Estate Investment Passive Activity Concerns, *Income Taxation of Fiduciaries and Beneficiaries* (2013), arguing that passive loss rules limit the extent to which a trust passes depreciation deductions to the beneficiaries.
[2311] See part III.A.3.e.ii.(b) ESBT Income Taxation.
[2312] See part II.K.1.b Grouping Activities.

individual owns to combine their participation even though they are separate taxpayers.[2313]

Because the nongrantor S corporation portion and the nongrantor non-S corporation portion are taxed as separate trusts for all income tax purpose other than administratively,[2314] they would not aggregate their income and loss in determining allowable passive losses and then disaggregate their income and loss in determining taxable income. Given uncertainty regarding how ESBTs treat net operating losses (NOLs),[2315] it's a good thing that this separate treatment applies.

II.K.2.c. Participation When Grantor Trusts Are Involved; Effect of Toggling

Because grantor trusts are ignored for income tax purposes,[2316] the deemed owner's work is what counts. Complications arise with Qualified Subchapter S Trusts.[2317]

A grantor can count her work in a business for only that part of the year in which she is treated as owning an interest in the business.[2318] If, when grantor trust status terminates, she has not yet worked sufficient hours in the current year (and does not qualify for participation based on participation in prior years),[2319] then consider making sure she keeps at least some ownership in the business after turning off grantor trust status, so that she can count the hours she works later that year. If necessary, the trustee might divide the trust and leave a small portion of the trust as a grantor trust.

II.K.2.d. Effect of Death of an Individual or Termination of Trust on Suspended Losses

If an interest in the activity is transferred by reason of the death of the taxpayer, losses generally are allowed to the extent such losses are greater than the excess (if any) of the basis of such property in the hands of the transferee, over the adjusted basis of such property immediately before the death of the taxpayer, but any losses to the extent of that excess are not allowed as a deduction for any taxable year.[2320] Let's turn this recitation of the Code's rule into common sense: Suspended losses reduce basis, but without the person incurring the losses receiving a benefit from that lost basis. If the owner disposes of the interest during life in a taxable disposition, the suspended losses are allowed, and the tax system has broken even. If the owner dies holding the interest, then the question is what it takes to get the basis restored on account of the suspended losses. To the extent that there is a basis step-up, the suspended losses have not caused a tax detriment, so those losses do not need to be taken to make up for lost basis; therefore, the losses are disallowed to that extent. However, if the suspended losses exceed the basis step-up, then the excess losses should be allowed.

[2313] Reg. § 1.469-4(a), (d)(5)(ii).
[2314] See part III.A.3.e.ii.(b) ESBT Income Taxation, especially fn. 4518.
[2315] See fn. 4524.
[2316] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[2317] See part II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items.
[2318] See part II.K.1.a.i Taxpayer Must Own an Interest in the Business to Count Work in the Business.
[2319] See part II.K.1.a Counting Work as Participation in Business under the Passive Loss Rules, especially part II.K.1.a.ii Material Participation.
[2320] Code § 469(g)(2).

The corollary is that losses are allowed on the decedent's final income tax return to the extent that the transferee does not receive a basis step-up at death, which would make beneficiary grantor trusts[2321] (including QSSTs),[2322] particularly attractive; in fact, substantial triggered losses can generate a net operating loss carryback, generating income tax refunds.[2323] That also might apply to irrevocable grantor trusts taxed to the settlor[2324] - "might" because the statute requires that the interest be "transferred by reason of the death of the taxpayer;" arguably the grantor's death would qualify, but for trust deemed owned by settlor legally the transfer to the trust preceded the deemed owner's death. So, in the latter case, the trust might consider selling the interest to an otherwise identical nongrantor trust – triggering the losses and increasing the basis – to make sure that the benefits of the losses offset their detriment (in that the losses reduced basis).

Code § 469(j)(12) provides that, when an estate or trust terminates, any passive losses suspended under Code § 469 will be permanently disallowed, but, to inject some fairness, added to the basis of the partnership interest.

Suppose an estate is terminating, using fractional pick-and-choose funding. At first, a Code § 469(j)(12) basis increase in the partnership interest might not appear to generate a Code § 743 basis step-up because, lacking a pecuniary aspect, there is no sale or exchange, and therefore the transfer is not "by sale or exchange or upon the death of a partner." Perhaps the termination of the estate might be attributed to the partner's death? This seems uncertain, however, because the suspended passive losses generating the Code § 469(j)(12) basis increase necessarily occurred post-mortem. On the other hand, a trust's or estate's distribution of a partnership interest probably does trigger Code § 743 basis adjustments, so a Code § 743 adjustment seems to be available after all.[2325] For more thoughts on planning for Code § 469(j)(12) and evaluating its impact, see Sutton & Howell-Smith, ¶15.07. Treatment of Suspended Passive Losses Upon Distribution of Activity by an Estate or Trust, *Federal Income Taxation of Passive Activities* (WG&L).

II.K.3. NOL vs. Suspended Passive Loss - Being Passive Can Be Good

II.K.3.a. Why Being Passive Can Be Good

Particularly when significant business interests are passed to the next generation, being passive can have good results, if the business has a significant net loss.

Suppose the taxpayer has a relatively modest income, other than what the business generates. Deducting a net loss will offset income in the lower tax brackets. This is especially true if the loss is so large that it generates a net operating loss (NOL) carryover under Code § 172. Another concern is the IRS' position on NOLs incurred by

[2321] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.
[2322] See part III.A.3.e QSSTs and ESBTs.
[2323] FSA 200106018.
[2324] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.
[2325] See part II.Q.8.e.ii.(b) Distribution of Partnership Interests.

an electing small business trust (ESBT) when the S corporation stock it owns generates losses.[2326]

However, in profitable years, the business income might be taxed in the highest tax bracket. The owner might save more taxes by offsetting the income in a later, high-tax-bracket year, than by deducting the loss in the lower tax brackets.

If and to the extent that the loss is passive and the taxpayer does not have passive income against which to offset it, the loss is suspended and carried forward.[2327] Thus, instead of offsetting income in lower brackets in the year in which the loss is generated, it offsets income in a later year that would otherwise push the taxpayer into a higher bracket.

Being passive does cause income to constitute net investment income (NII)[2328] subject to the 3.8% tax on net investment income.[2329] However, for taxpayers who have income below the NII thresholds,[2330] that impact might be small or none. If the NII tax impact is significant, compare (a) the possible income tax savings if income and loss years tend to fluctuate significantly, to (b) the extra cost of NII tax; I am not suggesting that being passive will usually be better – merely that one should consider it when planning.

II.K.3.b. Maximizing Flexibility to Avoid NOLs and Use Losses in the Best Year

One might increase planning flexibility in the planning described in part II.K.3.a Why Being Passive Can Be Good by engaging in significant participation (more than 100 hours)[2331] rather than material participation (more than 500 hours).[2332] If suspending the loss becomes important and one sees the loss coming (or perhaps is experiencing losses and expects them next year), one might cut back one's work.

Material participation might be difficult to impossible to turn off:

- One might have worked too many hours in the year before one realizes that being passive is desirable.

- One might have worked too many hours in a prior year to turn it off.

    - An individual is deemed to materially participate if the individual materially participated in the activity (determined without regard to this sentence) for any

[2326] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fn. 4524.
[2327] See the introduction to part II.K.1 Passive Loss Rules Generally.
[2328] See part II.I.8 Application of 3.8% Tax to Business Income.
[2329] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[2330] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[2331] See part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income, especially fns. 2226-2229.
[2332] See part II.K.1.a.ii Material Participation. Although more than 500 hours (see fn. 2043) is usually what people consider, it is not the only way to materially participate.

five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.[2333]

- An individual is deemed to materially participate if the activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.[2334]

Suppose an activity is passive when it generates losses and active when it generates income. The suspended passive losses offset active income from the same activity,[2335] and the active income avoids the 3.8% NII tax.[2336]

If one is leaning toward using significant participation instead of material participation, consider:

- Not being able to turn off material participation might be good, if the taxpayer stops working in the business and continues to generate business income.

- Part II.K.1.h.i.(b) Tax Trap from Recharacterizing PIGs as Nonpassive Income.

II.L. Self-Employment Tax (FICA)

II.L.1. FICA: Corporation

For corporations, compensation, including any distributions re-characterized as salaries, is subject to income tax and FICA tax.[2337] Income retained by the corporation and not paid as compensation is not subject to FICA tax.[2338]

If all of the remuneration to an individual from related corporations[2339] is disbursed through the common paymaster,[2340] the total amount of FICA imposed on the employer

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[2333] See part II.K.1.a.ii Material Participation, especially fn. 2049.
[2334] See part II.K.1.a.ii Material Participation, especially fn. 2050.
[2335] See part II.K.1.i Former Passive Activities.
[2336] See part II.I.8 Application of 3.8% Tax to Business Income.
[2337] IRS Fact Sheet 2008-25 (http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers) discusses recharacterizing distributions from S corporations as compensation for this purpose.
[2338] Rev. Rul. 59-221, which was cited with approval by *Ding v. Commissioner*, T.C. Memo. 1997-435, *aff'd* 200 F.3d 587 (9th Cir. 1999), and by *U.S. v. Asiru*, 222 Fed. Appx. 584 (9th Cir. 2007). *Ding* held that a distributive share of S corporation income was not subject to SE tax. For an excerpt from *Ding* that included an excerpt from Rev. Rul. 59-221, see fn. 2442.
[2339] Reg. § 31.3121(s)-1(b)(1) provides the following before providing examples in flush language following it:

> *Related corporations*. Corporations shall be considered related corporations for an entire calendar quarter (as defined in § 31.0-2(a)(9)) if they satisfy any one of the following four tests at any time during that calendar quarter:
>
> (i) The corporations are members of a controlled group of corporations, as defined in section 1563 of the Code, or would be members if section 1563(a)(4) and (b) did not apply and if the phrase more than 50 percent were substituted for the phrase at least 80 percent wherever it appears in section 1563(a).
>
> (ii) In the case of a corporation that does not issue stock, either fifty percent or more of the members of one corporation's board of directors (or other governing body) are

members of the other corporation's board of directors (or other governing body), or the holders of fifty percent or more of the voting power to select such members are concurrently the holders of fifty percent or more of that power with respect to the other corporation.

(iii) Fifty percent or more of one corporation's officers are concurrently officers of the other corporation.

(iv) Thirty percent or more of one corporation's employees are concurrently employees of the other corporation.

[2340] Reg. § 31.3121(s)-1(b)(2) provides the following:

(i) *In general*. A common paymaster of a group of related corporations is any member thereof that disburses remuneration to employees of two or more of those corporations on their behalf and that is responsible for keeping books and records for the payroll with respect to those employees. The common paymaster is not required to disburse remuneration to all the employees of those two or more related corporations, but the provisions of this section do not apply to any remuneration to an employee that is not disbursed through a common paymaster. The common paymaster may pay concurrently employed individuals under this section by one combined paycheck, drawn on a single bank account, or by separate paychecks, drawn by the common paymaster on the accounts of one or more employing corporations.

(ii) *Multiple common paymasters*. A group of related corporations may have more than one common paymaster. Some of the related corporations may use one common paymaster and others of the related corporations use another common paymaster with respect to a certain class of employees. A corporation that uses a common paymaster to disburse remuneration to certain of its employees may use a different common paymaster to disburse remuneration to other employees.

(iii) *Examples*. The rules of this subparagraph are illustrated by the following examples:
Example (1). S, T, U, and V are related corporations with 2,000 employees collectively. Forty of these employees are concurrently employed by two or more of the corporations, during a calendar quarter. The four corporations arrange for S to disburse remuneration to thirty of these forty employees for their services. Under these facts, S is the common paymaster of S, T, U, and V with respect to the thirty employees. S is not a common paymaster with respect to the remaining employees.
Example (2).

(a) W, X, Y, and Z are related corporations. The corporations collectively have 20,000 employees. Two hundred of the employees are top-level executives and managers, sixty of whom are concurrently employed by two or more of the corporations during a calendar quarter. Six thousand of the employees are skilled artisans, all of whom are concurrently employed by two or more of the corporations during the calendar year. The four corporations arrange for Z to disburse remuneration to the sixty executives who are concurrently employed by two or more of the corporations. W and X arrange for X to disburse remuneration to the artisans who are concurrently employed by W and X.

(b) A is an executive who is concurrently employed only by W, Y, and Z during the calendar year. Under these facts, Z is a common paymaster for W, Y, and Z with respect to A. Assuming that the other requirements of this section are met, the amount of the tax liability under sections 3102 and 3111 is determined as if Z were A's only employer for the calendar quarter.

(c) B is a skilled artisan who is concurrently employed only by W and X during the calendar year. Under these facts, X is a common paymaster for S and X with respect to B. Assuming that the other requirements of this section are met, the amount of the tax liability under sections 3102 and 3111 is determined as if X were B's only employer for the calendar quarter.

Reg. § 31.3121(s)-1(b)(3) provides the following before providing examples following it:

and employee is determined as though the individual has only one employer (the common paymaster).[2341] The common paymaster is responsible for filing information and tax returns and issuing Forms W-2 with respect to wages it is considered to have paid under this rule.[2342]

For S corporations, shareholders' health insurance is deductible to the S corporation and considered compensation to owners.[2343] However, it is subject to FICA only if offered in

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> *Concurrent employment*. For purposes of this section, the term concurrent employment means the contemporaneous existence of an employment relationship (within the meaning of section 3121(b)) between an individual and two or more corporations. Such a relationship contemplates the performance of services by the employee for the benefit of the employing corporation (not merely for the benefit of the group of corporations), in exchange for remuneration which, if deductible for the purposes of Federal income tax, would be deductible by the employing corporation. The contemporaneous existence of an employment relationship with each corporation is the decisive factor; if it exists, the fact that a particular employee is on leave or otherwise temporarily inactive is immaterial. However, employment is not concurrent with respect to one of the related corporations if the employee's employment relationship with that corporation is completely nonexistent during periods when the employee is not performing services for that corporation. An employment relationship is completely nonexistent if all rights and obligations of the employer and employee with respect to employment have terminated, other than those that customarily exist after employment relationships terminate. Examples of rights and obligations that customarily exist after employment relationships terminate include those with respect to remuneration not yet paid, employer's property used the employee not yet returned to the employer, severance pay, and lump-sum termination payments from a deferred compensation plan. Circumstances that suggest that an employment relationship has become completely nonexistent include unconditional termination of participation in deferred compensation plans of the employer, forfeiture of seniority claims, and forfeiture of unused fringe benefits such as vacation or sick pay. Of course, the continued existence of an employment relationship between an individual and a corporation is not necessarily established by the individual's continued participation in a deferred compensation plan, retention of seniority rights, etc., since continuation of those benefits may be attributable to employment with a second corporation related to the first corporation if the corporations have common benefits plans or if the benefits are continued as a matter of corporate reciprocity. An individual who does not perform substantial services in exchange for remuneration from a corporation is presumed not employed by that corporation. Concurrent employment need not exist for any particular length of time to meet the requirements of this section, but this section only applies to remuneration disbursed by a common paymaster to an individual who is concurrently employed by the common paymaster and at least one other related corporation at the time the individual performs the services for which the remuneration is paid. If the employment relationship is nonexistent during a quarter, that employee may not be counted towards the 30-percent test set forth in paragraph (b)(1)(iv) of this section; however, even if the employment relationship is nonexistent, section 3121(s) of the Code applies to remuneration paid to the former employee for services rendered while the employee was a common employee.

[2341] Reg. § 31.3121(s)-1(a).
[2342] Reg. § 31.3121(s)-1(a).
[2343] Rev. Rul. 91-26.

a plan that discriminates in favor of owners. The owners may deduct health insurance subject to the same rules as partners and sole proprietors.[2344]

II.L.2. Income Subject to Self-Employment Tax

II.L.2.a. Types of Income Subject to Self-Employment Tax

II.L.2.a.i. General Rules for Income Subject to Self-Employment Tax

FICA is paid one-half by the employee and one-half by the employer. If an individual is self-employed, the individual pays both halves, which combined are called self-employment (SE) tax.

Generally, all of a partnership's[2345] or sole proprietorship's[2346] income from business operations is subject to income tax and SE tax.[2347] SE tax is 15.3%[2348] (on income up to the taxable wage base (TWB) and 2.9%[2349] on all (RRA 1993 repealed the cap) income above the TWB until $200,000 (single) or $250,000 (married filing jointly), above which the tax is 3.8%.[2350] See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount ($128,400 in 2018). For timing, see part II.Q.1.d.iii Timeline for FICA and Income Taxation of Deferred Compensation.

Half of the SE tax is deductible for income tax purposes (which makes it less burdensome than the 3.8% tax on net investment income (NII), none of which is deducible). SE income is not subject to the 3.8% NII tax,[2351] which means that taxpayers who exceed the TWB each year would generally prefer to pay SE tax on the excess instead of NII tax, if they cannot qualify for exclusions from NII tax.

Specifically, Code § 1402(a) begins:

> The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member….

[2344] IRS Announcement 92-16, clarifying Rev. Rul. 91-26. See also IRS Notice 2005-8 (health savings accounts).
[2345] Reg. § 1.1402(a)-2(d). "Partnership" is defined in Code § 7701(a)(2) and includes a pool or joint venture whether the parties specifically elected to be excluded from the application of subchapter K, which generally governs partnership income taxation. *Methvin v. Commissioner*, T.C. Memo. 2015-81, *aff'd* 117 A.F.T.R.2d 2016-XXXX (10th Cir. 6/24/2016),.
[2346] Reg. § 1.1402(a)-2(b).
[2347] An attempt to deflect self-employment income to trusts (that do not pay self-employment tax), which distributed their income to the beneficiaries, did not succeed. *Olsen v. Commissioner*, T.C. Memo. 2008-275.
[2348] 12.4% under Code § 1401(a) plus 2.9% under Code § 1401(b).
[2349] Code § 1401(b).
[2350] Code § 1401(b)(2)(A). The thresholds are reduced (but not below zero) by wages, presumably so that a taxpayer cannot avoid this tax by splitting earned income between wages and self-employment income. Code § 1401(b)(2)(B)
[2351] See fn. 1527 in part II.I.5 What is Net Investment Income Generally.

When applied to an individual, "To be taxable as self-employment income, an individual's income must be (1) derived, (2) from a trade or business, (3) carried on by that individual."[2352]

Applying the "derived" test, the income must arise from the taxpayer's trade or business income producing activity.[2353] "To be taxable as self-employment income, earnings must be tied to the quantity or quality of the taxpayer's prior labor, rather than the mere fact that the taxpayer worked or works for the payor."[2354] When the taxpayer was fully compensated for prior work and the payments at issue were based on others' retention of the business, termination payments did not constitute SE income.[2355] Because such

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[2352] *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994), which continued:

> Milligan agrees with the tax court that the trade or business and carried on requirements have been satisfied. In other words, he agrees that the Termination Payments are subject to self-employment tax if they were derived from the carrying on of his previous work as an insurance agent. *Simpson v. Commissioner*, 64 T.C. 974, 989 (1975) (self-employment tax on insurance agent's trade or business earnings, e.g., commissions, as an independent contractor); *Erickson v. Commissioner*, 64 T.C.M. (CCH) 963, 966 (1992), *aff'd without op.*, 1 F.3d 1231 (1st Cir. 1993) (self-employment tax on deferred payments of unpaid commissions and renewal commissions to former insurance agent). It is immaterial that Milligan was no longer self-employed in 1987 when he received the Termination Payments. Treas. Reg. section 1.402(a)-1(c) (as amended in 1974) (Gross income derived from a trade or business includes gross income received ... in the taxable year even though such income may be attributable in whole or in part to services rendered or other acts performed in a prior taxable year ....); *Shumaker v. Commissioner*, 648 F.2d 1198, 1200 (9th Cir. 1981) (affirming self-employment tax on sale proceeds from wheat taxpayer grew in the past: [S]elf-employment income is determined by the source of the income, not the taxpayer's *status* at the time the income is realized.) (Emphasis added.)

[2353] *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994), reasoned:

> The term "derive" requires "a nexus between the income received and a trade or business that is, or was, actually carried on." *Newberry v. Commissioner*, 76 T.C. 441, 444 (1981). By nexus, we mean that the "trade or business activity by the taxpayer *gives rise to* the income...." *Id.* (emphasis added). The income is sufficiently related to the taxpayer's trade or business activity when the business activity is its source. *Id.* at 446 ("Any income must arise from some actual ... income-producing activity of the taxpayer before such income becomes subject to ... self-employment taxes...."). See, *e.g.*, *Shumaker*, 648 F.2d at 1200 (income derived from selling wheat from prior farming activity).

[2354] *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994).

[2355] *Milligan v. Commissioner*, 38 F.3d 1094 (9th Cir. 1994), reasoned:

> Because Milligan already had been fully compensated for his services, none of his business activity was the "source" of the Termination Payments. The payments did not represent deferred compensation of previously-earned commissions, *cf. Erickson*, *supra*, because none of Milligan's earnings were deferred, *i.e.*, he had no vested right to payment of an identifiable money amount. Nor were they renewal commissions on previously-generated policies, *cf. id.*; *Becker v. Tomlinson*, 9 A.F.T.R.2d 1408, 1409-10 (S.D. Fla. 1962), or retirement income tied to Milligan's years of service and overall earnings.
>
> At most, the *amount* of the Termination Payments, not the payments themselves, actually arose from Milligan's business activity. Milligan had a contingent right to receive an uncertain amount of money or nothing, depending upon the level of his prior business activity leading to compensation in his final year as an agent. The payment amount depended upon the level of his commissions (and service compensation from State

trailing commissions depend on others' maintaining the business, they are not SE income, regardless of their other income tax characteristics.[2356] In a reviewed decision with a lone dissent, the Tax Court has agreed with the above analysis.[2357] However,

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Farm-Auto) on personally-produced policies, *i.e.*, his previous value as a State Farm insurance agent.

However, in part, even the payment *amount* did not depend upon the level of Milligan's prior business activity because the Termination Payments were subject to two adjustments *unrelated* to any business activity on Milligan's part for State Farm. The State Farm companies adjusted the Termination Payments to reflect the amount of income received on Milligan's book of business during the first post-termination year, and the number of his personally-produced policies cancelled during that year. If all of Milligan's customers had cancelled their State Farm non-life policies during the first post-termination year, then Milligan would have received nothing. The adjusted payment amount depended not upon Milligan's past business activity, but upon the successor agent's future business efforts to retain Milligan's customers and to generate service compensation for State Farm. In this way too, the disputed Termination Payments did not "derive" from Milligan's prior services.

[2356] *Gump v. U.S.*, 86 F3d 1126 (Fed. Cir. 1996), commenting:

Because the payments are not "derived" from his insurance business, we need not determine the precise nature of the payments or specifically characterize them as a particular type of income. That is, we need not determine whether they represent consideration for an agreement not to compete or the purchase of his insurance franchise, including its assets and goodwill. It suffices to hold, as we do, that they are not derived from a trade or business carried on by Gump and thus they are not taxable as self-employment income.

[2357] *Jackson v. Commissioner*, 108 T.C. 130 (1997), holding:

In the interest of promoting uniformity, consistency, and fairness in the disposition of this issue with respect to former insurance agents who receive termination payments under similar contractual agreements, we follow the decision of the Court of Appeals for the Ninth Circuit in *Milligan v. Commissioner*, *supra*. Accordingly, upon further reflection and analysis, we hold that the termination payments petitioner received in 1990 and 1991 are not subject to self-employment tax. Because we conclude that the termination payments were not "derived" from the carrying on of petitioner's insurance business,[4] we need not decide the precise nature of the payments or specifically characterize them as a particular type of income. In other words, we need not decide in this case whether the termination payments are consideration for an agreement not to compete or the purchase of petitioner's agency, including its assets and goodwill. *Milligan v. Commissioner*, 38 F.3d at 1100.

[4] See, *e.g.*, *Ohio Farm Bureau Federation, Inc. v. Commissioner*, 106 T.C. 222, 236 (1996), an analogous case, in which we pointed out that the statutory language defining "unrelated business income" in sec. 512(a) is similar to that contained in sec. 1402(a). There it was held that a lump-sum payment made by Landmark, Inc., to the taxpayer, pursuant to the terms of a nonsponsorship and noncompetition clause contained in their termination agreement, did not constitute unrelated business taxable income under sec. 511(a). We applied the rationale of *Newberry v. Commissioner*, 76 T.C. at 444. The Government did not appeal our decision, and the IRS has since revoked GCM 39865, TR-45-1437-90 (Dec. 12, 1991), which reached a contrary conclusion.

Three judges would have reached the same result, viewing the payments as either for the goodwill of petitioner's former insurance business (his books of customer accounts) or for a covenant not to compete. Here are some excerpts:

Goodwill is acquired by the purchaser of a going concern where the transfer enables the purchaser to step into the shoes of the seller. See *Decker v. Commissioner*, 864 F.2d 51, 54 (7th Cir. 1988), *affg.* T.C. Memo. 1987-388; *Winn-Dixie Montgomery, Inc.*

payments tied to the quantity and quality of prior services are "derived from" those services.[2358] Congress codified this test with respect to insurance salesmen (see part II.L.8 Retirement Payments to Insurance Salesmen), and one court has stated, over a strong (and correct, in my view) dissent, that the line of cases described above is limited to insurance salesmen[2359] and held that payments labelled as deferred

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v. United States, 444 F.2d 677, 681 (5th Cir. 1971). Here the terms of the Agreement between petitioner and State Farm allowed petitioner's successor agent to step into his shoes. The successor agent continued the same business and sold insurance to the same customers….

Payments attributable to a covenant not to compete are not "earned" income, *Furman v. United States*, 602 F.Supp. 444, 451 (D.S.C. 1984), *affd.* without published opinion 767 F.2d 911 (4th Cir. 1985), and they are not subject to self-employment tax. *Barrett v. Commissioner*, 58 T.C. 284 (1972); see also *Ohio Farm Bureau Federation, Inc. v. Commissioner*, 106 T.C. 222, 236 n.8 (1996).

[2358] *Schelble v. Commissioner*, 130 F.3d 1388 (10th Cir. 1997) reasoned:

In contrast to Milligan, Mr. Schelble's payments are tied to the quantity and quality of his prior services performed for the Companies. Although the payments in *Milligan* and Mr. Schelble's payments have similar eligibility requirements such as (1) a minimum service requirement; (2) relinquishment of company records and policies; and (3) a covenant not to compete, Mr. Schelble's payments have distinguishing features related to Mr. Schelble's prior services. For example, unlike the plan in Milligan, Mr. Schelble must have 400 outstanding policies at his termination to be eligible for extended earnings payments. In addition, in contrast to Milligan, the amount of Mr. Schelble's payments was computed based on Mr. Schelble's length of service for the Companies. As an agent for the Companies for over fifteen years, Mr. Schelble's extended earnings payments were calculated using a higher percentage than if he had only been an agent for five or ten years. Furthermore, unlike the payments in Milligan, Mr. Schelble's extended earnings payments were calculated solely on the percentage applied to service fees paid to him during the twelve months preceding the Agreement's termination. No adjustments unrelated to Mr. Schelble's prior services were made in calculating these payments. Based on these distinguishing factors, we conclude Mr. Schelble's payments are sufficiently derived from his prior insurance business to constitute self-employment income subject to self-employment tax under 26 U.S.C. section 1401.

[2359] *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 2016), at fn. 42, commented:

In 1997, Congress amended 26 U.S.C. § 1402 by adding subsection (k) for the specific purpose of "codif[ying] the standard established in *Milligan* with respect to termination payments made ... to an insurance salesman." *Farnsworth v. Comm'r*, 83 T.C.M. (CCH) 1153, 1159 & n.5 (2002) (citing H.R. Rep. No. 105-220, at 458 (1997) (Conf. Rep.)). As codified in § 1402(k), the *Milligan* standard holds that self-employment tax does not apply to post-termination payments from an insurance company to its former insurance salesman, provided four requirements inapplicable to this case are satisfied. See 26 U.S.C. § 1402(k)(2), § 1402(k)(3), 1402(k)(4)(A), § 1402(k)(4)(B). The Petersons concede § 1402(k) was intended to codify the *Milligan* standard, which unambiguously applies only to contractual termination payments to former insurance agents. Appellants Br. at 19-20. By urging the application of *Milligan* in this case, the Petersons and amici invite this court to expand § 1402(k) beyond the confines of its text. Appellants Br. At 20; Amicus Curiae Br. at 9. If Congress had intended the *Milligan* standard to be applied outside the context of termination payments to insurance salesmen, it would have so stated. Instead, it unambiguously limited the standard to the context of termination payments to former insurance agents.

In addition, the legislative history of § 1402(k) states "[n]o inference is intended with respect to the [self-employment] tax treatment of payments that are not described in [§ 1402(k)]." H.R. Rep. No. 105-220, at 458 (1997) (Conf. Rep.), reprinted in 1997-4 compensation in an agreement with a beauty products salesman were subject to FICA,[2360] notwithstanding one of the two payment plans appearing to fall within the

(Vol. 2) C.B. 1457, 1928; see *Ruckelshaus v. Sierra Club*, 463 U.S. 680, 686 n. 8, 103 S.Ct. 3274, 3278 n.8 (1983) ("If Congress had intended the far-reaching result urged by respondents, it plainly would have said so, as is demonstrated by Congress careful statement that a less sweeping invitation was adopted."). Moreover, if *Milligan* accurately reflected the generally applicable "derived from" standard under § 1402(a), then § 1402(k) would be superfluous. See, *e.g.*, *Nunnally v. Equifax Info. Servs., LLC*, 451 F.3d 768, 773 (11th Cir. 2006) ("It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant." (citation omitted)). We decline to expand § 1402(k) beyond its text, as the Petersons and amici urge. The dissent, however, ignores this legislative history and case law clearly limiting *Milligan* to insurance salesmen.

[2360] *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 2016), at fn. 42, reasoned:

The Tax Court concluded the Petersons do not dispute the 2008 Amendments to the Family Program and the Futures Program expressly characterize them as "deferred compensation (i.e., related to Mrs. Peterson s prior labor)." *Peterson*, 106 T.C.M. (CCH) 619, *3. Under the "*Danielson* rule," that characterization is controlling for tax purposes. *Comm'r v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967) (en banc); *Spector v. Comm'r*, 641 F.2d 376, 384-86 (5th Cir. Unit A Apr. 1981) (adopting the *Danielson* rule). Our court has explained the *Danielson* rule:

> When a taxpayer characterizes a transaction in a certain form, the Commissioner may bind the taxpayer to that form for tax purposes. This is the rule: "a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties [to the agreement] would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, et cetera."

Plante v. Comm'r, 168 F.3d 1279, 1280-81 (11th Cir. 1999) (quoting *Danielson*, 378 F.2d at 775) (citation and alteration omitted). Because Peterson had signed the retirement Program Agreements respectively in 1992 and 2005 permitting Mary Kay to amend them prospectively, she necessarily had consented to the 2008 Amendments that expressly characterized the Family Program and Futures Program payments as "deferred compensation" under a nonqualified compensation plan pursuant to Section 409A of the Internal Revenue Code,[29] which makes the Danielson rule applicable.[30] See *Comm'r v. Nat'l Alfafa Dehydrating & Milling Co.*, 417 U.S. 134, 149, 94 S.Ct. 2129, 2137 (1974) ("This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not." (citations omitted)).[31]

The Tax Court applied the Danielson rule and determined Peterson's 2009 distributions from the Family Program and Futures Program were "subject to self-employment tax pursuant to section 1401," because the Petersons had "failed to adduce proof sufficient to alter the construction of these unambiguous agreements or show that they were unenforceable." *Peterson*, 106 T.C.M. (CCH) 619, *3 (citing *Plante*, 168 F.3d at 1280-81; *Danielson*, 378 F.2d at 775). The Petersons do not dispute the Amendments to the Program Agreements unambiguously characterize Peterson s post-retirement payments as deferred compensation. The undisputed lack of ambiguity in the terms of the Program Agreements necessarily precludes the Petersons from "adducing proof which in an action between the parties would be admissible to alter that construction." *Plante*, 168 F.3d at 1280-81. When a contract is unambiguous, Texas law holds the parties intent must be determined from the contract terms alone. *Friendswood Dev. Co. v. McDade & Co.*, 926 S.W.2d 280, 283 (Tex. 1996); see also *Valence Operating Co. v. Dorsett*, protection of case law. Information Letter 2016-0081 argued that certain undescribed post-retirement payments were SE income.

The taxpayer's work can determine whether an activity is a trade or business.[2361] However, if a taxpayer owns an interest in a trade or business, the taxpayer's share of business earnings is SE income, even if the taxpayer is inactive,[2362] unless the taxpayer is a limited partner.[2363]

Conversely, income from any activity that is not a trade or business, within the meaning of Code § 162,[2364] is not subject to SE tax:[2365]

- Trustee and executor fees are exempt from self-employment tax except to the extent that (a) they are attributable to the conduct of a trade or business by the trust or estate, or (b) an executor manages an estate that requires extensive management activities on the executor's part over a long period of time, in which latter case the activities might be sufficient in scope and duration to constitute the carrying on of a trade or business.[2366]

- An individual's distributive share of income from an investment club partnership does not constitute SE income.[2367]

> 164 S.W.3d 656, 662 (Tex. 2005) (recognizing, under Texas law, a written contract must be construed in accordance with "the true intentions of the parties as expressed in the instrument").[32] Therefore, the *Danielson* rule requires that the Petersons are bound by the characterization of her 2009 Mary Kay, post-retirement Program payments as deferred compensation, making them subject to self-employment tax.
> [footnotes omitted]

[2361] *Chai v. Commissioner*, T.C. Memo. 2015-42, stated:

> The term trade or business has the same meaning under section 1402(a) as under section 162. Sec. 1402(c); see *Bot v. Commissioner*, 118 T.C. 138, 146 (2002), *aff'd*, 353 F.3d 595 (8th Cir. 2003). In *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987), the Supreme Court determined that to be engaged in a trade or business under section 162 (and, in this case, section 1402(a)), the taxpayer must be involved in an activity with continuity and regularity and with the primary purpose of receiving income or profit.

[2362] See part II.L.3 Self-Employment Tax: General Partner or Sole Proprietor.

[2363] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.

[2364] Reg. § 1.1402(c)-1 provides:

> In order for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership. Except for the exclusions discussed in §§ 1.1402(c)-2 to 1.1402(c)-7, inclusive, the term "trade or business", for the purpose of the tax on self-employment income, shall have the same meaning as when used in section 162. An individual engaged in one of the excluded activities specified in such sections of the regulations may also be engaged in carrying on activities which constitute a trade or business for purposes of the tax on self-employment income. Whether or not he is also engaged in carrying on a trade or business will be dependent upon all of the facts and circumstances in the particular case.

See part II.G.3.i.i.(a) "Trade or Business" Under Code § 162.

[2365] Reg. § 1.1402(a)-1(b).

[2366] Rev. Rul. 58-5; see also Letter Ruling 8238055.

[2367] Rev. Rul. 75-525 held:

Beware that, starting January 1, 2013, generally investment income and income from any passive activity[2368] that is not subject to SE tax would be subject to the 3.8% tax on net investment income if the taxpayer's income exceeds the relevant threshold.[2369]

See also parts:

- II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner
- II.L.8 Retirement Payments to Insurance Salesmen, and
- II.Q.8.b.ii.(g) Code § 736 Payments As Retirement Income – Possible FICA and State Income Tax Benefits.

II.L.2.a.ii. Rental Exception to SE Tax

Income from real estate and from personal property leased with the real estate generally is not subject to SE tax, unless such rentals constitute certain types of farm activities[2370] or are received in the course of a trade or business as a real estate dealer.[2371]

Farm activities generate significant controversy as to what is rent and what constitutes payment for services[2372] or income from growing crops, raising livestock, etc. Payments

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> In *Higgins v. Commissioner*, 312 U.S. 212 (1941), 1941-1 C.B. 339, the Supreme Court of the United States held that the conduct of investment management activities with respect to one's own account was not a trade or business within the meaning of section 23(a) of the Revenue Act of 1932, predecessor of section 162.
>
> Therefore, a partnership whose activities are limited to investment in savings certificates and collection of interest thereon with respect to its membership accounts is not engaged in a trade or business as defined in section 162 of the Code.

Higgins is quoted in the text accompanying fn. 890 in part II.G.3.i.i.(a) "Trade or Business" Under Code § 162.

[2368] As defined in Code § 469, which generally includes rental as well as any trade or business in which the owner does not materially participate.

[2369] See part II.I 3.8% Tax on Excess Net Investment Income, particularly part II.I.8.c Application of 3.8% Tax to Rental Income.

[2370] Code § 1402(a)(1) provides that the rental exception:

> shall not apply to any income derived by the owner or tenant of land if (A) such income is derived under an arrangement, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities (including livestock, bees, poultry, and fur-bearing animals and wildlife) on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) in the production or the management of the production of such agricultural or horticultural commodities, and (B) there is material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant) with respect to any such agricultural or horticultural commodity.

See Reg. § 1.1402(a)-4(b) and *Mizell v. Commissioner*, T.C. Memo. 1995-571 (broadly construing arrangement).

[2371] Code § 1402(a)(1); Reg § 1.1402(a)-4. See Chief Counsel Advice 200816030 (Code § 761(f) active participation does not override exclusion of rental income from self-employment tax).

[2372] In reversing the Tax Court, *McNamara v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), *non-acq.* AOD CC-2003-003 (10/22/2003). said:

under USDA's Conservation Reserve Program are subject to self-employment tax according to the Tax Court and IRS, but not according to the Eighth Circuit.[2373] Instead

> What is missing from both the Commissioner's and the Tax Court's analyses is any mention of a nexus between the rents received by Taxpayers and the arrangement that requires the landlords' material participation. We believe this omission overlooks section 1402(a)(1)'s requirement that rents be derived under such an arrangement. That is to say, the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received by the landowner into self-employment income. It is only where the payment of those rents comprise part of such an arrangement that such rents can be said to derive from the arrangement.
>
> Rents that are consistent with market rates very strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an arrangement for participation in agricultural production. Although the Commissioner is correct that, unlike other provisions in the Code, section 1402(a)(1) contains no explicit safe-harbor provision for fair market value transactions, we conclude that this is the practical effect of the derived under language.
>
> At this point, the only evidence in the record is that the rents in question were at or below market rates. However, we believe the Commissioner is entitled to an opportunity to show a connection between those rents and the production arrangement it identified.

[2373] Payments under USDA's Conservation Reserve Program are subject to self-employment tax according to the Tax Court, *Morehouse v. Commissioner*, 140 T.C. 350 (unanimous reviewed decision), but not according to the Eighth Circuit, 114 A.F.T.R.2d 2014-6287 (2014); the IRS agrees with the Tax Court, A.O.D. 2015-002, IRB No. 2015-41. The *Morehouse* Tax Court opinion relied on *Timber Co. v. Commissioner*, 64 T.C. 700, 709-711 (1975), *aff'd without published opinion*, 552 F.2d 368 (5th Cir. 1977); *Webster Corp. v. Commissioner*, 25 T.C. 55, 61 (1955), *aff'd*, 240 F.2d 164 (2nd Cir. 1957); *Harding v. Commissioner*, T.C. Memo. 1970-179; and Rev. Rul. 60-32. The *Morehouse* Tax Court opinion cited *Johnson v. Commissioner*, 60 T.C. 829, 833 as holding that exception for rentals from real estate must be narrowly construed. Rev. Rul. 65-149, cited with approval in the *Morehouse* Eighth Circuit opinion, held that grain storage fees for delaying in selling grain one produced constitute income from farming and therefore net earnings from self-employment, but grain storage fees paid for the storage of a landlord's share of a crop paid to the landlord as rental income are excluded from net earnings from self-employment as rental income.

In a split opinion, the Eighth Circuit held [footnotes omitted]:

> [T]he record discloses that the government, whether by contractual right or otherwise, physically inspected the CRP properties nearly as often as Morehouse did. These entries, coupled with the significant tilling, seeding, fertilizing, and weed control work required by the CRP contracts reveal the government likely had more physical possession for its own land conservation uses than Morehouse did. Accordingly, we hold the 2006 and 2007 CRP payments were consideration paid [by the government] for use [and occupancy] of [Morehouse's] property and thus constituted rentals from real estate fully within the meaning of § 1402(a)(1).

Both the majority and dissent cited *Wuebker v. Commissioner*, 205 F.3d 897, 903-904 (6th Cir. 2000) and mentioned Notice 2006-108, without paying deference to the latter because the IRS never issued the promised Revenue Ruling (perhaps concluding that its position was not necessarily a consensus view). For a discussion of such payments generally and a brief overview of cases, see Malloy, Langstraat, and Wilkinson, "Conservation Reserve Program Payments and Self-Employment Tax: Farmers vs. Non-Farmers," *TAXES - The Tax Magazine* (8/2015).

A.O.D. 2015-002, IRB No. 2015-41, nonacquiesced to the Eighth Circuit's opinion, stating:

> We disagree with the Eighth Circuit's characterization of the revenue rulings as establishing a line of demarcation on the self-employment tax treatment of conservation

of conducting operations on one's farms and paying SE tax on all of the income, one may lease the farm to one's own S corporation for fair rental without paying SE tax on that rental, have the S corporation run operations and not pay SE tax on the operations, and simply take reasonable compensations for one's services to the S corporation – an arrangement that the Tax Court approved in a 2017 reviewed case.[2374] Citing an Eighth Circuit case[2375] that it decided to find persuasive in any jurisdiction, the Tax Court[2376] held:

> Regardless of a taxpayer's material participation, if the rental income is shown to be less than or equal to market value for rent, the income is presumed to be unrelated to any employment agreement. *Id*. At that point, the burden of production shifts to the Commissioner to show a nexus between the rent and the

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> reserve payments paid to farmers and nonfarmers. We also disagree with the Eighth Circuit's holding that the CRP payments were consideration paid by the government for use and occupancy of Morehouse's property and thus constituted rentals from real estate excluded from self-employment tax under section 1402(a)(1).
>
> The Eighth Circuit misinterprets Rev. Rul. 60-32 and Rev. Rul. 65-149 when it states that the rulings establish the position that CRP payments made to non-farmers constitute rentals from real estate and are excluded from the self-employment tax. *Morehouse*, 769 F.3d at 621….
>
> We recognize the precedential effect of the decision in *Morehouse* to cases appealable to the Eighth Circuit. Accordingly, we will follow *Morehouse* within the Eighth Circuit only with respect to cases in which the CRP payments at issue were both (1) paid to an individual who was not engaged in farming prior to or during the period of enrollment of his or her land in CRP and (2) paid prior to January 1, 2008 (i.e., the effective date of the 2008 amendment to section 1402(a)(1)). We will continue to litigate the IRS position in the Eighth Circuit in cases not having these specific facts. We will also continue to litigate the IRS position in all cases in other circuits.

[2374] *Martin v. Commissioner*, 149 T.C. No. 12 (9/27/2017). The Official Tax Court Syllabus (which syllabus is not precedential, but of course the text of the case is) summarized the case:

> Ps owned a farm, renting a portion of the land to wholly owned S corporation C. C contracted with unrelated entity S to raise chickens according to S' exacting specifications. Ps followed S' specific instructions to build structures designed only to raise S' chickens. C paid Ps wages for their labor and rent for the use of the farm and structures. R asserts that the rent is subject to self employment tax pursuant to sec. 1402(a)(1).
>
> *Held*: The facts of the instant case are not materially distinguishable from the facts of *McNamara v. Commissioner*, T.C. Memo. 1999-333, *rev'd*, 236 F.3d 410 (8th Cir. 2000). The U.S. Court of Appeals for the Eighth Circuit in *McNamara* also reversed *Hennen v. Commissioner*, T.C. Memo. 1999-306, and *Bot v. Commissioner*, T.C. Memo. 1999-256. In the light of the reversals by the Court of Appeals for the Eighth Circuit, the Court reconsiders its holdings.
>
> *Held*, further, Ps established that the rent received was at or below fair market value. R failed to show a sufficient nexus between the rental income and petitioners' obligations to participate in the production or management of the production of agricultural commodities. Therefore, the rent Ps received pursuant to the lease is not includible in their net self-employment income. To the extent *McNamara v. Commissioner*, T.C. Memo. 1999-333, *Hennen v. Commissioner*, T.C. Memo. 1999-306, and *Bot v. Commissioner*, T.C. Memo. 1999-256, are inconsistent with this holding, they are not followed.

[2375] See *McNamara* in fn. 2372.

[2376] *Martin*, fn. 2374.

> taxpayer's obligation to materially participate. Such a showing would render the lease and employment agreements part and parcel of a larger "arrangement". *Id*.

However, the Tax Court cautioned that rent payments tied to production may be recharacterized as SE income,[2377] so one should consider avoiding such an arrangement when renting to one's own S corporation.

Regulations clarify the distinction between a real estate investor and dealer:[2378]

> In general, an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is a real-estate dealer. On the other hand, an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer. Where a real-estate dealer holds real estate for investment or speculation in addition to real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, only the rentals from the real estate held for sale to customers in the ordinary course of his trade or business as a real-estate dealer, and the deductions attributable thereto, are included in determining net earnings from self-employment; the rentals from the real estate held for investment or speculation, and the deductions attributable thereto, are excluded.

See also part II.G.25 Real Estate Dealer vs. Investor.

Apartments that include the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc. fall within the rental real estate exception.[2379] However, payments for the use or occupancy of rooms or other space

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[2377] *Martin*, fn. 2374, noted:

> This Court has previously evaluated the nexus between the rental income and the taxpayer's production arrangement. See, *e.g.*, *Bot v. Commissioner*, 118 T.C. 138 (finding value-added payments reported as rental income includible in net self-employment income where the payments were directly related to the volume of corn acquired and delivered by taxpayers); *Solvie v. Commissioner*, T.C. Memo. 2004-55 (same when rent payments were tied directly to the number of pigs raised). But see *Johnson v. Commissioner*, T.C. Memo. 2004-56 (finding an insufficient nexus). But despite petitioners' presentation and the Court's previous application of the well-reasoned nexus requirement in *Solvie* and *Johnson*, respondent did not brief this issue.

[2378] Reg. § 1.1402(a)-4(a). *Pool v. Commissioner*, T.C. Memo. 2014-3 (see fn. 1042), set forth factors deciding whether the taxpayer is a real estate dealer and held that the taxpayer had the burden of proof of disproving the IRS findings in this area. When real estate is used in a business, see part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business; within that part, if property is bought for use in a trade or business but never placed in service, see text accompanying fns. 956-957.

[2379] Reg. § 1.1402(a)-4(c)(2). This regulation is similar to Reg. § 1.512(b)-1(c)(5); interpreting the latter regulation, Letter Ruling 201422027 ruled that, when local law required apartments to provide parking for tenants, extra charges for a carport constituted rental income (excluded from UBTI) because the carports were characteristic of the real property, pointing out that no services, such as a security guard, were provided and covered spots were charged only a minimal monthly amount in the set rental rate. However, the ruling held that the apartment complex providing coin-operated washers and dryers on-site for use of tenants without in-home laundry was an extra service not within the rental exclusion, because tenants could use commercial laundry and where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, or payments for the use or occupancy of space in parking lots, warehouses, or storage garages, do not qualify for this exception;[2380] neither does a university providing athletic facilities to third parties when not being used for university purposes.[2381] The real estate rental exception is narrowly construed.[2382]

How about leasing equipment or other tangible personal property not connected with real estate? Renting personal property on a short-term basis is self-employment income.[2383] Although I am unaware of any cases subjecting to self-employment tax the long-term rental of personal property, cases interpreting the tax on unrelated business income in the tax-exempt area clearly view long-term rental as a trade or business;[2384] and the rental exception for the unrelated business income tax is similar to that for SE tax,[2385] and the Tax Court has noted similarities between income subject to SE tax and

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cleaning establishments off-site; the ruling did not mention whether the apartment provided any services in connection with the washers and dryers.

2380 Reg. § 1.1402(a)-4(c)(2); Rev. Ruls. 57-108 (vacation rentals involved too many services to be excluded from SE income) and 83-139 (discussing when trailer park rentals do or do not qualify for the exclusion form SE income).

2381 See fn. 3343 in part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship, which applies by analogy to SE income, as described in fns. 2385-2387 in this part II.L.2.a.ii.

2382 *Johnson v. Commissioner*, 60 T.C. 829 (1973), denying the rental exclusion for boat sheds as part of a marina business in which the taxpayer provided many services included in the rental of the boat sheds.

2383 *Stevenson v. Commissioner*, T.C. Memo. 1989-357, pointing out, "His work in buying, assembling, storing, renting, selling, repairing and maintaining the portable signs required him to devote a substantial amount of time on a regular and continuous basis."

2384 Rev. Rul. 69-278 (owner of buildings also leased trucks to tenants, but the truck leases were not tied in any way to the real estate leases; truck leases did not qualify for rental exception even though the lessees were responsible for fueling, maintaining, and insuring the trucks); Rev. Rul. 60-206 (rent from long-term leases of railroad tank cars was a trade or business, even though the lessee was fully responsible for the cars' operation and maintenance of their cars, as well as replacement in case of destruction or loss); Rev. Rul. 78-144 (long-term lease of heavy machinery was a trade or business even though the lessee must provide insurance, pay any taxes, and make and pay for all repairs except those involving defects in the machine parts or workmanship; the taxpayer's only work was to find a lessee, arrange for the lease, and receive, record, and deposit the rents; did not qualify for the exception to unrelated business income tax for all work being done by volunteers because labor was not a material income-producing factor in the business); *Cooper Tire & Rubber Co. Employees' Retirement Fund v. Commissioner*, 36 T.C. 96, *aff'd* 306 F.2d 20 (6th Cir. 1962) (retirement plan's one-time purchase of twenty tire manufacturing machines and one press and long-term lease of them to the plan's employer was a business even though the plan's only activity was to lease the machinery, collect the rentals and make monthly payments on the bank note and the transaction appeared to have been done merely to avoid restriction against loans from the plan to the company). See also part II.Q.6.d Unrelated Business Income.

2385 Compare Code § 1402(a)(1) (there shall be excluded rentals from real estate and from personal property leased with the real estate… unless such rentals are received in the course of a trade or business as a real estate dealer) with Code § 512(b)(3) (there shall be excluded all rents from real property … and all rents from personal property ... leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents unrelated business income tax.[2386] The 2013 Instructions to Form 1040, Schedule E generally take that position as well.[2387]

II.L.2.a.iii. Whether Gain from Sale of Property is Subject to SE Tax

In testing whether a person is a dealer in real property, courts consider numerous factors when deciding the taxpayer's primary purpose for holding property, including:[2388]

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received or accrued under the lease, determined at the time the personal property is placed in service). Neither statute exempts rents from personal property that is not leased with real estate.

[2386] *Cokes v. Commissioner*, 91 T.C. 222, 234, in subjecting passive business income to SE tax, noted:

> We note that the concept that the character of trade or business income is retained in the partner's hands is not unique to the self-employment taxes area. The unrelated business income tax provisions (sec. 511 et seq.) generally provide that a tax-exempt organization's distributive share of a partnership's unrelated trade or business income is subject to the unrelated trade or business income tax. Sec. 512(c). The report of the House Ways and Means Committee on the bill enacting the unrelated business income tax, reads as follows (H. Rept. 2319, 81st Cong., 2d Sess. 111-112 (1950), 1950-2 C.B. 460):
>
> > In the event an organization to which Supplement U [the predecessor of sec. 511 et seq.] applies is a member of a partnership which is regularly engaged in a trade or business which is unrelated to the functions and purposes of the organization, the organization would include, in computing its unrelated business net income, so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto, and make the necessary adjustments for the exceptions and limitations which have been discussed above. For example, if an exempt educational institution is a silent partner in a partnership which runs a barrel factory and such institution also holds stock in a pottery manufacturing corporation, it would include in its unrelated business income its share of the barrel factory income, but not its proportionate share of any dividends received by the partnership from the pottery corporation. If the taxable year of the organization is different from that of the partnership, the amounts to be so included or deducted in computing the unrelated business net income are to be based upon the income and deductions of the partnership for any taxable year of the partnership ending within or with the taxable year of the organization.
>
> The example in the committee report explains that the unrelated business income tax provisions draw essentially the same line as that drawn in the self-employment tax provisions. Interestingly, both statutes were enacted by the 81st Congress.

[2387] From page E-4 of the Instructions:

> **Personal property**. Do not use Schedule E to report income and expenses from the rental of personal property, such as equipment or vehicles. Instead, use Schedule C or C-EZ if you are in the business of renting personal property. You are in the business of renting personal property if the primary purpose for renting the property is income or profit and you are involved in the rental activity with continuity and regularity.
>
> If your rental of personal property is not a business, see the instructions for Form 1040, lines 21 and 36, to find out how to report the income and expenses.

[2388] *SI Boo, LLC v. Commissioner*, T.C. Memo. 2015-19. In that case, the court easily concluded dealer status as follows (footnote omitted):

> In 2007 and 2008 S. I. Securities sold 29 and 14 parcels of real estate, respectively, by quitclaim deed. In 2008 Sabre sold 86 parcels of real estate by quitclaim deed, of which 53 were sold to third parties and 33 were assigned to SI Boo or S. I. Securities. In 2007 and 2008 SI Boo sold 52 and 20 parcels of real estate, respectively, by quitclaim deed. The entities' own accounting records, as well as the testimony presented at trial, showed

(1) the frequency and regularity of sales of real properties;

(2) the substantiality of the sales and the relative amounts of income taxpayers derived from their regular business and the sales of real properties;

(3) the length of time the taxpayers held the real properties;

(4) the nature and extent of the taxpayers' business and the relationship of the real properties to that business;

(5) the purpose for which the taxpayers acquired and held the real properties before sale;

(6) the extent of the taxpayers' efforts to sell the property by advertising or otherwise; and

(7) any improvements the taxpayers made to the real properties.

See also part II.G.25 Real Estate Dealer vs. Investor.

In deciding whether sales of personal property are of property "held primarily for sale to customers in the ordinary course of a trade or business" (and therefore SE income) or if they are of property held as an investment the Tax Court looks to:[2389]

- frequency and regularity of sales;
- substantiality of sales;
- length of time the property was held;
- segregation of property from business property;
- purpose of acquisition;

> that the entities desired to dispose of the real properties quickly and frequently and with the intent to make a profit and were successful. In fact, petitioners effectively concede on brief that most of the properties S. I. Securities, Sabre, and SI Boo sold by quitclaim deed during the years at issue were sold within one year of their acquisition. On this record, we give little weight to the fact that the entities acquired more certificates of purchase of tax lien than tax deeds. In sum, the entities' sales of real properties were frequent and regular during the years at issue.

The court held:

> On the basis of our findings that the entities earned income from the proceeds of sales of real properties, which was an integral part of their respective trades or businesses, we hold that the entities should have included the income in their reported net earnings from self-employment.

It also held that the sales were not eligible for installment sale reporting. See fn. 3101, found in part II.Q.3 Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future.

[2389] *Ryther v. Commissioner*, T.C. Memo. 2016-56, citing *Williford v. Commissioner*, T.C. Memo. 1992-450. *Ryther* held that a taxpayer who held scrap metal left over from his dissolved business was not subject to SE tax when he surprisingly discovered it had a market where he could easily sell it whenever he needed money.

- sales and advertising effort;
- time and effort spent on sales; and
- how the proceeds of the sales were used.

II.L.2.b. S Corporation Subjecting to FICA Payments for Managing Real Estate, When Net Rental Income Itself Is Exempt from SE Tax

Part II.L.2.a Types of Income Subject to Self-Employment Tax explains that real estate rental income generally is not subject to self-employment (SE) tax.[2390]

However, compensating a partner for services rendered subjects a partner to SE tax.[2391] So, the key to avoiding SE tax when working in real estate is to provide some sort of interest in profits rather than expressly compensating the person.

If an S corporation holds or manages the real estate, the IRS will assert that any distributions to its owners constitute compensation to the extent of the value of the services they provide the business and that FICA is owed.[2392] In a partnership, however, a very well-drafted allocation of profits does not constitute a guaranteed payment[2393] for services that would be classified as compensation income.

Note that converting real estate rental income to SE income or FICA wages might not be a bad result. SE income and FICA wages are not subject to the 3.8% tax on net investment income,[2394] whereas real estate rental income often is. For a discussion of the latter, see part II.I.8.c Application of 3.8% Tax to Rental Income. Furthermore, up to one-half of SE tax is deductible,[2395] whereas none of the 3.8% tax on NII is deductible.

II.L.3. Self-Employment Tax: General Partner or Sole Proprietor

Generally, all of a partnership's or sole proprietorship's operating income is subject to income tax and FICA (self-employment) tax.[2396] An entity that is disregarded for income tax purposes is also disregarded for self-employment tax purposes, notwithstanding that it is treated as a separate entity for payroll tax purposes.[2397] On the other hand, a partnership that elects out of applying subchapter K remains subject to self-employment tax.[2398]

[2390] See fns. 2371-2382, noting exceptions for dealers, certain short-term rentals, etc.
[2391] See fns. 2404-2405.
[2392] See fn. 77.
[2393] See fns. 435-433, which requires the allocation to be of net profits rather than being some percentage of gross rents or other formula measurement or fixed payment.
[2394] See fn. 1527.
[2395] See text accompanying fn. 1698.
[2396] See part II.L.2 Income Subject to Self-Employment Tax.
[2397] See part II.B Limited Liability Company (LLC), fns. 279-280.
[2398] *Cokes v. Commissioner*, 91 T.C. 222, 230-231 (1988), held:

> Article XVII of the unit operating agreement, set forth in our findings, *supra*, provides that each working interest owner elects under these regulations to be excluded from subchapter K. However, in our unanimous Court-reviewed opinion in *Bryant v.*

A partner who is inactive nevertheless receives income from a trade or business subject to self-employment tax.[2399] Even very small interests that contractually are unable to

Commissioner, 46 T.C. 848 (1966), *affd.* 399 F.2d 800 (5th Cir. 1968), we concluded as follows (46 T.C. at 864):

> When Congress has subtitlized, subchapterized, and sectionized its treatment of a many threaded statutory pattern like the complex Internal Revenue Code, its clear words seem to us a safe guide to meaning. The election under section 761(a) does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed.

Although *Bryant* involved application of the investment credit to partnerships which had elected out of subchapter K, this Court's above-quoted analysis (which was specifically adopted by the Court of Appeals (399 F.2d at 806-807)) is equally applicable to the self-employment taxes of chapter 2.[9]

[9] The discussion of this matter in *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521, 559 n. 9 (1979), *affd.* 633 F.2d 512 (7th Cir. 1980), sets aside for the future how the Bryant analysis is to be applied where the controlling statute outside of subch. K does not specifically refer to partnerships. In the instant case, sec. 1402(a) specifically refers to partnerships; thus the instant case falls within the *Bryant* analysis and we have no need to weigh the considerations discussed in the *Madison Gas* footnote.

Accordingly, article XVII of the unit operating agreement (1) does not serve to prevent us from agreeing with respondent that the unitization agreement and the unit operating agreement created a partnership for purposes of section 1402(a), and (2) does not serve to insulate petitioner from the self-employment taxes.

[2399] *Cokes v. Commissioner*, 91 T.C. 222, 233-234 (1988), held:

Petitioner stresses her lack of control of the working interest operations because of the close relationships among the other owners and the operator. The question before us is whether petitioner was a member of a partnership or of a joint venture treated as a partnership, and petitioner's lack of control does not affect that question.[11]

[11] The report of the Committee on Ways and Means on the Social Security Act Amendments of 1949 (H. R. 6000) explained the provision as follows (H. Rept. 1300, 81st Cong., 1st Sess. 136-137 (1949), 1950-2 C.B. 294):

> "The net earnings from self-employment of an individual include, in addition to the earnings from a trade or business carried on by him, his distributive share of the net income or loss from any trade or business carried on by each partnership of which he is a member. *** [A] partnership which constitutes an association taxable as a corporation *** is not recognized as a partnership for such purposes. Moreover, only the net income or loss derived by the partnership from carrying on a trade or business is taken into account. Any net income or loss of the partnership derived from sources clearly unrelated to the trade or business carried on by it is excluded in determining the net earnings from self-employment of the partners. The net earnings from self-employment of a partner include his distributive share of the net income or loss of a partnership of which he is a member, irrespective of the nature of his membership, as for example, as a limited or inactive member."

In 1977, the Congress amended sec. 1402(a) to add thereto par. (12), which excludes "the distributive share of any item of income or loss of a limited partner, as such" (sec. 313(b)(3) of the Social Security Amendments of 1977, Pub. L. 95-216, 91 Stat. 1509, 1536). (Sec. 124(c)(2) of the Social Security Amendments of 1983, Pub. L. 98-21, 97 Stat. 65, 90, redesignated par. (12) for taxable years beginning after Dec. 31, 1989.) Petitioner does not contend that the owners of the working interests constituted a limited partnership, nor that she is a limited partner . It appears that, in the participate generate SE income[2400] unless the taxpayer can qualify as a limited partner (or perhaps passive member of an LLC) under part II.L.4 Self-Employment Tax Exclusion for Limited Partner, which occurred in *Hardy v. Commissioner*, T.C. Memo. 2017-16, a case involving an LLC member who had management rights as an equal 1/8 owner but acted as a mere investor.[2401]

Guaranteed payments for services rendered generally are subject to SE tax.[2402] However, they are not subject to SE tax if and to the extent that the activity for which the services are rendered does not constitute a trade or business.[2403] On the other hand, an activity that is excluded from self-employment tax might constitute a trade or business for purposes of applying SE tax to guaranteed payments for services rendered.[2404]

> > words of the 1949 committee report, petitioner may fairly be described as an "inactive member", rather than a limited partner.
>
> Petitioner contends that "The situation is analogous to a minority interest in a close-held corporation."
>
> The problem is that petitioner (and Cokes) did not put their working interest in a corporation, and, for purposes of the self-employment taxes, the relevant statute makes receipt of distributive share of trade or business income from a partnership (defined expansively in section 7701(a)(2)) generally equivalent to the partner's engagement in a trade or business.

[2400] *Methvin v. Commissioner*, T.C. Memo. 2015-81, *aff'd* 653 Fed. Appx. 616 (10th Cir. 6/24/2016), imposed self-employment tax on the owner of working interests in several oil and gas ventures. The working interests were no more than 2%-3% in ventures that "were not part of a business organization (such as a partnership, a limited partnership, a limited liability company, or a corporation) that is registered under the laws of any State." Furthermore, "Petitioner had no right of involvement in the management or operation of the ventures." Nevertheless, the Tax Court held:

> In support of his contention petitioner emphasizes his lack of active involvement in the operation of the wells, his lack of knowledge and expertise in the oil industry, and the fact that his working interests were small, minority interests in each well. The record supports petitioner's contention that his personal involvement in the day-to-day operation of the wells was minimal. However, a taxpayer who is not personally active in the management or operation of a trade or business may be liable for self-employment tax if the trade or business is carried out on his behalf through his agents or employees or constitutes his distributive share of income from a partnership in which he was a member. Sec. 1402(a); *Cokes v. Commissioner*, 91 T.C. 222 (1988); *Perry v. Commissioner*, T.C. Memo. 1994-215; *Moorhead v. Commissioner*, T.C. Memo. 1993-314; secs. 1.1402(a)-2(b), 1.1402(c)-1, Income Tax Regs.

[2401] See text accompanying fns. 2421–2428.

[2402] Rev. Rul. 55-30. Furthermore, if the IRS asserts that guaranteed payments were for services and not for capital, the IRS will succeed unless the taxpayer proves that they were for capital. *Seismic Support Services, LLC v. Commissioner*, T.C. Memo. 2014-78 (accuracy-related penalties imposed) and 2015-151 (rejecting various additional arguments by the taxpayer).

[2403] Reg. § 1.1402(a)-1(b). Guaranteed payments are not W-2 wages. See fn. 438.

[2404] Reg. § 1.1402(c)-1.

II.L.4. Self-Employment Tax Exclusion for Limited Partners' Distributive Share

A limited partner's income is not subject to SE tax,[2405] except for guaranteed payments for services rendered to a partnership that engages in a trade or business.[2406] Being passive in an entity is insufficient; the entity must actually be a state law limited partnership;[2407] later this part II.L.4 discusses when this exception has been expanded for LLCs. One case, involving a general partnership that elect limited liability protection for its general partners, has led some commentators to suggest that the Tax Court might consider a limited partner's distributive share of income to be subject to SE tax if the limited partner performs services;[2408] I agree that the language is troublesome but disagree with this suggestion, because that case did not involve a limited partnership and the legislative history cited in the text accompanying fn. 2409 clearly contemplates that a partner can be a general partner and a limited partner and benefit from the limited partner exclusion.

If a person is both a general partner and a limited partner, income attributable to that person's interest as a general partner is subject to SE tax, as described in the legislative history of the statute that excludes a limited partner's self-employment income:[2409]

[2405] Code § 1402(a)(13). See *Hough v. Commissioner*, T.C. Memo. 1997-361 (loss from limited partnership could not offset self-employment earnings from law practice), *aff'd* 162 F.3d 1151 (3rd Cir. 1998).

[2406] Code § 1402(a)(13). See *Howell v. Commissioner*, T.C. Memo. 2012-303 (guaranteed payments from LLC were subjected to self-employment tax), initially discussed in the Shop Talk column by Banoff and Lipton, "Does *Renkemeyer*'s Legacy of Confusion Live On?" *Journal of Taxation* (February 2013).

[2407] *Perry v. Commissioner*, T.C. Memo. 1994-215, held:

> The evidence does not support petitioner's contention that he is a limited partner. State law requires that certain formalities be observed to create a limited partnership (partnership in commendam in Louisiana). Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (West Supp. 1994); La. Civ. Code Ann. arts. 2836-2848 (West Supp. 1994); *Johnson v. Commissioner*, *supra*. There is no evidence of such formalities having been observed by the owners of interests in the wells.

Norwood v. Commissioner, T.C. Memo. 2000-84, followed this:

> It is undisputed that petitioner's interest in Gallant was a general partnership interest. Accordingly, his distributive share of the partnership's trade or business income is, subject to the limitations of section 1402(b), subject to the taxes imposed by section 1401 on self-employment income. *Cokes v. Commissioner*, 91 T.C. 222, 229-230 (1988); *Anderson v. Commissioner*, T.C. Memo. 1992-130. That petitioner spent a minimal amount of time engaged in the operations of Gallant is irrelevant to this determination. *Cokes v. Commissioner*, *supra* at 233; *Anderson v. Commissioner*, *supra*. The passive activity rules under section 469 have no application in this case. Petitioner's lack of participation in or control over the operations of Gallant does not turn his general partnership interest into a limited partnership interest. A limited partnership must be created in the form prescribed by State law. *Perry v. Commissioner*, T.C. Memo. 1994-215; *Johnson v. Commissioner*, T.C. Memo. 1990-461.

[2408] See language highlighted in fn. 2418.

[2409] House Report No. 95-702, Part 1 (to accompany H.R. 7346, which became PL 95-216), October 12, 1977, p. 40, which further explained its reasons on pp. 40-41:

> Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. Under the bill the distributive share of income or loss

Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. Under the bill the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to guaranteed payments (as described in section 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership. Distributive shares received as a general partner would continue to be covered. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.

For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed.

Assigning one's income as an independent contractor to a limited partnership does not avoid SE tax if the payor does not recognize the assignment.[2410]

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received by a limited partner from the trade or business of a limited partnership would be excluded from social security coverage. However, the exclusion from coverage would not extend to guaranteed payments (as described in section 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership. Distributive shares received as a general partner would continue to be covered. Also, if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered under present law.

Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for social security benefits. In these situations the investor in the limited partnership performs no services for the partnership and the social security coverage which results is, in fact, based on income from an investment. This situation is of course inconsistent with the basic principle of the social security program that benefits are designed to partially replace lost earnings from work.

These advertisements and solicitations are directed mainly toward public employees whose employment is covered by public retirement systems and not by social security. Also, these advertisements frequently emphasize the point that those who invest an amount sufficient to realize an annual net income of $400 or more (the minimum amount needed to receive social security credit in a year) will eventually gain a high return on their social security contributions. Many of those who invest in limited partnerships will qualify for minimum benefits, which are heavily weighted for the purpose of giving added protection for people who have worked under social security for many years with low earnings. The cost of paying these heavily weighted benefits to limited partners must, of course, be borne by all persons covered by the social security program. The advertising injures the social security program in the public view and causes resentment on the part of the vast majority of workers whose employment is compulsorily covered under social security, as well as those people without work income who would like to be able to become insured under the social security program but cannot afford to invest in limited partnerships.

[2410] *Peterson v. Commissioner*, 827 F.3d 968 (11th Cir. 5/24/2016), affirming T.C. Memo. 2013-271. For as similar holding regarding an S corporation, see part II.G.23 Taxing Entity or Individual Performing Services, especially fn. 1267. Similarly, a person who controlled a

Although originally a limited partner lost liability protection by participating in the partnership's activities, that has not been the case for quite some time.[2411] In the

partnership and was paid directly for services lost his argument that the payments really were for a distributive share of a limited partnership and therefore were excluded under Code § 1402(a)(13), because he actually did not own an interest in the partnership. *Plotkin v. Commissioner*, T.C. Memo. 2011-260. When the taxpayer established an entity as a mere shell, *Robucci v. Commissioner*, T.C. Memo. 2011-19, disregarded the entity, and in fn. 11 declined to address the IRS' other argument:

> Although it is apparently respondent's position that profit distributions to service-providing members of a multimember, professional service LLC (which is what Robucci LLC was designed to be) are never excepted from net earnings from self-employment by sec. 1402(a)(13), which so excepts distributions to a limited partner other than sec. 707(c) guaranteed payments for services rendered, the Secretary has yet to issue definitive guidance with respect to that issue, and the law remains in a state of uncertainty. See, *e.g.*, Kalinka, 9A La. Civ. L. Treatise, Limited Liability Companies and Partnerships: A Guide to Business and Tax Planning, sec. 6.2, at 423 (3d ed. 2001); Chase, Self-Employment Tax and Choice of Entity, 34 Colo. Law. 109, 112 (Dec. 2005).

[2411] Footnotes to Bishop & Kleinberger, ¶ 11.03[1][c][ii] Distinguishing limited partnership cases, *Limited Liability Companies: Tax and Business Law* (WG&L) (viewed 9/3/2016), comment:

> The 1976 version of the RULPA provided that a limited partner risked personal liability if the partner takes part in the control of the business. See, *e.g.*, *Mursor Builders, Inc. v. Crown Mountain Apartment Assocs.*, 467 F. Supp. 1316, 1331–1332 (DC Virgin Islands 1978) (limited partners liable only for debts of the partnership incurred prior to filing certificate of limited partnership); *Antonic Rigging & Erecting of Mo., Inc. v. Foundry E. Ltd. Partnership*, 773 F.Supp. 420, 430 (SD Ga. 1991) (court held that limited partner was not liable to contractor for partnership debts on the ground that limited partner participated in management). The 1985 amendments significantly changed this provision, lengthening substantially a list of safe harbors. The newest version of the Uniform Limited Partnership Act eliminates the control rule entirely. ULPA (2001), § 303.
>
> ….
>
> As for ULPA (2001), the most modern uniform limited partnership act, in § 303, eliminates the control rule entirely: A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

A prior version of Willis & Postlewaite, *Partnership Taxation*, ¶2.02. Requirements of Section 704(e), stated:

> As originally written, the Uniform Limited Partnership Act provided that [a] limited partner shall not become liable as a general partner unless…he takes part in the control of the business. ULPA, § 7 (1916). The versions of the Revised Uniform Limited Partnership Act approved in 1976 and 1985 relaxed the control requirement by providing a safe harbor in the form of a lengthy list of activities deemed not to constitute participation in the control of the partnership and a limitation on a limited partner's liability for participation in activities not within the safe harbor to only those persons who transacted business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner. RULPA, § 303 (1985). Section 303 of the Uniform Limited Partnership Act approved in 2001 has eliminated the control requirement and provides that:
>
>> A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership.

passive loss area, being a general partner has a different effect – it converts an interest as a limited partner into an interest as a general partner when determining material participation.[2412]

A limited partnership[2413] may register as a limited liability limited partnership (LLLP) to limit its general partner's liability.[2414] However, rather than using an LLLP registration or perhaps to supplement the protection provided by LLLP registration,[2415] doing business through one or more LLC subsidiaries might simplify signature lines, with individuals signing as managers of each LLC rather than officers of the S corporation general partner [2416] signing on behalf of the partnership. For a comparison, see part II.E.8 Alternative Partnership Structure – LLLP Alone or LP with LLC Subsidiary.

It is uncertain how this exclusion for limited partners applies to limited liability entities, with more than one member, that are not state law limited partnerships.[2417] Reasoning that "partners who performed services for a partnership in their capacity as partners (*i.e.*, acting in the manner of self-employed persons)" were not intended to be "limited partners," *Renkemeyer, Campbell and Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), held that partners in a limited liability partnership (a general partnership that registers with the secretary of state to obtain limited liability for all partners) were subject to self-employment tax.[2418] The court pointed out that substantially:

> RULPA, § 303 (2001). According to the commentary accompanying the act, this provision is intended to provide a full, status-based liability shield for each limited partner even when the limited partner participates in the management and control of the limited partnership. The purpose is to bring limited partners into parity with the members of a limited liability company, partners in a limited liability partnership, and corporate shareholders. It is unclear how this change in state partnership law might affect the application of federal tax law in the context of family partnerships. Nevertheless, if the limited partners are to have no role in the management of the partnership, the partnership agreement should expressly provide that the limited partners have no management power.

2412 See part II.K.1.a.ii Material Participation, especially fn. 2057.

2413 See part II.C.11 Limited Partnership.

2414 See part II.C.12 Limited Liability Partnership Registration.

2415 In Missouri, failure to timely renew LLLP status creates a lapse in the general partner's protection, which lapse cannot be cured, in contrast to the many other states that allow retroactive reinstatement.

2416 See part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker.

2417 See RIA's *Fed. Tax Coord.2d* ¶A-6158. Letter Ruling 9432018 held that a member's interest generally is subject to self-employment tax. Note that the fact of limited liability is not sufficient to treat a member's interest as a limited partner interest for purposes of the Code § 469 passive loss rules. See fn 2042. Courts have ruled against the IRS when it argued that an LLC member was a limited partner for purposes of the passive loss rules (see fn. 2055); query whether they would treat an LLC member as a limited partner for SE tax purposes, especially when they have ruled that exceptions from SE tax are to be narrowly construed (see *Morehouse* and *Johnson* cases cited in fn 2371).

2418 The court cited the following legislative history:

> Under present law each partner's share of partnership income is includable in his net earnings from self-employment for social security purposes, irrespective of the nature of his membership in the partnership. The bill would exclude from social security coverage, the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. This is to exclude for coverage purposes certain

> all of the law firm's revenues were derived from legal services performed by [the partners] in their capacities as partners. [The partners] each contributed a nominal amount ($110) for their respective partnership units. Thus it is clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not 'earnings which are basically of an investment nature.' Instead, the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm.

> earnings which are basically of an investment nature . However, the exclusion from coverage would not extend to guaranteed payments (as described in 707(c) of the Internal Revenue Code), such as salary and professional fees, received for services actually performed by the limited partner for the partnership.

It then stated:

> The insight provided reveals that the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.

These comments were made in the context of a partner who argued that limited liability made him the equivalent of a limited partner; the court was not addressing the status of a limited partner in a limited partnership. For an in-depth discussion, see Banoff, *Renkemeyer* Compounds the Confusion in Characterizing Limited and General Partners—Part 2, *Journal of Taxation*, June 2012. Part 1 was in the December 2011 issue of the Journal. See also Banoff and Lipton, "Does *Renkemeyer*'s Legacy of Confusion Live On?" *Journal of Taxation* (February 2013). In their Shop Talk column, Who's a 'Limited Partner'? More Confusion Courtesy of *Renkemeyer* and *Howell*, *Journal of Taxation* (April 2013), Banoff and Lipton discussed comments, by Ronald M. Weiner, that in *Howell* (fn. 2406) the IRS merely attacked the taxpayer's characterization of guaranteed payments as not being self-employment income. They suggested that the IRS missed the boat in failing to attack as self-employment income the taxpayer's distributive share of partnership income. *Renkemeyer* involved an LLP, whereas *Howell* involved an LLC. The authors pointed out that, in *Renkemeyer*, the partners were general partners as a matter of state law, even though they had limited liability, so the *Renkemeyer* court's analysis was much more complicated than it needed to be.

Similarly, CCA 201436049 refused to apply the limited partner exception to an LLC, reasoning:[2419]

> Like the situation in *Renkemeyer*, Partners' earnings are not in the nature of a return on a capital investment, even though Partners paid more than a nominal amount for their Units. Rather, the earnings of each Partner from Management Company are a direct result of the services rendered on behalf of Management Company by its Partners. Similar to *Reither [*sic – *Riether]*, Management Company cannot change the character of its Partners' distributive shares by paying portions of each Partners' distributive share as amounts mislabeled as so-called "wages." Management Company is not a corporation and the "reasonable compensation" rules applicable to corporations do not apply.

However, CCA 201640014 treated an inactive member of an LLC as a limited partner, presumably consistent with the IRS' informal administrative practice of following subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2:

> Franchisee owns the majority of Partnership (D percent). During the years at issue, the remaining interests in Partnership were owned by Franchisee's wife (E percent) and her irrevocable trust (F percent). Partnership's operating agreement provides for only one class of unit of ownership. Neither Franchisee's wife nor her trust are involved with Partnership 's business operations and their status as limited partners for purposes of § 1402(a)(13) is not in dispute.

On the other hand, the CCA subjected to SE tax the entire distributive share of the majority owner of the LLC, who was active in the business, rejecting his argument that the portion of his distributive share that was not attributable to his work should be excluded from SE income:[2420]

[2419] *Riether* in the quote below is cited in fn. 438, found in part III.B.7.c.viii Creative Bonus Arrangements. In that case, a married couple jointly owned an LLC that operated a business. They paid themselves salary on Forms W-2 and said that the remaining income came from their employees' work, which made that income akin to being a limited partner because they did not participate in the work. The court pointed out that Rev. Rul. 69-184 required them to report compensatory payments as guaranteed payments subject to SE tax instead of on Forms W-2, said that their incorrect reporting on Forms W-2 did not somehow excuse the failure to report their distributive share of the LLC's income as SE income given that they had not proven themselves to be limited partners, and imposed an accuracy-related penalty (the latter because they had not shown that they had relied on their income tax return preparer's advice in reporting the income as not subject to SE tax..
CCA 201436049 might very well be the same case the IRS won that is discussed further below, *Castigliola v. Commissioner*, T.C Memo. 2017-62.

[2420] Preceding this conclusion, the CCA said (emphasis added):

> Partnership concedes that under the legislative history quoted above and the *Renkemeyer* opinion, service partners in a service partnership acting in the manner of self-employed persons are not limited partners. However, Partnership argues that a different analysis should apply to limited liability members which: (1) derive their income from the sale of products, (2) have made substantial capital investments, and (3) have delegated significant management responsibilities to executive-level employees. Partnership asserts that in these cases the IRS should apply substance over form principles to exclude from self-employment tax a reasonable return on capital invested.

As discussed above, the *Renkemeyer* Court reviewed the legislative history and concluded that § 1402(a)(13) was intended to apply to those who "merely invested" rather than those who "actively participated" and "performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons)." *Renkemeyer*, 136 TC at 150 Although the *Renkemeyer* Court noted the partners' small capital contributions and service-generated income as factors influencing its decision that the partners in that case were not limited partners, *Renkemeyer* does not stand for the proposition that a capital-intensive partnership should be treated like a corporation for employment tax purposes. Instead, as the Tax Court has repeatedly held, partners who are not limited partners are subject to self-employment tax, even in cases involving capital-intensive oil and gas joint ventures where all of the work was performed by other parties. See *Cokes*, *Methvin*, and *Perry*. Under the *Renkemeyer* Court's interpretation of the legislative history, and consistent with the Court's holding in *Riether*, Franchisee is not a limited partner in Partnership within the meaning of § 1402(a)(13) and is subject to self-employment tax on his full distributive shares of Partnership's income described in § 702(a)(8).

Hardy v. Commissioner, T.C. Memo. 2017-16, treated as a limited partner eligible for the exclusion from SE tax a doctor who owned a 12.5% interest in an LLC, owned together with seven other doctors, that operated a professionally managed[2421] surgery center:[2422]

Partnership interprets the legislative history quoted above to mean that § 1402(a)(13) applies to exclude a partner's reasonable return on capital-investment in a capital-intensive LLC partnership, regardless of the extent of the partner's involvement with the partnership's business. In effect, Partnership interprets the sentence from the legislative history This is to exclude for coverage purposes certain earnings which are basically of an investment nature as instead meaning This is to exclude for coverage purposes all earnings which constitute a reasonable return on capital invested in a capital-intensive business. Essentially, Partnership argues that the self-employment tax rules for capital intensive businesses carried on by LLC partnerships are identical to the employment tax rules for corporate shareholder employees: only reasonable compensation is subject to employment tax. Under this analysis, Partnership argues that (1) Partnership's guaranteed payments to Franchisee are reasonable compensation for Franchisee's services, and (2) Franchisee's distributive share represents a reasonable return on capital investments in Partnership's business, and therefore Franchisee is not subject to self-employment tax on his distributive share. Partnership argues that it would be inconsistent with the IRS's position in the Brinks case for the IRS to assert that Franchisee is subject to self-employment tax on his distributive share from Partnership.

Partnership's arguments inappropriately conflate the separate statutory self-employment tax rules for partners and the statutory employment tax rules for corporate shareholder employees. ***Section 1402(a)(13) provides an exclusion for limited partners, not for a reasonable return on capital***, and does not indicate that a partner's status as a limited partner depends on the presence of a guaranteed payment or the capital-intensive nature of the partnership's business.

Following the Court's analysis in *Riether*, Partnership cannot change the character of Franchisee's distributive shares by paying Franchisee guaranteed payments. Partnership is not a corporation and the wage and reasonable compensation rules which are applicable to corporations and were at issue in the Brinks case do not apply.

[2421] The court pointed out:

MBJ hires its own employees and does not share any employees with Northwest Plastic Surgery. Like hospitals, MBJ directly bills patients for facility fees. MBJ then distributes

> Dr. Hardy has never managed MBJ, and he has no day-to-day responsibilities there. Although he meets with the other members quarterly, he does not have any input into management decisions. He generally is not involved in hiring or firing decisions. His role and participation in MBJ have not changed since he became a member.

Contrasting Dr. Hardy's work with the lawyers practicing law in *Renkemeyer*[2423] and receiving distributive shares based on those fees from practicing law, the court pointed out:

> Dr. Hardy is receiving a distribution based on the fees that patients pay to use the facility. The patients separately pay Dr. Hardy his fees as a surgeon, and they separately pay the surgical center for use of the facility in the same manner as with a hospital. Accordingly, Dr. Hardy's distributive shares are not subject to self-employment tax because he received the income in his capacity as an investor.

This last comment, about viewing Dr. Hardy as an investor, ties into other aspects of the case. Dr. Hardy claimed that the income from the surgery center was passive, so that he could deduct passive losses against it.[2424] To avoid recharacterizing the income as nonpassive, he had to prove that he spent no more than 100 hours per year on it.[2425] The Tax Court seemed to view his quarterly meetings with other members as investor time, rather than time spent as a working owner.[2426]

When I read the case, I had expected to see this set up as a manager-managed LLC, with the non-owner CEO being the manager under the operating agreement. I was very surprised to see the most recent annual report (viewed 3/1/2017), which said that each owner is a member-manager. Other documents from the secretary of state indicate that three doctors (not Dr. Hardy) were the initial managers in 2004; the annual reports for the years involved in the case, 2008-2010 do not clarify whether Dr. Hardy was a member or a member-manager, but they also do not list as a manager a person other than the members. Taken as a whole, the court's opinion and related documentation suggest that, in this LLC, the members together had exclusive legal authority to run the business. No member had more rights to run the business than any other. Their legal rights were not akin to the legal rights of a limited partner. Collectively, their legal rights were equal and were those of general partners.

> to each of its members his or her share of the earnings based on the facility fees less expenses. MBJ uses a third-party accounting firm to prepare the Schedules K-1, Partner's Share of Income, Deductions, Credits, etc., for the members. MBJ does not pay physicians for their procedures.

2422 The IRS' post-trial brief pointed out that the members approved an employee termination at the CEO's request, but the transcript indicated that was an unusual situation and that the CEO usually took care of employment issues without consulting the members as an ownership group.

2423 See the extensive quotes from *Renkemeyer* in fn. 2418, found in this part II.L.4.

2424 The IRS tried to require Dr. Hardy to group his activity in his medical practice with his activity in the surgery center, but the Tax Court held that his decision not to group the two activities was reasonable. See part II.K.1.b Grouping Activities, especially fns. 2082 and 2129.

2425 See part II.K.1.h Recharacterization of Passive Income Generators (PIGs) as Nonpassive Income.

2426 See part II.K.1.a.v What Does Not Count as Participation.

Clearly, they delegated daily management to a non-owner and chose to oversee the business as mere investors, but that does not change the fact that the owners collectively had plenary legal rights to run the business on a daily basis. This looks to me like a general partnership in which the general partners agreed not to run the business themselves but rather agreed to hire staff to run the business. They are simply passive general partners. (Having limited liability does not cause one to be a limited partner, according to *Renkemeyer*, [2427] so the LLC's liability protection is of no consequence.) Neither the trial transcript nor the judge's opinion demonstrates any awareness of what Dr. Hardy's rights really were; they simply looked to his lack of activity. This approach appears to contradict *Methvin v. Commissioner*, T.C. Memo. 2015-81, involving an unincorporated venture in which the taxpayer had no management rights but nevertheless was subjected to self-employment tax.[2428]

Castigliola v. Commissioner, T.C Memo. 2017-62, held that three lawyers who were the only members in a law firm organized as a member-managed LLC were subject to SE tax on not only their guaranteed payments, which were comparable to salaries at other law firms, but also on their distributive share of the LLC's income. As was the case in *Hardy*, each member had an equal right to manage the LLC, and no member had a controlling interest. Unlike *Hardy* (where the members were passive investors), working for the LLC constituted the members' full-time jobs. Also unlike *Hardy*, the judge rigorously analyzed Code § 1402(a)(13) to determine what it means to be a limited partner.

Following *Renkemeyer*,[2429] *Castigliola* noted that "no statutory or regulatory authority defines 'limited partner' for the purposes of section 1402(a)(13)," and therefore "the term is to be given its ordinary meaning at the time of enactment."[2430] Because "*Renkemeyer* indicated that the meaning of 'limited partner' is not necessarily confined solely to the limited partnership context," the court first looked to "whether the person claiming the section 1402(a)(13) exemption held a position in an entity treated as a partnership for Federal tax purposes that is functionally equivalent to that of a limited partner in a limited partnership," asking whether a member of the LLC (a "professional limited liability company" or "PLLC") "is functionally equivalent to a limited partner in a limited partnership." The court pointed out:

> A limited partnership has two classes of partners, general and limited. *E.g.*, *Garnett v. Commissioner*, 132 T.C. at 375. General partners typically have management power and unlimited personal liability. 1 Bromberg & Ribstein, *Partnership*, sec. 1.01(B)(3) (2015-3 Supp.). On the other hand, limited partners typically lack management power but enjoy immunity from liability for debts of the partnership. *Id.*

[2427] See the extensive quotes from *Renkemeyer* in fn. 2418, found in this part II.L.4.
[2428] See fn. 2400, found in part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax.
[2429] See the extensive quotes from *Renkemeyer* in fn. 2418, found in this part II.L.4.
[2430] Citing *Gates v. Commissioner*, 135 T.C. 1, 6 (2010), and *Perrin v. United States*, 444 U.S. 37, 42 (1979).

The court noted limited partnership law when Code 1402(a)(13) was enacted in 1977 and how it has evolved since then.[2431] Applying that summary to the case at hand:

> Common to each of the definitions of "limited partner" discussed above are the primary characteristics of limited liability and lack of control of the business. In this case, the respective interests in the PLLC held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen made each a member of the PLLC, which was member-managed.[9] Therefore management power over the business of the PLLC was vested in each of them through the interest each held. *See id.* sec. 79-29-302 (effective after July 1, 1994). The PLLC had no written operating agreement, nor is there any evidence to show that any member's management power was limited in any way. Furthermore, all members participated in control of the PLLC: For example, they all participated in collectively making decisions regarding their distributive shares, borrowing money, hiring, firing, and rate of pay for employees. They each supervised associate attorneys and signed checks for the PLLC. On the basis of the foregoing facts, the respective interests held by Mr. Castigliola, Mr. Banahan, and Mr. Mullen could not have been limited partnership interests under any of the limited partnership acts. Therefore, they were not limited partners under section 1402(a)(13).

[2431] The court stated:

> More specifically, the exact meaning of "limited partner" may vary slightly from State to State. The Uniform Law Commission drafted the Uniform Limited Partnership Act in 1916 (ULPA (1916)), and the Revised Uniform Limited Partnership Act in 1976 (RULPA (1976)). Amendments were added to RULPA (1976) in 1985 (RULPA (1985)). Versions of these uniform acts have been adopted in most States, sometimes with modifications.
>
> Section 7 of ULPA (1916) states: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." ULPA (1916) allowed limited partners a narrow set of rights but did not specifically define which activities a limited partner could perform without losing limited partner status. See *id.* sec. 10 (allowing limited partners the rights to inspect books, demand an accounting of partnership affairs, and receive a share of the profits and return of capital, and also allowing limited partners the same right as general partners to request dissolution and winding up of the partnership).
>
> Section 303(a) of RULPA (1976) provides—in terms almost identical to those of ULPA (1916)—that a "limited partner" would lose limited liability protection if "in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." With regard to the meaning of "limited partner", the essential difference between ULPA (1916) and RULPA (1976) is that RULPA (1976) enumerates certain activities that a limited partner may perform without taking part in control of the business; for example, section 303(b)(5)(i) and (ii) of RULPA (1976) explicitly permits limited partners to vote on the dissolution of the partnership or the sale of substantially all of the partnership's assets.
>
> In 1987 Mississippi adopted RULPA (1985) with some modifications. See 1987 Miss. Laws, ch. 488, sec. 303 (effective from Jan. 1, 1988); Miss. Code Ann. sec. 79-14-303 (2009). In terms almost identical to those of ULPA (1916) and RULPA (1976), the version of the limited partnership act that Mississippi adopted in 1987—and which was effective throughout the years at issue—provided that a "limited partner" would lose limited liability protection if "in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business." Miss. Code Ann. sec. 79-14-303. Like RULPA (1976), Mississippi's version provides safe harbors for various activities a limited partner may perform without losing limited liability protection. *Id.*

> [9] There is no evidence to suggest that any member held a different type of interest in the PLLC or held more than one type of interest in the PLLC.

The court recognized that "a limited partnership must have at least one general partner"[2432] and, in reinforcing its conclusion that the members were not limited partners, reasoned:

> This is logical, because limited partners, as discussed above, cannot participate in control of the business and maintain their limited liability. Because there must be at least one partner who is in control of the business, there must be at least one general partner. The members testified that all members participated equally in all decisions and had substantially identical relationships with the PLLC. There was no PLLC operating agreement or other evidence to suggest otherwise. But since by necessity at least one of the members must have occupied a role analogous to that of a general partner in a limited partnership, and because all of the members had the same rights and responsibilities, they must all have had positions analogous to those of general partners in a limited partnership. This conclusion is affirmed by the history of the PLLC: Before the members organized the PLLC, they operated as a general partnership; and there is no evidence that organizing as a PLLC was accompanied by any change in the way they managed the business.

Thus, the court would not accept a headless entity,[2433] whereas *Hardy* implicitly accepted that idea because the members were mere investors who delegated daily running of the business to a skilled managerial employee. *Hardy* did not analyze either what it means to be a limited partner or what were the members' rights to run the LLC; it focused only on the fact that they did not run the LLC on a daily basis.

Moving on to other authority in this area: In light of the ascendancy of LLCs, subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2 would define a limited partner, if ever finalized:

> **(g) Distributive share of limited partner.** An individual's net earnings from self-employment do not include the individual's distributive share of income or loss as a limited partner described in paragraph (h) of this section. However, guaranteed payments described in section 707(c) made to the individual for services actually rendered to or on behalf of the partnership engaged in a trade or business are included in the individual's net earnings from self-employment.

[2432] Citing:

> *See*, *e.g.*, Miss. Code Ann. sec. 79-14-801 (2009) ("A limited partnership is dissolved and its affairs must be wound up upon the first of the following to occur: * * * (4) An event of withdrawal of a general partner unless at the time there is at least one other general partner[.]").

[2433] *Riether*, discussed in fn. 2419, implicitly made a similar assumption when it held that a married couple that jointly owned an LLC could not claim the limited partner exclusion without proving that status.

(h) Definition of limited partner.

(1) In general. Solely for purposes of section 1402(a)(13) and paragraph (g) of this section, an individual is considered to be a limited partner to the extent provided in paragraphs (h)(2), (h)(3), (h)(4), and (h)(5) of this section.

(2) Limited partner. An individual is treated as a limited partner under this paragraph (h)(2) unless the individual—

(i) Has personal liability (as defined in §301.7701-3(b)(2)(ii) of this chapter) for the debts of or claims against the partnership by reason of being a partner;[2434]

(ii) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership;[2435] or

(iii) Participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

(3) Exception for holders of more than one class of interest. An individual holding more than one class of *interest* in the partnership who is not treated as a limited partner under paragraph (h)(2) of this section is treated as a limited partner under this paragraph (h)(3) with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and,

(ii) The individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in paragraph (h)(3)(i) of this section.

(4) Exception for holders of only one class of interest. An individual who is not treated as a limited partner under paragraph (h)(2) of this section solely because that individual participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year is treated as a limited partner under this paragraph (h)(4) with respect to the individual's partnership interest if, immediately after the individual acquires that interest—

(i) Limited partners within the meaning of paragraph (h)(2) of this section own a substantial, continuing interest in that specific class of partnership interest; and

[2434] Does this mean personal liability as an inherent state law attribute of being an owner, or personal liability because lenders require all owners to guarantee loans?
[2435] Does this mean a manager-managed LLC and the limited partner is not a manager, or member-managed with voting and nonvoting interests?

(ii) The individual's rights and obligations with respect to the specific class of interest are identical to the rights and obligations of the specific class of partnership interest held by the limited partners described in paragraph (h)(4)(i) of this section.

(5) Exception for service partners in service partnerships. An individual who is a service partner in a service partnership may not be a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section.

(6) Additional definitions. Solely for purposes of this paragraph (h)—

(i) A *class of interest* is an interest that grants the holder specific rights and obligations. If a holder's rights and obligations from an interest are different from another holder's rights and obligations, each holder's interest belongs to a separate class of interest. An individual may hold more than one class of interest in the same partnership provided that each class grants the individual different rights or obligations. The existence of a guaranteed payment described in section 707(c) made to an individual for services rendered to or on behalf of a partnership, however, is not a factor in determining the rights and obligations of a class of interest.

(ii) A *service partner* is a partner who provides services to or on behalf of the service partnership's trade or business. A partner is not considered to be a service partner if that partner only provides a de minimis amount of services to or on behalf of the partnership.

(iii) A *service partnership* is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

(iv) A *substantial interest in a class of interest* is determined based on all of the relevant facts and circumstances. In all cases, however, ownership of 20 percent or more of a specific class of interest is considered substantial.

(i) Example. The following example illustrates the principles of paragraphs (g) and (h) of this section:

Example. (i) A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $1x for one LLC unit. B contributes $2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6x for 600 hours of services rendered to LLC and C receives a guaranteed payment of $10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.

(ii) *Application of general rule of paragraph (h)(2) of this section*. A is treated as a limited partner in LLC under paragraph (h)(2) of this section because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under section 1402(a)(13).

(iii) *Distributive share not included in net earnings from self-employment under paragraph (h)(4) of this section*. B's guaranteed payment of $6x is included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participates in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).

(iv) *Distributive share included in net earnings from self-employment*. C's guaranteed payment of $10x is included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited partner under paragraph (h)(2) of this section because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

Because these regulations are merely proposed, however, taxpayers may either argue that they provide a reasonable position or ignore them as not yet being effective. In using them, consider the following:

- The material participation component of these proposed regulations generally would prevent a limited partner in a trade or business from reaching the sweet spot of avoiding both SE tax and the 3.8% tax on net investment income, unless one participates for more than 100 hours and no more than 500 hours.[2436]

- Suppose one wants to argue that one's interest in an LLC has a general partner and a limited partner component:
  - (h)(3)(ii) requires that the individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by the limited partners described in (h)(3)(i).
  - Limited partners described in (h)(3)(i) must hold an aggregate 20% and be described in (h)(2).
  - To be described in (h)(2), a member cannot:
    - Have personal liability for the debts of or claims against the LLC by reason of being a member;
    - Have authority to contract on behalf of the LLC; or
    - Participate in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

Considering that owners of operating businesses frequently make loan guarantees, making sure that 20% of the owners are never on loan guarantees, never have authority to represent the LLC in any manner, and are active in the business only within the 101-500 hour sweet spot[2437] is a tall order. And *Renkemeyer* includes very strong language against granting an exclusion from self-employment tax for an active owner in an entity that is not a limited partnership, and some are concerned that *Renkemeyer* might be extended one day to prevent limited partners in a limited partnership from excluding from SE income their distributive share as limited partners.[2438] Those who are extremely concerned about the latter might advise each partner to form his or her own S corporation to hold all of his or her interest in the business, which might simply be a straight LLC, as described in parts II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker (idea that S corporations block SE income), II.L.5.c Examples of S Corporation Blockers (narrative description of alternatives), and II.L.5.e Flowchart: LLC with S Corporation as Blocker (diagram).

[2436] See part II.I 3.8% Tax on Excess Net Investment Income, especially part II.I.8 Application of 3.8% Tax to Business Income, summarized at part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[2437] See text accompanying fn. 2436 in this part II.L.4.
[2438] See highlighted language fn. 2418 in this part II.L.4. At least one tax expert whom I highly regard has expressed concern that *Renkemeyer* signals trouble for a limited partner in a state law limited partnership who is active. However, that expert concedes the language highlighted in fn. 2409 very strongly supports the exclusion for an active limited partner (but not the point that it eliminates his concern). Although I strongly disagree with that concern and feel quite confident in the structure described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart, I leave it up to the reader to consider this expert's views.

In many cases, using a traditional limited partnership to govern ownership, which partnership holds one or more LLC subsidiaries that are disregarded for tax purposes, would provide more long-term flexibility regarding the conduct of future business without falling out of the protection that the proposed regulations seem to provide. If a client finds a limited partnership cumbersome to operate on a daily basis, the limited partnership could do business through one or more wholly owned LLCs that are disregarded for income tax purposes.[2439]

Although administratively the IRS appears to be informally following this proposed regulation, CCA 201640014, particularly fn. 2420 and the accompanying text, makes clear that taxpayers need to use limited partnerships to maximize the possibility of refuting an IRS argument in this area. I prefer the structure described in parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

On the other hand, if the 3.8% net investment income (NII) tax is repealed and income from active businesses does not receive favorable tax treatment relative to passive businesses, investing in an LLC as a passive business owner, as in *Hardy*,[2440] may be a model that works. In that case, consider making sure that one's time spent qualifies as investor time, rather than time spent as a working owner.[2441] I would also recommend making the person who manages the LLC be the manager. However, I remain uneasy about *Hardy*, because *Methvin* involved facts that in most ways were more sympathetic to the taxpayer than *Hardy*, yet found the taxpayer subject to SE tax. Furthermore, if NII tax is not repealed and the owner is active enough to avoid NII tax, the owner might have moved away from being a mere investor and moved closer to *Renkemeyer* and *Castigliola*. So, I am not yet convinced that one should rely on *Hardy*, and I remain firmly in favor of using limited partnerships to save SE tax.

II.L.5. Self-Employment Tax: Partnership with S Corporation Blocker

II.L.5.a. S Corporation Blocker Generally

Because corporate income is not subject to self-employment (SE) tax, doing business through an S corporation avoids SE tax on the distributive share of income if and to the extent that distributions do not constitute disguised compensation payments.[2442] The

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[2439] See part II.B Limited Liability Company (LLC), especially the comments accompanying fns. 272-286, discussing when a single-member LLC is or is not disregarded.

[2440] In this part II.L.4, the text surrounding fn. 2421 discusses *Hardy*.

[2441] See part II.K.1.a.v What Does Not Count as Participation.

[2442] For corporate income not being subject to SE tax, see part II.L.1 FICA: Corporation, especially fn. 2338, citing Rev. Rul. 59-221, which was cited with approval by *Ding v. Commissioner*, T.C. Memo. 1997-435, *aff'd* 200 F.3d 587 (9th Cir. 1999). In rejecting a taxpayer's attempt to offset S corporation losses against SE income, the Tax Court in *Ding* held:

> We find the absence of any reference to S corporation pass-through items in section 1402 to be significant, and not merely a consequence of timing. The statute has been amended 34 times since the enactment of the S corporation provisions. None of the amendments address pass-through items from S corporations. We note that respondent's position on the issue here under consideration was published 38 years ago in Rev. Rul. 59-221, 1959-1 C.B. 225, which states, in part:

corporation needs to contract with those with whom business is conducted; the owner cannot merely transfer to the corporation income the owner receives and characterize it as income that the S corporation owned.[2443] Before deciding to do business as an S corporation, please see part II.E Recommended Structure for Entities.

If an owner wants the income tax benefits of the partnership structure but needs to avoid FICA on the business' earnings from the efforts of others or from earnings on capital, the owner might consider forming an S corporation to hold the owner's interest in the partnership, resulting in the structure depicted in part II.L.5.d Straight-Up Limited Partnership or II.L.5.e Flowchart: LLC with S Corporation as Blocker. The corporation would treat the owner as an employee with respect to reasonable compensation for services rendered.[2444] Because S corporation earnings are not subject to FICA,[2445] no

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> it is apparent that income not resulting from the conduct of a trade or business by an individual or by a partnership of which he is a member is not includible in computing the individual's net earnings from self-employment. Amounts which must be taken into account in computing a shareholder's income tax by reason of the provisions of *** [a predecessor of section 1366] of the Code, are not derived from a trade or business carried on by such shareholder. Neither the election by a corporation as to the manner in which it will be taxed for Federal income tax purpose nor the consent thereto by the persons who are shareholders results in the consenting shareholder's being engaged in carrying on the corporation's trade or business. Accordingly, amounts which a shareholder is required to include in his gross income by reason of the provisions of *** [a predecessor of section 1366] of the Code should not be included in computing his net earnings from self-employment *** .

> The revenue ruling concludes that S corporation pass-through items do not constitute net earnings from self-employment to the corporation's shareholder because such items are not derived from a trade or business carried on by the shareholder. We understand that we are not bound by the revenue ruling, *Stark v. Commissioner*, 86 T.C. 243, 250-251 (1986); however, the fact that the revenue ruling has remained in effect, unmodified, for 38 years provides a strong commentary on the validity of respondent's position. During the period the revenue ruling has been in effect, Congress has amended section 1402 approximately 30 times. If Congress had intended pass-through items from S corporations to be included in the definition of net earnings from self-employment, which would obviously be contrary to the conclusion of the revenue ruling, we expect that one of the many amendments made to the statute since its enactment would have so indicated. See generally *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939).
>
> Furthermore, respondent's position that the pass-through items were not derived from a trade or business carried on by petitioner is supported by two firmly established principles of Federal income taxation, namely: (1) A corporation formed for legitimate business purposes and its shareholders are separate entities, *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943); and (2) the business of a corporation is separate and distinct from the business of its shareholders, *id.*; *Deputy v. du Pont*, 308 U.S. 488, 494 (1940); *Crook v. Commissioner*, 80 T.C. 27, 33 (1983), *affd.* without published opinion 747 F.2d 1463 (5th Cir. 1984).

For distributions constituting compensation subject to FICA instead of merely a disbursement of a distributive share of income not subject to SE tax, see Rev. Rul. 74-44 and part II.A.2.c New Corporation - Avoiding Double Taxation and Self-Employment Tax, especially fns. 77-78 (the latter discussing sanctions against a CPA for preparing a return that resulted in penalties for failure to declare reasonable compensation).

[2443] See part II.G.23 Taxing Entity or Individual Performing Services.

[2444] Rev. Rul. 73-361 (shareholder officer compensation is subject to FICA, federal income tax withholding, and FUTA).

self-employment tax would be imposed on the distributive share of partnership self-employment income when it passes to the S corporation owner.[2446]

If these are new corporations, be sure that each corporation exercises any ownership rights it has, complying with corporate formalities in acting as a member of the LLC; having a service contract with the LLC and paying compensation to its officers or other employees would also help.[2447]

Furthermore, for business succession purposes, the owner can then transfer interests in the S corporation to family members without breaking up the single block of partnership voting rights.

On the other hand, when the owner of the S corporation blocker dies, the partnership's assets do not get an inside basis step-up.[2448] If the S corporation sells the partnership interest to an unrelated party and then liquidates in the year of sale, the deceased owner's beneficiaries might be able to replicate the inside basis step-up, although this strategy works better for federal income tax than state income tax purposes.[2449] For this

[2445] The trade or business must be carried on by the individual, either personally or through agents or employees, or by a partnership. Reg. § 1.1402(a)(2)(b), (d). The S corporation's existence as a separate taxpayer is respected for SE tax purposes, and a shareholder's K-1 income does not constitute self-employment income. See fn. 2338. However, if the S corporation is not a state law corporation, see part II.L.5.b Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election.

[2446] The effectiveness of such a blocker, when the K-1 earnings from the partnership were ultimately paid to each owner, was litigated in *Watson, P.C, v. U.S.,* 105 AFTR.2d 2010-2624 (denying the taxpayer's motion for summary judgment) and 107 AFTR.2d 2011-311 (S.D. Iowa) (finding in favor of the IRS), *aff'd* 109 AFTR.2d 2012-1059 (8th Cir.), cert. den. 10/1/2012. In 2002, the sole owner of the S corporation partner received $24K salary, $118K dividend payments, and $84K other payments. In 2003, the owner received $24K salary and $222K in dividend payments. Originally, the IRS contended that $131K of the dividend payments for 2002 and that $175K of the dividend payments for 2003 should be recharacterized as wages subject to employment taxes, assessing $49K in taxes, penalties, and interest against the corporation. Eventually, the IRS' trial position evolved to recharacterizing only $67K as compensation for each year, for a total of $91K compensation per year. Thus, the taxpayer received substantial savings from dividends that were not recharacterized by the IRS.

[2447] See *Robucci v. Commissioner*, T.C. Memo. 2011-19 (psychiatrist's C corporations disregarded for self-employment tax purposes; penalty imposed; excellent example of client not understanding what the tax professional was trying to accomplish). I noticed one commentator express concern about Code § 269, acquiring control of a corporation with the principal purpose being evasion or avoidance of Federal income tax. That same commentator suggested considering the economic substance rules, which would apply to an improper avoidance of Federal income tax, and saving self-employment tax would not be a proper motive under that rule; see part II.G.16 Economic Substance. Would statutes designed to prevent Federal income tax avoidance cause a strategy designed to save self-employment tax to fail? I am unaware of any cases applying these statutes to strategies designed to save self-employment tax.

[2448] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

[2449] See part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.

reason and due to certain estate planning considerations,[2450] it might be best to have the partnership interest be the S corporation's only asset.

II.L.5.b. Self-Employment Tax Caution Regarding Unincorporated Business That Makes S Election

When an unincorporated business makes an S election (using great caution to strip any partnership tax and accounting provisions from any operating agreement or partnership agreement forms),[2451] does the S election block self-employment tax?

Reg. § 1.1402(a)-2(g) appears to provide that electing to treat a partnership as an S corporation does not preclude self-employment tax:

> *Nature of partnership interest*. In the case of a partner who is a member of a partnership with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation, net earnings from self-employment include his distributive share of the income or loss, described in section 702(a)(9), from the trade or business carried on by the partnership computed without regard to the fact that the partnership has elected to be taxed as a domestic corporation.

Similarly, Reg. § 1.1402(a)-2(h) appears to provide that a sole proprietor may not avoid self-employment tax by electing to treat his or her business as an S corporation:

> *Proprietorship taxed as domestic corporation*. A proprietor of an unincorporated business enterprise with respect to which an election has been made pursuant to section 1361 and the regulations thereunder to be taxed as a domestic corporation shall compute his net earnings from self-employment without regard to the fact that such election has been made.

Thus, the above regulations appear to provide that a single member LLC that elects taxation as an S corporation will be subjected to self-employment tax as if the S election has not been made.

However, those regulations were promulgated before the current subchapter S was created, and subsections (g) and (h) of Reg. § 1.1402(a)-2 appear to be obsolete.[2452]

If one remains concerned about whether subsections (g) and (h) of Reg. § 1.1402(a)-2 are valid and wants the state law benefits of an unincorporated entity and the SE tax blocking benefit of an S corporation, one should consider using a limited partnership that has limited liability protection, which is commonly known as a limited liability limited partnership (LLLP).[2453] The general partner will have limited liability and be subject to

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[2450] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts, which includes a discussion of splitting assets when a trust terminates and the beneficiaries go their separate ways.
[2451] See part II.A.2.j Single Class of Stock Rules and especially fn. 297 in part II.B Limited Liability Company (LLC).
[2452] See Banoff's and Lipton's *Shop Talk* column, Does an S Election Block Self-Employment Tax When Made By an Unincorporated Business? *Journal of Taxation* (Sep. 2014).
[2453] See parts II.C.11 Limited Partnership and II.C.12 Limited Liability Partnership Registration.

SE tax, and generally the limited partners will avoid SE tax on their distributive share of income.

II.L.5.c. Examples of S Corporation Blockers

Consider the structures described below, which seek to thread the needle between avoiding the 3.8 tax on net investment income[2454] and avoiding self-employment tax. The "Real Estate Drop Down into Preferred Limited Partnership" scenario is more complex and would tend to be more appropriate in converting existing structures. The "Straight-Up Limited Partnership" scenario has an elegant simplicity if no real estate (or other rental property) is ever held and no LLCs are required; more details are discussed earlier in this document.[2455] The "Flowchart: LLC with S Corporation as Blocker" is an excellent defense in case the IRS ever succeeds in taxing limited partners in a state law limited partnership on their distributive share of income:

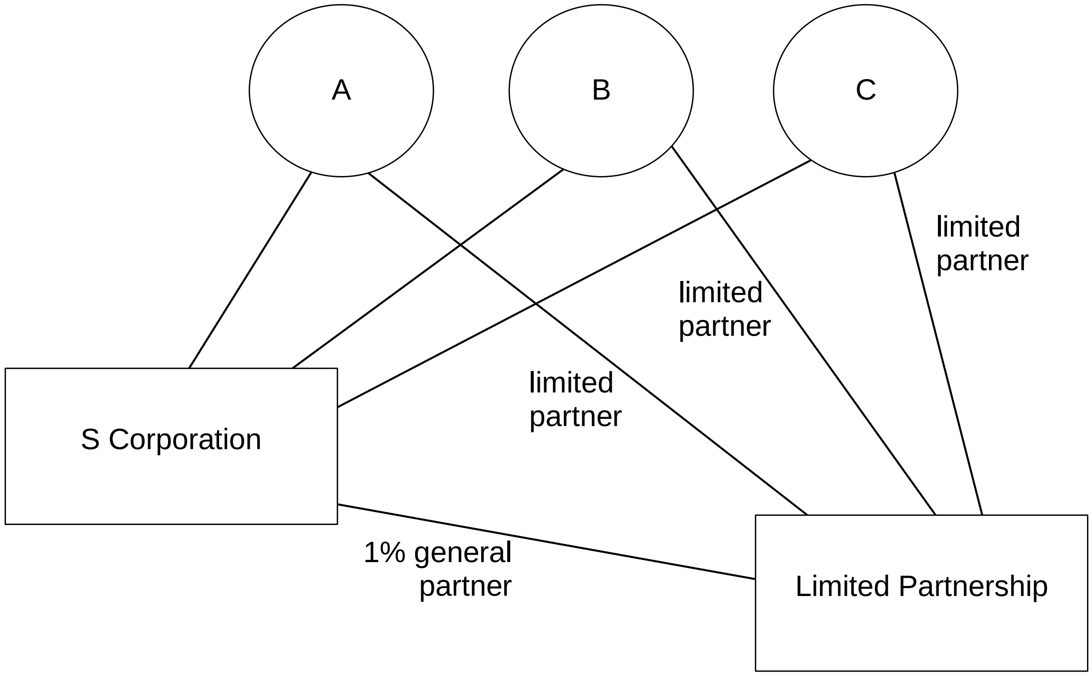
- The exit strategies in part II.Q Exiting from or Dividing a Business remain viable in that structure, although they can become more complicated.

- Basis step-up on the company's assets upon an owner's death becomes more complex and might or might not be attained.[2456] One would need to thoroughly explore the nuances of parts II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

Note that these structures would tend to defeat a possible goal of allowing the family members who do not participate in the business to receive income from long-term leases of property used in the business, which strategy is used to provide income to the outsiders without their needing a voice in how the business is run. One might need to give up on avoiding the 3.8% tax on net investment income regarding the use of valuable property if separating outsiders from insiders is too significant an issue. See part II.E.5.d Net Investment Income Tax and Passive Loss Rules Under Recommended Structure regarding the benefits of keeping real estate under the same umbrella as the operating business.

[2454] See part II.I 3.8% Tax on Excess Net Investment Income, especially part II.I.8 Application of 3.8% Tax to Business Income.
[2455] See part II.E Recommended Structure for Entities.
[2456] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

II.L.5.d. Straight-Up Limited Partnership

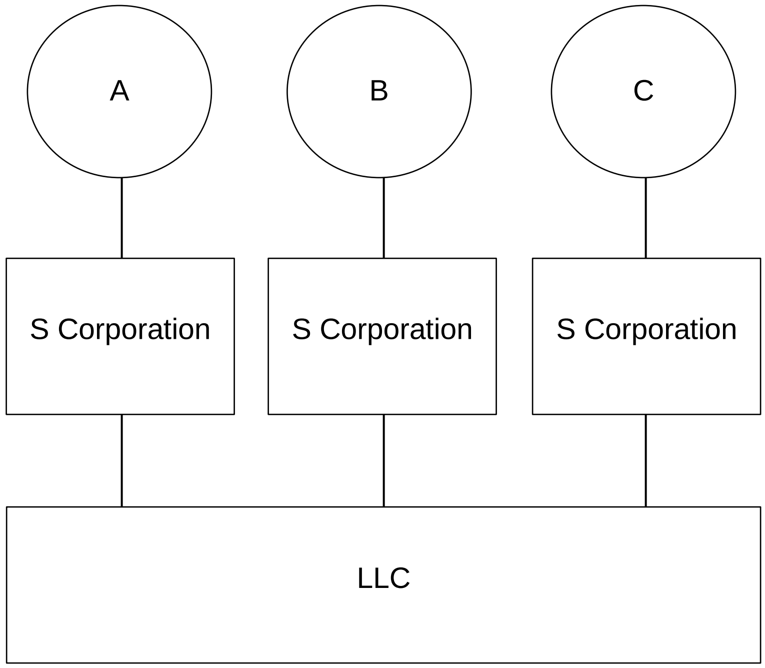


Notes:

- Assume A, B, and C are active in business (500+ hours) and receive reasonable compensation from the general partner for services rendered to the corporation as general partner of the limited partnership.
- This would not avoid self-employment tax on the limited partners if the long-ago proposed regulations defining limited partner for purposes of the self-employment tax were finalized.

Ideally, the limited partnership would hold the operating business(es) in a separate LLC (or LLCs) and any real estate in a separate LLC or LLCs. This is described more fully in part II.E Recommended Structure for Entities.

II.L.5.e. Flowchart: LLC with S Corporation as Blocker



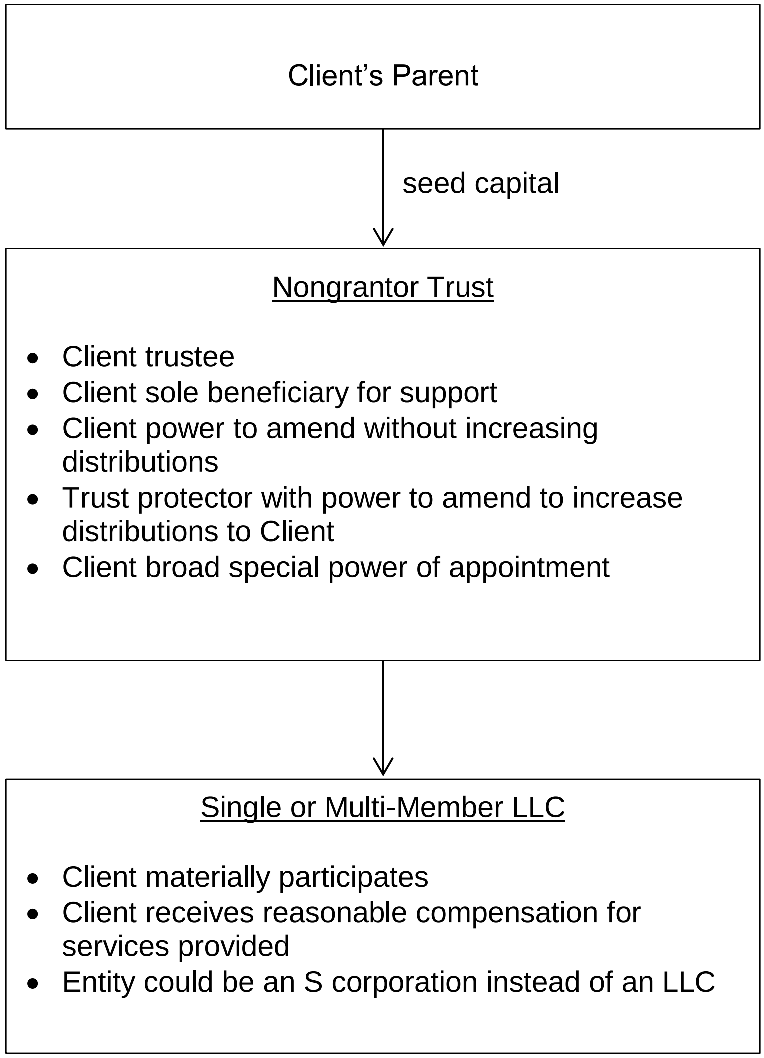
Notes:

- Assume A, B, and C are active in business (500+ hours) and receive reasonable compensation from their respective S corporations for services rendered to the corporation as a member and manager of the LLC.
- Significant disadvantages apply to the holding real estate in this structure.

II.L.6. SE Tax N/A to Nongrantor Trust

Self-employment tax does not apply to income earned by an estate or trust, at the trust level or at the beneficiary level.[2457] Just as the IRS will review whether distributions from an S corporation are disguised compensation,[2458] it might also consider whether individuals who are trustees and beneficiaries received reasonable and sufficient compensation for services performed for the business.[2459] If the trust is the sole member of the LLC, the trust's purpose must be to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.[2460]

[2457] Reg. § 1.1402(a)-2(b); *Huval v. Commissioner*, T.C. Memo. 1985-568.
[2458] See fn. 77 and accompanying text.
[2459] TAMs 200305001, 200305002.
[2460] See part II.D.1. Trust as a Business Entity.



II.L.7. SE Tax N/A to Qualified Retiring or Deceased Partner

Self-employment tax does not apply to amounts received by a partner pursuant to a written plan of the partnership, which satisfies IRS requirements and provides for payments on account of retirement, on a periodic basis,[2461] to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death,[2462] if:[2463]

[2461] Payments made by a partnership retirement plan to a retired partner from current partnership earnings excepted from the term net earnings from self-employment for purposes of Code § 1402(a) even if receipt of part of the payments is deferred until shortly after the beginning of the following year. Rev. Rul. 79-34.

[2462] Terminating payments before the partner's death disqualifies the payments from this exclusion. Letter Ruling 8052117.

[2463] Code § 1402(a)(10); Reg. § 1.1402(a)-17.

(A) such partner rendered no services with respect to any trade or business carried on by such partnership during the taxable year of such partnership, ending within or with such partner's taxable year, in which such amounts were received,[2464] and

(B) no obligation exists (as of the close of the partnership's taxable year described above) from the other partners to such partner except with respect to retirement payments under such plan, and

(C) such partner's share, if any, of the capital of the partnership has been paid to such partner in full before the close of the partnership's taxable year referred to above.

Note that such payments would likely be characterized as Code § 736(a) payments.[2465] And, although Code § 736 payments are generally excluded from the draconian Code § 409A nonqualified deferred compensation rules,[2466] payments under this provision are not excluded from Code § 409A.[2467]

[2464] A lawyer who retired from practicing law but continued to perform arbitration services through the same law firm did not fall within this exclusion from self-employment tax. *Brandschain v. Commissioner*, 80 T.C. 746 (1983).

[2465] Letter Ruling 7905032. For a general discussion of Code § 736, see part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[2466] For a general discussion of Code § 409A, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules. For general application (or lack thereof) of Code § 409A to partnerships, see text accompanying footnote 2656.

[2467] Notice 2005-1, A-7 provides:

> The application of § 409A is not limited to arrangements between an employer and employee. Accordingly, § 409A may apply to arrangements between a partner and a partnership which provides for the deferral of compensation under a nonqualified deferred compensation plan…. [U]ntil further guidance is issued, taxpayers may treat arrangements providing for payments subject to § 736 as not being subject to § 409A, except that an arrangement providing for payments which qualify as payments to a partner under § 1402(a)(10) are subject to § 409A. Finally, § 409A may apply to payments covered by § 707(a)(1) (partner not acting in capacity as partner), if such payments otherwise would constitute a deferral of compensation under a nonqualified deferred compensation plan.

This rule continues to apply under the final regulations issued under Code § 409A. Section 4 of Notice 2007-86.

In (G.) Arrangements Between Partnerships and Partners, T.D. 9321, which promulgated final regulations under Code § 409A, provides:

> Commentators raised issues concerning the application of the provision in Notice 2005-1, Q&A-7 stating that until further guidance is issued, taxpayers may treat arrangements providing for payments subject to section 736 (payments to a retiring partner or a deceased partner's successor in interest) as not being subject to section 409A, except that an arrangement providing for payments that qualify as payments to a partner under section 1402(a)(10) is subject to section 409A. Section 1402(a)(10) provides for an exception from the Self-Employment Contributions Act (SECA) tax for payments to a retired partner, provided that certain conditions are met…
>
> Commentators questioned the appropriateness of the inclusion of such arrangements under section 409A, because neither the statute nor the legislative history refers to section 1402(a)(10). However, the Treasury Department and the IRS believe it is

If the partner has moved from the state in which the partner has provided the services, the retirement payments might escape income taxation by that state. See part II.Q.8.b.ii.(g) Code § 736 Payments As Retirement Income – Possible FICA and State Income Tax Benefits (referring back to this part II.L.7 and then discussing the state income tax exclusion under federal law).

When a partner dies during the partnership's taxable year, the portion of the partner's distributive share earned during life is subject to self-employment tax (presumably to the extent not shielded by the rule for a retired partner).[2468]

II.L.8. Retirement Payments to Insurance Salesmen

Code § 1402(k) excludes from SE income any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesman for such company if-

(1) such amount is received after termination of such individual's agreement to perform such services for such company,

(2) such individual performs no services for such company after such termination and before the close of such taxable year,

(3) such individual enters into a covenant not to compete against such company which applies to at least the 1-year period beginning on the date of such termination, and

(4) the amount of such payment-

---

appropriate for such arrangements to be subject to section 409A because such arrangements are purposefully created to provide deferred compensation, and do not raise issues regarding the coordination of the provisions of section 409A with the provisions of section 736, specifically the rules governing the classification of payments to a retired partner under section 736(a) (payments considered as distributive share or guaranteed payments) and section 736(b) (payments for interest in partnership).
However, further clarification and relief is provided concerning the application of the deferral election timing rules to these payments. Until further guidance is issued, for purposes of section 409A, taxpayers may treat the legally binding right to the payments excludible from SECA tax under section 1402(a)(10) as arising on the last day of the partner's taxable year before the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10), and the services for which the payments are compensation as performed in the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). Accordingly, for purposes of section 409A, the time and form of payment of such amounts generally may be established, including through an election to defer by the partner, on or before the final day of the partner's taxable year immediately preceding the partner's first taxable year in which such payments are excludible from SECA tax under section 1402(a)(10). However, this interim relief does not apply a second time where an amount paid under an arrangement in one year has been excluded from SECA tax under section 1402(a)(10), and an amount paid in a subsequent year has not been excluded from SECA tax under section 1402(a)(10) because, for example, the partner performed services in that subsequent year.

[2468] Code § 1402(f); Reg. § 1.1402(f)-1; Rev. Rul. 58-607.

(A) depends primarily on policies sold by or credited to the account of such individual during the last year of such agreement or the extent to which such policies remain in force for some period after such termination, or both, and

(B) does not depend to any extent on length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service).

The taxpayer must prove that all of these elements applies.[2469]

II.M. Buying into a Business

Buying into a business includes starting a business from scratch and buying into an existing business. Each of those two issues is discussed as applied to corporations, as applied to partnerships, and as compared between the two.

II.M.1. Taxation on Formation of Entity: Comparison between Partnership and Corporation

Avoiding non-recognition of gain is much easier for a partnership than for a corporation. Assumption of liabilities generally does not cause problems with partnerships, because the partner who contributes the liability generally receives a special allocation of that liability under the partnership rules if the liability exceeds the contributing partner's basis.[2470] Neither the 80% control test nor any business purpose rule applies.

II.M.2. Buying into or Forming a Corporation

II.M.2.a. Initial Incorporation – Generally

No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.[2471] To qualify for non-recognition of gain, the transferor(s) must control at least 80% of the shares' votes and at least 80% of each class of nonvoting stock.[2472]

However, Code § 351 does not protect stock issued for services, indebtedness of the transferee corporation which is not evidenced by a security, or interest on indebtedness of the transferee corporation which accrued on or after the beginning of the transferor's holding period for the debt.[2473]

[2469] *Geneser v. Commissioner*, T.C. Memo. 2017-110, held that the exclusion did not apply, noting: "Petitioner's commission payments credited toward his account in 2010 were dependent on his length of service at AIL."

[2470] However, a shifting of liabilities might constitute a disguised sale.

[2471] Code § 351(a). If the transferor already owns stock, the transferor does not need to be issued stock. Rev. Rul. 64-155; *Lessinger v. Commissioner*, 872 F.2d 519 (2nd Cir. 1989).

[2472] Code § 368(c), incorporated by reference by Code § 351(a).

[2473] Code § 351(d).

No counterpart to the above rules restrict tax-free formation of partnerships. See part II.M.3 Buying into or Forming a Partnership.

Various other restrictions on favorable tax treatment may apply, depending on the situation. Among them are:

- If the shareholder in a Code § 351 transaction receives not only stock but also other property or money, then gain (if any) to such recipient shall be recognized, but not in excess of the amount of money received, plus the fair market value of such other property received; and no loss to such recipient shall be recognized.[2474]

- The IRS asserts, sometime successfully and sometimes not, that a business purpose is required, but Code § 351 and the regulations do not expressly require a business purpose.[2475]

- If shareholders contribute financial assets that are not diversified so that they can have an interest in a diversified portfolio held by the corporation, they may recognize gain.[2476]

- One who wishes to transfer assets to an unrelated corporation cannot simply form a new corporation under Code § 351 and immediately merge the new corporation into the buying corporation.[2477]

[2474] Code § 351(b).

[2475] ¶ F-1002 Business purpose requirement for tax-free transfer to controlled corporation, *Fed. Tax Coord.2d*; Bittker & Eustice, ¶ 3.17[6] Business Purpose, Step Transactions, and Other Principles, *Federal Income Taxation of Corporations & Shareholders* (WG&L).

[2476] Code § 351(e)(1); see part II.M.3.b Exception: Diversification of Investment Risk, applying this rule to partnerships, which are much more likely to be formed by pooling financial assets than are corporations.

[2477] Rev. Rul. 70-140 involved the following facts:

> All the outstanding stock of X corporation was owned by A, an individual. A also operated a similar business in the form of a sole proprietorship on the accrual basis of reporting income. Pursuant to an agreement between A and Y, an unrelated corporation, A transferred all the assets of the sole proprietorship to X in exchange for additional shares of X stock. A then transferred all his X stock to Y solely in exchange for voting common stock of Y, which was widely held.

The ruling held:

> The two steps of the transaction described above were part of a prearranged integrated plan and may not be considered independently of each other for Federal income tax purposes. The receipt by A of the additional stock of X in exchange for the sole proprietorship assets is transitory and without substance for tax purposes since it is apparent that the assets of the sole proprietorship were transferred to X for the purpose of enabling Y to acquire such assets without the recognition of gain to A.
>
> Section 351 of the Code is not applicable to the transfer of the sole proprietorship assets to Y inasmuch as A was not in control of Y immediately after the transfer. The sole proprietorship cannot be a party to a reorganization within the meaning of section 368(b) of the Code. Thus, the transfer of the sole proprietorship assets to X is treated as a sale by A of the assets to Y followed by a transfer of these assets by Y to the capital of X.
>
> Accordingly, that portion of the stock of Y received by A equal to the fair market value of the sole proprietorship assets is treated as an amount received from the sale of those

Also, see part II.M.3.h Reporting Real Estate Contributed to a Partnership or Corporation in a Nontaxable Transaction.

II.M.2.b. Initial Incorporation: Effect of Assumption of Liabilities

When property is contributed subject to liabilities, the contributing shareholder recognizes gain to the extent that liabilities by the corporation exceed the adjusted basis of assets contributed to the corporation.[2478] The contributing shareholder guaranteeing the loan does not prevent an assumption of liabilities;[2479] instead, the loan should be refinanced so that the shareholder is personally liable on the loan.[2480] However, at least in the Ninth Circuit, a shareholder can get basis for contributing a bona fide note indebting the shareholder to a C corporation, thereby offsetting the effect of the corporation assuming the corporation's liabilities.[2481]

Liabilities that would give rise to a deduction when paid are ignored.[2482] Thus, if a partnership interest is contributed to a corporation, accrued expenses allocated to the corporation would be ignored as liabilities, but only if the partnership uses the cash receipts and disbursements for income tax accounting. However, gain is fully recognized if the transaction's principal purpose is to avoid federal income tax.

> assets. Gain or loss is recognized to A as provided in sections 1001 and 1002 of the Code. The exchange by A of all the outstanding stock of X, solely for voting common stock of Y, other than the Y stock received in payment for the sole proprietorship assets, is a reorganization within the meaning of section 368(a)(1)(B) of the Code.

Oddly, the Revenue Ruling did not think to cite *West Coast Marketing Corporation v. Commissioner*, 46 T.C. 32 (1966), the Official Tax Court Syllabus to which says"

> T corp. owned an undivided one-fourth interest in a tract of land and C, its sole stockholder, owned an undivided one-fourth interest in two adjacent tracts. At a time when a taxable exchange of all those lands for stock in a publicly held corporation (U) was imminent, M corp. was organized by C, and both C and T transferred their interests in the land to M in exchange for stock of M. The stock of M was subsequently transferred to U in exchange for stock of U, and shortly thereafter M was dissolved. Held, M was not organized or used for any bona fide business purpose, and the exchange with U did not constitute a tax-free reorganization. The substance of the transaction was a taxable exchange of interest in land for stock of U. *Gregory v. Helvering*, 293 U.S. 465 [1935].

[2478] Code § 357(c)(1). Code § 357(c)(1) does not apply to transactions that qualify as certain types of reorganizations under Code § 368 to which Code § 351 also applies. Rev. Rul. 2007-8. See also Determining the Character of Section 357(c) Gain, *Tax Lawyer*, Vol. 62, No. 1 (Fall 2008).

[2479] *Seggerman Farms, Inc. v. Commissioner*, 308 F.3d 803 (7th Cir. 2002), *aff'g* T.C. Memo. 2001-99.

[2480] For similar issues determining whether shareholders were the true borrowers, see part II.G.3.c.i.(a) Limitations on Using Debt to Deduct S Corporation Losses.

[2481] *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998), *rev'g* T.C. Memo. 1996-191. The Ninth Circuit's footnote 16 noted, Our holding therefore does not extend to the partnership or S Corp context.

[2482] Code § 357(c)(3). Such liabilities do not cause a reduction in the contributing shareholder's basis. *Black & Decker v. United States*, 436 F.3d 431 (4th Cir. 2006); *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006).

II.M.2.c. Contribution of Partnership Interest to Corporation

Partnerships often incur liabilities, whether from money that the partnership borrows or liabilities the partnership incurs, such as accounts payable and accrued expenses. Contributing a partnership interest to a corporation often results in the corporation being allocated these liabilities[2483] and triggering gain to the extent that liabilities exceed basis.[2484]

Also, if the person contributing the partnership interest has losses suspended due to lack of basis[2485] or due to the passive loss[2486] or at-risk[2487] rules, consider whether the contribution might cause the suspended losses to be extinguished.[2488]

II.M.2.d. Contributing Installment Obligations

To the extent that a shareholder receives valuable stock for an installment obligation, gain is triggered.[2489]

II.M.3. Buying into or Forming a Partnership

See also part II.P.3.g Conversions from Partnership to Sole Proprietorships and Vice Versa.

The rules in this part II.M.3 make tax-free formation much more available than the tax-free formation of a corporation under part II.M.2 Buying into or Forming a Corporation. However, that flexibility comes at the cost of complexity regarding allocation of built-in gain or loss (and depreciation or amortization) with respect to assets contributed to the partnership or built-in gain or loss on partnership assets when new partners join the partnership; see part II.P.1.a.i Allocations of Income in Partnerships.

II.M.3.a. General Rule: No Gain on Contribution to Partnership

Subject to exceptions,[2490] when a partner contributes property (other than items constituting income in respect of a decedent)[2491] to a partnership, the partner does not recognize any gain or loss inherent in the property at the time of contribution;[2492]

2483 Code § 752.
2484 See part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.
2485 Code § 704(d).
2486 Code § 469. See part II.K Passive Loss Rules.
2487 Code § 465.
2488 See McKee, Nelson & Whitmire: *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 11.05[2][c] Availability of Suspended Losses to Transferees, and T.M. 710: Partnerships — Conceptual Overview, III.D. Disposition of Partnership Interest or Partnership Business; Termination of Partnership.
2489 See part II.G.14 Limitations on the Use of Installment Sales, especially fn. 1053.
2490 Various exceptions are included in the subsequent subparts of this part II.M.3 Buying into or Forming a Partnership. See also Willis & Postlewaite, ¶ 4.02[2] Exceptions to General Rule of Non-Recognition of Gain or Loss, *Partnership Taxation*.
2491 See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up, especially fns. 1386-1387.
2492 Code § 721(a). For the general lack of income recognition when a noncompensatory option to acquire a partnership interest is exercised, see Reg. § 1.721-2, adopted by T.D. 9612

however, see part II.M.3.h Reporting Real Estate Contributed to a Partnership or Corporation in a Nontaxable Transaction. Even if an initial transfer qualifies as a Code § 721 contribution, later contributions might be characterized as something else, such as a sale when the partner does not intend to retain an economic interest in the contributed property over the long run.[2493] Although gain is not recognized, any accrued interest on a note contributed to the partnership would be recognized.[2494]

(effective 2/5/2013). See also Abrams and Crnkovich, The Non-Tax Implications of The Taxation of Partnership Options, *TM Real Estate Journal* (BNA) (1/7/2015).

[2493] *Russian Recovery Fund, Ltd. v. U.S.*, 116 A.F.T.R.2d 2015-5582 (Ct. Fed. Cl. 2015). The court focused on strong evidence of actual intent rather than looking to the rules described in part II.M.3.e Exception: Disguised Sale. Instead, it relied on the economic substance test:

> The Court of Appeals for the Federal Circuit in *Coltec Industries, Inc. v. United States*, explained the rationale behind the economic substance test:
>
> > The economic substance doctrine represents a judicial effort to enforce the statutory purpose of the tax code. From its inception, the economic substance doctrine has been used to prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit. In this regard, the economic substance doctrine is not unlike other canons of construction that are employed in circumstances where the literal terms of a statute can undermine the ultimate purpose of the statute.
> >
> > ....
> >
> > The Supreme Court, various courts of appeals, and our predecessor court, have identified a number of different factors pertinent to the determination of whether a transaction lacks economic substance and thus should be disregarded for tax purposes. We understand the economic substance doctrine to incorporate the following principles.
> >
> > First, although the taxpayer has an unquestioned right to decrease or avoid his taxes by means which the law permits, the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality. This principle emerged early on in *Gregory*, where the Supreme Court disregarded intermediate transfers of stocks as falling outside the tax code because the transfers had no business or corporate purpose and performed no function other than to reduce taxes. 293 U.S. at 469....
> >
> > While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance.
> >
> > Second, when the taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance. In describing the history of the economic substance doctrine, our predecessor court in *Rothschild* stated, *Gregory v. Helvering* requires that a taxpayer carry an unusually heavy burden when he attempts to demonstrate that Congress intended to give favorable tax treatment to the kind of transaction that would never occur absent the motive of tax avoidance. 407 F.2d at 411 (quoting *Diggs v. Comm'r of Internal Revenue*, 281 F.2d 326, 330 (2d Cir. 1960))....
> >
> > Third, the economic substance of a transaction must be viewed objectively rather than subjectively. The Supreme Court cases and our predecessor court's cases have repeatedly looked to the objective economic reality of the transaction in applying the economic substance doctrine. While the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of the transaction [in] assessing its economic substance....

When no gain or loss is recognized, the partnership's adjusted basis in the contributed property is the same as it was in the hands of the contributing partner.[2495] The partner's

> Fourth, the transaction to be analyzed is the one that gave rise to the alleged tax benefit.... [I]n economic substance cases, the focus is on the specific transaction whose tax consequences are in dispute, and the Second Circuit has stated that [t]he relevant inquiry is whether the transaction that generated the claimed deductions ... had economic substance, *Nicole Rose Corp. v. Comm'r of Internal Revenue*, 320 F.3d 282, 284 (2d Cir. 2003)....
>
> Finally, arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.

454 F.3d 1340, 1353-57 (Fed. Cir. 2006) (select citations omitted).

For more on the economic substance doctrine, see part II.G.16 Economic Substance Penalty and Doctrines, particularly the cases (including *Coltec*) cited at fn. 1094.

The *Russian Recovery* court also rebuffed the taxpayer's attempted reliance on Code § 704(e) [modified and partially renumbered as Code § 761(b) starting in 2016]:

> Plaintiff makes no real effort to address the large body of case law which requires a look beyond these formalities. Instead, it relies heavily on IRC § 704(e)(1):
>
> > e) *Family partnerships*.—
> >
> > (1) *Recognition of interest created by purchase or gift*.--A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.
>
> Plaintiff views this statutory provision as supporting an inquiry independent of the judicially created challenges to over-reliance on formalism. We disagree for two reasons. First, although admittedly there is some debate on the question, we believe that the provision, as its name suggests, is directed at preventing the IRS from undoing intra-familiar partnership transactions, something far afield from the Tiger-RRF transaction.[25] Second, even if the provision is of broader application, there is no reason to think Congress intended to insulate taxpayers from decades of judicial scrutiny into abusive reliance on formalism.
>
> [25] In that respect it was a reaction to Culbertson, which did involve a family partnership. See S. Rep. 82-781, at 38-40 (1951) (noting that IRC § 704(e)(1) was intended to harmonize the rules regarding family partnerships, particularly in light of the confusion caused by *Culbertson* and its progeny).
>
> As defendant correctly points out, the IRS has adopted regulations interpreting section 704(e)(1) that preserve the traditional inquiries into whether the creation of a partnership interest was a sham transaction. Treas. Reg. § 1.704-1(e)(1)(iii) (A ... purchaser of a capital interest in a partnership is not recognized as a partner under the principles of section 704(e)(1) unless such interest is acquired in a bona fide transaction, not a mere sham for tax avoidance or evasion purposes ....). Section 704(e)(1) plainly does not insulate plaintiff from the assertions made in the FPAA.

The Code § 704(e) analysis might have changed since then. See part III.B.1.a.iv.(b) Income Tax Aspects of Family Partnerships.

[2494] See Reg. §§ 1.721-1(d) and 1.721-2(e).

[2495] Code § 723. A partner does not get basis for contributing his own promissory note to a partnership. *VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182, holding:

> The value of what a partner contributes to his partnership can be tricky when he contributes something other than cash—like the notes at issue here. VisionMonitor argues that the contribution of the promissory notes increased Mantor's and Smith's outside bases in amounts equivalent to their face value. But a partnership's basis in property contributed by a partner is the adjusted basis of that property in the hands of the contributing partner at the time of the contribution. Sec. 723. The Commissioner argues that the company's basis in the notes is zero because Mantor's and Smith's bases in

basis in the partnership is also equal to the partner's basis in the partner's contributed property.[2496] If the partnership is mainly to hold marketable securities, using only cash to form it has certain advantages.[2497]

The substituted basis portion continues the contributing partner's depreciation schedule.[2498]

However, a contributing partner must recognize gain on the occasions described below.

II.M.3.b. Exception: Diversification of Investment Risk

Code § 721(b) requires a contributing partner to recognize built-in gain on contributed property if the partnership is equivalent to an "investment company," as defined in Code § 351. Thus, when a partner contributes property with a fair market value that is greater than its adjusted basis to an "investment company" partnership, the partner recognizes the appropriate gain.[2499] The gain recognized by the contributing partner increases the basis of not only the contributor's partnership interest,[2500] but also the partnership's basis in the property.[2501]

Generally, the contribution to a partnership will be considered to be made to an investment company if (a) the transfer results in a diversification of the transferor's interests,[2502] and (b) more than 80% of the partnership's assets are held for investment and are readily marketable stocks or securities or interests in regulated investment companies or real estate investment trusts.[2503] Thus, the main way to avoid having a

> them were each zero. We have to agree with the Commissioner. We have long held that the contribution of a partner's own note to his partnership isn't the equivalent of a contribution of cash, and without more, it will not increase his basis in his partnership interest. *See Dakotah Hills Offices Ltd. P'ship v. Commissioner*, T.C. Memo. 1998-134, 75 T.C.M. (CCH) 2122 (no increased basis because not cash equivalent and not property in which partner has basis); *Gemini Twin Fund III v. Commissioner*, T.C. Memo. 1991-315, 62 T.C.M (CCH) 104 (partner's outside basis not increased by contribution of promissory note), *aff'd without published opinion*, 8 F.3d 26 (9th Cir. 1993); *Oden v. Commissioner*, T.C. Memo. 1981-184, 41 T.C.M. (CCH) 1285 (partner has zero basis in own promissory note), *aff'd without published opinion*, 679 F.2d 885 (4th Cir. 1982).[5]
>
> [5] Revenue Ruling 80-235, 1980-2 C.B. 229, summarizes this corner of partnership-tax law. It states that the contribution of a note by itself does not increase a partner's outside basis because he has a zero basis in the note. His outside basis will, however, increase if and when he actually makes payments on the note. *Id.; cf.* sec. 1.704-1(b)(2)(iv)(d)(2), Income Tax Regs. (providing that a partner's capital account is not increased with respect to a note written by that partner until there is either a taxable disposition of the note by the partnership, or the partner makes principal payments on the note).

[2496] Code § 722.
[2497] See footnotes 4175-4176 and the accompanying text.
[2498] Code § 168(i)(7).
[2499] Code § 721(b).
[2500] Code § 722.
[2501] Code § 723.
[2502] in determining diversification when an entity is contributed to a partnership, one might be able to look to the entity's underlying assets. Letter Ruling 201547003.
[2503] Reg. § 1.351-1(c)(1). Code § 351(e)(1)(A) requires that, in determining whether a company is an investment company, one must take into account all stock and securities held by the company. § 351(e)(1)(B) lists the following assets that are to be treated as stocks and securities: (1) money

contribution treated as having been made to an investment company is to ensure the transfer does not result in diversification of the transferor's interests.[2504] One way to do this would be to have all transferors contribute identical stock and securities in the same proportions, but this could require gifts or sales among the transferors before any contributions are made.[2505] Another way to avoid investment company status would be to have each transferor contribute a portfolio of stock and securities that is already diversified.[2506] Finally, the transferor will not attain diversification (and will not recognize gain) if the contributions of other partners are de minimis.[2507]

Another approach might be to manage the situation the way one would an "exchange fund." The whole point of the rules is to avoid economic diversification – meaning shifting risk of investment results from the contributing partners to the other partners. If the partnership agreement provided for the investment results to be specifically allocated to the contributing partners, then they will not have diversified their risk. "Exchange

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(contrary to the Regulations), (2) stocks, options, forwards, futures, notional principal contracts and derivatives, (3) foreign currency, (4) interests in real estate investment trusts, common trust funds, regulated investment companies, publicly traded partnerships, (5) interests in precious metals, (6) interests in any entity if substantially all of that entity's assets consist of the aforementioned assets, or (7) any other assets specified in the Regulations. The Regulations have not been amended to reflect Code § 351(e). The Senate Report to P.L. 105-34, 8/5/97, provides:

> Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are assets listed, and to the extent provided in Treasury regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to assets listed.[69]
>
> [69] Until such regulations are issued, it is intended that the Treasury regulations promulgated under the similar provisions of section 731(c)(2) generally will apply. Specifically, it is intended that an entity will meet the substantially all requirement if 90 percent or more of its assets are listed assets (Treas. reg. sec. 1.731-2(c)(3)(i)). Similarly, with respect to partnerships and the non-corporate entities, it is intended that, where 20 percent or more (but less than 90 percent) of the entity's assets consist of listed assets, a *pro rata* portion of the interest in the entity will be treated as a listed asset. (Treas. reg. sec. 1.731-2(c)(3)(ii)).

Reg. § 1.731-2(c)(3)(i), (ii) are reproduced in fns. 3873-3874, respectively, which are in part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

[2504] As discussed later, partnerships that invest substantially all of their assets in stock, bonds, etc. have certain favorable rules when distributing marketable securities. Investing directly in real estate or operating a trade or business generally precludes using these favorable rules. See the discussion of an investment partnership within part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

[2505] Reg. § 1.351-1(c)(5). Pre-contribution transfers between spouses may be an excellent solution. Letter Ruling 200317011.

[2506] See Reg. § 1.351-1(c)(6), referring to the 25 and 50-percent tests of § 368(a)(2)(F)(ii) to determine whether a portfolio is diverse. Under § 368(a)(2)(F)(ii), the 25% test requires that not more than 25% of the value of the portfolio be invested in the stock and securities of any one issuer, and the 50% test requires that nor more than 50% of the value of the portfolio's total assets be invested in the stock and securities of five or fewer issuers.

[2507] Reg. § 1.351-1(c)(7) includes an example where the partner whose contribution was being tested for diversification contributed $20,000, while all other partners contributed $200. The $200 was disregarded for purposes of testing diversification, and no gain was recognized by the partner who contributed $20,000.

funds" provide such an allocation for seven years (to comply with Code § 704(c)(1)(B) and 737),[2508] then they allow the partners to withdraw a diversified portfolio. I don't have any citations for private letter rulings approving this approach, but I would think that some are out there.

II.M.3.c. Exception: Triggering IRD

The sale or exchange of an item of income in respect of a decedent[2509] triggers income recognition.[2510]

Triggering income may convert the item to a capital asset.[2511]

II.M.3.d. Exception: Liability Shifts

Another exception to the general nonrecognition rule of Code § 721(a) can occur when a partner's share of liability in the partnership shifts. If a partner's share of liabilities increases, that increase is treated as hypothetical cash contribution and the partner's partnership interest basis is increased by that amount, but no immediate tax consequences occur.[2512] However, if the partner's share of liability decreases, then the decrease is treated as a hypothetical cash distribution, the partner's partnership interest's basis is decreased, and the partner must recognize gain to the extent the hypothetical distribution is greater than the partner's basis in such partner's partnership interest immediately before the deemed distribution.[2513] One situation that could lead to an increase or decrease in partnership liabilities is when a partner contributes to the partnership property subject to a liability. In such a case, the partner's partnership interest basis is increased to the extent of the partner's allocated share of liabilities, but is also decreased by the amount of the liability that is allocated to the other partners. The net result could be a decrease in the partner's share of partnership liabilities, which could lead to gain recognition.[2514]

[2508] See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[2509] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[2510] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up, especially fns. 1386-1387.

[2511] See part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up, fn. 1387, cross-referencing part II.G.6 Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A.

[2512] Code § 752(a); Code § 722.

[2513] Code § 752(b); Code § 731(a).

[2514] Reg. § 1.752–1(f). Generally, the allocation rules for nonrecourse liabilities will prevent the hypothetical distribution amount to the contributing partner from exceeding the basis of the contributing partner's partnership interest. Reg. § 1.752-3(a). Often, the contributing partner's Code § 704(c) responsibility will cause the contributing partner to be allocated nonrecourse debt sufficient to take care of this issue. Reg. § 1.752-3(a)(2). Additionally, if the partner contributes property subject to a recourse liability and the property remains recourse only to him, there will be no hypothetical distribution and no related recognition. Reg. § 1.752-1(g), Ex. 1. If the debt is part recourse and part nonrecourse, it is bifurcated. Reg. § 1.752-1(i). See also T.D. 9207 (5/23/2005), promulgating Reg. §§ 1.752-6 and 1.752-7 regarding certain assumptions of liability. See also Rubin, Whiteway, and Finkelstein, Recourse or Nonrecourse, That Is the Question, *TM Memorandum* (BNA) (Vol. 51, No. 17, 8/16/2010). See also Harris, I Am Not My Brother's

II.M.3.e. Exception: Disguised Sale Rules

Reg § 1.731-1(c)(3) provides:

> If there is a contribution of property to a partnership and within a short period:
>
> (i) Before or after such contribution other property is distributed to the contributing partner and the contributed property is retained by the partnership, or
>
> (ii) After such contribution the contributed property is distributed to another partner,
>
> such distribution may not fall within the scope of section 731. Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners or between the partnership and a partner. Such a transaction shall be treated as an exchange of property.

Code § 707(a)(2) provides:

> Under regulations prescribed by the Secretary—
>
> (B) *Treatment of certain property transfers*. If—
>
> > (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
> >
> > (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and
> >
> > (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,
>
> such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

Together with cases and other authority, these statutes set the stage for parts:

- II.M.3.e.i Disguised Sale When Partner Who Contributes Property Receives a Distribution,

Keeper and Other Lessons From the Related-Party Rules of Section 752, *Journal of Taxation* (Jan. 2011). For a scathing critique of proposed regulations under Code § 752, see Lipton, Proposed Regulations on Debt Allocations: Controversial, and Deservedly So, *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014); the proposed regulations were converted into final and temporary regulations in October 2016 (see part II.C.3 Allocating Liabilities (Including Debt)), but I have not analyzed how the changes responded to the criticism.

- II.M.3.e.ii Disguised Sale When One Partner Contributes Property and Another Receives a Distribution, and

- II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner.

II.M.3.e.i. Disguised Sale When Partner Who Contributes Property Receives a Distribution

II.M.3.e.i.(a). Distributions Presumed to Be Disguised Sales

Another case in which a partnership contribution can lead to tax consequences is when a partner transfers property to the partnership and there is a related transfer back to the partner, which falls outside the scope of part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. When a partner receives a direct or indirect transfer of money or other property related to a transfer that partner made to the partnership, the transfer can be treated as a sale or exchange of property between partner and the partnership;[2515] furthermore, if a partner contributes cash in connection with a distribution of property, the partnership may be treated as making a disguised sale of the property to the partner.[2516] Also, TAM 9510002 asserts that, if a taxpayer merely receives consideration for agreeing to enter into a partnership and transfer property to it and that transaction is found to be separate and distinct from the subsequent transfer of property to the partnership and a later partnership distribution, the entire amount received for agreeing to enter the partnership is taxable as ordinary income in the year received.

[2515] Code § 707(a)(2) and Reg. § 1.707-3(b). Reg. § 1.707-3(f), Example (1) describes the consequences of a transfer that is partly a sale and partly a transfer for a partnership interest.
For more on whether a transfer is a disguised sale, see A Tale of Two Cases: G-I Holdings and Virginia Historic Tax Credit Fund—Can They Both Be Right?, *Journal of Taxation* (Mar. 2010), discussing *In re: G-I Holdings, Inc.*, 105 AFTR.2d 2010-697 (D. N.J. 2009) and *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, T.C. Memo. 2009-295, in which the authors conclude, Taxpayers should be heartened by the court's rulings in these cases because they illustrate that partnership transactions structured with undeniable elements of risk sharing and recourse financing should be respected by the courts and the Service, but then caution that, If a taxpayer wishes to structure certain types of leveraged partnership transactions to minimize the risk of an economic substance challenge by the Service, care should be taken that any such arrangement involves the bearing of both risks and benefits—including having the loan structured as a recourse obligation of a creditworthy party. However, *Virginia Historic Tax* was reversed, 639 F.3d 129 (4th Cir. 2011); the Fourth Circuit's holding was followed in *Route 231, LLC v. Commissioner*, T.C. Memo. 2014-30, *aff'd* 810 F.3d 247 (4th Cir. 2016), and *SWF Real Estate LLC v. Commissioner*, T.C. Memo. 2015-63. See *Canal Corporation v. Commissioner*, 135 T.C. 199 (2010), characterizing a transaction as a disguised sale (transfer to partnership of assets worth $775 million, simultaneously receiving a $755 million cash distribution from the partnership) and imposing a substantial understatement penalty when the taxpayer relied on a tax opinion for which the taxpayer paid an $800,000 contingent fee, the sole contingency being the issuance of a should opinion; the court cited several cases preventing a taxpayer from relying on opinions given by promoters of various transactions. See also the anti-abuse regulations, Reg. § 1.701-2, under which transactions could be recharacterized to the extent not expressly addressed by exceptions to the disguised sale rules. For a critical analysis of *Canal Corporation v. Commissioner*, see Rubin, Whiteway, and Finkelstein, Partnership Tax Planning: Navigating the Canal, *Practical Tax Strategies*, Vol. 90, No. 5 (5/2013) (although the IRS won that case, a carefully structured leveraged partnership transaction should survive judicial scrutiny).

[2516] See part II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner.

Transfers to the contributing partner are presumed to be a sale or exchange if made within two years of one another, unless the facts and circumstances clearly establish the transfers were not a sale or exchange;[2517] however, the presumption of no disguised sale can be rebutted, particularly by step transaction principles.[2518] Among the facts and circumstances that may tend to prove the existence of a disguised sale are the following:[2519]

(i) That the timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the transferor has a legally enforceable right to the subsequent transfer;

(iii) That the partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(iv) That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

(v) That any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations;

[2517] Reg. § 1.707-3(c)(1).

[2518] In Reg. § 1.701-2(d), Example (8), a three-year wait did not prevent a pre-arranged transaction from constituting a disguised sale.

[2519] Reg. § 1.707-3(b)(2). *Gateway Hotel Partners, LLC v. Commissioner*, T.C. Memo. 2014-5, applied this test, giving greatest weight to the first two factors under those particular circumstance, to find that no disguised sale had occurred. See Lipton, *Gateway Hotel Partners*: Decision Illustrates the Disguised Sale Quandary, *Journal of Taxation* (7/2014), offering tips in addition to analyzing the law:

> It was also interesting to observe the manner in which the court and the IRS reviewed all of the documents involved in the transaction. The IRS was essentially looking for a gotcha document to support its argument that the transaction should be subject to different tax consequences, while the taxpayer had to defend each of the relevant documents and explain some apparent inconsistencies. It probably would have been better for the taxpayer if it had entered into some type of master agreement explaining the manner in which the transaction documents should be interpreted, thereby assuring that any minor inconsistencies (such as language in resolutions) could not be used as a basis to completely alter the tax consequences of the transaction. When a transaction has numerous complex steps (as these transactions did), the language of the transaction may appear to have a plain meaning to the drafter of the transaction but ambiguities will almost certainly appear with hindsight. The court appeared to address the various ambiguities so as to reach the right result, but the taxpayer would likely have saved substantial money (in legal fees) and have had much less heartburn if there had been an overriding document that explained how all of the various transaction documents should have been interpreted.

(vi) That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(vii) That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(viii) That partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(ix) That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(x) That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

This rule can be especially important when a partner contributes to the partnership property subject to a liability. If the partnership assumes or takes subject to the liability, the transfer may be considered a sale and some or all of the liability amount may be treated as consideration received by the contributing partner.[2520] If the liability assumed or taken subject to is considered a "qualified liability"[2521] (and refinancing a qualified

[2520] Reg. § 1.707-5.

[2521] Reg. § 1.707-5(a)(6)(i) describes qualified liabilities as:

(A) A liability that was incurred by the partner more than two years before the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period before the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (additional rules apply to a liability incurred within two years of a property transfer or of a written agreement to transfer);

(C) A liability that is allocable under the rules of Reg. § 1.163-8T to capital expenditures (as described under Reg. § 1.707-4(d)(5)) with respect to the property;

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; or

(E) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business liability - or the transfer of a liability in conjunction with the transfer of a business it historically financed - does not appear to change its character),[2522] then the liability is not treated as consideration for a sale unless some other reason exists for the transfer to be treated as such.[2523] If the liability is not a qualified liability, then the partner is treated as having received consideration for his transfer to the extent the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability.[2524] My understanding is that liabilities that are not qualified liabilities can surprisingly change the calculations that would apply relative to involving only qualified liabilities.[2525] Generally,[2526] a partner steps in the shoes of a person for purposes of Code § 1.707-5(a) with respect to a liability the person incurred or assumed

> are transferred other than assets that are not material to a continuation of the trade or business (additional rules apply to a liability incurred within two years of a transfer presumed to be in anticipation of the transfer)….

If the liability is a recourse liability, the amount of the liability cannot exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are certain other liabilities) at the time of the transfer. Reg. § 1.707-5(a)(6)(ii).

[2522] Qualified liabilities do not lose their character as such by being transferred, along with related business assets, to a disregarded entity that is then contributed to the partnership. Letter Ruling 201714028, which (subject to various representations) held the following to constitute qualified liabilities under Reg. § 1.707-5(a)(6)(i)(E) (highlighting added):

> All of the Liabilities were incurred more than f years before the proposed Transfer. Some of the Liabilities were originally incurred to make distributions in connection with Company's formation on D1 and have been subsequently refinanced. The remaining balance of the Liabilities have been used to acquire assets, make improvements, pay expenses, and otherwise operate Company's business and that of its subsidiaries, including to refinance other liabilities incurred for the same purposes. Company has also regularly distributed cash to its members in proportion to their ownership interests. Those cash distributions, however, have been less than Company's earnings. The Liabilities (and the liabilities they refinanced) are an integral part of Company's existing and historical capital structure.

[2523] Reg. § 1.707-5(a)(5)(i).

[2524] Reg. § 1.707-5(a)(1).

[2525] Recorded discussion of these rules at the American Bar Association Section on Taxation's Midyear (January) 2017 meeting.

[2526] The exception is Reg. § 1.707-5(e)(2), which provides:

> If an interest in a partnership that has one or more liabilities (the lower-tier partnership) is transferred to another partnership (the upper-tier partnership), the upper-tier partnership's share of any liability of the lower-tier partnership that is treated as a liability of the upper-tier partnership under § 1.752-4(a) is treated as a qualified liability under paragraph (a)(6)(i) of this section to the extent the liability would be a qualified liability under paragraph (a)(6)(i) of this section had the liability been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership's property to the upper-tier partnership by the lower-tier partnership. For purposes of determining whether the liability constitutes a qualified liability under paragraphs (a)(6)(i)(B) and (E) of this section, a determination that the liability was not incurred in anticipation of the transfer of property to the upper-tier partnership is based on whether the partner in the lower-tier partnership anticipated transferring its interest in the lower-tier partnership to the upper-tier partnership at the time the liability was incurred by the lower-tier partnership.

to the extent the partner assumed or took property subject to the liability from the person in a nonrecognition transaction described in Code § 351,[2527] 381(a), 721,[2528] or 731.[2529]

If within a two-year period a partner incurs certain types of liability and transfers property to a partnership or agrees in writing to transfer the property, and in connection with the transfer the partnership assumes or takes the property subject to the liability, the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer.[2530] Liabilities to fund various preformation expenditures may be excluded from liabilities deemed to have been relieved under the disguised sale rules.[2531] If a partner treats a liability assumed or taken subject to by a partnership in connection with a transfer of property as a certain type of qualified liability and the partner incurred the

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[2527] See part II.M.2 Buying into or Forming a Corporation.

[2528] See part II.M.3 Buying into or Forming a Partnership.

[2529] Reg. § 1.707-5(a)(8). For Code § 731, see part II.Q.8.b.i Distribution of Property by a Partnership.

[2530] Reg. § 1.707-5(a)(7)(i).

[2531] Reg. § 1.707-4(d)(1) provides:

> (1) *In general*. A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under § 1.707-3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that—
> > (i) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and
> >
> > (ii) Are incurred by the partner with respect to—
> > > (A) Partnership organization and syndication costs described in section 709; or
> > >
> > > (B) Property transferred to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the transfer (the 20-percent limitation). However, the 20-percent limitation of this paragraph (d)(1)(ii)(B) does not apply if the fair market value of the transferred property does not exceed 120 percent of the partner's adjusted basis in the transferred property at the time of the transfer (the 120-percent test). This paragraph (d)(1)(ii)(B) shall be applied on a property-by-property basis, except that a partner may aggregate any of the transferred property under this paragraph (d)(1) to the extent—
> > > > (1) The total fair market value of such aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under section 731(c)), transferred by the partner to the partnership, or $1,000,000;
> > > >
> > > > (2) The partner uses a reasonable aggregation method that is consistently applied; and
> > > >
> > > > (3) Such aggregation of property is not part of a plan a principal purpose of which is to avoid §§ 1.707-3 through 1.707-5.
> > >
> > > (C) [Reserved].

For a discussion of how this rule works, listen to recordings (primarily Part 2) of "New Partnership Regulations under Sections 707 and 752," a discussion at the January 2017 meeting of the ABA's Section on Taxation that included those who write the regulations, and see slides 15-22 in "New Partnership Regulations under Sections 707 and 752," the latter saved as Thompson Coburn LLP doc. no. 6591807. That discussion also covers the remaining paragraphs of Reg. § 1.707-4(d).

liability within the two-year period before the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership, see part II.M.3.e.i.(c) Disclosure Requirements.

If a partner contributes property and the partnership incurs indebtedness, seeking to allocate that debt to the contributing partner to support a distribution to that partner, the IRS might argue that the debt should not have been allocated to that partner.[2532] Also, some of the rules for allocating nonrecourse debt do not apply for purposes of the disguised sale rules, leading to surprisingly unfavorable results.[2533]

[2532] CCA 201324013.

[2533] See part II.C.3.c.iii Allocating Nonrecourse (Remaining) Liabilities, especially fn. 377 and the accompanying text. T.D. 9788 (10/5/2016) explained:

> … for disguised sale purposes only, it is appropriate for partners to determine their share of any partnership liability, whether recourse or nonrecourse under section 752, in the manner in which excess nonrecourse liabilities are allocated under Sec. 1.752-3(a)(3), as limited for disguised sale purposes in the 752 Final Regulations. For purposes of the disguised sale rules, this allocation method reflects the overall economic arrangement of the partners more accurately than the current regulations or the 2014 Proposed Regulations. In most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. This is true whether: (1) A partner's liability is assumed by a partnership in connection with a transfer of property to the partnership or by a partner in connection with a transfer of property by the partnership to the partner; (2) a partnership takes property subject to a liability in connection with a transfer of property to the partnership or a partner takes property subject to a liability in connection with a transfer of property by the partnership to the partner; or (3) a liability is incurred by the partnership to make a distribution to a partner under the debt-financed distribution exception in Sec. 1.707-5(b). Accordingly, under the 707 Temporary Regulations, a partner's share of any partnership liability for disguised sale purposes is the same percentage used to determine the partner's share of the partnership's excess nonrecourse liabilities under Sec. 1.752-3(a)(3), as limited for disguised sale purposes under the 752 Final Regulations.
>
> … the 707 Temporary Regulations provide that a partner's share of a partnership liability for disguised sale purposes does not include any amount of the liability for which another partner bears the [economic risk of loss] for the partnership liability under Sec. 1.752-2.
>
> The liability allocation approach for disguised sale purposes in the 707 Temporary Regulations does not conflict with Congress's directive relating to section 752, which had been raised as a potential concern by some commenters with respect to the 2014 Proposed Regulations. Section 79 of the Deficit Reduction Act of 1984 (Pub. L. 98-369) overruled the decision in *Raphan v. United States*, 3 Cl. Ct. 457 (1983) (holding that a guarantee by a general partner of an otherwise nonrecourse liability of the partnership did not require the partner to be treated as personally liable for that liability) and directed the Secretary of the Treasury to amend the regulations under section 752 to reflect the overruling of the *Raphan* decision. At issue in the *Raphan* case was debt allocation under section 752; accordingly, Congress's directive related to regulations under section 752 only. As noted, the 707 Temporary Regulations treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for purposes of section 707. Thus, the approach adopted in the 707 Temporary Regulations does not conflict with the approach directed by Congress after the *Raphan* case.

For an explanation of unfair and surprising consequences of applying this rule to nonrecourse debt guaranteed by a partner and a criticism of this rule, see Smith, "Temporary disguised-sale

For more general rules, see part II.C.3 Allocating Liabilities (Including Debt). "New Partnership Regulations under Sections 707 and 752," a discussion at the January 2017 meeting of the ABA's Section on Taxation that included those who write the regulations, discussed 2016 changes to regulations and included slides with charts explaining some key changes.[2534]

II.M.3.e.i.(b). Distributions Presumed Not to Be Disguised Sales

Certain distributions are *presumed* not to constitute disguised sales:

- 150% of AFR.[2535] If the written partnership agreement characterizes a cash distribution as a preferred return[2536] or a guaranteed payment for capital and this distribution is a payment for the use of capital in a reasonable amount,[2537] it is presumed not to be part of a sale of property to the partnership unless the facts and circumstances[2538] clearly establish that the transfer is part of a sale.[2539] A preferred return or guaranteed payment for capital is reasonable in amount if the sum of any such distributions payable for that year do not exceed the amount determined by multiplying either the partner's capital[2540] by 150% of the AFR.[2541]

  - Operating Cash Flow Distributions. An operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts

regulations raise concerns," *The Tax Adviser* (7/2017), saved as Thompson Coburn LLP doc. no. 6599934.

2534 The text above references a two-part panel discussion chaired by Eric Sloan. The slides, "New Partnership Regulations under Sections 707 and 752," are saved as Thompson Coburn LLP doc. no. 6591807.

2535 AFR refers to the applicable federal rate as defined under Code § 1274, which applies for Code § 7872 as well as in other contexts.

2536 As used here, preferred return means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.

2537 Reg. § 1.707-4(a)(3)(i).

2538 Including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return. Reg. § 1.707-4(a)(2).

2539 Reg. § 1.707-4(a)(2).

2540 Based on the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner). A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than transfers of money that are presumed to be reasonable guaranteed payments for capital under Reg. § 1.707-4(a)(1)(ii), transfers of money that are reasonable preferred returns within the meaning of Reg. § 1.707-4(a)(3), and operating cash flow distributions within the meaning of Reg. § 1.707-4(b)(2) (described below). Reg. § 1.707-4(a)(3)(ii).

2541 Reg. § 1.707-4(a)(3)(ii). The regulation refers to a safe harbor interest rate, which for a partnership's taxable year equals 150% of the highest AFR, at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year.

and circumstances clearly establish that the transfer is part of a sale.[2542] If the partnership agreement characterizes a payment as a distribution to a partner, then the payment is an operating cash flow distribution to the extent it does not exceed the partnership's net cash flow from operations for the year multiplied by the lesser of (a) the partner's percentage interest in overall partnership profits for that year, or (b) the partner's percentage interest in overall partnership profits for the partnership's life.[2543] The partnership's net cash flow from operations for a taxable year is an amount equal to the partnership's taxable income or loss arising in the ordinary course of the partnership's business and investment activities:[2544]

- Increased by tax exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income, and
- Decreased by:
    - Principal payments made on any partnership indebtedness,
    - Property replacement or contingency reserves actually established by the partnership,
    - Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow, and
    - Any other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

I tend to suggest preferred returns of operating cash flow over guaranteed payments.[2545]

The partnership anti-abuse rules[2546] should not apply when one of the above safe harbors is satisfied. If the transaction is contemplated by a particular regulation, then the situation is not considered an abuse of entity treatment.[2547] However, to minimize any risk that the anti-abuse rules would apply, the seller should not be protected from loss. Looking at the larger picture, the anti-abuse rule applies only if the transaction is

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[2542] Reg. § 1.707-4(b)(1). This exception is especially helpful in preferred partnerships, as described in part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.
[2543] Reg. § 1.707-4(b)(2)(i). Without limiting the choices a partner may make in applying this rule, in determining a partner's operating cash flow distributions for a taxable year the partner may use the partner's smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with that taxable year. Reg. § 1.707-4(b)(2)(ii). In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership applying principles similar to those described in Reg. § 1.707-4(b)(2)(i), so that the amount of the upper-tier partnership's operating cash flow distributions is neither overstated nor understated. Reg. § 1.707-4(b)(2)(iii).
[2544] Reg. § 1.707-4(b)(2)(i).
[2545] See fn. 1472.
[2546] Reg. § 1.701-2(c)(3).
[2547] Reg. § 1.701-2(e)(2)(i).

inconsistent with Subchapter K's intent. For this purpose, Subchapter K's intent has three prongs:[2548]

- The partnership must be bona fide, and each transaction must have a "substantial business purpose."
- The form of each transaction must be respected under substance over form principles.
- Clear reflection of income: All distributions the old owner receives is being taxed. The new owner is not being taxed on income the new owner does not receive.

II.M.3.e.i.(c). Disclosure Requirements

Certain transactions must be disclosed on Form 8275 or an appropriate statement.[2549]

The transactions requiring disclosure are referred to in:

> § 1.707-3(c)(2) (regarding certain transfers made within two years of each other),
>
> § 1.707-5(a)(7)(ii) (regarding a liability incurred within two years prior to a transfer of property), and
>
> § 1.707-6(c) (relating to transfers of property from a partnership to a partner in situations analogous to those listed above)….

If more than one partner transfers property to a partnership pursuant to a plan, this disclosure may be made by the partnership on behalf of all the transferors rather than by each transferor separately.[2550]

II.M.3.e.ii. Disguised Sale When One Partner Contributes Property and Another Receives a Distribution

This part II.M.3.e.ii discusses whether a contribution to a partnership, followed by a distribution to another partner, constitutes a purchase by the contributing partner of the distributee partner's partnership interest.

[2548] Reg. § 1.701-2(a).

[2549] Reg. § 1.707-8(b), which provides:

> *Method of providing disclosure*. Disclosure is to be made on a completed Form 8275 or on a statement attached to the return of the transferor of property for the taxable year of the transfer that includes the following:
>
> (1) A caption identifying the statement as disclosure under section 707;
>
> (2) An identification of the item (or group of items) with respect to which disclosure is made;
>
> (3) The amount of each item; and
>
> (4) The facts affecting the potential tax treatment of the item (or items) under section 707.

[2550] Reg. § 1.707-8(c).

Part II.M.3.e Exception: Disguised Sale Rules quotes Reg § 1.731-1(c)(3) and Code § 707(a)(2) as regulatory and statutory authority under the disguised sale rules, which are supplemented by case law and other authority.

Not until 2004 were proposed regulations issued, which are discussed after reviewing cases leading up to them.

TAM 200037005 asserts that Code § 707(a)(2)(B) applies even if regulations have not been adopted.[2551]

Communications Satellite Corp. v. U.S., 625 F.2d 997 (Ct. Cl. 1980), held that admission of a partner followed by a related distribution to the other partners being diluted was not a disguised sale by the distributees. In that case, the distributee partners, instead of receiving full fair market value, received a proportionate share of their initial capital contribution, adjusted by income and distributions. The court held:

> The effect of the arrangements for admitting new partners was to eliminate the possibility that gains from the reduction of the existing partner's interests resulting from the admission of new partners would influence decisions on admitting new partners. Moreover, these arrangements exhibited in several important respects characteristics not commonly associated with sale transactions.
>
> There were no financial negotiations with the incoming partners by either INTELSAT or the existing partners, and there were no contracts of sale between old and new partners. Neither the partnership nor the existing partners had any control over who joined INTELSAT (other than the restriction in the agreements to members of the International Telecommunications Union) or over the terms under which the new partners joined. The entry fees—the price paid for the partnership interests—had no relationship to the actual value of the new partners' percentage interests in the partnership; there was no attempt at appraising the value of partnership interests at any time. The entry fees were determined mechanically, based not on the fair market value of the partnership or its assets but on the original capitalization of the partnership. Although the Committee had an opportunity to affect the entry fees through its role in setting the incoming quotas, this power was restricted by the requirement that the quotas reflect only

[2551] Looking to cases in other areas, the TAM asserted:

> Although the Service has not promulgated regulations for disguised sales of partnership interests under section 707(a)(2)(B) (Income Tax Regulation Section 1.707-7 is reserved), it may enforce section 707(a)(2)(B) in the context of a disguised sale of a partnership interest in the absence of regulations. See *Pittway Corp. v. United States*, 102 F.3d 932 (7th Cir. 1996) (although the statute provided "to the extent provided in regulations" the plain language of the statue [sic] directs a single conclusion); *Estate of Neuman*, 106 T.C. 216 (1996) (regulations contemplated under section 2663(2) is not a necessary precondition to the imposition of the generation-skipping transfer tax on transfers involved in the case); Rev. Rul. 91-47 (Service enforced section 108(e)(4), which applies "to the extent provided in regulations" before the regulations were issued). The plain language of the statute, as confirmed by the legislative history, imposes liability on the taxpayer in this case.

> the anticipated use of the system and not the business or investment goals of any partner or the partnership.
>
> Although none of these characteristics individually may establish that the transactions were not sales, their combined effect, viewed in the context of the unique and special nature and purpose of this partnership, is inconsistent with the view that the transactions by which new partners were admitted were sales by the existing partners of part of their interests. To the contrary, the receipt by the existing partners of their pro rata share of the amounts paid by new partners to the partnership were distributions of partnership property on which, under section 731, no gain is recognized.

In giving context to Reg § 1.731-1(c)(3), in fn. 6 the court noted:

> An example of the type of transaction that the regulation covers is given in Rev. Rul. 57-200, 1957-1 Cum. Bull. 205. The ruling deals with a situation in which two people each owned half of a partnership and each owned half of two corporations. Each of the partners contributed his half-interest in the two corporations to the partnership, and the partnership thereafter distributed one of the two corporations to each of the partners along with a liquidating distribution of half of the partnership itself. These transfers "constituted steps in an integral transaction entered into for the purpose of effecting an exchange of the corporate stock interests between the partners without the recognition of gain to the partners or the partnership. Accordingly, to such extent, section 731 of the Code does not apply ... ." *Id.* At 206. See also 1 A. Willis, *Partnership Taxation* § 33.07 (2d ed. 1976).

Jupiter Corp. v. U.S.[2552] held that, when the contributing partner receives a partnership interest that is very different in nature from that of the distributee partner and both partners stay in the partnership, a disguised sale cannot have occurred.[2553]

[2552] 2 Cl. Ct. 58 (Ct. Cl. 1983).

[2553] Describing the interests of the contributing partner, Wilkow Group, and the distributee partners, plaintiff and Empire, the court found no disguised sale:

> The uncontradicted evidence in the record establishes that plaintiff would not have considered a sale, and the Wilkow Group would not have considered a purchase, of a portion of plaintiff's general partnership interest. The economic and legal pre-requisites of plaintiff and the Wilkow Group mandated that the partnership be reorganized to admit the Wilkow Group as new limited partners.
>
> The Wilkow Group's limited partnership interest did not exist prior to the reorganization of the Venture. This newly-created limited partnership interest gave the Wilkow Group cumulative rights to monthly distributions of income which had priority over all distributions to plaintiff and Empire. Neither plaintiff nor Empire owned such a cumulative priority right to the Venture's income prior to the reorganization. The Wilkow Group's limited partnership interest created by the reorganization carried no obligation to advance money needed by the Venture beyond the initial capital contribution and loan. Plaintiff's and Empire's partnership interests imposed such an obligation, to varying extents, both before and after the reorganization. Since the Wilkow Group's limited partnership interest was unique from the partnership interests owned by plaintiff and Empire, the Wilkow Group could not have purchased this interest directly from either partner.

TAM 200301004 asserts that Congress adopted Code § 707(a)(2)(B) to overturn *Jupiter Corp.* and *Communications Satellite Corp*.[2554]

Expressly assuming another partner's liabilities tends to make the transactions look more like a sale.[2555]

> Although plaintiff's general partnership interest was decreased from 77.5 percent to 57.5 percent after the reorganization, plaintiff remained in a more favorable position after the reorganization than it would have if it had directly sold a 20 percent general partnership interest to the Wilkow Group. Both before and after the reorganization, plaintiff remained the sole general partner with 100 percent control of the management of the Venture. Plaintiff did not want to share its management responsibilities with any other partner. Furthermore, the Wilkow Group was not interested in acquiring a share of the management responsibilities. The parties could not have accomplished these goals by a direct purchase and sale of a portion of plaintiff's general partnership interest.
>
> A further indication that this transaction was intended, and could only have been accomplished, as a reorganization of the Venture is found in a change which the amended partnership agreement made in the rights and obligations of plaintiff and Empire vis-a-vis each other. Prior to the reorganization, plaintiff and Empire were both obligated to advance all amounts which the Venture required. After the reorganization, the amended partnership agreement expressly removed Empire's obligation to advance amounts which the Venture needed to make the monthly payments to the Wilkow Group. Of course, no change in the rights between plaintiff and Empire could have been accomplished solely by a direct sale of a portion of plaintiff's general partnership interest to the Wilkow Group.

[2554] The TAM asserted:

> The legislative history of § 707(a)(2)(B) indicates that the provision was adopted as a result of Congress' concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by a related partnership distribution. See S. Prt. No. 169, (Vol. I), 98th Cong., 2d Sess. 225 (1984)(hereinafter "S. Prt."); H.R. Rep. No. 432, (Pt. 2) 98th Cong., 2d Sess. 1218 (1984) (hereinafter "H.R. Rep."). Specifically, Congress was concerned about court decisions that allowed tax-free treatment in cases which were economically indistinguishable from sales of property to a partnership or another partner. See S. Prt. At 225; H.R. Rep. at 1218 (discussing *Jupiter Corp. v. United States*, No. 83-842 (Ct. Cl. 1983) and *Communications Satellite Corp. V. United States*, 223 Ct. Cl 253 (1980) both of which involved the disguised sale of a partnership interest). Congress believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See S. Prt. at 225; H.R. Rep. at 1218.

[2555] Distinguishing *Communications Satellite*, *Colonnade Condominium, Inc., v. Commissioner*, 91 T.C. 793 (1988), found a disguised sale, noting:

> The fact that the three shareholders of Colonnade expressly assumed Colonnade's liabilities, in return for partnership interests which are capital assets under section 741, is especially significant. In determining whether an actual or constructive sale or exchange took place, we note that the touchstone for sale or exchange treatment is consideration. In *LaRue v. Commissioner*, 90 T.C. 465, 483-484 (1988), we noted that where liabilities are assumed as consideration for a partnership interest a sale or exchange exists:
>
>> If, in return for assets, any consideration is received, even if nominal in amount, the transaction will be classified as a sale or exchange. *Blum v. Commissioner*, 133 F.2d 447 (2d Cir. 1943). *** When the transferee of property assumes liabilities of the transferor encumbering the property, the liability is an amount realized by the transferor. *Crane v. Commissioner*, [331 U.S. 1 (1947)]; *Commissioner v. Tufts*,

The IRS has asserted that elements of a sale from the distributee partner to the contributing partner include the contribution being the same amount as the redemption[2556] and that the continuing partners' interest did not increase proportionately upon the withdrawal of the partner.[2557]

> [461 U.S. 300 (1983)]. Assumption of liabilities by the transferee constitutes consideration making the transaction a sale or exchange. *Wilkinson v. United States*, 177 F. Supp. 101 (S.D. Ala. 1959).
>
> *** Where assets are transferred to third parties, assumption of liabilities constitutes consideration. ***
>
> *** the assumption of liabilities by a third party transferee constitutes an amount realized, and this is consideration to the transferor. *Crane v. Commissioner*, [supra]; *Tufts v. Commissioner*, [supra].

I am unsure why the court did not simply invoke Code § 311 to tax a distribution from the corporation to its shareholders.

[2556] FSA 200024001, citing *Jacobson v. Commissioner*, 96 T.C. 577, 587-88 (1991), *aff'd*, 963 F.2d 218 (8th Cir. 1992), asserted:

> The court, however, will look behind the chosen form of a transaction where "elements of artificiality" are present. The presence of such elements can be ascertained by looking at the business purpose for the transaction. *Jacobson*, 96 T.C. at 590. One element of artificiality is that the funds used to terminate Q's interest were derived from U, and not from P. *Jacobson*, 96 T.C. at 592. Pursuant to the Redemption Agreement, Q's entire interest in P would be redeemed for $s and certain contingent payments. Ten days before the redemption date, R and U entered into an agreement wherein U would contribute $s to fund the payment to be made to Q. The agreement also provided that U was required to make a contribution to P in an amount equal to each of the contingent payments to be made to Q.

[2557] FSA 200024001 asserted:

> Another element of artificiality is that the continuing partners' interest did not increase proportionately upon the withdrawal of the partner. Specifically, to the extent the interests of the continuing partners' interest does not increase proportionately upon the withdrawal of a partner, the economic substance of the transaction is generally considered a sale. *Colonnade Condominium, Inc.*, *supra* (where new general partners were admitted to a limited partnership, the interests of one pre-admission general partner decreased, and the interests of all pre-admission limited partners remain unchanged, holding that the general partner whose interest decreased sold a portion of its partnership interest to the new general partners); *Coven v. Commissioner*, 66 T.C. 295 (1976) (holding that the termination of a partner's interest was a sale of the interest to a partner rather than a liquidation because, among other things, the majority partner contributed the cash for the terminating payments and its interest increased while the minority partner's interests did not). After U's contribution of $s to P, the continuing partners' (R and U's) interest did not increase proportionately upon the withdrawal of Q. Rather, U's interest increased to z percent and R's interest remained w percent.
>
> Based on the above facts and circumstances, we conclude that a reasonable inference can be drawn that the overarching business purpose for the transaction was to sell Q's partnership interest in P to U. The substance of the transaction was a transfer of money by a partner, Q, to a partnership, P, followed by a related direct transfer of money by the partnership, P, to another partner, U. The transfers, when viewed together, are properly characterized as a sale or exchange of Q's partnership interest. Accordingly, the transfers must be treated as a transaction between two or more partners acting other than in their capacity as members of the partnership, specifically, as a sale. See I.R.C. section 707(a)(2)(B).

Proposed regulations under Code § 707(a)(2)(B) on the topic of a disguised sale from one partner to another were proposed November 26, 2004 and withdrawn January 21, 2009, [2558] and as of 12/16/2017 I am unaware of any having been promulgated after that. The preamble to the Prior Prop. Regs. expressed antipathy to *Communications Satellite* and *Jupiter Corp.*[2559] Although the proposed regulations have been withdrawn, one may want to consider what factors the government viewed as relevant when it issued them:[2560]

(i) That the timing and amount of all or any portion of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(ii) That the person receiving the subsequent transfer has a legally enforceable right to the transfer or that the right to receive the transfer is secured in any manner, taking into account the period for which it is secured;

(iii) That the same property (other than money, including marketable securities that are treated as money under section 731(c)(1)) that is transferred to the partnership by the purchasing partner is transferred to the selling partner;

(iv) That partnership distributions, allocations or control of operations are designed to effect an exchange of the benefits and burdens of ownership of transferred property (other than money, including marketable securities that are treated as money under section 731(c)(1)), including a partnership interest;

(v) That the partnership holds transferred property (other than money, including marketable securities that are treated as money under section 731(c)(1)) for a limited period of time, or during the period of time the partnership holds transferred property (other than money, including marketable securities that are treated as money under section 731(c)(1)), the risk of gain or loss associated with the property is not significant;

Colonnade is discussed in fn. 2555, and *Coven* is discussed in fn. 3975, the latter being found in part II.Q.8.b.ii.(a) Introduction to Code § 736.

[2558] FR Doc. 2009-1101, withdrawing REG-149519-03 (11/26/2004).

[2559] [REG-149519-03] stated:

> Congressional concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by related partnership distributions. See H.R. Rep. No. 861, 98th Cong. 2nd Sess. 861 (1984), 1984-3 (Vol. 2) C.B. 115. Specifically, Congress was concerned about court decisions that allowed tax-free treatment in cases that were economically indistinguishable from sales of property to a partnership or another partner, and believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1218 (1984) (H.R. Rep.), and S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 225 (1984) (S. Prt.) (discussing *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980), and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983), both of which involved disguised sales of a partnership interest).

[2560] Former Prop. Reg. § 1.707-7(b)(2).

(vi) That the transfer of consideration by the partnership to the selling partner is disproportionately large in relationship to the selling partner's general and continuing interest in partnership profits;

(vii) That the selling partner has no obligation to return or repay the consideration to the partnership, or has an obligation to return or repay the consideration due at such a distant point in the future that the present value of that obligation is small in relation to the amount of consideration transferred by the partnership to the selling partner;

(viii) That the transfer of consideration by the purchasing partner or the transfer of consideration to the selling partner is not made pro rata;

(ix) That there were negotiations between the purchasing partner and the selling partner (or between the partnership and each of the purchasing and selling partners with each partner being aware of the negotiations with the other partner) concerning any transfer of consideration; and

(x) That the selling partner and purchasing partner enter into one or more agreements, including an amendment to the partnership agreement (other than for admitting the purchasing partner) relating to the transfers.

(Code § 731(c) is discussed in part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).)

Prior Prop. Reg. § 1.707-7(c) provided that, "if within a two-year period a purchasing partner transfers consideration to a partnership and the partnership transfers consideration to a selling partner (without regard to the order of the transfers), the transfers are presumed to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers do not constitute a sale."

However, Prior Prop. Reg. § 1.707-7(d) presumed that distributions liquidating a partnership interest were not disguised sale to the recipient.[2561] Reg. § 1.761-1(d), "Liquidation of partner's interest," provides:[2562]

[2561] Prior Prop. Reg. § 1.707-7(d) provided:

> *Transfers of money in liquidation of a partner's interest presumed not to be a sale*. Notwithstanding the presumption set forth in paragraph (c) of this section, for purposes of this section, if a partnership transfers money, including marketable securities that are treated as money under section 731(c)(1), to a selling partner, or is treated as transferring consideration to the selling partner under paragraph (j)(2) of this section, in liquidation of the selling partner's interest in the partnership, the transfer is presumed not to be a sale, in whole or in part, of the selling partner's interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfer is part of a sale. See § 1.761-1(d) for the definition of the term liquidation of a partner's interest.

The preamble to the above explained:

> The IRS and the Treasury Department believe that the abuse that section 707(a)(2)(B) was intended to address typically is not present in situations involving complete liquidations of partners' partnership interests for money. Accordingly, the proposed

> The term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. A series of distributions will come within the meaning of this term whether they are made in one year or in more than one year. Where a partner's interest is to be liquidated by a series of distributions, the interest will not be considered as liquidated until the final distribution has been made.

Furthermore, Prior Prop. Reg. § 1.707-7 would not have applied to the deemed termination of a partnership.[2563] See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.

Also, Prior Prop. Reg. § 1.707-7 would not have applied to service partnerships,[2564] referring to the rules described in part II.G.9 Personal Service Corporations. Furthermore, operating cash flow distributions and similar safe harbors, under the rules governing disguised sales from a partner to a partnership,[2565] would also have been safe harbors.[2566]

> regulations provide that, notwithstanding the presumption relating to transfers within two years, a transfer of money, including marketable securities that are treated as money under section 731(c)(1), to a selling partner in liquidation of that partner's entire interest in the partnership is presumed not to be part of a disguised sale of that interest. However, the IRS and the Treasury Department recognize that there are instances in which a liquidating distribution may properly be characterized as part of a disguised sale of a partnership interest, particularly when the tax consequences of a liquidating distribution are significantly different from those of a sale of a partnership interest. Accordingly, the presumption against sale treatment may be rebutted in those cases.

[2562] After the quoted language, Reg. § 1.761-1(d) continues:

> For the basis of property distributed in one liquidating distribution, or in a series of distributions in liquidation, see section 732(b). A distribution which is not in liquidation of a partner's entire interest, as defined in this paragraph, is a current distribution. Current distributions, therefore, include distributions in partial liquidation of a partner's interest, interest, and distributions of the partner's distributive share. See paragraph (a)(1)(ii) of § 1.731-1.

[2563] Prior Prop. Reg. § 1.707-7(a)(8) provided:

> *Certain transfers disregarded*. Section 707(a)(2)(B) and the rules of this section do not apply to deemed transfers resulting from a termination of a partnership under section 708(b)(1)(B) and transfers incident to the formation of a partnership. However, transfers incident to the formation of a partnership may be transfers to which § 1.707-3(a) applies.

[2564] Prior Prop. Reg. § 1.707-7(g) provided:

> Exception for certain transfers to and by service partnerships. Section 707(a)(2)(B) and the rules of this section do not apply to transfers of money, including marketable securities that are treated as money under section 731(c)(1), to and by a partnership that would be described in section 448(d)(2) if the partnership were a corporation. Solely for purposes of applying section 448(d)(2) to partnerships under this paragraph (g), partners are treated as employees of the partnership and "partnership interest" is substituted for "stock" in testing for ownership by the employees performing services.

[2565] See part II.M.3.e.i.(b) Distributions Presumed Not to Be Disguised Sales.

[2566] Prior Prop. Reg. § 1.707-7(f) provided:

> *Application of §1.707-4 (special rules applicable to guaranteed payments, preferred returns, operating cash flow distributions, and reimbursements of preformation*

In withdrawing Prop. Reg. § 1.707-7, Ann. 2009-4 stated:

> The Treasury Department and the IRS will continue to study this area and may issue guidance in the future. Until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law.

I am unaware of cases discussing the disguised sale of a partnership interest form one partner to another after the Prior Prop. Regs. were issued. One might consider looking to them as guidelines in planning to try to develop a comfort level in light of the lack of guidance beyond the cases we have toward which the IRS has expressed antipathy.

II.M.3.f. Exception: Corporate Partners

Corporate stock can be transferred to affiliated corporations or their owners in a variety of ways, some of which are tax-free. Some of this involves partnerships of corporations, which partnerships might at first glance appear to allow corporations to shift or increase basis, based on the interaction of Subchapter C and partnership rules. Although these materials touch upon various elements of Subchapter C, one should review materials that focus intensively on Subchapter C when restructuring any structure involving the interaction between more than one C or S corporation.

Among these concerns, a corporate partner might be required to recognize gain when a partnership directly or indirectly owns, acquires, or distributes stock of the corporate partner, and that transaction (or series of transactions) has the effect of an exchange by the corporate partner of its interests in appreciated property for an interest in stock of the corporate partner owned, acquired, or distributed by a partnership.[2567]

II.M.3.g. Exception: Foreign Partner

Regulations may provide that Code § 721(a) nonrecognition shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a foreign person.[2568]

Notice 2015-54 announced detailed rules that will be integrated into regulations effective as to transfers occurring on or after August 6, 2015, as well as transfers occurring before that date that result from entity classification elections that are filed on or after that date, and that are effective on or before that date. T.D. 9814 issued temporary regulations, effective January 18, 2017. The May 2017 meeting of the American Bar Association Section of Taxation included a session with the person who worked on the regulation project. Remarks made by panelists mentioned that one needed to be concerned with foreign taxpayers who were direct or indirect owners of partnership interests and that surprising results could happen even with what seemed to be a simple situation.

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expenditures). Notwithstanding the presumption set forth in paragraph (c) of this section, rules similar to those provided in § 1.707-4 apply to determine the extent to which a transfer to a selling partner is treated as part of a sale of the selling partner's interest in the partnership to the purchasing partner.

[2567] See Reg. § 1.337(d)-3T.

[2568] Code § 721(c).

II.M.3.h. Reporting Real Estate Contributed to a Partnership or Corporation in a Nontaxable Transaction

The “real estate reporting person” must file an information return (Form 1099) and provide a copy to the grantor.[2569] The person (including any attorney or title company) responsible for closing the transaction has primary responsibility for filing information returns.[2570] The person responsible for closing the transaction is:[2571]

1. If a Uniform Settlement Statement is used under RESPA, the person listed as settlement agent on the statement.

2. If no settlement agent is listed or a closing statement is used that is not a Uniform Settlement Statement, the person who prepared the closing statement.

3. If no closing statement is used or if multiple closing statements are used, then either the transferee’s attorney who is present at delivery of the consideration or the transferee’s attorney who prepares or reviews the deed, or if no such attorney is present then either the transferor’s attorney who is present at delivery of the consideration or the transferor’s attorney who prepares or reviews the deed.

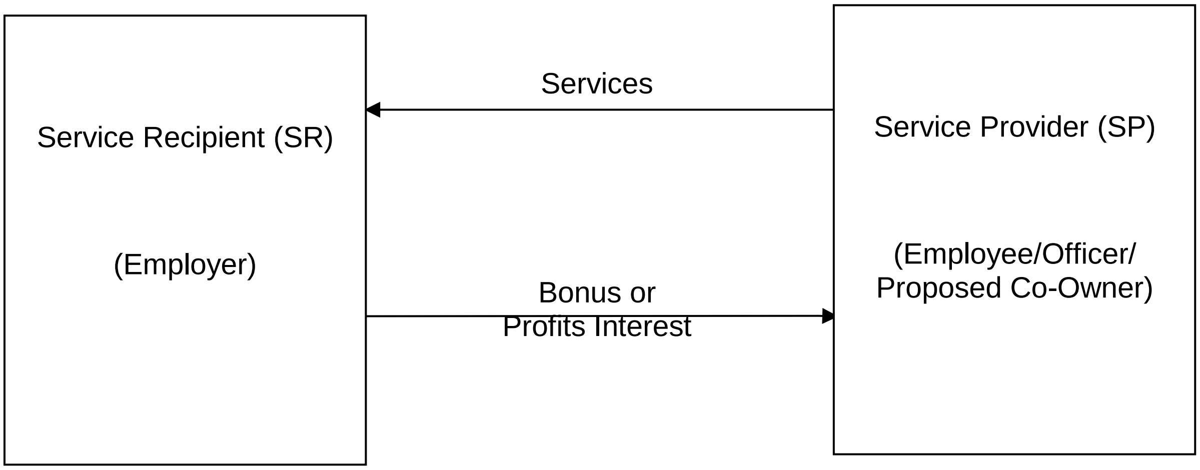
The real estate reporting person may not separately charge a customer for reporting the transaction but may take the reporting requirement into account in charging a fee for the overall transaction.[2572]

Except as otherwise provided, all “sales” effected by a broker in the ordinary course of business shall be reported.[2573] Distributions from partnerships do not need to be reported if properly reported on IRS Form 1065 and Schedule(s) K-1.[2574] However, Code § 721 contributions to a partnership and Code § 351 contributions to a corporation were intentionally not excluded from reporting.[2575]

[2569] Code § 6045(e)(1). All references to the Code are to the Internal Revenue Code of 1986, as amended.
[2570] Code § 6045(e)(2)(A).
[2571] Reg. § 1.6045-4(e)(3). Reg. means a United States Treasury Regulation under the Code. Although Code § 6045(a) refers to a broker, Reg. § 1.6045-1(a)(1) defines a broker to include any person who stands ready to effect sales to be made by others.
[2572] Code § 6045(e)(3).
[2573] Reg. § 1.6045-1(c)(2).
[2574] Reg. § 1.6045-1(c)(3)(v).
[2575] Preamble to Reg. § 1.6045-1 under Treasury Decision 8323.

II.M.4. Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules

II.M.4.a. Overview



Before working in this area, consider reading part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation.

II.M.4.a.i. Bonus vs. Equity

Advantages of Bonus

- Service provider (SP) has no rights to information about the business beyond what is necessary to enforce rights to bonus.
- Don't need to worry about buying out SP upon divorce, SP's financial hardship (creditors), disability, death, or other separation from service.

Disadvantages of Bonus

- Code § 409A complicates timing of payment for performance after year-end; however, easy to get around if recognize the issue.
- Code § 409A complicates payments deferred into future as "golden handcuffs."

Advantages of Equity

- Immediate issuance of profits interest or stock often avoids all Code § 409A issues.
- SP feels like an owner and might be more motivated.
- Courts tend to accept more restrictive covenants not to compete, etc. when SP is an owner.

Disadvantages of Equity

- Complicates capital structure. Need to worry about buy-sell-related issues.

- SP might be able to demand more on separation from service, in addition to any employment issues.

- Creditors might very well require loan guarantees of SP, which might make ownership unattractive to SP. This might be more of an advantage, however, in that SP will be much less likely to abandon a sinking ship - because SP might go down with it!

- A transfer of part of the business' current value might be deemed to occur in a family business setting.[2576]

II.M.4.a.ii. Equity vs. Synthetic Equity.

What is synthetic equity?

- Bonus payments that mirror distributions to owners have the same Code § 409A issues as other bonus payments.

- Options to acquire stock or partnership interests are not subject to Code § 409A if a sufficient exercise price that makes them equivalent to profits interest.

Profits Interest vs. Pro Rata Share of Entire Entity

- "Profits interest" means an interest in the partnership's future income, gains, deductions, and losses, with a zero beginning capital account so that, if entity dissolved at the time of transfer, the holder would receive nothing.[2577]

- "Pro rata share of entire entity" means that the owner receives not only a profits interest but also a proportionate share of the proceeds if the entity liquidates.

- Issuance of a profits interest generally is not taxable, but issuance of a pro rata share of entire entity is. Need to gross-up SP for taxes on issuance of a pro rata share of entire entity; however, SR receives an equivalent deduction and tax benefit, so long as timing is not messed up.

- Issuance of a profits interest is forward-looking, whereas issuance of a pro rata share of entire entity often has a large backward-looking component.

[2576] See part III.B.7.b Code § 2701 Overview for when an entity needs to consider gift tax valuation rules when using profits interests and part III.B.7.c Code § 2701 Interaction with Income Tax Planning for planning for equity awards to those in the same family.

[2577] This is done by valuing the partnership's assets at the time the profits interest is issued and booking up the partners' capital accounts under Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii). The partners' capital accounts are adjusted as if the partnership had sold all of its assets for their fair market value, but no gain or loss is recognized and tax basis does not change as a result of that hypothetical sale and actual capital account adjustment.

- Issuance of a profits interest is more conducive to golden handcuffs. SR distributes enough to pay taxes but holds the rest of the cash until agreed-upon event occurs. Undistributed cash is reflected in SP's capital account (which originally started at zero). Generally, when SP has a pro rata share of entire entity, SP receives distributions at the same time as though who provide investment capital. See S corporation example below.

II.M.4.b. When is an Award or Transfer to an Employee Includible in the Employee's Income

II.M.4.b.i. Income Tax Recognition Timing Rules re Equity Incentives

Property[2578] is not taxable under Code § 83(a) until it has been transferred to such person and become substantially vested in such person.[2579] For Code § 83 to apply to defer a deduction to a later date when the property was more valuable, the service recipient must show that: (1) the property was transferred in connection with the performance of services and (2) the property was subject to a substantial risk of forfeiture until that later date.[2580]

In determining whether property was transferred in connection with the performance of services, the following factors apply:[2581]

(1) whether the property right is granted at the time the employee or independent contractor signs his employment contract;

(2) whether the property restrictions are linked explicitly to the employee's or independent contractor's tenure with the employing company;

(3) whether the consideration furnished by the employee or independent contractor in exchange for the transferred property is services; and

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[2578] Reg. § 1.83-3(e) provides:

> … the term property includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account...

[2579] Reg. § 1.83-1(a)(1). *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), disallowed a C corporation's assertion that stock issued several years before had not vested until right before the corporation was sold. The disputed deduction was almost $118 million.

[2580] *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), the Fourth Circuit also referring to *Strom v. United States*, 641 F.3d 1051, 1055-56 (9th Cir. 2011); *United States v. Bergbauer*, 602 F.3d 569, 580 (4th Cir. 2010).

[2581] *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123 (finding that the taxpayer failed to prove transfer in connection with the performance of services), *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), the Tax Court citing as follows:

> See *Bagley v. Commissioner*, 806 F.2d at 170-171; *Alves v. Commissioner*, 734 F.2d 478, 481-482 (9th Cir. 1984), *aff'g* 79 T.C. 864 (1982); *Montelepre Systemed, Inc. v. Commissioner*, T.C. Memo. 1991-46 (citing *Centel Commc'ns Co. v. Commissioner*, 92 T.C. 612), *aff'd*, 956 F.2d 496 (5th Cir. 1992).

(4) the employer's intent in transferring the property.

A transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding certain lapse restrictions).[2582] Imposing restrictions on substantially vested stock that cause the substantially vested stock to become substantially nonvested does not constitute a transfer of substantially nonvested stock subject to Code § 83.[2583]

Property is substantially vested when it is either transferable or not subject to a substantial risk of forfeiture.[2584]

Based on the facts and circumstances, a substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.[2585] The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial.[2586] Special rules apply where

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[2582] Reg. § 1.83-3(a)(1).

[2583] Rev. Rul. 2007-49, which also held that there is a transfer of substantially nonvested stock subject to Code § 83 where (a) a service provider exchanges substantially vested stock for substantially nonvested stock in a reorganization described in Code § 368(a), or (b) a service provider exchanges substantially vested stock for substantially nonvested stock in a taxable stock acquisition.

[2584] Reg. § 1.83-3(b). *Gluckman v. Commissioner*, T.C. Memo. 2012-329, *aff'd*, 545 F. App'x 59 (2d Cir. 2013), held:

> Therefore, consistent with the Advantage Plan's provisions and the plan withdrawal procedures communicated to participating employers, at that point it appears that the underlying policies were substantially certain to be distributed to petitioners or placed within their control. Even if transfers to other welfare benefit plans were still being permitted by BISYS at that time, subsequent events demonstrate that the policies were placed within petitioners' control no later than early November 2003. After receiving the resolution, BISYS sent endorsed, partially completed change of ownership forms that lacked only the new owner information and sent blank change of beneficiary designation forms, as well as duplicate copies of the policies, to petitioner's attention. The forms and the original insurance policies also were provided to petitioners' insurance agent. These actions placed petitioners' underlying policies squarely within their control because petitioners were then free to name the policies' new owner and beneficiary, which could have been themselves or another welfare benefit plan. When a taxpayer has dominion and control over property, the value of such property generally will be included in his or her gross income. See *Cadwell v. Commissioner*, 136 T.C. 38, 52-56 (2011), *aff'd* without published opinion, 109 A.F.T.R.2d 2012-2693 (4th Cir. 2012); *Chambers v. Commissioner*, T.C. Memo. 2011-114.

O'Connor v. Commissioner, T.C. Memo. 2015-244, reaffirmed *Gluckman* and imposed penalties when the taxpayer did not give the tax advisor complete information.

[2585] Reg. § 1.83-3(c)(1), which further provides:

> Property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture.

[2586] Reg. § 1.83-3(c)(2), which further provides:

> The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial. Where stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of forfeiture. Where an employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase, such property is subject to a substantial risk of forfeiture. On the other hand, requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture. An enforceable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary. Factors which may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants. Similarly, rights in property transferred to a retiring employee subject to the sole requirement that it be returned unless he renders consulting services upon the request of his former employer will not be considered subject to a substantial risk of forfeiture unless he is in fact expected to perform substantial services.

Austin v. Commissioner, 141 T.C. 551 (2013), held that the following facts might or might not support a finding of substantial risk of forfeiture based on the following definition of cause:

> A. Dishonesty, fraud, embezzlement, alcohol or substance abuse, gross negligence or other similar conduct on the part of the Employee. Upon termination of this Agreement, Employee shall be entitled to receive compensation through the date of termination.
>
> B. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by faithfully and diligently performing the usual and customary duties of his employment and adhere to the provisions of this Agreement.
>
> C. Failure or refusal by Employee, after 15 days written notice to Employee, to cure by complying with the reasonable policies, standards and regulations applicable to employees which * * * [UMLIC S-Corp.] may establish from time to time.

The court looked carefully at the circumstances behind that regulation's promulgation and reasoned:

> This history of section 1.83-3(c)(2), Income Tax Regs., strongly suggests that discharge for cause, like discharge for committing a crime, refers to a narrow and serious form of employee misconduct that is very unlikely to occur and is thus properly regarded as too remote—as a matter of law—to create a substantial risk of forfeiture.

After trial, T.C. Memo. 2017-69, the court held:

> In sum, we conclude that petitioners' stock was subject to a substantial risk of forfeiture when issued to them in 1998 and remained subject to that risk until the restrictions lapsed on January 1, 2004. Neither petitioner held a controlling position in UMLIC S-Corp. If either failed to perform his duties or left the company before the earnout restriction ended, the other would have had every incentive to insist on enforcement of the forfeiture provision according to its terms. The ESOP had (if anything) even stronger economic incentives to do this. Because "the possibility of forfeiture * * * [was] substantial," sec. 1.83-3(c)(3), Income Tax Regs., the stock held by petitioners and their grantor trusts did not become "substantially vested" until petitioners completed their promised service through the five-year earnout period.

In *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), the Tax Court cited *Austin* (2013) when determining that a corporation failed to prove that the possibility of forfeiture was substantial.

the employee is a significant owner [2587] or where securities laws impose certain restrictions.[2588]

[2587] Reg. § 1.83-3(c)(3) provides:

> In determining whether the possibility of forfeiture is substantial in the case of rights in property transferred to an employee of a corporation who owns a significant amount of the total combined voting power or value of all classes of stock of the employer corporation or of its parent corporation, there will be taken into account (i) the employee's relationship to other stockholders and the extent of their control, potential control and possible loss of control of the corporation, (ii) the position of the employee in the corporation and the extent to which he is subordinate to other employees, (iii) the employee's relationship to the officers and directors of the corporation, (iv) the person or persons who must approve the employee's discharge, and (v) past actions of the employer in enforcing the provisions of the restrictions. For example, if an employee would be considered as having received rights in property subject to a substantial risk of forfeiture, but for the fact that the employee owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on rights in property transferred to the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

In *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017), the Tax Court applied these factors to determine that a corporation failed to prove that the possibility of forfeiture was substantial.

[2588] *Strom v. U.S.*, 641 F.3d 1051 (9th Cir. 2011), summarized:

> Ordinarily, when an employee is compensated with nonstatutory stock options that do not have a readily ascertainable fair market value at the time of the grant, the employee realizes income for tax purposes upon exercising the options. [Here, footnote 1 provides, Statutory stock options are compensatory options meeting criteria entitling them to special treatment under the Internal Revenue Code. See 26 U.S.C. § 422. Compensatory options that do not meet these requirements are referred to as nonstatutory. See *United States v. Tuff*, 469 F.3d 1249, 1251 n.2 (9th Cir. 2006) (citing *Cramer v. Comm'r*, 64 F.3d 1406, 1408–09 (9th Cir. 1995)).] See 26 U.S.C. § 83(e)(3)-(e)(4); 26 C.F.R. § 1.83-7(a). The taxpayer is taxed on an amount equal to the fair market value of the stock on the date of exercise minus the option price paid for the stock. See 26 C.F.R. § 1.83-1(a)(1); *id.* § 1.83-7(a). Internal Revenue Code § 83(c)(3), however, allows taxpayers to defer recognition and valuation of income so long as a profitable sale of the stock acquired through the exercise of the options could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934. 26 U.S.C. § 83(c)(3). Section 16(b), in turn, forbids a corporate insider from profiting on a purchase made within six months of a sale (or a sale made within six months of a purchase) of the corporation's stock. See 15 U.S.C. § 78p(b). If a taxpayer is permitted to defer tax consequences under IRC § 83(c)(3), the taxpayer will be later taxed on an amount equal to the fair market value of the stock on the date that § 83(c)(3) no longer applies minus the option price paid for the stock. See 26 U.S.C. § 83(a); 26 C.F.R. § 1.83-1(a)(1).
>
> In this opinion, we first interpret the phrase could subject a person to suit under section 16(b) and determine what that phrase requires a taxpayer to demonstrate before she can postpone tax consequences under § 83(c)(3). We then hold that the taxpayer

The rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture.[2589]

Consider planning for the contingency that a distributive share of income is allocated to a person whose interest was assumed to be vested but turned out not to be vested.[2590]

Furthermore, Code § 83(e) provides that Code § 83 does not apply to:

(1) a transaction to which section 421 applies,

(2) a transfer to or from a trust described in section 401(a) or a transfer under an annuity plan which meets the requirements of section 404(a)(2),

(3) the transfer of an option without a readily ascertainable fair market value,

(4) the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant, or

(5) group-term life insurance to which section 79 applies.

Beyond the issue of forfeiture, if an employee or independent contractor (or beneficiary thereof) is granted, in connection with the performance of services, an option to which Code § 421 (relating generally to certain qualified and other options) does not apply, Code § 83(a) applies to such grant if the option has a readily ascertainable fair market value at the time the option is granted.[2591] Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market.[2592] If Code § 83(a) does not apply to the grant of an option because the option does not have a readily ascertainable fair market value at the time of grant, Code §§ 83(a) and (b) apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time.[2593] If the option is exercised, Code §§ 83(a) and (b) apply to the transfer of property under the exercise, and the

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> here has not demonstrated an entitlement to deferral of tax consequences under § 83(c)(3), and after addressing a distinct legal issue pertinent to the ultimate resolution of this case, reverse and remand for further proceedings.

[2589] Reg. § 1.83-3(d), which further provides:

> Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of such property and if the transferee is not required to give up the property or its value in the event the substantial risk of forfeiture materializes. On the other hand, property is not considered to be transferable merely because the person performing the services or receiving the property may designate a beneficiary to receive the property in the event of his death.

[2590] See part II.M.4.f.iii What Happens If a Nonvested Partnership Interest Does Not Qualify As a Profits Interest for a similar situation.

[2591] Reg. § 1.83-7(a).

[2592] Reg. § 1.83-7(b)(1).

[2593] Reg. § 1.83-7(a).

employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under Code §§ 83(a) and (b).[2594] Thus, when the service provider exercises such an option and the option is vested, the service recipient deducts the excess of value over exercise price and the service provider reports that as income.[2595]

For more details on how Code § 83 applies and the impact of a Code § 83(b) election in accelerating income, see part II.M.4.e.i Issuing Stock to an Employee - Generally.

II.M.4.b.ii. Strategic Issues re Income Tax Timing of Equity Incentives

If the employer can deduct the compensation expense at the same or a higher rate than that of the employee, then the incentive payment is tax-efficient. This can be especially important when paying key employees bonuses in connection with the sale of a company. The bonuses might even be grossed up to pay the employees' taxes – see the example in part II.M.4.e.i Issuing Stock to an Employee - Generally.

Sometime a mismatch might occur. For example, suppose a partnership or S corporation sells its assets, recognizing long-term capitals taxable at favorable rates, but has little ordinary income. In that case, the deduction benefits the employer to the extent of capital gain rates, while the income is taxed to the employee at ordinary income rates. Also, if the employer has insufficient income against which to deduct the compensation, then the compensation award is even less efficient. These mismatches might make grossing up employees for taxes be untenable.

II.M.4.c. Gifts to Employees

II.M.4.c.i. When a Gift to an Employee Is Compensation and Not a Gift

A gift to an employee generally is considered to be compensation and not a true gift.[2596] For the payment to be a gift, "the dominant reason that explains [the employer's] action in making the transfer" must be "detached and disinterested generosity" or "out of affection, respect, admiration, charity or like impulses."[2597]

When a majority stockholder of a corporation transferred some of his stock in the corporation to the employees of that corporation, the number of shares transferred to each employee being dependent on the number of years of service to the corporation, the IRS viewed the majority stockholder as benefitting economically through increased initiative in the employees resulting from their ownership of stock in their employer corporation, so the IRS ruled that the transferor's intent was recognizing past services rather than "detached and disinterested generosity."[2598]

[2594] Reg. § 1.83-7(a).

[2595] Letter Ruling 201610006, dealing with warrants issued to an independent contractor that was an entity.

[2596] Code § 102(c). See Bittker & Lokken, ¶10.2. Exclusion of Gifts From Gross Income, *Federal Taxation of Income, Estates, and Gifts* (WG&L).

[2597] *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

[2598] Rev. Rul. 69-140.

If a shareholder of a corporation transfers property to an employee of such corporation or to an independent contractor (or to a beneficiary thereof), in consideration of services performed for the corporation, the transaction shall be considered to be a contribution of such property to the capital of such corporation by the shareholder, and immediately thereafter a transfer of such property as compensation paid by the corporation to the employee or independent contractor.[2599]

On the other hand, when a parent transferred stock to a grantor retained income trust that passed to children if the parent lived ten years, past work from time to time was considered incidental to donative intent: the children were full-time students when the trust was created, no mention was made of future work for the company, and the survivorship requirement persuaded the IRS that the transfer was purely a gift.[2600]

II.M.4.c.ii. Is Compensation to an Employee Better or Worse Than a Gift?

An employer may deduct reasonable compensation for services rendered in carrying out the employer's activity for profit.[2601]

The employer's deduction might offset the detriment of the employee's inclusion in income. For example, suppose each of the employer and employee have a 40% marginal tax rate and the employer wanted to get $100 to the employee, net of tax. The employer could award $167 of compensation, consisting of $100 cash to the employee and $67 (40% of $167) withholding to the government. The employer's $167 deduction generates a $67 tax saving (40% of $167), effectively reimbursing the employer for the $67 withholding paid to the government.

The actual math is not quite so tidy as illustrated above. For example, the employer and employee need to pay FICA tax on the compensation. The employer and employee might not be in the same bracket, which might cause a windfall or detriment to one party. If the payment is very large, the deduction might very well push the employer into a lower bracket and the employee into a higher bracket.

From a gift tax perspective, a gift is preferable if the donor has much more estate/gift tax exemption than assets. On the other hand, if the donor has a taxable estate, a 40% federal estate tax, without any corresponding tax savings, might represent a much larger net tax to the parties than a compensation scenario.

II.M.4.c.iii. FICA On Amounts Paid After Death, Including Death Benefits

Any taxable payment made by an employer to a survivor or the estate of a former employee after the calendar year in which such employee died is not subject to FICA.[2602] This includes amounts that would have been payable even if the employee had lived.[2603]

[2599] Reg. § 1.83-6(d)(1).
[2600] Letter Ruling 9109027, which is further described in fn. 4920 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.
[2601] Code § 162(a)(1). Code § 162(m) is among the authority for not deducting excessive compensation.
[2602] Code §3121(a)(14).
[2603] Letter Ruling 8321051.

Payments made in the calendar year of death are exempted from FICA by reason of the employee's death only if they:[2604]

- Are made under a plan established by the employer which makes provision for employees generally or a class or classes of his employees (or for such employees or class or classes of employees and their dependents), and

- Would not have been paid if the employee had not died.

For more information, see Zaritsky & Leimberg, ¶ 6.06[2][a][ii] Income tax treatment of the beneficiaries, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L).

II.M.4.d. Introduction to Code § 409A Nonqualified Deferred Compensation Rules

Before working in this area, consider reading part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation.

Enacted by the American Jobs Creation Act of 2004,[2605] Code § 409A imprints a layer of rules that supplements previously existing rules on taxing deferred compensation.[2606] It punishes service providers (employees and independent contractors) who receive deferred compensation without complying with its terms; it is so broad that even public school teachers need to be careful![2607]

The service provider must pay a penalty of 20% of the deferred compensation when it is includible in gross income.[2608] At the same time, the service provider must also pay interest to the IRS on the deferred tax, measured from the taxable year that is the later of when compensation was earned or when it was not subject to a substantial risk of forfeiture.[2609] However, these rules do not apply to compensation payments that are taxed when earned but paid in a later year.[2610]

Permissible triggering events for payments under Code § 409A include separation from service, disability, death, a specified time or fixed schedule, a change in control of the service recipient, or an unforeseeable emergency.[2611] Special rules apply to split-dollar life insurance arrangements that were entered into before 2005.[2612] These materials are

[2604] Code §3121(a)(13).
[2605] Although the statute became effective January 1, 2005, existing plans did not need to be modified until December 31, 2008. Notice 2007-86.
[2606] Constructive receipt, Code § 83, Code § 457(f), etc.
[2607] Notice 2008-62.
[2608] Code § 409A(a)(1)(B)(i)(I); Prop. Reg. § 1.409A-4.
[2609] Code § 409A(a)(1)(B)(i)(II); Prop. Reg. § 1.409A-4.
[2610] See Rev. Rul. 2007-48 (treatment of amounts vested 1/1/2009 in the scenario that is used in the ruling), stating, Under § 1.409A-1(b)(6)(i), a right to compensation income that will be required to be included in income under § 402(b)(4) is not a deferral of compensation for purposes of § 409A.
[2611] The regulations and various IRS pronouncements provide very detailed rules on how to apply these concepts. The author always works with employee benefits practitioners in his firm who know these rules better than he does.
[2612] Notice 2007-34. See part II.Q.4.f Split-Dollar Arrangements.

not intended to provide a thorough knowledge of Code § 409A. The discussion below focuses on satisfying exceptions to Code § 409A with respect to equity and substitutes for equity.[2613]

Note, however, that the present value of a deferred compensation obligation is an expense on the business's income statement and a liability on its balance sheet. See part II.Q.1.d.ii.(b) Balance Sheet Effects of Deferred Compensation.

Also note that, to be exempt from ERISA, a plan needs to be a "top hat" plan for the benefit of a person or select group of persons with bargaining power.[2614] The employer must notify the Department of Labor that such a plan exists.[2615]

II.M.4.d.i. Performance Bonuses

Performance bonuses that are due March 15 after a calendar year-end can have excellent motivational effects. Because the date is fixed no later than 2.5 months after yearend, paying compensation after that fixed date would not cause the payment to violate Code § 409A if the payment is made during the calendar year including the fixed date.[2616] One glitch is that it is possible that the information needed to determine the bonus might not be available until after March 15. To avoid this, require the employee to work at least one day in the next year. For example, suppose a bonus relates to 2010 performance. Require the employee to work at least one day in 2011. Imposing this requirement means that the payment is not vested until 2011, so the payment date could be fixed at a date on or before March 15, 2012. Of course, for motivational reasons, the payment should be made in 2011 as soon as the information is available to ensure that the employee does not have to wait too long, but the important point is that the deadline for the bonus relating to 2010 work can be after March 15, 2011, to take into account practical business exigencies.

Be sure that, when a performance bonus is added to other compensation, the service provider's total compensation remains reasonable.

Performance bonuses based on profits should not constitute an equity interest under Code § 2701 if the service provider does not have any other equity interest, the service provider is not identified to the IRS or third parties as being an owner, and the service provider does not share in any losses.

II.M.4.d.ii. Pushing Back a Scheduled Retirement Date

After a plan has been set up, the employee cannot elect to postpone a scheduled payment unless the election is at least 12 months before the scheduled payment date

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[2613] For benefits of using profits interests, see part II.M.4.f.i Overview of Profits Interest; Contrast with Code § 409A.

[2614] 'Top-Hat' Plans, part XI.C. of Deferred Compensation Arrangements, T.M. 385.

[2615] The simplest way might be a letter under 29 C.F.R. § 2520.104-23. For some relief for failure to send the letter, see https://www.irs.gov/retirement-plans/irs-penalty-relief-for-dol-dfvc-filers-of-late-annual-reports and https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/correction-programs/dfvcp.

[2616] Reg. §§ 1.409A-1(b)(4)(i), 1.409A-3(b), (d).

and the payment is deferred at least 5 years.[2617] (Postponing previously deferred payments is often referred to as re-deferral.)

However, that rule might not be as big an obstacle as it seems. Suppose an employee makes $150K per year and is scheduled to receive $100K annual retirement payments from 2020-2029. Suppose that 2019 comes along, and the parties agree that employee should continue working. In that case:

- In 2019, the employee agrees to receive his $150K in compensation for 2020 over two periods: $50K in 2020 and $100K in 2030.

- The employee receives $150K in 2020, of which $100K is the originally scheduled deferred compensation and $50K that is earned for 2020 work.

- Thus, the employee receives $150K in 2020 and earns an additional payment of $100K to be paid in 2030, the year after the $100K retirement payments were scheduled to end.

The employee has effectively pushed back retirement by one year. However, the original payment stream of $100K per year from 2020-2029 remains intact. Thus, the Code § 409A rules on postponing a stream of payments have not been violated. The above plan not only offers flexibility but also avoids the strict deadlines that apply to re-deferral.

Setting a fixed payment upon attaining a particular age would satisfy Code § 409A without causing Code § 2701 or other income or estate tax problems, and that could be coupled with disability and death benefits to provide financial security.[2618]

II.M.4.d.iii. Change in Control as a Permitted Triggering Event under Code § 409A

Change in the entity's control is an event that can trigger payment of deferred compensation without the harsh consequences of Code § 409A.[2619] Generally, such a change in control in a corporation occurs when any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, constitutes more than 50% of the total fair market value or total voting power of the stock of such corporation.[2620] Similar rules

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[2617] Code § 409A(a)(4)(C).

[2618] See part III.B.7.c.vi, Code § 2701 Interaction with Income Tax Planning.

[2619] In order to cover earn-out provisions where the acquirer in a change of control contracts to make an immediate payment at the closing of the transaction with additional amounts payable at a later date, delayed payments may meet the requirements for a payment at a specified time or pursuant to a fixed schedule if they are paid on the same schedule and under the same terms and conditions as payments to shareholders generally pursuant to the change in control event to the extent paid not later than five years after the change in control event. Reg. § 1.409A-3(i)(5)(iv).

[2620] Reg. § 1.409A-3(i)(5)(v)(A). This applies to a change in the ownership of the corporation, a change in effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation. Reg. § 1.409A-3(i)(5)(i).

apply to partnerships.[2621] Using principles that apply to other forms of performance-based compensation, Code § 2701 should not apply to compensation awarded upon change of control.

II.M.4.e. Issuing Stock to an Employee

II.M.4.e.i. Issuing Stock to an Employee - Generally

For the fundamental rules underlying this part II.M.4.e.i, see part II.M.4.b.i Income Tax Recognition Timing Rules re Equity Incentives.

An employee who receives stock as compensation for services must pay tax on that stock.[2622]

Rev. Proc. 2012-29 explains the consequences of nonvested or nontransferable stock:[2623]

> Section 83(a) provides generally that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of the property (determined without regard to any restriction other than a restriction which by its terms will never lapse) as of the first time that the transferee's rights in the property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over the amount (if any) paid for the property is included in the service provider's gross income for the taxable year which includes such time.[2624]
>
> Under § 1.83-3(f) of the Income Tax Regulations, property is transferred in connection with the performance of services if it is transferred to an employee or independent contractor (or beneficiary thereof) in recognition of the performance of services, or refraining from performance of services. The existence of other persons entitled to buy stock on the same terms and conditions as an employee, whether pursuant to a public or private offering may, however, indicate that in such circumstance a transfer to the employee is not in recognition of the performance of, or refraining from performance of, services. The transfer of property is subject to § 83 whether such transfer is in respect of past, present, or future services.[2625]
>
> Section 83(b) and § 1.83-2(a) permit the service provider to elect to include in gross income the excess (if any) of the fair market value of the property at the

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[2621] Third paragraph of Part VI.E. to the Preamble to the Prop. Regs., allowing taxpayers to rely on similar rules until further guidance is issued for a partnership setting. This continues to apply under section III.G. of the preamble to the final regulations.
[2622] Code § 83. Letter Ruling 201405005 is a good example of a simultaneous exit of two owners and entrance of key employees with restricted stock in an S corporation.
[2623] Footnotes below are mine and are not in the Rev Proc.
[2624] Rev. Proc. 2012-29, § 2.01.
[2625] Rev. Proc. 2012-29, § 2.02.

time of transfer over the amount (if any) paid for the property, as compensation for services.[2626]

Under § 83(e)(3) and § 1.83-7(b), § 83 does not apply to the transfer of an option without a readily ascertainable fair market value at the time the option is granted. As a result, a § 83(b) election may only be made with respect to the transfer of an option that has a readily ascertainable fair market value (as defined in § 1.83-7(b)), at the time the option is granted and that is substantially nonvested (as defined in § 1.83-3(b)). If substantially nonvested property is received upon exercise of an option without a readily ascertainable fair market value at grant, a service provider is permitted to make a § 83(b) election with respect to the transfer of such property upon the exercise of the option.[2627]

Under § 1.83-2(a), if property is transferred in connection with the performance of services, the person performing such services may elect to include in gross income under § 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) over the amount (if any) paid for such property, as compensation for services. If this election is made, the substantial vesting rules of § 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in § 83(d)(2) and the regulations thereunder (relating to the cancellation of a nonlapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, the value of property with respect to which this election is made is included in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in § 1.83-3(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested.[2628]

In computing the gain or loss from a subsequent sale or exchange of property for which a § 83(b) election was filed, § 1.83-2(a) provides that the basis of such property shall be the amount paid for the property (if any) increased by the amount included in gross income under § 83(b).[2629]

If property for which a § 83(b) election was filed is forfeited while substantially nonvested, § 83(b)(1) provides that no deduction shall be allowed with respect to such forfeiture. Section 1.83-2(a) further provides that such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of (1) the amount paid (if any) for such property, over (2) the amount realized (if any) upon such forfeiture. If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss.[2630]

[2626] Rev. Proc. 2012-29, § 2.03.
[2627] Rev. Proc. 2012-29, § 2.04.
[2628] Rev. Proc. 2012-29, § 4.01.
[2629] Rev. Proc. 2012-29, § 4.02.
[2630] Rev. Proc. 2012-29, § 4.03.

The Rev. Proc. provided a sample form for making a Code § 83(b) election.[2631]

When stock is transferred to the employee that is subject to a substantial risk of forfeiture[2632] and is not transferable,[2633] the employee recognizes income and treated as owning the stock if the employee makes a Code § 83(b) election.[2634] Conversely, if the corporation awards nonvested stock, then the employee does not recognize compensation until the stock vests, unless the employee makes a Code § 83(b) election no later than 30 days after the award.[2635]

Similarly, in determining who is a shareholder of an S corporation: Stock that is issued in connection with the performance of services[2636] and that is substantially nonvested[2637] is not treated as outstanding stock of the corporation, and the holder of that stock is not treated as a shareholder solely by reason of holding the stock, unless the holder makes a Code § 83(b) election with respect to the stock.[2638] In the event of such an election, the stock is treated as outstanding stock of the corporation, and the holder of the stock is treated as a shareholder for purposes of subchapter S.[2639] Substantially nonvested stock with respect to which a Code § 83(b) election has been made is taken into account in determining whether a corporation has a second class of stock, and such stock is not treated as a second class of stock if the stock confers rights to distribution and liquidation proceeds that are identical,[2640] to the rights conferred by the other outstanding shares of stock.[2641] See part II.A.2.j Single Class of Stock Rules, especially part II.A.2.j.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules.

Rev Proc. 2012-29, Section 5, provides various examples, the tax results of which "do not depend on whether or not the stock transferred to the employee is traded on an established securities market":

2631 Reg. § 1.83-2(e) sets forth the requirements for the election's contents, and Rev. Proc. 2012-29 provides a way to satisfy those requirements.
2632 Within the meaning of Code § 83(c)(1).
2633 Within the meaning of Code § 83(c)(2).
2634 Rev. Rul. 83-22.
2635 Code § 83(b)(2). Letter Rulings 201405008 and 201528001 excused failure to file with the taxpayer's individual tax return a copy of a timely Code § 83(b) election; T.D. 9779 finalized without changes REG-135524-14, Property Transferred in Connection with the Performance of Services, 7/16/2015, amending Reg. § 1.83-2(c) to remove this requirement, effective for property transferred on or after January 1, 2016, the latter per Reg. § 1.83-2(g). T.D. 9779 also revoked Rev. Proc. 2012-29, in part, to the extent it requires, inconsistent with the final regulations, a taxpayer to submit a copy of a Code § 83(b) election with his or her income tax return. Note that Code § 83(b)(2) requires only the initial filing to make the election; the requirement to file the election with one's individual return appeared to be merely an administrative requirement for preparing a complete return – a requirement that the IRS appears to have abandoned as of January 1, 2015, although this apparent abandonment for 2015 was done in a peculiar way.
2636 Within the meaning of Reg. § 1.83-3(f).
2637 Within the meaning of Reg. § 1.83-3(b).
2638 Reg. § 1.1361-1(b)(3).
2639 Reg. § 1.1361-1(b)(3).
2640 Within the meaning of Reg. § 1.1361-1(*l*)(1).
2641 Reg. § 1.1361-1(*l*)(3).

Example 1. Company A is a privately held corporation and no stock in Company A is traded on an established securities market. On April 1, 2012, in connection with the performance of services, Company A transfers to E, its employee, 25,000 shares of substantially nonvested stock in Company A. In exchange for the stock, E pays Company A $25,000, representing the fair market value of the shares at the time of the transfer. The restricted stock agreement provides that if E ceases to provide services to Company A as an employee prior to April 1, 2014, Company A will repurchase the stock from E for the lesser of the then current fair market value or the original purchase price of $25,000. E's ownership of the 25,000 shares of stock will not be treated as substantially vested until April 1, 2014 and will only be treated as substantially vested if E continues to provide services to Company A as an employee until April 1, 2014. On April 1, 2012, E makes a valid election under § 83(b) with respect to the 25,000 shares of Company A stock. Because the excess of the fair market value of the property ($25,000) over the amount E paid for the property ($25,000) is $0, E includes $0 in gross income for 2012 as a result of the stock transfer and related § 83(b) election. The 25,000 shares of stock become substantially vested on April 1, 2014 when the fair market value of the shares is $40,000. No compensation is includible in E's gross income when the shares become substantially vested on April 1, 2014. In 2015, E sells the stock for $60,000. As a result of the sale, E realizes $35,000 ($60,000 sale price - $25,000 basis) of gain, which is a capital gain.

Example 2. The facts are the same as in Example 1 above, except that E does not make an election under § 83(b). Under § 83(a), E includes $0 in gross income in 2012 as a result of the transfer of stock from Company A because the stock is not substantially vested. When the shares become substantially vested on April 1, 2014, E includes $15,000 ($40,000 fair market value less $25,000 purchase price) of compensation in gross income. E's basis in the stock as of April 1, 2014 is $40,000 ($25,000 paid for the stock and $15,000 included in income under § 83(a)). As a result of the 2015 sale of the stock for $60,000, E realizes $20,000 ($60,000 sale price - $40,000 basis) of gain, which is a capital gain.

Example 3. The facts are the same as in Example 1 above, except that E terminates employment with Company A on August 1, 2013 before the shares become substantially vested. Because the excess of the fair market value of the property ($25,000) over the amount E paid for the property ($25,000) is $0, E includes $0 in gross income for 2012 as a result of the stock transfer and related § 83(b) election. When E terminates employment on August 1, 2013, the fair market value of the stock is $30,000 but Company A purchases the stock from E for $25,000 pursuant to the terms of the restricted stock agreement. As a result of the 2013 sale of the stock for $25,000, E realizes $0 in gain ($25,000 sale price - $25,000 basis).

Example 4. Company B is a publicly held corporation and Company B stock is traded on an established securities market. On April 1, 2012, in connection with the performance of services, Company B transfers to F, its employee, 25,000 shares of substantially nonvested stock in Company B. At the time of the transfer, the shares have an aggregate fair market value of $25,000. F is not required to pay Company B any consideration in exchange for the stock. The restricted stock agreement provides that if F ceases to provide services to Company B as an employee prior to April 1, 2014, F will forfeit the stock back to Company B. F's ownership of the 25,000 shares of stock will not be treated as substantially vested until April 1, 2014 and will only be treated as substantially vested if F continues to provide services to Company B as an employee until April 1, 2014. On April 1, 2012, F makes a valid election under § 83(b) with respect to the 25,000 shares of Company B stock. Because the excess of the fair market value of the property ($25,000) over the amount F paid for the property ($0) is $25,000, F includes $25,000 of compensation in gross income for 2012 as a result of the stock transfer and related § 83(b) election. The 25,000 shares of stock become substantially vested on April 1, 2014 when the fair market value of the shares is $40,000. No compensation is includible in F's gross income when the shares become substantially vested on April 1, 2014. In 2015, F sells the stock for $60,000. As a result of the sale, F realizes $35,000 ($60,000 sale price - $25,000 basis) in gain, which is a capital gain.

Example 5. The facts are the same as in Example 4 above, except that F does not make an election under § 83(b). Under § 83(a), F includes $0 in gross income in 2012 as a result of the transfer of stock from Company B because the stock is not substantially vested. When the shares become substantially vested on April 1, 2014, F includes $40,000 ($40,000 fair market value less $0 purchase price) of compensation in gross income. F's basis in the stock as of April 1, 2014 is $40,000 ($0 paid for the stock and $40,000 included in income under § 83(a)). As a result of the 2015 sale of the stock for $60,000, F realizes $20,000 ($60,000 sale price - $40,000 basis) of gain, which is a capital gain.

Example 6. The facts are the same as in Example 4 above, except that F terminates employment with Company B on August 1, 2013 and forfeits the shares before the shares become substantially vested. Because the excess of the fair market value of the property ($25,000) over the amount F paid for the property ($0) is $25,000, F includes $25,000 of compensation in gross income for 2012 as a result of the stock transfer and related § 83(b) election. In the year F terminates employment, F forfeits the 25,000 shares back to Company B and such forfeiture is treated as a sale of the shares in exchange for no consideration. Pursuant to § 1.83-2(a), F realizes no loss as the result of such sale. F is not entitled to a deduction or credit for taxes paid as the result of filing the § 83(b) election or the subsequent forfeiture of the property.

Note the unfairness in Example 6: F included an amount in income for stock F received but got no deduction – not even a capital loss – when F forfeited the stock with respect to that amount included (but would have received a deduction for any out-of-pocket purchase price)[2642]. Presumably, if F does not receive a deduction, Company B will not recognize income on account of F forfeiting the shares. Note that the result would have been different if Company B had separately bonused $25,000 cash and F had paid $25,000 cash for the stock, so long as the bonus and the payment were not tied together.

[2642] Although the Example cited a regulation, Code § 83(b)(1) mandates the position the regulation takes.

Often the corporation will "gross-up" the employee's pay by paying the employee's taxes on that compensation. If the corporation and employee are in the same income tax bracket, this arrangement will not cost anyone any income tax. For example, suppose everyone is in a 40% income tax bracket (federal and state) and $100 of stock is issued:

- The corporation receives $167 compensation deduction, consisting of $100 stock and $67 income tax withholding.
- The corporation saves $67 income tax (40% of $167). That $67 income tax savings offsets the $67 cash out-of-pocket for the withholding. Therefore, the corporation has no net cash expenditure.
- The employee incurs $67 of income tax liability (40% of the $167 compensation income). However, the $67 income tax withholding offsets that liability.
- Note that the above analysis ignores FICA.
- Note that lower corporate rates and the Code § 199a qualified business income deduciton[2643] may make the employer's deduction worth less than the income tax that the servce provider.
- For an S corporation, the compensation deduction benefits the shareholders, not the corporation, although the corporation indirectly benefits by reducing the need to make distributions to pay the shareholders' income tax. Note the new shareholder will benefit from this deduction, because all items are allocated pro rata, per share per day owned regardless of the timing of ownership, except to the extent that an election is made to close the books as of the date of the transfer.[2644] The election to close the books can be made only if issuance is at least 25% of the previously outstanding stock to one or more new shareholders.[2645]

Consider timing the issuance to coincide with taxable years in which the employer has sufficient ordinary income to absorb the deduction and provide a tax benefit at a sufficiently high income tax rate. Note also that, if an S corporation issues stock to its key employees in the year of the sale of the business, the deduction (if high enough) might wind up offsetting capital gain income, which is taxed at a lower rate – often too low to take advantage of the income tax dynamics described above.

Compare these concepts to the income tax dynamics of part II.Q.1.a, Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis, and more fully explored in part II.Q.1.d, Nonqualified Deferred Compensation.

Nonvested stock options provide the least complication when the exercise price is no less than the amount of the underlying stock's value. This approach avoids the forfeiture

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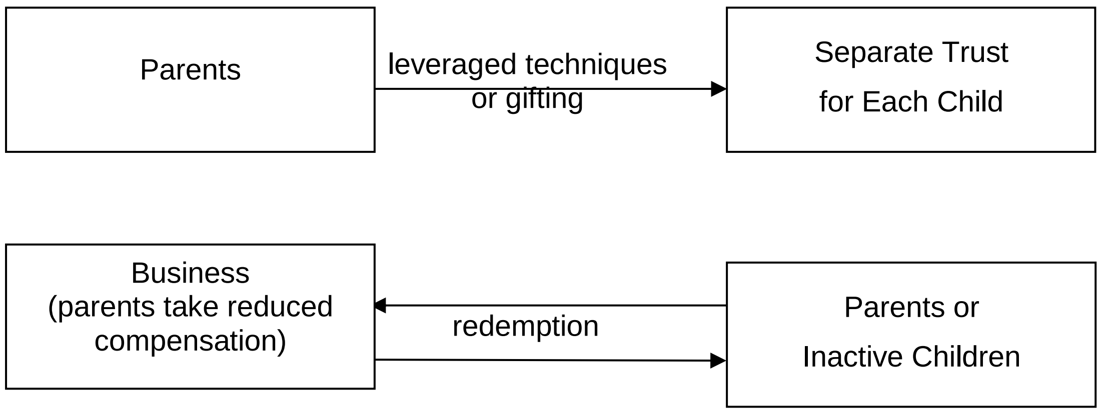
[2643] See part II.E.1.c Code § 199A Pass-Through Deduction Qualified Business Income.
[2644] See part III.B.2.j Tax Allocations upon Change of Interest, particularly III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.
[2645] Reg. § 1.1361-1(g)(2)(i)(C).

described above. It also avoids the need to comply with the restrictions that Code § 409 imposes on nonqualified deferred compensation.[2646]

If an employee is upset about stock being diluted when other investors enter and the buyer pays the employee the amount necessary to make up for the dilution, the payments in excess of a pro-rata purchase price that the buyer designates as being compensation is taxed as such.[2647]

Also, a corporation cannot treat a person as a shareholder with the same rights as the other shareholder and then claim that the stock was not yet vested to try to obtain a deduction at a later time when the stock was more valuable.[2648]

II.M.4.e.ii. Succession Planning Using Redemptions When Parent is Living



Leveraged Techniques of Gifting

The first chart represents the concept that leveraged techniques, such as GRATs and sales to irrevocable grantor trusts, result in all of the next generation having an equal interest in the business. See part III.B.1, Transfers During Life.

This might be through one trust that later splits through the trustee's power to divide or a family agreement or through separate trusts created from inception.

Reducing or Eliminating Parents or Inactive Owners

Inactive owners generally wish to maximize their return through distributions and by keeping compensation down.

Active owners typically wish to reinvest earnings to grow the business and wish to have incentive compensation.

[2646] See footnote 2682.

[2647] *Brinkley v. Commissioner*, T.C. Memo. 2014-227, *aff'd* 808 F.3d 657 (5th Cir. 2015) (penalties assessed for the manner in which the taxpayer engaged in self-help merely through tax return positions rather than by negotiating a better deal with the company).

[2648] *Qinetiq U.S. Holdings, Inc. and Subsidiaries v. Commissioner*, T.C. Memo. 2015-123, *aff'd* 119 A.F.T.R.2d 2017-330 (4th Cir. 1/6/2017). See part II.M.4.b When is an Award or Transfer to an Employee Includible in the Employee's Income.

The business entity might redeem the inactive owners to minimize future conflict.

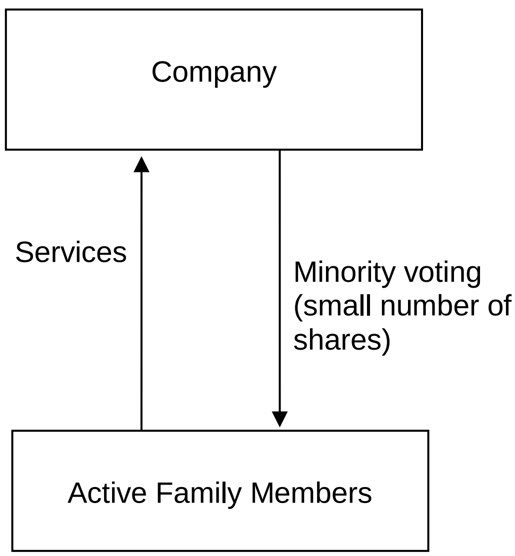
If the older generation is still working in the business, then the older generation might agree to take less compensation. This might have income tax consequences to partnerships[2649] or S corporations,[2650] but it would not have gift tax consequences.

If the entity is an S corporation, then a partial redemption that the tax law treats as a distribution rather than a redemption might actually be favorable if it can be made out of AAA. See part II.Q.7.b Redemptions or Distributions Involving S Corporations.

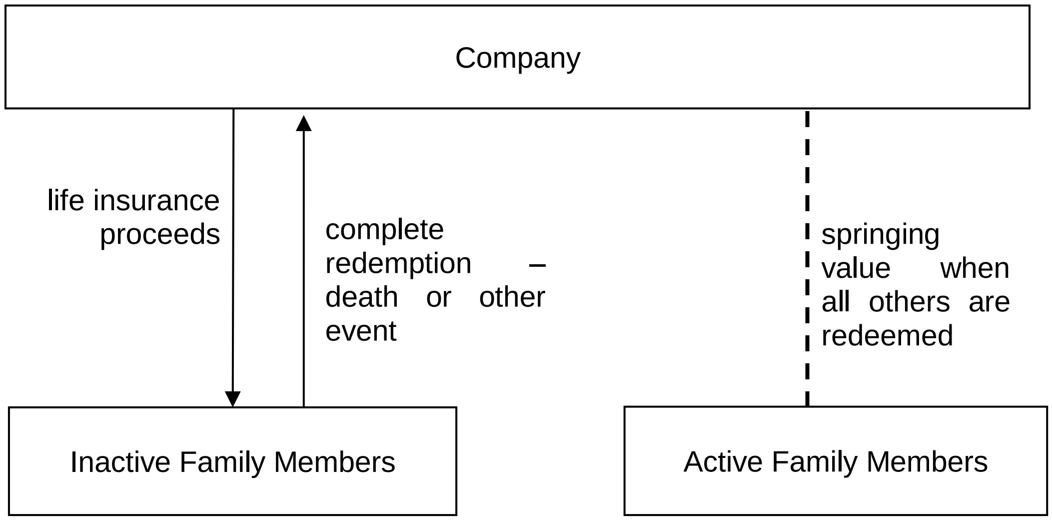
The corporation might use a promissory note to redeem a parent's interest in a corporation.[2651]

II.M.4.e.iii. Succession Planning Using Redemptions Funded by Life Insurance

Consider the following business succession strategy:



[2649] Code § 704(e).
[2650] Code § 1366(e).
[2651] Letter Ruling 9408018.



From a tax perspective, this structure can help solve the problem of inactive owners want to maintain their equity position, but key employees need entrepreneurial incentive to run and grow the business.

Below are some issues:

1. If a C corporation, make an S election. This will enable the profits to be distributed to the inactive owners using only one level of tax.

2. Grant incentive compensation to key employees based on formula.

3. Recapitalize into voting and nonvoting, for example, by issuing 19 shares of nonvoting for every share of voting stock; a similar idea would apply to an LLC or other entity taxed as a partnership.

4. Issue voting stock to key employees as compensation for services so that:

    - Key employees and inactive owners have an appropriate balance of voting power.

    - Key employees receive compensation increases or bonuses only if part of the agreements made when restructuring or if approved by inactive owners. Similarly, key employee compensation decreases only if part of the agreements made when restructuring or if approved by key employees.

    - Distributions are made according to a set formula and can be increased only if approved by key employees. Similarly, distributions decrease only if part of the agreements made when restructuring or if approved by inactive owners.

5. Life insurance funds a buy-sell agreement.

    - When all of the inactive owners' interests are redeemed, the only ownership remaining is held by the key employees. Thus, their small ownership suddenly blossoms into sole ownership.

- If a cross-purchase (each owner holds insurance on the lives of the other owners and uses the proceeds to buy stock at death) is used rather than a redemption, then the key employees' ownership might increase more quickly, depending on how the cross-purchase is structured.

- A cross-purchase is generally better from a tax perspective.

  - It is less risky from an estate tax perspective. Redemption agreements typically exclude the life insurance from the calculated purchase price. The IRS might be able to persuade a court to disregard that exclusion and count the life insurance as part of the business' value for estate tax purposes. See II.Q.4.h Establishing Estate Tax Values.

  - C corporations might be subjected to alternative minimum tax on the death benefit.

  - If a redemption is used, S corporations and partnerships might experience income tax basis distortions,[2652] and S corporations that have significant accumulated E&P from when they were C corporations would lose AAA.[2653]

  - However, if one owner leaves the business and a policy (or interest in a policy) is transferred to another owner, beware of the transfer-for-value rules, which might subject the death benefit to income tax.[2654]

- Cross-purchases and redemptions entail various nontax risks. Neither is perfect. Probably the safest method, which is a little complicated, is the life insurance LLC:

  - The owners of the main company are also members of the LLC. Each owner is specially allocated the responsibility for paying premiums on the other owners and the benefit of the associated life insurance death benefit.

  - A corporate trustee (or other independent deep pocket) serves as the manager and may be removed only by consent of all the members.

  - The manager's only job is to hold policies, collect premiums, and hold proceeds until all parties agree on implementation of the buy-sell agreement.

  - This avoids various business and tax risks, including the transfer for value rule that might apply when owners come and go.

  - For details, see part II.Q.4.i Life Insurance LLC.

[2652] See part II.Q.7.b.iii S Corporation Receipt of Life Insurance Proceeds, which discusses the impact on S corporations, but the same principles would seem to apply to partnerships.
[2653] Part II.Q.7.b.iv S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds. Although life insurance adds to each shareholder's stock basis, it adds to the other adjustments account rather than to AAA.
[2654] Code § 101(a)(2).

If one expects to sell a business interest for all cash in a few years and would like to defer capital gain on the sale of a business interest, consider selling the business interest in an installment sale to a nongrantor trust. The note might be interest-only for a few years, with principal payments beginning some time after the business interest is expected to be sold. The trust receives basis for the full amount of the promissory and can sell the business interest tax-free to the extent of that basis.

Similar principles apply to the sale of land or other property that is not depreciable or amortizable.

Potential pitfalls include the following:

- If the trust is a related person (which usually is the case) and it re-sells the business interest within two years, the original seller's deferred gain is accelerated.

- The original seller's death will not generate a basis step-up in the note. If the original seller had simply held the business interest until death, part or all of the gain would be eliminated by basis step-up. Consider buying term insurance against the risk of loss of the financial benefit of the basis step-up.

- Be sensitive to possible acceleration of the deferred gain if the original seller later transfers the installment note, including by gift (or transfer to or from a nongrantor trust), or pledges the note.

- Beware of the possible need to pay interest on the deferred tax liability if the sale exceeds $5 million.[2655]

- The part of the gain on the sale of a partnership interest attributable to "hot assets" is not eligible for installment sale treatment.

- The direct or indirect sale of depreciable or amortizable assets to a related party (the nongrantor trust) might trigger ordinary income tax.

II.M.4.f. Issuing a Profits Interest to an Employee

II.M.4.f.i. Overview of Profits Interest; Contrast with Code § 409A

Issuing a profits interest usually makes more sense than issuing stock to the employee, in that a service provider usually is interested more in sharing the fruits of the business' future success than in buying its existing assets. Awarding a profits interest is also less expensive, because it does not require buying any of the business' current value.

Code § 409A does not apply to the issuance of a profits interest.[2656] The profits interest could turn into golden handcuffs that avoid the strict rules on timing that Code § 409A

[2655] Code § 453A(b)(2).

[2656] Notice 2005-1, Q&A 7 (third sentence). For a general discussion of the broader topic, see, The Proper Tax Treatment of the Transfer of a Compensatory Partnership Interest and also Finding the Right Balance: A Critical Analysis of the Major Proposals to Reform the Taxation of Carried Interests in Private Equity, both in *Tax Lawyer*, Vol. 62, No. 1 (Fall 2008). This Notice continued to apply under section III.G of the preamble to the final regulations under Code § 409A imposes. For example, a partnership distributes enough of the service partner's share of profits to pay the service partner's income taxes. The rest of the service partner's share of profits is accumulated in the service partner's capital account and may be subject to any timing rules the parties choose. Because the service partner has already paid income tax on this accumulated income, this deferral does not offend the principles of Code § 409A, which are concerned about the timing of taxation. For more on Code § 409A, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

Profits interests have Code § 2701 consequences for family-controlled businesses, so the transferor either prepares to be treated as making a gift of the capital account that would ordinarily be associated with the profits interest or retains preferred payments that help reduce the impact of Code § 2701. For a discussion of how Code § 2701 might apply, see III.B.7.c Code § 2701 Interaction with Income Tax Planning.

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and still applies under the final regulations pursuant to Section 4 of Notice 2007-86. Reg. § 1.409A-1(b)(7) has the following text: Arrangements between partnerships and partners. [Reserved.] The preamble to the final regulations, T.D. 9321, provides:

> (G.) Arrangements Between Partnerships and Partners
>
> The proposed regulations did not address the application of section 409A to arrangements between partnerships and partners, and these final regulations also do not address such arrangements. The statute and the legislative history of section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership and do not explicitly exclude such arrangements from the application of section 409A. Commentators raised a number of issues, relating both to the scope of the arrangements subject to section 409A and the coordination of the provisions of subchapter K and section 409A with respect to those arrangements that are subject to section 409A. The Treasury Department and the IRS are continuing to analyze the issues raised in this area. Notice 2005-1, Q&A-7 provides interim guidance regarding the application of section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7 and sections II.E. and VI.E. of the preamble to the proposed regulations.
>
> Notice 2005-1, Q&A-7 provided that until further guidance is issued for purposes of section 409A, taxpayers may treat the issuance of a partnership interest (including a profits interest) or an option to purchase a partnership interest, granted in connection with the performance of services under the same principles that govern the issuance of stock. For this purpose, taxpayers may apply the principles applicable to stock options or stock appreciation rights under these final regulations, as effective and applicable, to equivalent rights with respect to partnership interests.
>
> Taxpayers also may continue to rely upon the explanation in the preamble to the proposed regulations regarding the application of section 409A to guaranteed payments for services described in section 707(c). As stated in that preamble, until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.

Also, receiving a profits interest causes the service provider to be taxed as a partner for all of that person's compensation, because bona fide members of a partnership are not employees for tax purposes.[2657]

II.M.4.f.ii. Tax Effects of Profits Interests

Below we discuss that issuing a profits interest generally does not have a tax consequence.

Then we discuss that certain sales of compensatory partnership interests are recharacterized from long-term to short-term capital gains.

II.M.4.f.ii.(a). Tax Effects of Issuing a Profits Interest

Under Rev. Proc. 93-27, if a person receives a profits interest[2658] for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of

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[2657] See note 438. For self-employment tax on guaranteed payments, see text accompanying notes 2403-2404.

[2658] Under the Rev. Proc., a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. For the rules on revaluing partnership assets and adjusting capital accounts when that occurs, see part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 422.

See also *Mark IV Pictures, Inc. v. Commissioner*, T.C. Memo. 1990-571, which held:

> Deciding whether a partner's interest in a partnership is a capital interest, rather than a mere profits interest, turns on whether that partner has the right to receive a share of the partnership's assets upon a hypothetical winding up and liquidation immediately following acquisition of the interest, rather than the mere right to share in future partnership earnings or profits. Here, a fair reading of paragraphs 2.4 and 9.2 of the Articles indicates that the general partners had the *right to receive* a specified share of the partnerships' liquidation proceeds (assets). Thus, even if no partnership proceeds remained to be distributed to the general partners after distributing the liquidating proceeds in accordance with section 545.42, they nevertheless had the *right to receive* a share of the partnerships' assets.
>
> Based on the foregoing, we conclude that the general partners received a capital interest in their respective limited partnerships. See sec. 1.721-1(b)(1), Income Tax Regs.

Reg. § 1.721-1(b)(1) provides:

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) whether made at the formation of the partnership or subsequent thereto. To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61. The amount of such income is the fair market value of the interest in capital so transferred, either at the time the transfer is made for past services, or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services….

being a partner, generally the IRS will not treat the receipt of such an interest as a taxable event for the partner or the partnership. However, that rule does not apply:

(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) If within two years of receipt, the partner disposes of the profits interest; or

(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of Code § 7704(b).

If Rev. Proc. 93-27 applies, the profits interest is treated as a capital asset when the service provider sells it.

Rev. Proc. 2001-43 applies Rev. Proc. 93-27 to the grant of a partnership profits interest that is substantially nonvested for the provision of services to or for the benefit of the partnership. Under Section 4 of Rev. Proc. 2001-43, the service provider will be treated as receiving the interest on the date of its grant, and a Code § 83(b) election will not be required, if:

.01 The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest;

.02 Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and

.03 All other conditions of Rev. Proc. 93-27 are satisfied.

If Rev. Proc. 2001-43 does not apply to the grant of a substantially nonvested partnership profits interest and if case law[2659] does not provide otherwise, then the service provider recognizes ordinary income (and the partnership is deemed to have paid compensation) when the profits interest vests. The holding period for a later sale of the profits interest would be based on the date of vesting, rather than the date of grant.

[2659] *Diamond v. Commissioner*, 56 T.C. 530 (1971 reviewed decision) (taxing service partner on issuance of profits interest), *aff'd* 492 F.2d 286 (7th Cir. 1974); *Campbell v. Commissioner*, T.C. Memo. 1990-162 (finding taxation on issuance), *rev'd* 943 F.2d 815 (8th Cir. 1991) (finding no taxation on issuance); *St. John v. U.S.*, 53 A.F.T.R.2d 84-718 (C.D. Ill. 1983) (no taxation because partnership's success was undetermined and speculative); *Kenroy, Inc. v. Commissioner,* T.C. Memo. 1984-232 (no taxation because partnership's liabilities exceeded assets). The Eighth Circuit in *Campbell* cited an earlier version (that has since been updated) of McKee, Nelson & Whitmire, ¶5.02 Distinguishing Taxable From Nontaxable Service-Connected Transfers of Partnership Interests: Is There a Difference Between Capital and Profits Interests? *Federal Taxation of Partnerships & Partners* (WG&L), and of Willis & Postlewaite, ¶4.06 Partnership Profits Interest Received in Exchange for Services, *Partnership Taxation*.

The IRS has proposed regulations[2660] that would change these rules for profits interests, effective only when the regulations are finalized. Under the proposed regulations, a service provider would be required to recognize income upon receipt of a vested profits interest. A Code § 83(b) election would be required to treat a substantially nonvested profits interest as if it were vested. At any rate, determining the value of the profits interest generally would require an appraisal and complicate future accounting on many levels. IRS Notice 2005-43 proposes a Rev. Proc. to allow taxpayers to elect to determine the value based on the awarded partnership interest's liquidation value determined immediately after the grant of the partnership interest. If the partnership interest is merely a profits interest, the liquidation value would be zero. The proposed Rev. Proc. would supersede Rev. Proc. 93-27 and Rev. Proc. 2001-43; however, until the proposed Rev. Proc. is finalized, taxpayers may continue to rely on Rev. Proc. 93-27 and Rev. Proc. 2001-43.

Furthermore, the preamble to subsequent proposed regulations[2661] announced:

> The Treasury Department and the IRS are aware of transactions in which one party provides services and another party receives a seemingly associated allocation and distribution of partnership income or gain. For example, a management company that provides services to a fund in exchange for a fee may waive that fee, while a party related to the management company receives an interest in future partnership profits the value of which approximates the amount of the waived fee. The Treasury Department and the IRS have determined that Rev. Proc. 93-27 does not apply to such transactions because they would not satisfy the requirement that receipt of an interest in partnership profits be for the provision of services to or for the benefit of the partnership in a partner capacity or in anticipation of being a partner, and because the service provider would effectively have disposed of the partnership interest (through a constructive transfer to the related party) within two years of receipt.

[2660] REG-105346-03, proposing changes to Reg. §§1.83-3, 1.83-6, 1.704-1, 1.706-3, 1.707-1, 1.721-1, and 1.761-1. Over the past several years, various proposals to tax hedge fund managers on the sale of their profits interests have had a chilling effect on the progress of these proposed regulations, particularly since the safeguards needed to make those proposals effective would cause radical changes in this area of tax law, well beyond the scope of taxing hedge fund managers.

[2661] REG-115452-14 (7/22/2015), which continued:

> Further, the Treasury Department and the IRS plan to issue a revenue procedure providing an additional exception to the safe harbor in Rev. Proc. 93-27 in conjunction with the publication of these regulations in final form. The additional exception will apply to a profits interest issued in conjunction with a partner forgoing payment of an amount that is substantially fixed (including a substantially fixed amount determined by formula, such as a fee based on a percentage of partner capital commitments) for the performance of services, including a guaranteed payment under section 707(c) or a payment in a non-partner capacity under section 707(a).
>
> In conjunction with the issuance of proposed regulations (REG-105346-03; 70 FR 29675-01; 2005-1 C.B. 1244) relating to the tax treatment of certain transfers of partnership equity in connection with the performance of services, the Treasury Department and the IRS issued Notice 2005-43, 2005-24 I.R.B. 1221. Notice 2005-43 includes a proposed revenue procedure regarding partnership interests transferred in connection with the performance of services. In the event that the proposed revenue procedure provided for in Notice 2005-43 is finalized, it will include the additional exception referenced.

Returning to the law when this portion was written, should one file a Code § 83(b) election, to preserve future capital gain treatment on the profits interest holder's future sale of the profits interest due to any noncompliance with the Revenue Procedures, either by the structure or by subsequent events within two years after the grant? If the profits interest's issuance is determined to be like the issuance a capital interest (for example, if it is determined that the book-up[2662] on issuance of the profits interest undervalued the partnership's assets), then filing a Code § 83(b) election would trigger income on issuance. Consider, however, that the tax economics if capital gain treatment were disallowed are not necessarily so bad, if certain tax indemnification agreements are in place:

Example

Suppose the basis at the time of the subsequent sale is zero (all profits have been paid out), the fair market value is $100x, the federal and state capital rate is 20%, and the federal and state income tax rate is 40%.

If the profits interest is given capital gain treatment, the holder of the profits interest pays $20x tax on the sale.

If the profits interest is deemed not to have been property until the sale (due to lack of vesting, etc.), then the following should occur:

- The holder receives $100x from the sale, which is deemed compensation income.
- The partners pay $67x withholding to the federal and state taxing authorities, covering the tax on the $100x and the $67x (40% of $167x is $67x). This is also deemed income to the holder of the profits interest.
- The partners deduct $167x compensation, saving $67x of tax, assuming they have basis for this deduction.
- The $67x tax savings to the partners pays for $67x withholding they paid.
- Except as described below, nobody pays anything out-of-pocket on the holder's receipt of the $100x sale proceeds.
- The partners pay capital gain tax on the sale proceeds they are deemed to have received.
- An appropriate adjustment needs to be made to the allocations set forth above so that the holder reimburses the partners for their capital gain tax paid on the sale, which capital gain tax the parties had originally assumed the holder would have paid.

[2662] See footnote 2577.

Articles explain some of the nuances and practical implications of profits interests[2663] and some prominent authors' reconsideration of their position that a taxable issuance of a profits interest might not be a big deal.[2664]

II.M.4.f.ii.(b). Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains

Effective for taxable years beginning after December 31, 2017, special rules apply when a taxpayer transfers certain compensatory partnership interests, with surprising results when transferring to a related party.

Subject to exceptions, Code § 1061 targets an ""applicable partnership interest," which is:[2665]

> any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business.

The House report, which was accepted by the Conference Committee, elaborated:

> It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent.

However, an "applicable partnership interest," does not include "an interest held by a person who is employed by another entity that is conducting a trade or business (other than an applicable trade or business) and only provides services to such other entity."[2666]

Before getting into which businesses are being targeted, let's focus on the type of equity interest being targeted. Code § 1061(c)(5) provides:

> *Exceptions*. The term "applicable partnership interest" shall not include-
>
> (A) any interest in a partnership directly or indirectly held by a corporation, or
>
> (B) any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with-
>
> (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or
>
> (ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest.

2663 Schippel, Should My CEO Be My Partner? A Practical Approach to Dealing with LLC and Partnership Equity Compensation, *TM Memorandum*, Vol. 53, No. 5 (2/27/2012).

2664 Banoff & Lipton's Shop Talk column, So You Received a Taxable Profits Interest-Maybe You *Should* Care! *Journal of Taxation* (2/2016), reconsidering their 11/2015 column.

2665 Code § 1061(c)(1).

2666 Code § 1061(c)(1).

Thus, if a corporation provides services and receives a partnership interest of any kind, Code § 1061 does not apply. The House report, which was accepted by the Conference Committee, elaborated:

> For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests.

The other exception above is the right to share in partnership capital commensurate with the partner's capital contribution or the actually taxed value of services provided.[2667] The House report, which was accepted by the Conference Committee, elaborated:

> An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner's share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

Thus the provision is directly targeting nontaxable issuances of profits interests described in part II.M.4.f.ii.(a) Tax Effects of Issuing a Profits Interest. Consider, however what happens if the partnership is not a straight pro-rata deal. What if the partnership involves preferred returns? How about multiple tiers of preferred returns – commonly referred to as waterfalls? What does it mean for the right to share in partnership capital to be commensurate with the partner's capital contribution?

Now, on to the targeted businesses:

Code § 1061(c)(1) provides:

> *Applicable trade or business*. The term "applicable trade or business" means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of-
>
> (A) raising or returning capital, and
>
> (B) either-
>
> > (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or

[2667] Code § 1061(c)(4).

(ii) developing specified assets.

"Specified asset" means securities,[2668] commodities,[2669] real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.[2670] The House report, which was accepted by the Conference Committee, elaborated:

> Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.
>
> *Specified assets*
>
> Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.
>
> A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example,

[2668] As defined in Code § 475(c)(2) without regard to its last sentence.
[2669] As defined in Code § 475(e)(2).
[2670] Code § 1061(c)(3).

assume that a hedge fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.

Suppose we have a compensatory partnership interest, that shares in capital disproportionately to the contribution, and a targeted business, all as described above, so that the taxpayer has an "applicable partnership interest." What are the consequences?

Code § 1061(a) treats as a short-term capital gain the excess, if any, of the taxpayer's (A) net long-term capital gain with respect to applicable partnership interests for a taxable year, over (B) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by using a more-than-three-year holding period in determining whether a gain or loss is long-term.[2671] Thus, if the taxpayer's applicable partnership interests held for more than one year but not more than three years are sold at a net loss, Code § 1061(a) does not recharacterize the character of the loss. Here's how Code § 83 interacts with the holding period rule, according to the Conference Committee report:

> The conferees wish to clarify the interaction of section 83 with the provision's three-year holding requirement, which applies notwithstanding the rules of section 83 or any election in effect under section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest.

Explaining the exception to this rule in Code §§ 1061(b)[2672] and (c)(5),[2673] the House report, which was followed by the Conference Committee on this issue, said:

[2671] Code § 1061(a) provides:

> *In general*. If one or more applicable partnership interests are held by a taxpayer at any time during the taxable year, the excess (if any) of-
>
> (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over
>
> (2) the taxpayer's net long-term capital gain with respect to such interests for such taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting "3 years" for "1 year",
>
> shall be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b).

The Conference Committee report concludes:

> Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

[2672] Which provides:

A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. Third party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged). A related person for this purpose is a family member (within the meaning of attribution rules[833]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

[833] Sec. 318(a)(1).

In addition to related party transfers not qualifying for this exception, they also do not qualify for the netting of gains and losses that Code § 1061(a) allows regarding the sale of applicable partnership interests held for more than one year but not more than three years. The House Report explains Code § 1061(d):[2674]

> *Transfer of applicable partnership interest to related person*
>
> If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income as short-term capital gain so much of the taxpayer's net long-term capital gain

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Special rule. To the extent provided by the Secretary, subsection (a) shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

[2673] Which provides:

Third party investor. The term "third party investor" means a person who-

(A) holds an interest in the partnership which does not constitute property held in connection with an applicable trade or business; and

(B) is not (and has not been) actively engaged, and is (and was) not related to a person so engaged, in (directly or indirectly) providing substantial services described in paragraph (1) for such partnership or any applicable trade or business.

[2674] Code § 1061(d), "Transfer of applicable partnership interest to related person," provides:

(1) *In general*. If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, the taxpayer shall include in gross income (as short term capital gain) the excess (if any) of-
  (A) so much of the taxpayer's long-term capital gains with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest, over
  (B) any amount treated as short term capital gain under subsection (a) with respect to the transfer of such interest.

(2) *Related person*. For purposes of this paragraph, a person is related to the taxpayer if-
  (A) the person is a member of the taxpayer's family within the meaning of section 318(a)(1), or
  (B) the person performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted). A related person for this purpose is a family member (within the meaning of attribution rules[834]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

[834] Sec. 318(a)(1).

The government must require appropriate reporting[2675] and issue regulations or other guidance as is necessary or appropriate to carry out the purposes of Code § 1061.[2676]

II.M.4.f.iii. What Happens If a Nonvested Partnership Interest Does Not Qualify As a Profits Interest

Crescent Holdings, LLC v. Commissioner[2677] determined the tax consequences of an unvested interest in partnership capital and profits:

- The taxpayer's partnership interest was conditioned upon his future performance of substantial services. In other words, it wasn't vested.

- If the partnership had liquidated immediately after the unvested partnership interest was awarded, the agreement would have allocated liquidation proceeds to the taxpayer. Therefore, the unvested partnership interest was not a pure profits interest and was subject to Code § 83 income taxation.

- The Tax Court held that, under Code § 83, the taxpayer did not own the partnership interest for tax purposes and was taxed on only the cash that was distributed to him. Instead, the unvested, undistributed profits were taxable to those who would have received them if he had terminated employment.

- Furthermore, if the taxpayer were to become vested (no requirement to perform future substantial services), he would be taxable on the fair market value of the partnership interest at the time of vesting.

This case illustrates the big swing that can occur when awarding a partnership interest without making sure it is a pure profits interest. Until this case, most tax lawyers assumed that the only tax consequence to not having a pure profits interest was possible inclusion of the fair market value of the profits interest in the recipient's income. The remaining partners would get a corresponding deduction, and presumably they could use the taxes saved from the deduction to pay the recipient's taxes. Now the stakes are higher: if the recipient has a falling out with the partnership and challenges

[2675] Code § 1061(e).

[2676] Code § 1061(f).

[2677] 141 T.C. 477 (2013). For an exhaustive analysis, see Carman and Banoff, *Crescent Holdings*: Unvested Capital Partner Avoids Income Allocations, But Many Questions Remain, *Journal of Taxation* (WG&L), Vol. 120, No. 4 (April 2014).

the income tax treatment, the income allocated to the recipient might instead be taxed to the other partners; however, the tax distribution was made to the recipient and might not be available to the remaining partners.

In light of this case, consider the following measures:

- When including in the partnership agreement a reference to the parties' intent that the partnership interest be a profits interest described in Rev. Procs. 93-27 and 2001-43, add language along the lines of: "Without limiting the generality of the foregoing, if the [partnership] were to liquidate immediately after granting [the profits interest], holders of [the profits interest]would receive no payment in respect of [the profits interest]."

- Include a savings clause that, if the IRS does find that we didn't have a good profits interest and this reallocation occurs, the recipient shall refund any tax distributions. That would remove a terminated employee's incentive to challenge the K-1 and hopefully provide cash to pay the partners' taxes.

II.M.4.f.iv. Alternative If a Prospective Partner Wants a Capital Interest Instead of a Profits Interest

Profits interests are great because they are forward-looking. Sometimes, however, the prospective partner insists on having a share of the existing business. The easiest, most certain way to do that is to give the new partner a share of capital and report granting the partnership interest as compensation, much as when one would issue corporate stock.[2678]

An alternative approach might work - if the insistent partner is willing to take some risk. The partnership agreement could allocate net income to the new partner until the new partner's capital account increases to the desired level. That approach would not generate the desired results if the partnership does not earn enough income to increase the partner's capital account sufficiently. Also, if the income allocated to the partner is ordinary income, the partner risks having this ordinary income generate a capital loss if the partner is unable to sell the partnership interest for enough in the future (plus the fact that the basis acquired by this ordinary income would tend to offset future capital gain).

Some partnerships allocate gross income to generate this result, leading to more certainty of the partner's capital account attaining the desired level. However, if the IRS views the allocation of gross income as being certain, the IRS might assert that the agreement to allocate gross income generates compensation immediately, so one might want to take that possibility into account when considering the effect of the agreement.

II.M.4.g. Options to Acquire Equity (Stock Options, etc.)

Options to acquire equity do not constitute an equity interest in a corporate setting and, if the service provider is not a partner, do not constitute an equity interest in a partnership

[2678] See part II.M.4.e.i Issuing Stock to an Employee - Generally.

interest.[2679] Thus, they should not be subject to Code § 2701. However, they are subject to Code § 2703 in a family-controlled business, so they must be binding during life and after death and must satisfy the comparability test. The rest of these materials focus on the requirements to exclude stock options from Code § 409A; satisfying these tests is likely to bring a taxpayer into compliance (or least close to compliance) under the Code § 2703(b) comparability test under the *Amlie* case.[2680]

The Treasury and IRS have not issued guidance on options to acquire partnership interests, other than to provide that such options are subject to rules similar to those governing corporate stock options.[2681] If the stock option's exercise price is never less than the underlying stock's fair market value on the date the option is granted, then generally the stock option does not constitute deferred compensation.[2682] Thus, the key to a successful stock option is determining the value on the date that the option is granted.

For stock options issued on or after January 1, 2005 and before the effective date of final regulations, taxpayers have the following ways to determine fair market value:[2683]

- <u>Notice 2005-1, Q&A-4(d)(ii)</u> provides that for purposes of determining the value of the underlying stock upon the grant of a nonstatutory stock option, "any reasonable valuation method may be used." This includes estate tax valuation under Reg. § 20.2031-2. Taxpayers may rely on Notice 2005-1 for stock rights issued on or after January 1, 2005 but before January 1, 2008.[2684]

- <u>Prop. Reg. § 1.409A-1(b)(5)(iv)(B)</u> provided additional details in response to commentators' assertions that the above Notice is too vague. Taxpayers may rely on either the proposed regulations or the final regulations for stock rights issued any date before January 1, 2008.[2685]

- <u>Reg. § 1.409A-1(b)(5)(iv)(B)</u> provides the following for stock that is not readily tradable on an established securities market:[2686]

[2679] A partner's option to acquire a partnership interest might or might not constitute an equity interest. See part III.B.7.c.vii Stock Options.

[2680] The *Amlie* case is described in the text accompanying footnote 3259.

[2681] Notice 2005-1, Q&A-7. This continues to be the case under section III.G. of the preamble to the final regulations. Reg. § 1.409A-1(b)(7) is a placeholder for future regulations on arrangements between partnerships and partners.

[2682] Reg. § 1.409A-1(b)(5)(i)(A).

[2683] Notice 2006-4. Final regulations were effective generally January 1, 2008. Notice 2006-79.

[2684] Section XII.C. of the Preamble to the final regulations.

[2685] Section XII.C. of the Preamble to the final regulations.

[2686] CCA 201521013 provides:

> Section 1.409A-1(k) provides that, for purposes of section 409A, the term established securities market means an established securities market as defined under § 1.897-1(m). Section 1.409A-1(b)(5)(vi)(G) provides that, for purposes of section 409A, stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in the stock. In explaining § 1.409A-1(b)(5)(vi)(G), the preamble to the final section 409A regulations (72 Fed. Reg. 19,234, 19,240 (April 17, 2007)) states that the rule was intended to adopt the same standard as that set forth under § 1.280G-1, Q&A-6(e). Section 1.280G-1, Q&A-6(e) provides that, for purposes of section 280G, stock is treated

> as readily tradable if it is regularly quoted by brokers or dealers making a market in the stock. Section 1.280G-1, Q&A-6(f) provides that, for purposes of section 280G, the term established securities market means an established securities market as defined under § 1.897-1(m).
>
> Section 1.897-1(m) provides that the term established securities market means (1) a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f), (2) a foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and (3) any over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.
>
> It is a common practice for new issues of publicly traded stocks and bonds to be traded on a when, as and if issued (commonly called a when issued) basis days prior to when the issuer actually issues and distributes the security to holders. A when-issued trade is made between a seller and a buyer contingent on actual issuance of the security, after which settlement of the trade is made.
>
> A when-issued market for a security yet to be issued may occur on an over-the-counter market or any other established securities market as defined under § 1.897-1(m). Section 703.02 (part 1) of the New York Stock Exchange's Listed Company Manual provides guidelines applicable to when-issued trading on the Exchange of a security expected to be issued as a stock dividend: Normally, the Exchange will initiate when issued trading when the percentage of additional stock distributed is 25% or more of the outstanding. There is no fixed date for the commencement of when issued trading, but the Exchange will usually wait until such time as all corporate and official action requisite to the issuance of shares has been taken.
>
> The Tax Court held that a when-issued trading price on an over-the-counter market indicates the fair market value of a security prior to its issuance. *Frizzelle Farms, Inc. v. Comm.*, 61 T.C. 737 (1974), *aff'd* 511 F.2d 1009 (4 Cir., 1975).

CCA 201603025, the IRS' response to the taxpayer's assertion that the stock was not readily tradable so that the taxpayer's valuation should be used, included the following:

> Under § 1.409A-1(b)(5)(vi)(G), stock is treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock. Therefore, a stock is readily tradable if brokers or dealers make the stock available to trade by listing it on an established securities market. The readily tradable standard therefore requires only the ability to buy and sell the stock through a third party….
>
> Taxpayers argue that there were therefore no actual transactions in the Common Stock as reported by the over-the-counter market for purposes of determining the fair market value of the Common Stock under § 1.409A- 1(b)(5)(iv)(A) on the Grant Date.[2] However, the rule does not require that the Common Stock must actually exchange hands on the trading date, but rather only that there are actual transactions in such stock on the trading date. Transactions in stock generally mean either the sale or transfer of stock. Even assuming that only contracts to purchase the Common Stock were actually purchased on the Grant Date, the contracts provided for the transfer of the Common Stock. The buyers were contractually obligated to complete their when-issued purchases of the Common Stock if [a certain condition] occurred. The [condition] had already occurred… on the Grant Date before the over-the-counter market opened for that trading date. Moreover, the buyers were contractually obligated to pay the auction price that applied at the time that they purchased the Common Stock on the Grant Date regardless of the auction prices of the Common Stock on the settlement date. Thus, there is no basis for treating the when-issued purchases of the Common Stock as anything other than actual transactions in such stock reported by the established securities market.

(B) Stock not readily tradable on an established securities market.

(1) In general. For purposes of paragraph (b)(5)(i) of this section, in the case of service recipient stock that is not readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by the reasonable application of a reasonable valuation method. The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date. Factors to be considered under a reasonable valuation method include, as applicable, the value of tangible and intangible assets of the corporation, the present value of anticipated future cash-flows of the corporation, the market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the corporation the stock of which is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction), recent arm's length transactions involving the sale or transfer of such stock or equity interests, and other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the service recipient, its stockholders or its creditors. The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology, all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used. The service recipient's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers, is also a factor supporting the reasonableness of such valuation method.

(2) Presumption of reasonableness. For purposes of this paragraph (b)(5)(iv)(B), the use of any of the following methods of valuation is presumed to result in a reasonable valuation, provided that the Commissioner may rebut such a

[2] The cases cited by Taxpayers do not support Taxpayers' position. The *Stavisky* court assumed that contracts to purchase stock when issued reflect the fair market value of the stock on the date the contract is entered into: In the case at bar the performance of the original contract—that is, the purchase of the shares—at the price fixed— remained what it had been. *Stavisky v. Comm'r*, 291 F.2d 48, 49 (2d Cir. 1961). Furthermore, the *Stavisky* holding applied to a transaction that occurred before the enactment of section 1233. Section 1233(e)(2)(A) treats stock traded on a when-issued basis the same as the stock. Under Example 6 of § 1.1233-1(c)(6), the price contracted to sell stock when issued applies for purposes of determining the applicable gain or loss when the stock is actually issued.

presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable:

(i) A valuation of a class of stock determined by an independent appraisal that meets the requirements of section 401(a)(28)(C) and the regulations as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the date of grant of a stock option).

(ii) A valuation based upon a formula that, if used as part of a nonlapse restriction (as defined in §1.83-3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to §1.83-5, provided that such stock is valued in the same manner for purposes of any nonlapse restriction applicable to the transfer of any shares of such class of stock (or any substantially similar class of stock) to the issuer or any person that owns stock possessing more than 10 percent of the total combined voting power of all classes of stock of the issuer (applying the stock attribution rules of § 1.424-1(d)), other than an arm's length transaction involving the sale of all or substantially all of the outstanding stock of the issuer, and such valuation method is used consistently for all such purposes, and provided further that this paragraph (b)(5)(iv)(B)(2)(ii) does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the operation of a nonlapse restriction.

(iii) A valuation, made reasonably and in good faith and evidenced by a written report that takes into account the relevant factors described in paragraph (b)(5)(iv)(B)(1) of this section, of illiquid stock of a start-up corporation. For this purpose, illiquid stock of a start-up corporation means service recipient stock of a corporation that has no material trade or business that it or any predecessor to it has conducted for a period of 10 years or more and has no class of equity securities that are traded on an established securities market (as defined in paragraph (k) of this section), where such stock is not subject to any put, call, or other right or obligation of the service recipient or other person to purchase such stock (other than a right of first refusal upon an offer to purchase by a third party that is unrelated to the service recipient or service provider and other than a right or obligation that constitutes a lapse restriction as defined in §1.83-3(i)), and provided that this paragraph (b)(5)(iv)(B)(2)(iii) does not apply to the valuation of any stock if the service recipient or service provider may reasonably anticipate, as of the time the valuation is applied, that the service recipient will undergo a change in control event as described in §1.409A-3(i)(5)(v) or §1.409A-3(i)(5)(vii) within the 90 days following the action to which the valuation is applied, or make a public offering of securities within the 180 days following the action to which the valuation is applied. For purposes of this paragraph (b)(5)(iv)(B)(2)(iii), a valuation will not be treated as made reasonably and in good faith unless the valuation is performed by a person or persons that the corporation reasonably determines is qualified to perform such a valuation based on the person's or persons' significant knowledge, experience, education, or training. Generally, a person will be qualified to perform such a valuation if a reasonable individual, upon being apprised of such knowledge, experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

(3) Use of alternative methods. For purposes of this paragraph (b)(5), a different valuation method may be used for each separate action for which a valuation is relevant, provided that a single valuation method is used for each separate action and, once used, may not retroactively be altered. For example, one valuation method may be used to establish the exercise price of a stock option, and a different valuation method may be used to determine the value at the date of the repurchase of stock pursuant to a put or call right. However, once an exercise price or amount to be paid has been established, the exercise price or amount to be paid may not be changed through the retroactive use of another valuation method. In addition, notwithstanding the foregoing, where after the date of grant, but before the date of exercise or transfer, of the stock right, the service recipient stock to which the stock right relates becomes readily tradable on an established securities market, the service recipient must use the valuation method set forth in paragraph (b)(5)(iv)(A) of this section for purposes of determining the payment at the date of exercise or the purchase of the stock, as applicable.

If value is off, consider whether relief provisions might be available.[2687]

For gift, estate, and generation-skipping transfer tax purposes, Rev. Proc. 98-34 provides a safe harbor for valuing nonpublicly traded stock options that are granted in connection with the performance of services (including stock options that are subject to the provisions of Code § 421), which options are granted on stock that is publicly traded on an established securities market.

A form of compensation similar to stock options is a stock appreciation right (SAR). An SAR is like a stock option, except that the employee never buys the stock. In many cases involving stock options, an employee borrows to exercise the stock option, repays the exercise price by selling the shares, and then keeps the remaining stock. An SAR gives the employee the same cash the employee would have received if the employee had borrowed to exercise the option, sold all of the stock immediately, and repaid the loan, without making the employee go through all of those steps and without the employee ever owning any of the underlying stock. If properly structured, an SAR would receive Code § 409A treatment similar to an option.[2688] An SAR is likely have few, if

[2687] Notice 2008-113, as modified by Notice 2010-6 and Notice 2010-80.

[2688] Reg. § 1.409A-1(b)(5)(i)(B). An SAR that complies with this regulation is also exempt from Code § 457A (which taxes deferred compensation from certain types of foreign entities when vested). Rev. Rul. 2014-18. In AM 2016-003, the IRS was asked:

any, Chapter 14 implications because the employee never receives any equity in the company.

Finally, awards of restricted stock could work well. Code § 409A does not apply merely because property is not includable income in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture under Code § 83 or is includable in income solely due to a valid election under Code § 83(b).[2689] The service provider should receive actual shares of stock subject to forfeiture; a promise to transfer stock in the future may be subject to Code § 409A,[2690] although it could be excluded from Code § 409A for other reasons. However, the IRS takes the position that a gift of a stock option that is not exercisable until after the performance of services is an incomplete gift until exercise of the option is no longer conditioned on the performance of services by the transferor;[2691] presumably, this

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> May a service provider making an overall accounting method change under section 446(e) of the Code —from the cash receipts and disbursements method of accounting to an accrual method of accounting —include in its adjustment under section 481(a) (section 481(a) adjustment) vested deferred compensation under a plan of a nonqualified entity that would have been includible under section 457A had the services not been performed before January 1, 2009, resulting in some of the vested deferred compensation being included in income later than the service provider's last taxable year beginning before 2018?

Reasoning that the statute regarding deferral overrode otherwise applicable principles, it asserted:

> To the extent the section 481(a) adjustment relates to vested deferred compensation that is attributable to services performed before January 1, 2009, under a plan of a nonqualified entity, the service provider may not take the adjustment into account later than the service provider's last taxable year beginning before 2018.

2689 Reg. §§ 1.409A-1(b)(6)(i), 1.83-3(b). If an important goal is to convert nonvested restricted stock to deductible compensation upon the transfer of an interest in the business to the holder, a Code § 83(b) election should not be made.

2690 Reg. § 1.409A-1(b)(6)(ii).

2691 Rev. Rul. 98-21, reversing the IRS' prior Letter Ruling position. Rev. Rul. 98-21 reasoned:

> In the present case, Company grants to A a nonstatutory stock option conditioned on the performance of additional services by A. If A fails to perform the services, the option cannot be exercised. Therefore, before A performs the services, the rights that A possesses in the stock option have not acquired the character of enforceable property rights susceptible of transfer for federal gift tax purposes. A can make a gift of the stock option to B for federal gift tax purposes only after A has completed the additional required services because only upon completion of the services does the right to exercise the option become binding and enforceable. In the event the option were to become exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option for the purpose of applying this analysis. In the event that B is a skip person (within the meaning of section 2613(a)), the generation-skipping transfer tax would apply at the same time as the gift tax. See Rev. Proc. 98-34, 1998-18, which sets forth a methodology to value certain compensatory stock options for gift, estate, and generation-skipping transfer tax purposes.

Rev. Rul. 98-21 is inconsistent with Rev. Rul. 72-307, which held, An insured's power to cancel his insurance coverage by terminating his employment is a collateral consequence of the power that every employee has to terminate his employment, in holding that the power to cancel group term life insurance coverage by quitting one's job did not constitute an incident of ownership under Code § 2042. *DiMarco v. Commissioner*, 87 T.C. 653, 662-663 (2001 regarding tax year 1986), held, Respondent argues, however, that decedent's simple act of going to work for attitude would also apply to restricted stock. The author disagrees with the IRS' position regarding incomplete gifts but cautions planners to consider whatever litigation risks the IRS' position might entail when making transfers of property conditioned on the performance of services by the transferor.

II.N. Shareholder Agreements and Operating Agreements

II.N.1. Comparison of Ability to Specify Future Actions

In a corporation, generally each member of a board of directors has certain fiduciary duties that cannot be waived on a blanket basis by the organizational documents,[2692] and the way to enforce actions promised in shareholder agreements is to remove a noncompliant board and replace it with directors who will carry out the shareholders' wishes. However, depending on state law, a corporation can be organized as a statutory close corporation that functions more like a limited liability company.[2693]

A limited liability company's operating agreement can dictate specific actions. The drafting lawyer might consider whether to relieve managers and members of various fiduciary duties. Some states, such as Illinois, do not allow fiduciary duties to be negated by contract; other states, such as Missouri, allow any arrangement to which the parties agree. The absence of fiduciary duties generally is not recommended for estate planning purposes. If one wants (and is permitted) to negate fiduciary duties, consider including the duties of good faith that generally apply to commercial contracts. Some cases have held lawyers liable to the injured party (who is not the lawyers' client) for advising clients to breach fiduciary duties, whereas lawyers generally are not liable for advising clients to breach contract duties.

IBM on January 9, 1950, constituted an act of transfer by decedent for gift tax purposes. We disagree. None of the cases cited by respondent hold that, without more, the simple act of going to work for an employer that has an automatic, nonelective, company-wide survivors income benefit plan similar to the one at issue in this case constitutes a transfer of an interest in the benefit for either estate or gift tax purposes. Rev. Rul. 92-68 confirmed the IRS' acquiescence, Rev. Rul. 81-31 held that a decedent made a gift of the value of a death benefit passing to the decedent's surviving spouse and that the gift became complete in the calendar quarter in which the decedent died, at which time the amount of the gift first became susceptible of valuation. The ruling is inconsistent with the result in *DiMarco*. Rev. Rul. 81-31 is hereby revoked. Rev. Rul. 98-21 did not refer to Rev. Rul. 92-68. Instead, it cited areas outside of the employment arena:

- a case involving a prenuptial agreement (no gift until marriage takes place), and
- two revenue rulings - that were issued before the now-revoked Rev. Rul. 81-31- holding that a parent's promise to make a gift was a completed gift only after it became legally enforceable.

In Letter Ruling 199952012, the taxpayer sought a ruling only regarding options that were vested and exercisable, in light of the position of Rev. Rul. 98-21.

Rev. Ruls. 84-130 and 72-307 expanded the protection that Rev. Rul. 68-334 provides when an employer has irrevocably assigned all rights to a group term policy.

[2692] See How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors, *The Business Lawyer*, Vol. 63, No. 3, May 2008.

[2693] See fn. 776.

II.N.2. Retroactivity of Amendment to Partnership Agreement (Including Operating Agreement)

For purposes of the partnership income tax rules, a partnership agreement includes any modifications of the partnership agreement made before, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.[2694] A partnership agreement or modifications can be oral or written; as to any matter on which the partnership agreement, or any modification thereof, is silent, the provisions of local law are part of the agreement.[2695]

When a partnership agreement did not have a fixed method to determine the current and future allocations of profits or losses and instead allocates them based on the determinations of an executive committee, an agreement to determine the allocation of then-currently unrealized profits and losses arising from many years of operations did not give rise to an analysis of how much profit and loss might have been allocated to the partners before the amendment.[2696]

II.O. Buy-Sell Agreements

II.O.1. General Buy-Sell Concepts

A buy sell agreement is a contract between owners and/or the entity that provides for the sale of an owner's interest upon the occurrence of a triggering event such as disability, retirement, or death. The three types of buy-sell agreements are: (1) redemption agreements; (2) cross-purchase agreements; and (3) a combination of redemption and cross-purchase. Deciding which type to use requires consideration of a number of factors including the number and ages of the shareholders involved and the weighing of tax consequences for each type of agreement.

These agreements determine the price and payment terms and restrict who can own an interest in the business. In a limited liability company (LLC), the buy-sell agreement is integrated into the operating agreement. In a partnership, the buy-sell agreement is integrated into the partnership agreement. In a corporation, whether a C corporation or an S corporation, the buy-sell agreement is integrated into a shareholders' agreement.

Key circumstances triggering a buy-sell agreement include the owner's divorce, bankruptcy, incapacity, or death. Special considerations may apply to an owner who works in the business, especially if the ownership interest was granted as an employment incentive. Also, owners like to choose their partners, so frequently the buy-sell provisions restrict transfers to outsiders.

In LLCs and partnerships, voting and management rights are not transferred automatically when ownership is transferred. An owner without voting and management

[2694] Code § 761(c); Reg. § 1.761-1(c).
[2695] Reg. § 1.761-1(c).
[2696] Letter Ruling 9821051.

rights is called an assignee. LLC and partnership buy-sell provisions specify whether a transferee is an assignee or has voting and management rights.[2697]

An S corporation may revert to a C corporation if too many shareholders own stock or if stock is transferred to an ineligible shareholder. Special buy-sell provisions are required to preserve the S election.

The Business Planning Committee of the American College of Trust & Estate Counsel has put together a model shareholder agreement and related outline of technical issues. These two documents can be found at the web page of the Business Planning Group of the American Bar Association's Real Property, Trust & Estate Law Section at http://apps.americanbar.org/dch/committee.cfm?com=RP519000.

II.O.2. Spousal Issues in Buy-Sell Agreements and Related Tax Implications

Generally speaking, it is usually best to have a spouse hold a business interest through a trust, rather than through outright ownership. The trust can protect the property from creditors and from new spouses if the surviving spouse remarries. A trust also allows the decedent to choose to have a third party involved in the management and investment of the property, if desirable. Additionally, a trust allows the decedent to designate who the remainder interest in the property passes to upon the spouse's death and might enable the decedent to devise property to successive generations without incurring estate tax. Finally, the trust form will allow the donor to structure the estate plan to take advantage of any potential minority discounts or control premiums that may apply.

II.O.2.a. Spouses and Buy-Sell Agreements – State Law Issues

A number of issues can arise related to spouses holding interests in closely-held businesses. If these issues are not addressed, closely-held business owners could end up in losing a portion of their business to an ex-spouse, or an owner's estate could lose part or all of the marital deduction.

Some courts have held a business owner's buy-sell agreement not binding on the spouse, so spousal consent should be considered necessary to ensure enforcement of buy-sell agreements. First, such consent can prevent a divorce proceeding or elective share from causing an ex-spouse to be involved in the business. It also prevents a spouse from leaving her community property interest in the business to a third party. Finally, it protects the spouse from claiming a community property interest in the business upon the business owner's death.

However, even if the spouse consents by signing the buy-sell agreement, a court might rule that the spouse did not truly consent to the agreement because the spouse did not fully understand the agreement.[2698] Preferably, the spouse would be represented by his

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[2697] A Delaware Court of Chancery held that an assignee's admission as a member must be done formally and that an assignee who is not a creditor could assert rights in equity without being admitted as a member. *In re Carlisle Etcetera LLC*, C.A. No. 10280-VCL (4/30/2015), found at https://casetext.com/case/in-re-carlisle-etcetera-llc.

[2698] See, e.g. *Suther v. Suther*, 627 P.2d 110 (Wash. App. 1981).

or her own counsel. Be sure to update spousal consent when amending the buy-sell agreement.

II.O.2.b. Divorce – Income Tax Issues Relating to Buy-Sell Agreements

In order to accomplish its objectives, a buy-sell agreement needs to specifically address transfers incident to divorce. If an agreement focuses on voluntary transfers, it is possible a court would not apply the restriction in the case of an involuntary transfer, such as a divorce transfer.

When a business interest is transferred to a spouse pursuant to a divorce agreement and the stock is then redeemed by the business for cash pursuant to the buy-sell agreement, the non-recognition rules for spousal transfers and the stock redemption rules collide. Before tax regulations addressed this situation, there was some question as to whether the transferring spouse should be taxed on the redemption or the spouse receiving the interest should be taxed. Reg. § 1.1041-2(c) addresses this question and states that the spouses may chose who will be taxed on the redemption.[2699]

II.O.2.c. Effect of Buy-Sell Agreement on Marital Deduction

The buy-sell agreement price can have a significant effect on the estate tax marital deduction. If stock held in a marital trust is subject to a bargain buy-sell agreement, the marital deduction might be totally disallowed.[2700] Such a provision might run afoul of Code § 2056(b)(5), which allows a marital deduction only if no other person has the power to appoint any portion of the interest to anyone except the surviving spouse, and

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[2699] In another setting indirectly involving a transfer of a business interest, Letter Ruling 201024005 held that the transfer of qualified replacement property (QRP) to a divorcing spouse is not subject to income tax. Under Code § 1042, QRP is certain stock purchased with the proceeds of a sale of stock to an employee stock ownership plan (ESOP); this purchase allows the seller to defer gain on the sale, which deferred gain reduces the QRP's basis. Code § 1042(e) requires the deferred gain to be recognized if the seller later disposes of the QRP. Code § 1042(e)(3)(C) provides that a gift does not count as a Code § 1042(e) disposition. Code § 1041(b)(1) and its legislative history provide that a transfer in a divorce counts as a gift for income tax purposes, so the ruling held that a transfer of QRP by divorce was not subject to Code § 1042(e) recapture.

[2700] See *Estate of Rinaldi v. U.S.*, 38 Fed. Cl. 341 (1997); *Estate of McCabe v. U.S.*, 475 F.2d 1142 (Ct. Cl. 1973); TAM 9147065. See also TAM 8843004. The IRS took a similar position (without citing these cases) and lost in *Alan Baer Revocable Trust v. U.S.*, 105 A.F.T.R.2d 2010-1544 (D.C. Neb.), when the court disregarded a contingent distribution to beneficiaries because the possibility that the transfer to the contingent beneficiaries would ever come to fruition is so remote that it is negligible. The IRS acquiesced in result only in AOD 2012-001, arguing that any possibility whatsoever of others receiving the trust's possibility violated the Code § 2056(b)(7)(B)(ii)(II) prohibition against any person having the power to appoint any part of the property to any person other than the surviving spouse. The IRS claimed that Reg. § 20.2056(b)-7(d)(6) supports its position. That regulation provides that, if the surviving spouse is legally bound to transfer the distributed property to another person without full and adequate consideration in money or money's worth, the requirement of section 2056(b)(7)(B)(ii)(II) is not satisfied. Although generally I would want to avoid arguing with the IRS over this issue in a buy-sell agreement, perhaps some sort of formula adjustment clause (see part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers) might work if one can find no other way to plan around this issue?

Code § 2056(b)(7), which requires that the spouse be the only beneficiary. Consider the following:

- Provide that, if the property passes to a marital deduction trust, the agreement provide that the sale price shall be adjusted up as necessary to be no less than the fair market value, as finally determined for estate tax purposes.

- Bequeath the business interest to a marital deduction that is separate from other marital deduction trust assets, so that the marital deduction for those other assets is not jeopardized.

On the other hand, FSA 200018020[2701] stated that directing stock to be sold for a bargain price before funding the QTIP Trust did not disqualify the QTIP trust; it simply affected the amount available for the marital deduction. The FSA distinguished the *Rinaldi* case cited in fn. 2700. If a bargain sale before funding the marital trust is not directed by the estate plan but rather is done as part of estate administration, then the marital deduction should be allowed in full and the surviving spouse is treated as making a gift.[2702]

Also, generally, giving the surviving spouse a choice between various bequests does not violate the terminable interest rule.[2703] In determining the deadline for an election, one might consider the 9 month disclaimer deadline under Code § 2518 or the 6 month survival requirement that may be imposed under Code § 2056(b)(3) without making the interest terminable. Rev. Rul. 82-184 approved a six-month simple election procedure[2704] but rejected an election that was conditioned on the surviving spouse's

[2701] FSA 200018020 was approved by Melissa Liquerman, who has had a long and successful career with the IRS and I believe is very well-regarded.

[2702] See Rev. Rul. 84-105, which is described in fn. 4779, which is found in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers.

[2703] See, *e.g.*, *Mackie v. Commissioner*, 64 T.C. 308 (1975), *aff'd per curiam* 545 F.2d 883 (4th Cir. 1976), which approved the following clause:

> My said wife shall have, however, the right to elect whether to accept this devise, bequest and appointment, or to reject it, or to accept it in part and reject it in part, which election she shall make by a statement in writing to that effect delivered to my executrix within four months from the date of my death. The failure of my said wife to deliver such statement to my executrix within such time shall be deemed an election by her to reject this devise, bequest and appointment in full.

See also Reg. § 20-2056(c)-2(c), regarding elective shares.

[2704] Rev. Rul. 82-184 held:

> A cash bequest in lieu of a life estate, payable unconditionally at the election of the surviving spouse within a reasonable time after the decedent's death qualifies for the estate tax marital deduction under section 2056 of the Code.

The election procedure is described more fully in fn. 2705. Rev. Rul. 82-184 reasoned:

> Section 2056(b)(1) provides that the marital deduction is not allowed for certain interests passing to the surviving spouse that will terminate or fail on the occurrence or nonoccurrence of an event or contingency where an interest in the property also passes to another person, who may enjoy the property after the surviving spouse's interest has terminated.
>
> In *Estate of Tompkins v. Commissioner*, 68 T.C. 912 (1977), *acq.*, 1982-1 C.B. 1, the spouse was given alternative bequests of a life income interest in a trust or an option to

"performance of significant acts and upon events beyond mere procedural requirements."[2705] Letter Ruling 201410011 approved a 180-day election procedure in

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take $40,000 in cash outright. The election to take the $40,000 in lieu of the income interest was to be made within 60 days after the qualification of the executor. The decedent's spouse timely elected the cash bequest. The court held that for purposes of section 2056 of the Code, the surviving spouse had not received a terminable interest, but received, at the decedent's date of death, an absolute right to take outright a specific portion of the decedent's estate. The court considered the requirement that the spouse must make a timely election of the alternative bequest a mere procedural requirement, and thus not a contingency within the meaning of section 2056(b)(1), as long as the interest was otherwise nonterminable. The court noted that there is no substantial difference between an elective testamentary bequest of a non- terminable interest and a spouse's election against a will under state law. See section 20.2056(e)-2 of the Estate Tax Regulations. See also *Estate of Neugass v. Commissioner*, 555 F.2d 322 (2d Cir. 1977), *rev'g*, 65 T.C. 188 (1975).

Similarly, in *Mackie v. Commissioner*, 64 T.C. 308 (1975), *acq.*, 1982-1 C.B. 1, *aff'd per curiam*, 545 F.2d 883 (4th Cir. 1976), it was held that a spouse's right to select any property out of the estate in an amount equal to the maximum marital deduction, was an absolute right to take outright a specified portion of the estate.

[2705] After its favorable holding in fn. 2704, Rev. Rul. 82-184 held:

> However, a cash bequest payable on the condition that the spouse purchase a new home is a nondeductible terminable interest for purposes of section 2056.

The holding included the following facts:

> D died on February 2, 1982. Under the terms of D's will, a trust was established in which D's surviving spouse, A, received a life income interest. However, under the will A could elect to take an outright bequest of $50,000 in lieu of the life income interest. The election was to be made by the spouse by filing written notice to the executor within six months of D's death. The will also provided that if A was at any time to buy a new house, A could receive on demand from the trustee the amount needed to buy a house, up to $200,000. A timely elected the cash bequest and sometime later demanded $200,000 for the purchase of a new home. D's executor deducted both the $50,000 cash bequest and the $200,000 distribution as bequests qualifying for the marital deduction under section 2056 of the Code.

After its reasoning in fn. 2704, Rev. Rul. 82-184 continued:

> In *Estate of Edmonds v. Commissioner*, 72 T.C. 970 (1979), the decedent's spouse was bequeathed a life estate in the decedent's house and, in addition, if the decedent's spouse purchased another residence, the spouse was entitled to receive the amount necessary to do so, up to $100,000. The $100,000 was payable to the spouse upon notice to the executor and demand of the trustee. Approximately three years subsequent to the decedent's death, the spouse demanded and received $100,000 for a new residence. The court held that the estate could not deduct the distribution because, unlike the situations in Mackie and Tompkins, the spouse was not given an absolute right to take outright a specified portion of the decedent's estate. The requirement that the distribution be made only if the spouse relinquished the life tenancy and purchased a new house was considered a significant condition precedent to the spouse's enjoyment of the property. There was no way of ascertaining at the time of the decedent's death whether the surviving spouse would purchase a new home, or how much of the $100,000 would be needed to effect the purchase. Consequently, the bequest was a terminable interest for purposes of section 2056 of the Code. See also *Allen v. United States*, 359 F.2d 151 (2nd Cir. 1966), *cert. denied*, 385 U.S. 832 (1966).
>
> In the present case, the optional bequest of $50,000 A received at the time of D's death was an absolute right to a specific portion of D's estate, and A made the election within a reasonable time for purposes of section 2056 of the Code. Since A timely elected to take

conjunction with a prenuptial agreement,[2706] with the QTIP trust funded with preferred partnership interest.[2707] Letter Ruling 8735003 held that a no-contest clause did not preclude the marital deduction.[2708]

> the alternate bequest, D's estate can deduct the $50,000 bequest under section 2056. However, the bequest of the $200,000 is a terminable interest under section 2056(b) because it was conditioned upon A's performance of significant acts and upon events beyond mere procedural requirements. As is the case in *Edmonds*, there is no way of knowing at the time of D's death whether A would exercise the demand right or how much of the funds will be paid over. Because the residuary trust beneficiaries would benefit upon the failure of A to purchase a new home, D's bequest of the $200,000 is a nondeductible terminable interest under section 2056(b).

[2706] Letter Ruling 201410011 approved a revocable trust while the grantor was living. Part of its provisions resulted from a prenuptial agreement. Key terms included:

> Section 3A(7) of Revocable Trust provides that, if Spouse survives Taxpayer and if Taxpayer and Spouse are married and living together at the time of Taxpayer's death, the trustee will allocate and make distributions to Spouse as provided in Section 3A(7)(a). However, if Spouse makes a timely election as provided in Section 3A(7)(b), then the trustee will allocate and make distributions to Spouse as provided in that section (Elective Marital Portion).
>
> Section 3A(7)(a) provides that Spouse will take under the terms of Antenuptial Agreement, and that the trustee will make any distributions to Marital Trust, to be added to the principal of Marital Trust, and to be held and distributed as may be required by the Antenuptial Agreement. The terms of Revocable Trust specify that the trustee has the discretion to satisfy any distribution to Marital Trust under the Antenuptial Agreement with LLC preferred units (Preferred Units).
>
> Section 3A(7)(b) provides that if, within 180 days following Taxpayer's death, Spouse elects pursuant to Section 3A(7)(b) to receive the Elective Marital Portion in lieu and instead of any distributions under Antenuptial Agreement, the trustee will distribute to Spouse outright the sum of $w and will distribute those property interests specified in Section 3(A)(7)(b), to be added to the principal of Marital Trust, and to be held and distributed as may be required by the Marital Trust agreement. If Spouse elects to receive the Elective Marital Portion Marital Trust will still be funded in part with Preferred Units.

It started its reasoning:

> In Rev. Rul. 54-446, 1954-2 C.B. 303, a decedent and his wife were parties to an antenuptial agreement in which the wife relinquished any marital rights she might acquire in the decedent's property or estate by reason of their marriage. The decedent's will bequeathed property to his wife that was different from and of a greater value than the amount due to her under the antenuptial agreement. The will specifically provided that the bequests to wife were in lieu of any rights she might have under the antenuptial agreement. The revenue ruling determined that the amount bequeathed to the wife under the will "passed from the decedent to his surviving spouse" and therefore qualified for the estate tax marital deduction.
>
> In Rev. Rul. 68-271, 1968-1 C.B. 409, a decedent and his wife entered into an antenuptial agreement pursuant to which wife renounced and relinquished any marital rights she might acquire in his property or estate by reason of their marriage, in return for a stated sum from his estate, provided she survived him. Following the decedent's death, the estate paid the required sum to the widow pursuant to a claim filed by her. Decedent's will did not mention wife, and there was no will contest. The revenue ruling determined that the value of the interest transferred to the surviving spouse pursuant to the antenuptial agreement "passed from the decedent to his surviving spouse" and therefore qualified for the estate tax marital deduction.

Then it cited *Tompkins* and Rev. Rul. 82-184; see fns. 2704-2705. After that, it said:

> In the instant case, Spouse will receive certain property interests under the terms of the Antenuptial Agreement pursuant to Section 3A(7)(a) of Revocable Trust unless, within 180 days following Taxpayer's death, Spouse elects pursuant to Section 3A(7)(b) of Revocable Trust to receive certain other property interests (Elective Marital Portion). In each event, Spouse will have an absolute right to any property passing outright to her as well as an absolute right to the income from any property passing to Marital Trust. Therefore, the property interest passing outright to Spouse will be a nonterminable interest and the property interest passing to Marital Trust will be treated as a nonterminable interest if it otherwise satisfies the requirements of § 2056(b)(7). The requirement that Spouse make a timely election is "a mere procedural formality" *Tompkins*, 68 T.C. at 917, and is not a contingency within the meaning of § 2056(b)(1).
>
> Consequently, based on the facts submitted and the representations made, we conclude that Spouse's right to elect under section 3A(7) of Revocable Trust is not a "contingency" within the meaning of § 2056(b)(1). The Revocable Trust property actually distributed outright to Spouse and to Marital Trust (if it otherwise satisfies the requirements of § 2056(b)(7)) will be "property which passes from the decedent to his surviving spouse," for purposes of § 2056(a).

[2707] See text accompanying fn. 2711.

[2708] Letter Ruling 8735003 involved the following provision:

> I hereby direct and expressly provide that it shall be a condition precedent to the taking, vesting, receiving or enjoyment of any property, benefit, or thing whatsoever under and by virtue of this Will, that no such devisee or legatee shall in any manner contest the probate thereof, or question or contest the same, or any part or clause thereof, in any judicial proceeding, and I further will and provide that, should any such devisee or legatee so contest or question, or in any manner aid in such contesting or questioning, such devisee or legatee shall thereupon lose and forfeit all right to any benefit and all right or title to any property or thing herein directly or indirectly devised or bequeathed to said devisee and legatee, and same shall thereupon vest in such of my devisees or legatees herein as do not so question or contest, or give aid in such questioning or contesting of, this Will or the probate or any clause or provision thereof, in the same proportion as to value in which they otherwise take in value of my estate under this Will.

Letter Ruling 8735003 cited Reg. § 20.2056(e)-2(c), *Tompkins*, Rev. Rul. 82-184, and *Mackie*; see fns. 2704-2705. After that, it said:

> Under local law, forfeiture provisions in a will are strictly construed and a forfeiture of property interests will be avoided by the Texas courts unless the acts of the parties come strictly within the express terms of the forfeiture clause. Accordingly, the local courts have generally held that an action or proceeding for the construction of a will in which a beneficiary participates does not bring the beneficiary within the provision of a forfeiture provision. See, for example, the following cases where a state court held that a forfeiture clause was not applicable (1) where the decedent's granddaughter sued to obtain a fee simple title to property devised by will and the court held that the suit was brought to construe the decedent's will [*Roberts v. Chisum*, 238 S.W.2d 822 (Tex. Civ. App., 1951)]; and (2) where beneficiaries under a will sued to have provisions of the decedent's will devising real estate among four persons construed to ascertain the decedent's intent [*Reed v. Reed*, 569 S.W.2d 645 (Tex. Civ. App., 1978)].
>
> In the present case, C could either (1) accept the terms of B's will, or (2) contest the provisions of B's will. C chose the former course of action. Although under Texas law a will contest by C might result in a forfeiture of the assets C would otherwise receive under B's will, the existence of this option does not convert what are otherwise fee property interests into nondeductible terminable interests. The court in *Tompkins*, *supra*, found no substantial difference between an elective testamentary bequest of a nonterminable interest which relates back to the testator's date of death and a spouse's election against a will under state law. Similarly, we see no reason to distinguish a situation where a

A right of first refusal to buy at fair market value stock that a QTIP Trust sells upon the surviving spouse's demand did not disqualify a QTIP trust.[2709] A thirty day period in which to exercise a right of first refusal is not an unreasonable burden on a spouse's right to make a QTIP trust productive.[2710]

Here is an example of another business interest that qualified:[2711]

> The surrounding circumstances also manifest Taxpayer's intention that, after his death, Marital Trust should produce for Spouse during her life that degree of beneficial enjoyment of the LLC Preferred Units which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. Under the terms of Operating Agreement, as the owner of LLC Preferred Units, Marital Trust will be entitled to an eight percent return on the aggregate face value of its LLC Preferred Units, payable no less often than annually. LLC cannot redeem Marital Trust's LLC Preferred Units for less than the greater of their face value or fair market value. In addition, without the affirmative vote or consent of all of the Preferred Members, LLC's Voting Common Members cannot amend, restate, alter or repeal Operating Agreement whether by merger, consolidation or otherwise so as to directly materially and adversely affect any right or preference of the Preferred Units or Preferred Unit holders.
>
> Moreover, the sale of LLC Preferred Units is not unreasonably restricted. At the written request of Spouse, the trustee of Marital Trust may sell the LLC Preferred Units to permitted purchasers without the consent of other LLC Members. Subject only to reasonable administrative restrictions, these purchasers will become substitute Preferred Members. The permitted purchases are other Members of LLC, Taxpayer's children, and Qualified Institutional Investors (as defined by Operating Agreement). Taxpayer has demonstrated that a substantial

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> surviving spouse has a choice between accepting a testamentary bequest or challenging the provision of her husband's will in order to obtain her statutory share. In each situation, the beneficiary has a choice between two groups of assets. Furthermore, all interests that C received under B's will were in all respects nonterminable interests, that is, they were fee interests in property that C could transfer by gift or by will. Accordingly, the principles described in *Tompkins*, *Mackie*, section 20.2056(e)-2(c) of the regulations, and Rev. Rul. 82-184 are applicable to this case. Thus the value of the assets that C received under Articles III and VI of B's will are deductible under section 2056(a) of the Code.

[2709] Letter Ruling 199951029 held:

> If Spouse requests the trustee to convert the stock into income producing property, Grantor's children have the right of first refusal to purchase the stock at its fair market value as determined by an independent appraisal and under such terms and conditions as would be agreed upon by parties dealing at arm's length. This restriction does not prevent the trust from receiving full value for the stock if the stock is sold to the children, nor does it restrict the trustees' ability to sell the stock.

[2710] Letter Ruling 8931005 held:

> Given the fact that Corporation is a closely-held entity and the Children's Trust (owner of the controlling interest) is one of the most likely purchasers of the minority interest held by the Marital Trust, we do not consider the thirty day right of first refusal to place an undue burden on the ability of Spouse to require that the trust corpus be made productive.

[2711] Letter Ruling 201410011.

number of Qualified Institutional Investors currently own interests in B and that they are common purchasers of REITs. With respect to the actual receipt of income from an investment in B, an indirect owner of interests in B who owns LLC Preferred Units is in a similar position as a direct owner of interests in B because LLC is required to distribute an eight percent preferred return annually to owners of LLC Preferred Units.

II.O.2.d. Marital Trusts - S Corporations

When a business passes to a surviving spouse in a trust, a QSST or an ESBT election must be made.

Testamentary QTIP trusts generally qualify as QSSTs, and QSSTs often have more favorable income tax effects than ESBTs.

See parts III.A.3.c.iii Deadlines for QSST and ESBT Elections and III.A.3.e QSSTs and ESBTs (including part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies).

II.O.2.e. Marital Deduction Trusts - Discount Planning

Much of the discussion below assumes that valuation reduction is good. That is not necessarily the case; see part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property), including part II.H.3 Valuation Discounts – Friend or Enemy. Accordingly, consider whether to plan to avoid valuation discounts, as needed.

Minority and fractional discounts for closely-held businesses and marital trusts need to be considered in estate planning as well. When spouses together own a majority in a business under community property laws, they will be considered to own one-half of that interest, and thus will be entitled to discounts for lack of control in determining their estate value.[2712] Additionally, fractional interest discounts may come into play when property interests are divided between a QTIP trust and a spouse. For example, if the surviving spouse owns 60% of a business and the remaining 40% is held in a QTIP trust, one might assume discounts for lack of control will not come into play when the second spouse dies. However, courts have held that the spouse's estate will be entitled to a discount for lack of control by disaggregating the QTIP trust from the spouse's other assets (in this example, providing a discount for lack of control for the QTIP stock).[2713] However, this disaggregation would not apply to a general power of appointment marital trust (Code § 2056(b)(5)).[2714]

Another issue arises when a business owner has a controlling interest in the company and bequeaths some portion of that interest to his spouse. Upon the owner's death, the full controlling interest value must be included in determining the owner's gross estate, and the estate will be entitled to some marital deduction for the portion passing to the spouse. However, that deduction is based on what passes to the spouse, not what is included in the estate. In *Estate of Chenoweth v. Commissioner*,[2715] the decedent

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[2712] See *Estate of Bright v. U.S.*, 658 F.2d 999 (5th Cir. 1981).
[2713] See *Estate of Bonner v. U.S.*, 84 F.3d 196 (5th Cir. 1996); *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999); *Nowell v. Commissioner*, T.C. Memo. 1999-15.
[2714] *Estate of Fontana v. Commissioner*, 118 T.C. 318, 322 (2002).
[2715] 88 T.C. 1577 (1987).

owned 100% of a business and left his spouse a 51% interest. The IRS claimed the highest marital deduction the estate could take was 51% of the full value of the business included in the gross estate, but the estate claimed it should be entitled to increase the deduction by some control premium. The court ruled that the estate should be entitled to attempt to prove the increased value and that no rule required that the marital deduction amount equal the value the property was assigned when included in the gross estate. While this holding can lead to a potential tax advantage for an estate, it also has a potentially negative effect. What if the decedent owned a controlling interest but passed a minority interest to the spouse? In this case, the marital deduction will be based on the value of the minority interest, even though the full value of the interest will be used in calculating the gross estate.[2716] This same result can occur in the charitable contribution deduction context, when a decedent leaves a minority interest in stock to a charity.[2717] Thus, estate planners need to be aware of this whipsaw effect when determining how the estate will be divided.[2718] For example, if a controlling interest is to be divided among

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[2716] TAM 9403005. In *Estate of Frank M. DiSanto v. Commissioner*, T.C. Memo 1999-421, the decedent had a controlling interest and a non-controlling interest passed to the surviving spouse, creating a mismatch between inclusion and deduction.

[2717] See generally *Estate of Schwan v. Commissioner*, T.C. Memo 2001-174 (taking into account post-mortem transformations occurring in funding a charitable bequest).

[2718] Steve Akers of Bessemer Trust has a post-mortem outline that, as of 2/8/2014, included the following as possible solutions:

> * Have the executor to fund the marital bequest with a note. The residuary estate would then be burdened with the note as a liability that would be distributed along with the residuary assets to the residuary beneficiaries.
>
> A strategy that may have worked previously: Have someone purchase a minority interest from the estate within the first six months, and elect the alternate valuation date. If the remaining interest is a minority interest, the alternate valuation date values would reflect minority interest values in the estate. Alternatively, consider merely distributing minority block of stock, and value the block distributed (minority interest) and the remaining block of stock in the estate at the end of the six month period (which might also be a minority interest). See Treas. Reg. § 20.2032-1(c)(1)(phrase distributed, sold, exchanged or otherwise disposed of includes surrender of stock in complete or partial liquidation of a corporation but not mere changes in form such as a transfer of assets to a corporation in a manner that no gain or loss is recognizable under § 351); *Kohler v. Comm'r*, T.C. Memo 2006-152, nonacq. AOD 2008-001 (tax-free reorganization is not a disposition that accelerates alternate valuation date). Proposed regulations prohibit this strategy, with an effective date of when the regulation is finalized. Prop. Treas. Reg. § 20.2032-1(h).
>
> * For fractional interests in real estate, use a co-ownership agreement at the first spouse's death that will eliminate the discount, by providing that either co-tenant can sell the property and distribute the proceeds pro rata.
>
> * For stock, use a pro rata funding but have a shareholder agreement that will eliminate the discount (by giving the marital legatee the right to liquidate the company or otherwise have control).
>
> * Sell the majority interest to a Family Trust for a note, then fund the Marital Trust with a part of the note, and fund the Family Trust with the balance of the note (which the Family Trust would then owe to itself).
>
> * Distribute a majority interest in an asset (that exceeds the marital bequest amount) to the Marital Trust, and have the Marital Trust give the estate back a note for the excess value. (For example, assume there is a $2MM Family Trust and a $8MM Marital Trust and the only asset is a 51% interest in a closely held company that is worth $10MM. If the Marital Trust is funded with 8/10 of the 51% interest, it will not be worth $8MM. Fund the Marital Trust with the entire 51% controlling interest, and have the Marital Trust give a

charities, with each receiving a minority interest, the IRS might argue that the bequest to each receives a minority discount; instead, consider (a) bequeathing the controlling interest to a private foundation for the benefit of those charities, or (b) including a direction to sell the business interest and distribute the proceeds, perhaps giving the charities an option to take in kind.

II.O.3. Effect of Buy-Sell on Charitable Estate Tax Deduction

If a decedent owns voting and nonvoting shares, the shares are valued together as a single block; however, if the charitable bequest is a specific bequest of stock that is less than the combined block, the charitable deduction is based on the block it actually received.[2719]

> note back to the estate for $2MM. The Marital Trust might later end up paying off the $2MM note with an interest in the company (which would be valued at a discount, thus requiring more shares than if there were no discount).
>
> * Fund the bequest using a defined value formula conveyance. For example, a pecuniary bypass trust bequest could be funded by a conveyance having a defined value—reduced only by the amount necessary that will not result in an increased estate tax.
>
> * To avoid the valuation problem on funding marital bequests, make the marital gifts during lifetime. In that event, there would not be a mismatch between the amount of the gift and the allowed marital deduction. (But lifetime gifts would lose the benefit of a basis step-up at death.)

[2719] *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981). In that case, the sole share of voting stock was specifically bequeathed to a noncharitable beneficiary, and ninety-nine shares of nonvoting stock were specifically bequeathed to charity. The court reasoned:

> The Foundation argues that it makes no difference if we conclude, as we did in section II, that the gross estate should include the value of the 600 HFA shares in the hands of Ahmanson, because the 99 nonvoting shares must have the same value for the charitable deduction as they have in the gross estate. The Foundation argues that inconsistent valuations, for these two purposes, would be incompatible with the orderly administration and application of the estate tax law. There is, certainly, an initial plausibility to the suggestion that fairness dictates that the same method of valuation be used in computing the gross estate and the charitable deduction. This initial plausibility, however, does not survive a close second look.
>
> The statute does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction. Instead, it states that the value of the charitable deduction shall not exceed the value of the transferred property required to be included in the gross estate. 26 U.S.C. §2055(d). Moreover, the statutory scheme specifically requires a lower valuation for the charitable deduction than for the same item within the gross estate under certain circumstances. If the alternate valuation date is used and the property becomes more valuable by virtue of a contingency occurring between the date of death and the alternate valuation date, the higher value is included in the gross estate, but the lower value is used in computing the charitable deduction. 26 U.S.C. § 2032(b).
>
> In light of the purpose of the charitable deduction to encourage gifts to charity, it seems doubtful that Congress intended to give as great a charitable deduction when the testamentary plan diminishes the value of the charitable property as it would when the testamentary plan conveys the full value of the property to the charity intact. That is, the intent of encouraging charitable gifts suggests the further policy of encouraging greater rather than lesser charitable gifts. By severing the voting power of the stock from its economic entitlement, and giving only the economic entitlement to charity, Ahmanson

Furthermore, when the trustee caused controlling stock bequeathed to charity to be redeemed for a value based on discounts for lack of control, the charitable deduction was correspondingly reduced, and the estate was assessed penalties.[2720]

II.O.4. Effect of Buy-Sell on Reasonable Compensation Arguments

In recharacterizing deductible compensation as nondeductible dividends, the Tax Court in 2016 held that an independent investor[2721] would have demanded a return on investment as a shareholder.[2722]

> reduced the value of the stock to the charity. In the present case, the district judge found that the reduction in value was relatively small. Under other circumstances, however, the reduction in value might be substantial. The proper administration of the charitable deduction cannot ignore such differences in the value actually received by the charity.
>
> Thus there are compelling considerations in conflict with the initially plausible suggestion that valuation for purposes of the gross estate must always be the same as valuation for purposes of the charitable deduction. When the valuation would be different depending on whether an asset is held in conjunction with other assets, the gross estate must be computed considering the assets in the estate as a block. Otherwise, as discussed above, the testator would be able to produce an artificially low valuation by manipulatively disbursing complimentary assets into the hands of different beneficiaries—only to have those beneficiaries recombine the assets in their more valuable arrangements at some later time. The valuation of these same sorts of assets for the purpose of the charitable deduction, however, is subject to the principle that the testator may only be allowed a deduction for estate tax purposes for what is actually received by the charity—a principle required by the purpose of the charitable deduction.
>
> Therefore the district judge erred in concluding that the valuation of the 99 nonvoting shares of Ahmanco stock would be the same for the purpose of the charitable deduction and for purpose of the gross estate. The district judge should recompute the taxable estate, beginning with a value in the gross estate equal to the 100 shares of Ahmanco undiminished by the 3 percent reduction for the nonvoting status of the 99 shares. The charitable deduction should then be computed on the basis of that 3 percent decrease in value that resulted from the severance of the voting rights from these 99 shares.

[2720] *Estate of Dieringer v. Commissioner*, 146 T.C. No. 8 (2016), reasoning:

> We do not believe that Congress intended to allow as great a charitable contribution deduction where persons divert a decedent's charitable contribution, ultimately reducing the value of property transferred to a charitable organization. This conclusion comports with the principle that if a trustee is empowered to divert the property … to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed … the deduction will be limited to that portion, if any, of the property, or fund which is exempt from an exercise of the power. Sec. 20.2055-2(b)(1), Estate Tax Regs. Eugene and his brothers thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest.
>
> The trust did not transfer decedent's bequeathed shares nor the value of the bequeathed shares to the foundation. Accordingly, we hold that the estate is not entitled to the full amount of its claimed charitable contribution deduction.

In sustaining the penalty, the court reasoned:

> DPI's lawyer's advice regarding the charitable contribution deduction was based on an errant appraisal. The date-of-death appraisal and the redemption appraisal--performed only seven months apart--differed substantially in value. The estate knew that a significant percentage of the value of decedent's bequeathed shares was not passing to the foundation and that Eugene and his brothers were acquiring a majority interest in DPI at a discount.

In that particular case, the net book value, determined on a cash basis, was sufficient to justify the IRS' conclusion that a particular portion of distributions constituted dividends. Consider, however, that a buy-sell agreement might constitute evidence of a company's value that might support an IRS attack asserting that the corporation's value is higher and that therefore distributions taxable as nondeductible dividends should be higher:

- Generally, a business is worth the present value of its future profits, as they are distributed annually or upon liquidation.[2723]

- Therefore, if a company has no profits, it has no value. Conversely, if a company has value but does not report profits, then presumably either the value is based on expected future profits based on efforts that have not yet generated results or the expenses are overstated.

- Appraisals of controlling interests in business often adjust compensation to what the appraisers believe is reasonable. These appraisals might be dangerous to a C corporation, that does not want its compensation deductions to be denied.

C corporation owners often assert that compensation to zero out income is reasonable, yet the business has value to an investor. The IRS might asset that the latter is an admission of value on which dividends should be paid. An advisor might consider addressing this issue very directly with the client and revisiting choice of entity in light of a possible intellectual inconsistency that might come back to bite the taxpayer in the long run.

A seller-financed buyout is best done using a partnership,[2724] so consider converting to a partnership to avoid these issues,[2725] which does not necessarily mean paying otherwise avoidable self-employment tax.[2726] If converting to a partnership is not acceptable, consider making an S election.[2727]

II.P. Operations

Taxation of operations focuses on whether income from operations is taxed to the entity or to its owner(s), effect of contributed property on taxation of operations, to what extent are FICA taxes imposed, and miscellaneous issues.

[2721] Many cases have looked to the independent investor test in determining reasonable compensation. See fn. 28.

[2722] *Brinks Gilson & Lione A Professional Corporation v. Commissioner*, T.C. Memo. 2016-20, discussed in fn. 28.

[2723] See part III.C Fairness Within Families; Valuation.

[2724] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

[2725] See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure.

[2726] See parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart. See the paragraph that includes fn. 709 for avoiding self-employment tax and when one might not want to avoid self-employment tax.

[2727] See parts II.A.2.b Existing Corporation - Paying Retired Shareholder-Officers and II.P.3.c Conversion from C Corporation to S corporation.

II.P.1. Income Taxation of Operations

II.P.1.a. Allocations of Income in Partnerships and S corporations

Partnership income taxation of owners is more complex but more flexible than S corporation income taxation of owners. Defining the ownership in a partnership can be challenging.[2728] Although receiving K-1s after the original due date of a return is aggravating, a taxpayer who uses estimates rather than actual K-1 amounts can be penalized.[2729]

Also see part III.B.2.j Tax Allocations upon Change of Interest.

II.P.1.a.i. Allocations of Income in Partnerships

II.P.1.a.i.(a). General Rules for Allocations of Income in Partnerships

Allocation of income, gain, loss, deductions and credits among partners are governed by Code § 704(b) and Reg. § 1.704-1. These provisions set up a rule that requires the allocation of such income, gain, loss, deduction, or credit to have substantial economic effect or to be in accordance with the partner's interest in the partnership. These rules are set up to ensure that, when a partner is allocated income, the partner is able to enjoy the economic benefit associated with that income, or that when he is allocated economic loss, the partner suffers the burden of that loss. This allocation is usually achieved through the use of partner capital accounts, that, in most basic terms, are increased by a partner's contributions or share of income and are decreased by distributions or the partner's share of a loss.[2730] The goal of the capital account is to track the distribution amount a partner would receive if the partnership sold all of its assets at book value, paid off all liabilities, and then distributed any remaining cash to the partners in liquidation of the partnership.

Allocations of gross income in preferred partnerships would tend to be based on the ratio of a partnership's overall distributive share of profit for the year, divided by all partners'

[2728] See Banoff, FAQ-Filled Guidance on Computing a Partner's Interest in Profits, Losses, and Capital, *Journal of Taxation*, April and May 2009 (two-part article). See also Banoff, "Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps," *Taxes* (CCH) 3/1/2007.

[2729] *Sampson v. Commissioner*, T.C. Memo. 2013-212.

[2730] Reg. § 1.704-1(b)(2)(iv). A partner's capital account is increased by the fair market value, not basis, of assets that partner contributes. Reg. § 1.704-1(b)(2)(iv)(d). The fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm's-length negotiations, and (2) the partners have sufficiently adverse interests. Reg. § 1.704-1(b)(2)(iv)(h)(1). In calculating book-tax differences under Code § 704(c), A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of Code § 704(c). Reg. § 1.704-3(a)(2). For events causing accounts to be revalued, see part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 422.

distributive share of profit for the year, unless special allocations with substantial economic effect provide otherwise.[2731]

Losses that generate or exacerbate a negative capital account complicate the issue. If a partner's capital account has a deficit balance following the liquidation of the partnership interest,[2732] the partner must be unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year,[2733] which amount shall, when the partnership liquidates, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances.[2734] In most cases, however, those wanting partnership income taxation use a limited liability company or other entity that blocks personal liability and do not wish to have such a deficit restoration obligation (DRO). Instead of a DRO, a partnership agreement may contain a "qualified income offset."[2735] A "qualified income offset" is a provision that a partner who unexpectedly receives an adjustment, allocation, or distribution described in Reg. § 1.704-1(b)(2)(ii)(d)(4),[2736] (5),[2737] or (6)[2738] will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible.[2739] (However, I am unsure that there is a consensus about what it means to unexpectedly receive such an adjustment, allocation, or distribution.) Allocations of items of income and gain made pursuant to the qualified income offset are deemed to be made in accordance with the partners' interests in the partnership if the partnership determines and maintains capital

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[2731] See Banoff, FAQ-Filled Guidance on Computing a Partner's Interest in Profits, Losses, and Capital, *Journal of Taxation*, April 2009 (part one of two-part article) (see discussion of IRS FAQ1); see also Banoff, Identifying Partners' Interests in Profits and Capital: Uncertainties, Opportunities and Traps, *TAXES - The Tax Magazine* (3/1/2007).

[2732] As determined after taking into account various capital account adjustments for the partnership taxable year during which such liquidation occurs.

[2733] Or, if later, within 90 days after the date of such liquidation.

[2734] Reg. § 1.704-1(b)(2)(ii)(b)(3).

[2735] Reg. § 1.704-1(b)(2)(ii)(d)(3).

[2736] Reg. § 1.704-1(b)(2)(ii)(d)(4) provides for:

> Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership.

[2737] Reg. § 1.704-1(b)(2)(ii)(d)(5) provides for:

> Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of § 1.751-1.

[2738] Reg. § 1.704-1(b)(2)(ii)(d)(6) provides for:

> Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under § 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain.

[2739] Reg. § 1.704-1(b)(2)(ii)(d)(6).

accounts under Reg. § 1.704-1(b)(2)(iv)[2740] and liquidating distributions are made in accordance with the positive capital account balances of the partners, as determined after taking into account various capital account adjustments[2741] for the partnership taxable year during which such liquidation occurs.[2742] (Once a loss is allocated, the partner also needs to satisfy various other rules to deduct the loss.[2743])

Special allocation rules govern contributions of property and the income, gain, loss, and deductions associated with contributed property. Under Code § 704(c), a contributed property's income, gain, loss, and deductions[2744] are allocated to all partners to account for differences between the partnership's basis in the property and the fair market value of the property at the time of its contribution.[2745] This allocation ensures that the right person, the contributing partner, will realize any net pre-contribution gain or loss.[2746]

[2740] Reg. § 1.704-1(b)(2)(ii)(b)(1).

[2741] Reg. § 1.704-1(b)(2)(ii)(b)(2).

[2742] Reg. § 1.704-1(b)(2)(ii)(d)(6).

[2743] See generally part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner.

[2744] Regarding book-tax depreciation differences, see Reg. §§ 1.704-1(b)(2)(iv)(g)(3) (book depreciation) and 1.704-3 (accounting for book-tax differences). Amoni and Schmalz, Section 704(c): The Disparity Offset Method Provides Answers to Difficult Questions, *Journal of Taxation* (WG&L), Vol. 114, No. 4 (Apr. 2011), suggests a way to apply the mechanics of existing regulations in this area. For the impact on allocating depreciation deductions and a basic overview of some tax planning flexibility on that issue, see Lawson, Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs, 36 *Estate Planning*, No. 8, 12 (August 2009); however, note that remedial allocations might be attacked under Reg. § 1.701-2(b) or under Reg § 1.704-3(a)(1), the latter added by T.D. 9485 (6/8/2010). Note also that special allocations for book purposes might raise Code § 2701 issues, an issue that is not discussed in that article, which focuses on allocations for income tax purposes. See III.B.7.b Code § 2701 Overview, and III.B.7.c, Code § 2701 Interaction with Income Tax Planning, for a discussion of Code § 2701.

[2745] Code § 704(c)(1)(A).

[2746] The purpose of Code § 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. Reg. § 1.704-3(a)(1), which further provides:

> Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution. Notwithstanding any other provision of this section, the allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). For this purpose, an allocation method includes the application of all of the rules of this section (*e.g.*, aggregation rules). An allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. Paragraphs (b), (c), and (d) of this section describe allocation methods that are generally reasonable. Other methods may be reasonable in appropriate circumstances. Nevertheless, in the absence of specific published guidance, it is not reasonable to use an allocation method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts. See § 1.704-3(d). Paragraph (e) of this section contains special rules and exceptions. The principles of this paragraph (a)(1), together with the methods described in paragraphs (b), (c) and (d) of this section, apply only to contributions of property that are otherwise respected. See for example § 1.701-2. Accordingly, even though a partnership's allocation method may be

Except for personal property included in the same general asset account of the contributing partner and the partnership under Code § 168,[2747] personal property with a basis equal to zero,[2748] certain inventory,[2749] and a securities partnership making certain reverse-Code § 704(c) allocations[2750] to gains and losses from qualified financial assets,[2751] Code § 704(c) and Reg. § 1.704-3 apply on a property-by-property basis.[2752] A partnership may use different methods with respect to different items of contributed property, provided that the partnership and the partners consistently apply a single reasonable method for each item of contributed property and that the overall method or combination of methods are reasonable based on the facts and circumstances and consistent with the purpose of Code § 704(c).[2753] Using one method for appreciated property and another method for depreciated property may be unreasonable.[2754] A new partnership formed as the result of the termination of a partnership under Code § 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to Code § 704(c) property deemed contributed to the new partnership by the terminated partnership under Reg. § 1.708-1(b)(1)(iv).[2755]

Code § 704(c)(1)(B) prevents a partner from avoiding Code § 704(c) gain or loss by contributing property and having the partnership turn around and distribute it to another partner.[2756]

A partner cannot erase the Code § 704(c) taint by transferring the partner's interest to a third party. When a partnership interest is transferred, any tax attributes associated with

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> described in the literal language of paragraphs (b), (c) or (d) of this section, based on the particular facts and circumstances, the Commissioner can recast the contribution as appropriate to avoid tax results inconsistent with the intent of subchapter K. One factor that may be considered by the Commissioner is the use of the remedial allocation method by related partners in which allocations of remedial items of income, gain, loss or deduction are made to one partner and the allocations of offsetting remedial items are made to a related partner.

[2747] Reg. § 1.704-3(e)(2)(i).

[2748] Reg. § 1.704-3(e)(2)(ii).

[2749] Reg. § 1.704-3(e)(2)(iii) excludes:

> For partnerships that do not use a specific identification method of accounting, each item of inventory, other than qualified financial assets (as defined in paragraph (e)(3)(ii) of this section.).

[2750] For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 3932-3935.

[2751] See part II.P.1.a.i.(b) Special Rule for Allocations of Income in Securities Partnerships.

[2752] Reg. § 1.704-3(a)(2).

[2753] Reg. § 1.704-3(a)(2).

[2754] Reg. § 1.704-3(a)(2).

[2755] Reg. § 1.704-3(a)(2).

[2756] See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

the interest travel from the old partner to the new partner, and the new partner becomes the "contributing partner."[2757]

In addition to allocating gain or loss, Code § 704(c) also requires allocations of depreciation and amortization related to contributed property.

Partnerships may revalue assets for book purposes when certain events occur, so that partners' capital accounts better reflect the partners' economic interests at the time of those events. The events may include: [2758]

- a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership,

- the liquidation of the partnership,

- a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or

- the grant of an interest in the partnership (other than a de minimis interest), as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner.[2759]

When the partnership adjusts capital accounts to reflect such an event:[2760]

- The adjustments must be based on the fair market value of partnership property on the date of adjustment.

- The adjustments must reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date.

- The partnership agreement must require that the partners' capital accounts be adjusted (as provided in regulations) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property.

- The partnership agreement must require that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax

[2757] Reg. § 1.704-4(d)(2).

[2758] Reg. § 1.704-1(b)(2)(iv)(f)(5). See part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 422.

[2759] This last bullet point generally refers to the issuance of a profits interest, as discussed in II.M.1 Taxation on Formation of Entity: Comparison between Partnership and Corporation.

[2760] Reg. § 1.704-1(b)(2)(iv)(f), which is reproduced in fn. 422 in part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts).

purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under Code § 704(c).

- The adjustments must be made principally for a substantial non-tax business purpose on account of one of the events described above.

When this revaluation occurs, book-tax differences arise, not necessarily because of the contribution of property, but rather because the book value of the partnership's property has changed. Allocating the responsibility for these new book-tax differences is called a reverse-Code § 704(c) allocation.[2761] Partnerships are not required to use the same allocation method for reverse-Code § 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to Code § 704(c) and Reg. § 1.704-3(a).[2762] In addition, partnerships are not required to use the same allocation method for reverse-Code § 704(c) allocations each time the partnership revalues its property.[2763] A partnership that makes allocations with respect to revalued property must use a reasonable method that is consistent with the purposes of Code § 704(b), (c).[2764] A partnership making adjustments under Reg. § 1.743-1(b) or 1.751-1(a)(2) must use Reg. § 1.704-3 to account for built-in gain or loss under Code § 704(c).[2765] Special rules apply to such allocations when goodwill or similar assets are being amortized.[2766]

If one partner transfers a partnership interest to another person, the transferee receives the transferor's capital account. Also see part III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership.

[2761] Reg. § 1.704-3(a)(6)(i) provides:

> The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to § 1.704-1(b)(2)(iv)(f) or 1.704-1(b)(2)(iv)(s) (reverse section 704(c) allocations).

For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 3932-3935.

[2762] Reg. § 1.704-3(a)(6)(i).

[2763] Reg. § 1.704-3(a)(6)(i).

[2764] Reg. § 1.704-3(a)(6)(i).

[2765] Reg. § 1.704-3(a)(6)(ii).

[2766] Rev. Rul. 2004-49 held:

> If, pursuant to § 1.704-1(b)(2)(iv)(f), a partnership revalues a section 197 intangible that was amortizable in the hands of the partnership, then the § 197 anti-churning rules do not apply and the partnership may make reverse § 704(c) allocations (including curative and remedial allocations) of amortization to take into account the built-in gain or loss from the revaluation of the intangible. If the revalued section 197 intangible was not amortizable in the hands of the partnership, then the partnership may make remedial, but not traditional or curative, allocations of amortization to take into account the built-in gain or loss from the revaluation of the intangible, provided that such allocations are not limited by § 1.197-2(h)(12)(vii)(B).

Because of very complicated estate and gift tax rules governing family businesses,[2767] generally family partnerships should be set up with one class of partnership interests. In other words, each partner's capital account is proportionate to that partner's percentage in interest in profits and losses.[2768] However, businesses not involving family members can be more flexible, allocating different tiers of income as rewards for each partner's relative contributions of capital or services. In any event, the tax allocations need to be consistent with the economic arrangements; the tax jargon is that tax allocations must have a "substantial economic effect."

Whether the partnership has one or multiple classes of equity, issues arise when a partner contributes property whose value exceeds its basis. This excess value is known as Code § 704(c) responsibility. When contributed property is subjected to depreciation or amortization or is later sold, the contributing partner receives a special allocation to properly take into account that partner's Code § 704(c) responsibility. Beware if the contribution and corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the direct and indirect partners' aggregate tax liability.[2769]

Hedge funds are complicated partnership tax structures.[2770]

II.P.1.a.i.(b). Special Rule for Allocations of Income in Securities Partnerships

Below is a discussion about allocating income in securities partnerships. This discussion focuses on a subset of allocations described in part II.P.1.a.i.(a) General Rules for Allocations of Income in Partnerships, which upon any distribution from a partnership may have the tax consequences described in part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value. If securities partnerships have money flowing and out, they should consider not only those rules but also the rules described in parts II.M.3.e Exception: Disguised Sale (exception to the general idea that the formation of a partnership is not a taxable event) and II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner, as well concerns that distributions of securities from a partnership to a partner may be treated as cash distributions, as described in part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them). The disguised sale rules generally look to entrepreneurial risk, and the risk of disguised sales from a partnership with many investors may be smaller than that with many investors; however, in any event, a contribution of cash or property and a distribution of cash or property that occur

[2767] See parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.
[2768] See part III.B.7.b.ii Certain Exclusions from Code § 2701, fns. 5571-5572.
[2769] Reg. § 1.704-3(a)(10), added by T.D. 9485 (6/8/2010). For the regulation's text, see fn. 2777 in part II.P.1.a.i.(b) Special Rule for Allocations of Income in Securities Partnerships.
[2770] Miller and Bertrand, "Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers," *Tax Lawyer*, pp. 309-397, Vol. 65, No. 2 (Winter 2002).

within two years tends to trigger a disguised sale reporting requirement, even if the transaction does not constitute a disguised sale.[2771]

Tracking Code § 704(c) and reverse-Code § 704 (c) [2772] responsibility often is administratively cumbersome. Rev. Proc. 2007-59, § 2 points out:

> .01. To prevent the shifting of tax consequences among partners with respect to precontribution gain or loss, section 704(c) requires partnerships to allocate income, gain, loss, and deductions with respect to property contributed by a partner so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of the contribution. These allocations must be made using a reasonable method that is consistent with the purpose of section 704(c). Section 1.704-3(a)(6) provides that similar rules apply to differences between book value and tax basis that are created by a revaluation of partnership assets pursuant to § 1.704-1(b)(2)(iv)(f) (reverse section 704(c) allocations).
>
> .02. Section 1.704-3(a)(2) provides that section 704(c) allocations are generally made on a property-by-property basis. Therefore, built-in gains and losses from different items of contributed or revalued property generally cannot be aggregated.

See part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 422 (quoting the regulation governing revaluations).

For purposes of making reverse-Code § 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets using any reasonable approach that is consistent with the purpose of Code § 704(c).[2773] Once a partnership adopts an aggregate approach, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a securities partnership.[2774] Further below are approaches for aggregating reverse-Code § 704 (c) gains and losses that are generally reasonable.[2775] Other approaches may be reasonable in appropriate circumstances.[2776] In some circumstances, various Code § 704(c) methods, including the aggregate approaches described further below, are not reasonable.[2777] A partnership using an aggregate

[2771] See part II.M.3.e.i.(c) Disclosure Requirements, incorporated by reference by parts II.M.3.e Exception: Disguised Sale and II.Q.8.b.i.(c) Disguised Sale from Partnership to Partner

[2772] For a description of reverse-Code § 704(c) allocations of gain on sale, see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 3932-3935.

[2773] Reg. § 1.704-3(e)(3)(i).

[2774] Reg. § 1.704-3(e)(3)(i), expressly overriding Reg. § 1.704-3(a)(2) and (a)(6)(i).

[2775] Reg. § 1.704-3(e)(3)(i), referring to Reg. § 1.704-3(e)(3)(iv) and (v).

[2776] Reg. § 1.704-3(e)(3)(i).

[2777] Reg. § 1.704-3(e)(3)(i), referring to Reg. § 1.704-3(a)(10), titled, "Anti-abuse rule," which provides:

approach must separately account for any built-in gain or loss from contributed property.[2778]

When getting into details on the two aggregate approaches below, one finds that they limit the assets that can be aggregated and require one to go to an asset-by-asset approach if one later fails to qualify. Consider using one of the approaches without formally adopting it. For example, one might use an aggregate approach in practice for marketable securities and an asset-by-asset approach for unmarketable assets. Given that Reg. § 1.704-3(e)(3)(i) permits using any reasonable approach and given that the IRS views an aggregate approach as reasonable for marketable securities (or it would not have provided it), such a hybrid approach would seem to allow one to comply with the regulations without hamstringing one with the artificial rules that are imposed on using an aggregate method as a safe harbor. As a practical matter, given that using an aggregate method is intended as a reasonable shortcut to avoid laborious asset-by-asset tracking, an IRS examiner might need to do laborious asset-by-asset tracking to show that this method is unreasonable, going into such an ordeal with no reason to believe it would be productive. A potential drawback to this approach is that, if the IRS goes to this effort, reallocations might generate unfair results for partnerships that cannot opt out of the post-2017 audit regime.[2779]

A "qualified financial asset" is any personal property (including stock) that is actively traded.[2780] For a management company, it includes various additional assets, even if not

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(i) *In general*. An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability. For purposes of this paragraph (a)(10), all references to the partners shall include both direct and indirect partners.

(ii) *Definition of indirect partner*. An indirect partner is any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation (as defined in section 957(a) or 953(c)), or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership, and any consolidated group of which the partner in the partnership is a member (within the meaning of § 1.1502-1(h))…. [The rest provides details on controlled foreign corporations and Code § 951(a).]

[2778] Reg. § 1.704-3(e)(3)(i).

[2779] See part II.G.18.c Audits of Partnership Returns.

[2780] Reg. § 1.704-3(e)(3)(ii)(A), which continues:

> Actively traded means actively traded as defined in § 1.1092(d)-1 (defining actively traded property for purposes of the straddle rules).

Reg. § 1.1092(d)-1(a) provides:

> *Actively traded*. Actively traded personal property includes any personal property for which there is an established financial market.

Reg. § 1.1092(d)-1(b)(1) provides:

> *In general*. For purposes of this section, an established financial market includes—
>
> (i) A national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);
>
> (ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934;
>
> (iii) A domestic board of trade designated as a contract market by the Commodities Futures Trading Commission;

actively traded.[2781] A "qualified financial asset" does not include a partnership interest, but a partnership (upper-tier partnership) that holds an interest in a securities partnership (lower-tier partnership) must take into account the lower-tier partnership's assets and qualified financial assets.[2782]

A partnership is a securities partnership if the partnership is either a management company that is registered with the SEC[2783] or an investment partnership, and the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership).[2784] A partnership is an investment partnership if:[2785]

(i) On the date of each capital account restatement, the partnership holds qualified financial assets that constitute at least 90% of the fair market value of the partnership's non-cash assets; and

(ii) The partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under Reg. § 1.704-3(e)(3), to make revaluations at least annually.

(iv) A foreign securities exchange or board of trade that satisfies analogous regulatory requirements under the law of the jurisdiction in which it is organized (such as the London International Financial Futures Exchange, the Marche a Terme International de France, the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited, the Frankfurt Stock Exchange, and the Tokyo Stock Exchange);

(v) An interbank market;

(vi) An interdealer market (as defined in paragraph (b)(2)(i) of this section); and

(vii) Solely with respect to a debt instrument, a debt market (as defined in paragraph (b)(2)(ii) of this section).

Reg. § 1.1092(d)-1(b)(2) defines various terms above. Reg. § 1.1092(d)-1(c) discusses notional principal contracts, and Reg. § 1.1092(d)-1(d) discusses debt linked to the value of personal property and may be part pf a straddle.

[2781] Reg. § 1.704-3(e)(3)(ii)(B), which lists those additional assets as:

notes, bonds, debentures, or other evidences of indebtedness; interest rate, currency, or equity notional principal contracts; evidences of an interest in, or derivative financial instruments in, any security, currency, or commodity, including any option, forward or futures contract, or short position; or any similar financial instrument.

[2782] Reg. § 1.704-3(e)(3)(ii)(C), which continues:

(1) In determining whether the upper-tier partnership qualifies as an investment partnership, the upper-tier partnership must treat its proportionate share of the lower-tier securities partnership's assets as assets of the upper-tier partnership; and

(2) If the upper-tier partnership adopts an aggregate approach under this paragraph (e)(3), the upper-tier partnership must aggregate the gains and losses from its directly held qualified financial assets with its distributive share of the gains and losses from the qualified financial assets of the lower-tier securities partnership.

[2783] Reg. § 1.704-3(e)(3)(iii)(B)(1), provides:

Management company. A partnership is a management company if it is registered with the Securities and Exchange Commission as a management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a).

[2784] Reg. § 1.704-3(e)(3)(iii)(A).

[2785] Reg. § 1.704-3(e)(3)(iii)(B)(2).

A partnership that establishes appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses may adopt the partial netting approach of making reverse-Code § 704 (c) allocations. [2786] Reg. § 1.704-3(e)(3)(iv) further provides:

> Under the partial netting approach, on the date of each capital account restatement, the partnership:
>
> (A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;
>
> (B) Separately aggregates all tax gains and all tax losses from qualified financial assets since the last capital account restatement; and
>
> (C) Separately allocates the aggregate tax gain and aggregate tax loss to the partners in a manner that reduces the disparity between the book capital account balances and the tax capital account balances (book-tax disparities) of the individual partners.

Reg. § 1.704-3(e)(3)(ix), Example (1), illustrates the following under the partial netting approach:

- Each partner has a single revaluation account that shows a net positive or negative book-tax difference.
- Recognized gains and recognized losses are accounted for separately in each of the next two bullet points.
- Recognized gains are allocated only to the partners with positive revaluation accounts, until the positive accounts are exhausted. After that, recognized gains are allocated in proportion to partnership interests.
- Recognized losses are allocated only to the partners with negative revaluation accounts, until the negative accounts are exhausted. After that, recognized losses are allocated in proportion to partnership interests.

A partnership that establishes appropriate accounts for each partner for the purpose of taking into account each partner's share of the book gains and losses and determining each partner's share of the tax gains and losses may also adopt the full netting approach

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[2786] Reg. § 1.704-3(e)(3)(iv). Letter Ruling 201421001 (described more fully in fn. 307 in part II.B Limited Liability Company (LLC)) approved separate partnerships investing in equities or in fixed income funds using this method to track not only Code § 704(c) allocations but also reverse-Code § 704(c) allocations:

> provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

of making reverse-Code § 704 (c) allocations. [2787] Reg. § 1.704-3(e)(3)(v) further provides:

> Under the full netting approach, on the date of each capital account restatement, the partnership:
>
> (A) Nets its book gains and book losses from qualified financial assets since the last capital account restatement and allocates the net amount to its partners;
>
> (B) Nets tax gains and tax losses from qualified financial assets since the last capital account restatement; and
>
> (C) Allocates the net tax gain (or net tax loss) to the partners in a manner that reduces the book-tax disparities of the individual partners.

The character and other tax attributes of gain or loss allocated to the partners under these approaches must:[2788]

> (A) Preserve the tax attributes of each item of gain or loss realized by the partnership;
>
> (B) Be determined under an approach that is consistently applied; and
>
> (C) Not be determined with a view to reducing substantially the present value of the partners' aggregate tax liability.

Reg. § 1.704-3(e)(3)(ix), Example (2), illustrates the following under the full netting approach:

- Each partner has a single revaluation account that shows a net positive or negative book-tax difference.
- Recognized gains and losses are netted against each other.
- If the net is a gain, then this net recognized gains in allocated only to the partners with positive revaluation accounts, until the positive accounts are exhausted. After that, the recognized gain is allocated in proportion to partnership interests.
- If the net is a loss, then the recognized loss is allocated only to the partners with negative revaluation accounts, until the negative accounts are exhausted. After that, the recognized loss is allocated in proportion to partnership interests.

If a securities partnership adopts an aggregate approach under these rules and later fails to qualify as a securities partnership, it must make reverse-Code § 704 (c) allocations on an asset-by-asset basis after the date of disqualification.[2789] However, it is not required to disaggregate the book gain or book loss from qualified asset revaluations

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[2787] Reg. § 1.704-3(e)(3)(v).
[2788] Reg. § 1.704-3(e)(3)(vi).
[2789] Reg. § 1.704-3(e)(3)(vii).

before the date of disqualification when making reverse-Code § 704 (c) allocations on or after the date of disqualification.[2790] A securities partnership revaluing its qualified financial assets pursuant to Reg. § 1.704-1(b)(2)(iv)(f) on or after the effective date of these rules may use any reasonable approach to coordinate with revaluations that occurred before these rules' effective date.[2791]

The IRS may, by published guidance or by letter ruling, permit aggregation of properties other than those described above, partnerships and partners not described above to aggregate gain and loss from qualified financial assets, and aggregation of qualified financial assets for purposes of making Code § 704(c) allocations in the same manner as that described above.[2792]

Letter Rulings have approved:

- Two separate partnerships, one holding equities and another holding fixed income, created on trust termination.[2793]

[2790] Reg. § 1.704-3(e)(3)(vii).

[2791] Reg. § 1.704-3(e)(3)(viii).

[2792] Reg. § 1.704-3(e)(4).

[2793] In Letter Ruling 201421001, a trust used two series LLCs – one invested in equities (X) and the other in fixed income securities (Y) – to distribute its investment assets to remaindermen. The IRS ruled:

(1) Before the distribution of interests in X and Y to the remainder beneficiaries, X and Y will be disregarded entities as long as they remain single member series of a single-member limited liability company (wholly-owned by trust) and items of income, deduction, credit, gains and losses with respect to assets held within X and Y should be reported directly on the trust's federal income tax returns (as if Trust continued to hold X and Y assets directly).

(2) Upon the distribution of interests in X and Y to the remainder beneficiaries, X and Y will be converted from disregarded entities to partnerships for federal tax purposes, and distribution of X and Y interests by the trust shall be treated as (i) a non-taxable pro rata distribution of X and Y assets (subject to any related liabilities) to the remainder beneficiaries (in accordance with the fractional share of Trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from Trust to the remainder beneficiaries; followed by (ii) a deemed capital contribution of those same assets by the remainder beneficiaries to X and Y in a non-taxable exchange for interests in X and Y.

(3) Once X and Y become partnerships for federal tax purposes, to avoid taxation under Code § 721(b) any later in-kind trust distribution of a diversified portfolio of stocks and securities that is transferred as an addition to X or Y on behalf of some or all remainder beneficiaries who hold or thereby acquire membership interests in X or Y shall be treated as: (i) a non-taxable pro rata distribution of such trust assets (subject to any related liabilities) to the remainder beneficiaries holding or thereby acquiring membership interests in X or Y (in accordance with the proportionate fractional share of the trust residue to which each remainder beneficiary, respectively, is entitled), as if such assets had been distributed outright from the trust to such remainder beneficiaries; followed by (ii) a deemed capital contribution of those same assets by such remainder beneficiaries to X or Y in a non-taxable exchange for membership interests in X or Y. See part II.M.3 Buying into or Forming a Partnership.

(4) X's and Y's use of the partial netting approach as defined in Reg. § 1.704-3(e)(3)(iv) for aggregating gains and losses from qualified financial assets for the purpose of making reverse Code § 704(c) allocations is reasonable within the meaning of Reg. § 1.704-3(e)(3). See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a

- Partnerships between a voluntary employees' beneficiary association (VEBA) and plans providing for pension and welfare benefits of a common employer and its current and former subsidiaries.[2794]

- A partnership was allowed to apply this rule to Code § 704(c) allocations when applying the usual Code § 704(c) rules would have been two cumbersome, if a contribution or revaluation of the property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[2795]

- Use of the partial netting approach when three partnerships merged.[2796]

Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

(5) X and Y have permission to aggregate built-in gains and losses from qualified financial assets contributed to X and Y by a partner with built-in gains and built-in losses from revaluations of qualified financial assets held by X and Y for purposes of making allocations under Code § 704(c)(1)(A) and Reg. § 1.704-3(a)(6). See parts II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 3932-3935 (describing reverse-Code § 704(c) allocations, which is where a partner makes a disproportionate contribution or receives a disproportionate distribution when the partner has assets with values not equal to basis, which book-tax difference needs to be accounted for) and II.P.1.a.i.(b) Special Rule for Allocations of Income in Securities Partnerships.

(6) After X and Y become partnerships for federal tax purposes, in-kind distributions of qualified financial assets from X and Y to one or more of its members will not be deemed a distribution of money under Code § 731(c). As a result, an in-kind distribution will not be treated as a "sale or exchange" and the distributee member should not recognize any gain or loss in connection therewith. Further, both (i) the "aggregate built-in gain or loss" at the partnership level, and (ii) the portion of such "aggregate built-in gain or loss" allocable to the partner receiving such distribution, may be adjusted by the full amount of net unrealized gain or loss in the assets so distributed.

See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. For rules on revaluing capital accounts on certain events, see part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 422.

[2794] Letter Rulings 201028016 and 201028017.

[2795] Letter Ruling 201032003.

[2796] Letter Ruling 201710008 held:

> … Surviving Partnership's use of the partial netting approach for making reverse § 704(c) allocations is a reasonable approach within the meaning of § 1.704-3(e)(3), provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability….
>
> … if Surviving Partnership uses the partial netting approach to make § 704(c) allocations, including reverse § 704(c) allocations, this will be a reasonable method within the meaning of § 1.704-3(a)(1), and is permitted by the Commissioner under § 1.704-3(e)(4)(iii), provided that a contribution or revaluation of property and the corresponding allocation of tax items with respect to the property are not made with a view to shifting the

Rev. Proc. 2007-59 allows certain partnerships to aggregate gains and losses from an expanded class of qualified financial assets in applying the above rules. It provides special rules for a "Qualified Partnership," which is a partnership that satisfies the following requirements:[2797]

(1) the partnership makes all of its book allocations in proportion to the partners' relative book capital accounts (except for reasonable special allocations to a partner that provides management services or investment advisory services to the partnership);

(2) the partnership reasonably expects, as of the end of the first taxable year in which the partnership adopts an aggregate approach under this revenue procedure, to make revaluations of qualified financial assets at least four times annually;

(3) on the date of each capital account restatement during the taxable year, the partnership holds qualified financial assets that constitute at least 90 percent of the partnership's non-cash assets;

(4) the partnership reasonably expects, as of the first day of each taxable year for which the partnership seeks to aggregate under this revenue procedure, that the partnership

(a) will have at least 10 unrelated partners at all times during the taxable year; and

(b) will make at least 200 trades of qualified financial assets during the taxable year, the aggregate value of which will comprise at least 50% of the book value of the partnership's assets (including cash) as of the first day of the taxable year; and

(5) the application of the aggregation method to reverse section 704(c) allocations under this revenue procedure is not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner

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tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

This ruling is limited to allocations of gain or loss from the sale or other disposition of qualified financial assets made under § 704(b), § 704(c)(1)(A), and § 1.704-3(a)(6). Specifically, no opinion is expressed concerning allocations of items other than items of gain or loss from the sale or other disposition of qualified financial assets, or the aggregation of built-in gains and losses from qualified financial assets contributed to Surviving Partnership by any person other than Terminating Partnership A and Terminating Partnership B. Surviving Partnership must maintain sufficient records to enable it and its partners to comply with § 704(c)(1)(B) and § 737. Additionally, this ruling applies only to the contributions to Surviving Partnership made in connection with the mergers of Terminating Partnership A and Terminating Partnership B into Surviving Partnership and not to any other contributions or any other future partner.

Letter Ruling 201710007 seemed to be the same as Letter Ruling 201710008.

[2797] § 3.01.

that substantially reduces the present value of the partners' aggregate tax liability.

In applying the above definition, "partners are treated as related if they are related within the meaning of sections 267(b) or 707(b)."[2798]

In applying Rev. Proc. 2007-59, "qualified financial assets" are:[2799]

(1) those assets described in § 1.704-3(e)(3)(ii)(A) and (B);

(2) any interest in a partnership that is traded on an established securities market or readily tradable on a secondary market or the substantial equivalent thereof within the meaning of § 1.7704-1(c); and

(3) any interest owned by the partnership (the upper-tier partnership) in a partnership (the lower-tier partnership) that represents it is a securities partnership or a Qualified Partnership, provided that such interest is

  (i) less than 10 percent of the capital and profits of the lower-tier partnership and that the upper-tier partnership does not actively or materially participate in the management or operations of the lower-tier partnership; and

  (ii) less than 5 percent of the total book value of the upper-tier partnership's assets (including cash) as of the first day of the taxable year.

Rev. Proc. 2007-59 grants permission to any Qualified Partnership to aggregate built-in gains and losses from qualified financial assets for purposes of making reverse-Code § 704 (c) allocations under Reg. § 1.704-3(e)(3).[2800] Once a partnership adopts an aggregate approach under this revenue procedure, that partnership must apply the same aggregate approach to all of its qualified financial assets for all taxable years in which the partnership qualifies as a Qualified Partnership.[2801] However, a partnership may choose not to aggregate all of the partnership's qualified financial assets if such qualified assets do not exceed in the aggregate 30% of the book value of the partnership's non-cash assets at the time any such qualified financial assets is acquired.[2802]

A Qualified Partnership that adopts an aggregate approach under Rev. Proc. 2007-59 and later fails to qualify as a Qualified Partnership must make reverse-Code § 704 (c) allocations on an asset-by-asset basis after the date of disqualification.[2803] The partnership, however, is not required to disaggregate the book gain or book loss from

[2798] § 3.01.
[2799] § 3.02.
[2800] § 4.01.
[2801] § 4.01, citing Reg. § 1.704-3(e)(3)(i).
[2802] § 4.01.
[2803] § 4.02.

qualified asset revaluations before the date of disqualification when making reverse-Code § 704 (c) allocations on or after the date of disqualification.[2804]

Rev. Proc. 2001-36 grants automatic permission for certain securities partnerships to aggregate contributed property for purposes of making Code § 704(c) allocations.[2805] Rev. Proc. 2001-36[2806] provides that a Qualified Master-Feeder Structure (QMFS) may "aggregate built-in gains and losses from contributed qualified financial assets for purposes of making section 704(c) and reverse section 704(c) allocations." [2807] Section 4.02 provides:

> A QMFS is created where two or more investors contribute cash or qualified financial assets to a Master Portfolio in exchange for beneficial interests in the Master Portfolio. To qualify as a QMFS, the following requirements must be met:
>
> (1) Each partner in the Master Portfolio is a Feeder Fund, or an investment advisor, principal underwriter, or manager of the Master Portfolio;
>
> (2) Each Feeder Fund contributes only cash and/or a portfolio of diversified stocks and securities that satisfies the 25 and 50 percent tests of section 368(a)(2)(F)(ii) in exchange for beneficial interests in the Master Portfolio;

[2804] § 4.02.

[2805] It also described the information that must be included with ruling requests for permission to aggregate contributed property for purposes of making Code § 704(c) allocations submitted by partnerships that do not qualify for automatic permission, but Rev. Proc. 2002-3, § 6.06, titled "Section 704(c)," superseded that part, providing that private letter rulings will not ordinarily be issued regarding:

> Contributed Property-Requests from Qualified Master-Feeder Structures, as described in section 4.02 of Rev. Proc. 2001-36, 2001-23 I.R.B. 1326, for permission to aggregate built-in gains and losses from contributed qualified financial assets for purposes of making § 704(c) and reverse § 704(c) allocations.

[2806] §§ 2.07 and 2.08 describe the Rev. Proc.'s purpose:

> .07. In a typical Master-Feeder Structure, two or more Feeder Funds or one or more Feeder Funds and an investment advisor, principal underwriter, or manager contribute their assets, consisting primarily of cash or financial investments, to a single Master Portfolio in exchange for beneficial interests in the Master Portfolio. In these cases, each Feeder Fund and the Master Portfolio is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 (1940 Act). The shares of these Feeder Funds are typically publicly offered and widely held by individuals, corporations, and institutional investors. Generally, each Feeder Fund is an open-end mutual fund, which continuously offers to sell new shares or redeem existing shares for a price equal to the net asset value of their proportionate interest in the portfolio.
>
> .08. The IRS and Treasury Department have determined that it is in the best interest of sound tax administration to reduce the burden on taxpayers of submitting ruling requests by granting to certain Master-Feeder Structures automatic permission to aggregate built-in gains and losses from contributed securities.

[2807] § 4.01.

(3) Each partner in the Master Portfolio that is an investment advisor, principal underwriter, or manager, contributes only cash and/or services in exchange for beneficial interests in the Master Portfolio;

(4) The Master Portfolio is treated as a partnership for federal tax purposes and qualifies as a securities partnership under section 1.704-3(e)(3)(iii);

(5) Each Feeder Fund is a publicly offered regulated investment company, as defined in section 67(c)(2)(B) and section 1.67-2T(g)(3)(iii);

(6) The Master Portfolio is registered as an investment company under the 1940 Act.

(7) The Master Portfolio makes section 704(c) and reverse section 704(c) allocations under the partial netting approach or the full netting approach as described in section 1.704-3(e)(3)(iv) or section 1.704-3(e)(3)(v), respectively, and;

(8) The contributions to the Master Portfolio and the corresponding allocations of tax items with respect to the property contributed to the Master Portfolio are not made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.

II.P.1.a.ii. Allocations of Income in S corporations

As described further below, S corporations generally must have a single class of stock. Income is always allocated in proportion to stock ownership.[2808] Special allocations of profits are not permitted, and Code § 704(c) responsibility does not exist. However, trusts cannot use the Code § 179 expensing of equipment, etc., so if the corporation reports Code § 179 expense and has a nongrantor trust shareholder then the corporation will need to separately track as an asset the trust's share of Code § 179 expense and specially allocate to the trust depreciation from that asset.[2809]

Also described further below are ways to creatively compensate employees, providing incentive that is the same as, or similar to, the results one can attain from partnerships.

S corporations are superior to C corporations in that undistributed S corporation income adds to the basis of the shareholders' stock.

Also see part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[2808] Code § 1377(a)(1). For allocations of income when ownership changes, see part III.B.2.j Tax Allocations upon Change of Interest, particularly III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.
[2809] See part II.J.11.a.i Code § 179 Disallowance for Nongrantor Trust.

II.P.1.a.iii. Advantages of C and S Corporation Reporting of Owners' Compensation on Forms W-2

C and S corporations must withhold taxes and file quarterly forms 941 and annual forms W-2 for owners' compensation, whereas partnerships and sole proprietorships are not involved in withholding taxes regarding owner compensation.

Timely filing forms W-2 helps support the 20% deduction for qualified business income ("QBI") for owners of partnerships,[2810] but W-2 income itself does not constitute QBI.[2811]

Filing W-2 forms for owners provides some minor benefits:

(a) Unless the employee elects otherwise, federal income tax withheld is deemed paid evenly throughout the year. If the owner falls behind during the year, the owner may withhold large amounts at year-end, which generally will be deemed paid evenly throughout the year.

(b) Qualified retirement plans have a cap on compensation that can be considered in allocating contributions to the plans. Owners of corporations could adjust their W-2 income to reduce their compensation in good years and increase it in bad years to plan around this cap. Partners and sole proprietors do not have this flexibility. Of course, all businesses on the cash basis could delay or accelerate billings or disbursements.

(c) Providing a better base for the special deduction for domestic manufacturing.[2812]

II.P.2. C Corporation Advantage Regarding Fringe Benefits

Only a C corporation may deduct the following items without including them in the recipient's income:

(a) Dependent care (child care) assistance payments for owners subject to a dollar cap (generally $5,000).

(b) The owners' meals and lodging for the employer's convenience without including them in the owner's income.[2813]

[2810] See part II.E.1.c.iii Calculation of Deduction If Owner's Taxable Income Is Well Above Certain Taxable Income Thresholds, text accompanying fns 637-646.

[2811] See part II.E.1.c.ii Types of Income and Activities Eligible for Deduction, fns. 621-622.

[2812] Note the W-2 limitation mentioned in part II.G.24 Code § 199 Deduction for Domestic Production Activities especially fn. 1270.

[2813] Code § 119. See Campbell and Mitchell, The Exclusion for Meals and Lodging, *The Tax Adviser* (April 2015) (also discussing the partnership issue described below), saved as doc. no. 6206076.

However, this exclusion might apply beyond the C corporation context. See McKee, Nelson & Whitmire, ¶14.02. Partners Acting in Nonpartner Capacities: Section 707(a) Transactions, *Federal Taxation of Partnerships & Partners* (WG&L), citing a Fifth Circuit case looking with favor on the Code § 119 exclusion for a partner:

> *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968) (remanding for determination whether partner was in fact employee of his partnership, and therefore entitled to exclude

(c) Non-discriminatory premiums for up to $50,000 in group-term life insurance covering the owners without including them in the owner's income.[2814]

Partners' fringe benefits are summarized by McKee, Nelson & Whitmire;[2815] RIA has prepared summaries of fringe benefits that partners and S corporation shareholders can and cannot claim.[2816] Any partner who performs services for a partnership is considered employed by the partnership for purposes of Code § 132(a)(1) (relating to no-additional-cost services) and Code § 132(a)(2) (relating to qualified employee discounts),[2817] as well as Code § 132(a)(3) (relating to working condition fringes)[2818] and Code § 132(h)(5) (relating to on-premises athletic facilities).[2819] Partners are eligible for educational assistance programs under Code § 127.[2820] Qualified transportation fringe benefits under Code § 132(f) are available to partners only if they are entirely below the limits for the working condition and de minimis fringe exclusions under Code § 132(a)(3), (4).[2821]

II.P.3. Conversions

Conversion to a C corporation is less taxing than conversion from a C corporation. Often, start-up businesses open as a pass-through entity (partnership or S corporation) to enable the owner to deduct initial losses, and then convert to a C corporation when

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under § 119 value of meals and lodging furnished by the partnership). *Contra Wilson v. United States*, 376 F.2d 280 (Ct. Cl. 1967). The courts generally applied aggregate principles under the 1939 Code. See *Commissioner v. Doak*, 234 F.2d 704 (4th Cir. 1956) (partner may not be employee of his partnership); *Commissioner v. Moran*, 236 F.2d 595 (8th Cir. 1956) (same); *Commissioner v. Robinson*, 273 F.2d 503 (3d Cir. 1959) (cert. denied) (same); Rev. Rul. 53-80, 1953-1 CB 62 (same). See also *George A. Papineau*, 16 T.C. 130 (1951) (nonacq.); Tech. Adv. Mem. 9134003 (May 6, 1991) (incorporation of farming business; shareholder/employees claim benefits of § 119; § 269 not applicable because same benefits available if partnership had been formed). But *cf. Dilts v. United States*, 845 F.Supp. 1505 (D. Wyo. 1994) (§ 119 not available to shareholders of family-owned S corporation; result of *Armstrong v. Phinney* justified on grounds that taxpayer only 5 percent partner).

For more on *Armstrong v. Phinney* and when a partner may be considered as being compensated for services not in his or her capacity as a partner under Code § 707(a)(2), as contrasted as compensation for services rendered in his or her capacity as a partner under Code § 707(c), see fns. 438, 435 in part III.B.7.c.viii Creative Bonus Arrangements. Reg. § 1.707-1(c) provides that "partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d)."

2814 The arrangement must truly be group term and not some bundled package of various separate life insurance policies. See part II.Q.4.f Split-Dollar Arrangements, especially fn. 3181.

2815 Federal Taxation of Partnerships & Partners (WG&L), ¶2.04 Qualified Plans and Other Fringe Benefits.

2816 See "Fringe benefits partners and more-than-2% S shareholder employees can and can't claim," *Federal Taxes Weekly Alert Newsletter* (RIA) (5/25/2017) and *Pension & Benefits Week Newsletter* (RIA) (7/3/2017), the latter saved as Thompson Coburn doc. no. 6591733. See also part II.P.1.a.iii Advantages of C and S Corporation Reporting of Owners' Compensation on Forms W-2.

2817 Reg. § 1.132-1(b)(1).

2818 Reg. § 1.132-1(b)(2)(ii).

2819 Reg. § 1.132-1(b)(3).

2820 Code § 127(c)(2), (3).

2821 Reg. § 1.132-9, A-24 (adopted in 2001 and amended in 2006); see Notice 94-3, Q-5(b).

they become profitable. To the extent that timing is discussed below, it is when changes in entity arise from check-the-box elections, which elections generally may be effective up to 75 days before the date of filing.[2822]

An eligible entity may elect to be classified other than its default classification or to change its classification, by filing Form 8832.[2823] If an eligible entity makes an election under the preceding sentence to change its classification (other than an election made by an existing entity to change its classification as of the effective date of this section), the entity cannot change its classification by election again during the 60 months succeeding the effective date of the election.[2824] However, the IRS may permit the entity to change its classification by election within the sixty months if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.[2825] An election by a newly formed eligible entity that is effective on the date of formation is not considered a change for purposes of the 60-month rule.[2826]

[2822] Reg. § 301.7701-3(c)(1)(iii) provides:

> *Effective date of election*. An election made under paragraph (c)(1)(i) of this section will be effective on the date specified by the entity on Form 8832 or on the date filed if no such date is specified on the election form. The effective date specified on Form 8832 can not be more than 75 days prior to the date on which the election is filed and can not be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 75 days prior to the date on which the election is filed, it will be effective 75 days prior to the date it was filed. If an election specifies an effective date more than 12 months from the date on which the election is filed, it will be effective 12 months after the date it was filed. If an election specifies an effective date before January 1, 1997, it will be effective as of January 1, 1997. If a purchasing corporation makes an election under section 338 regarding an acquired subsidiary, an election under paragraph (c)(1)(i) of this section for the acquired subsidiary can be effective no earlier than the day after the acquisition date (within the meaning of section 338(h)(2)).

[2823] Reg. § 301.7701-3(c)(1)(i).

[2824] Reg. § 301.7701-3(c)(1)(iv). T.D. 8697 (12/18/1996) provides:

> The sixty month limitation only applies to a change in classification by election; the limitation does not apply if the organization's business is actually transferred to another entity.

The preamble to the proposed regulations, PS-43-95 (5/1996), followed a sentence similar to the above with:

> For example, an organization could liquidate into its parent, terminate and reform as another entity (e.g., by merger), or contribute its business to another organization without restriction.

[2825] Reg. § 301.7701-3(c)(1)(iv).

[2826] Reg. § 301.7701-3(c)(1)(iv). The preamble to the proposed regulations, PS-43-95 (5/1996), commented:

> The sixty month limitation only applies to a change in classification by election. Thus, if a new eligible entity elects out of its default classification effective from its inception, that election is not a change in the entity's classification.

Letter Ruling 201516034 confirmed that electing out of default classification is not a change in the entity's classification. The ruling permitted corporate subsidiaries to convert to LLCs under their original state law and for those LLCs to elect corporation taxation, after which the LLCs converted

II.P.3.a. Need for New Tax ID

See http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Do-You-Need-a-New-EIN.

If one changes names but keeps the same tax ID, request from the IRS Form 147C, Confirmation Letter, to be able to prove to third parties that the name changed but the tax ID did not.

II.P.3.b. From Corporations to Partnerships and Sole Proprietorships

If a corporation has more than one shareholder, the corporation is deemed to distribute all of its assets and liabilities to its owners, who immediately contribute all of the distributed assets and liabilities to the partnership.[2827] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.[2828]

If a corporation has only one shareholder, the corporation is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the corporation.[2829] The deemed transaction is treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transaction is treated as occurring immediately before the close of December 31 and must be reported as of December 31. Thus, the last day of the corporation's taxable year will be December 31 and the first day of the individual's taxable year regarding the activity will be January 1.[2830] If a parent corporation converts a wholly-owned subsidiary corporation to a single member LLC that is disregarded for tax purposes, the conversion constituted a tax free liquidation of the subsidiary under Code § 332.[2831]

The liquidation of a corporation is a taxable event.[2832] The corporation (or its shareholders through K-1s if it is an S corporation) is taxed on the extent by which any asset's fair market value (FMV) exceeds its basis.[2833] Each shareholder generally

to LLCs governed by a different state's laws, and the newest LLCs were also permitted to elect corporation taxation.

2827 Reg. § 301.7701-3(g)(1)(ii).

2828 Reg. § 301.7701-3(g)(3).

2829 Reg. § 301.7701-3(g)(1)(iii).

2830 Reg. § 301.7701-3(g)(3).

2831 Letter Ruling 201452016.

2832 See Code §§ 336 and 337.

2833 Contributing property with a built-in loss within 2 years of liquidation so as to avoid gain on liquidation generally would not work. Code § 336(d)(2).

realizes capital gain or loss on the difference between the FMV received and the stock's adjusted basis. This double tax can be expensive.[2834]

II.P.3.c. Conversion from C Corporation to S corporation

Converting from a C corporation to an S corporation can trigger LIFO recapture for companies that carry an inventory[2835] or built-in gain tax when assets are sold with a certain number of years after the S election.[2836]

Any S corporations that have not cleansed themselves of C corporation earnings and profits encounter constraints regarding too much investment income[2837] and reduced benefits from tax-exempt interest.[2838]

II.P.3.c.i. LIFO Recapture

If a C corporation inventoried goods under the LIFO method immediately before making an S election, it shall include in income the LIFO recapture amount in its last taxable year as a C corporation (for which its inventory then receives appropriate basis adjustments.[2839]

The corporation pays tax imposed on this conversion in its last C year and first three S years.[2840]

Considering that any inventory on hand is likely to be sold during the recognition period for the built-in gain tax, this recapture avoids double taxation. On the other hand, the corporation might have been able to maintain its old layer of inventory for tax purposes during the entire built-in gain recognition period, and this might be viewed as an additional tax burden.

[2834] See, *e.g.*, Everett, Hennig, and Raabe, Converting a C corporation into an LLC: Quantifying the Tax Costs and Benefits, *Journal of Taxation* (Aug. 2010).

[2835] See part II.P.3.c.i LIFO Recapture.

[2836] See part II.P.3.c.ii Built-in Gain Tax.

[2837] See part II.P.3.c.iii Excess Passive Investment Income.

[2838] See part II.P.3.c.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

[2839] Code § 1363(d)(1).

[2840] Code § 1361(d)(2). FSA 20153001F discussed the treatment of a consolidated group with a C corporation parent being acquired by an S corporation and became a Qualified Subchapter S Subsidiary. The FSA included the following clarification:

> The recapture date is the day before the effective date of the S election. Treas. Reg. § 1.1363-2(c)(1). However, with reference to transactions described in § 1.1363-2(a)(2) (including Qsub elections), there appears to be a typo in the regulations. Treas. Reg. § 1.1363-2(c)(1) states that for a nonrecognition transaction described in § 1.1363-2(a)(2) or (b)(2), the recapture date is the date of the transfer of the partnership interest to the S corporation. However, only section (b)(2) refers to a transfer of a partnership interest, (a)(2) refers to transfers of LIFO inventory assets by the C corporation to an S corporation. The LIFO recapture amount is determined as of the end of the recapture date for S corporation elections described in § 1.1363-2(a)(1), and as of the moment before the transfer occurs for nonrecognition transactions (including Qsub elections) described in 1.1363-2(a)(2). Treas. Reg. § 1.1363-2(c)(2).

II.P.3.c.ii. Built-in Gain Tax on Former C Corporations under Code § 1374

II.P.3.c.ii.(a). Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374

When any asset is disposed of within 5 years of the S election,[2841] generally double taxation applies - normal taxation as a flow-through entity, plus a separate corporate level tax imposed on the lesser of the gain on disposition or the unrealized gain on the effective date of the S election.[2842] The corporation must disclose its unrealized built-in gain annually.[2843]

[2841] Code § 1374(d)(7) generally provides a 5-year recognition period, which was 7 years for a sale in 2009 or 2010 or 10 years for a sale before then. Code § 1374(d)(7) describes the recognition period as follows:

> (A) *In general*. The term 'recognition period' means the 5-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation. For purposes of applying this section to any amount includible in income by reason of distributions to shareholders pursuant to section 593(e), the preceding sentence shall be applied without regard to the phrase '5-year'.
>
> (B) *Installment sales*. If an S corporation sells an asset and reports the income from the sale using the installment method under section 453, the treatment of all payments received shall be governed by the provisions of this paragraph applicable to the taxable year in which such sale was made.

Letter Ruling 201150023 includes some nuances as the 2011 transition rules related to an installment sale. The ABA Section of Taxation S corporations Committee meeting in May 2015 discussed various nuances to Code § 1374(d)(7) before the Protecting Americans from Tax Hikes Act of 2015 enacted the language quoted above; see Thompson Coburn document no. 6214396.

[2842] Code § 1374. For ways to minimize this tax using a charitable remainder trust, see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax. Also, see generally, Dealing with the S corporation Built-In Gains Tax, Parts 1 and 2, *Journal of Taxation* (April and May 2008). Reg. § 1.1374-2(a) provides that an S corporation is taxed is the lesser of:

> (1) Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and recognized built-in gain carryover (pre-limitation amount);
>
> (2) Its taxable income determined by using all rules applying to C corporations as modified by section 1375(b)(1)(B) (taxable income limitation); and
>
> (3) The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years (net unrealized built-in gain limitation).

[2843] Form 1120S (2014), page 2, Schedule B, question 8. To avoid an understatement penalty, the taxpayer might consider hiring an appraiser to value the more significant items that have value that differs from basis. For a taxpayer to rely on a professional's advice, Reg. § 1.6664-4(c)(1)(i) provides;

> *All facts and circumstances considered*. The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

If the taxpayer obtains more than one opinion of value, the taxpayer does not need to provide the tax return preparer with an earlier appraisal if a later appraisal was obtained to correct errors and incorporate more current data. *The Ringgold Telephone Company v. Commissioner*, T.C. Memo. 2010-103 (no penalty assessed for underpayment of built-in gain tax). The court also

Generally, any item of income properly taken into account during the recognition period is recognized built-in gain if the item would have been properly included in gross income before the beginning of the recognition period by an accrual method taxpayer.[2844] Assets subject to this tax include inventory (but see part II.P.3.c.i LIFO Recapture) and a cash basis taxpayer's accounts receivable,[2845] as well as goodwill;[2846] however, an accrual taxpayer's the receipt of franchise fees not constituting a sale or exchange of a capital asset under Code § 1253(a) are not subject to built-in gain tax.[2847] If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method during or after the recognition period, that income is subject to built-in gain tax.[2848]

This gain can be offset by built-in losses,[2849] such as a cash basis taxpayer's accounts payable.[2850] Thus, a cash basis taxpayer with accounts receivable at the time of the

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rejected the IRS' criticism of the taxpayer's failure to give the tax return preparer a copy of a memorandum suggesting a value, because the memorandum was prepared primarily as a marketing tool, not as an objective valuation.

[2844] Reg. § 1.1374-4(b)(1). This determination disregards any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation. Reg. § 1.1374-4(b)(3), Example (4) discusses deferred prepayment income, and Example (5) discusses changes in accounting methods. For further discussion of various items of built-in gain, see McMahon and Simmons, Where Subchapter S Meets Subchapter C, *Tax Lawyer*, vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177833.

[2845] For accounts receivable, the S corporation takes them account in full when it collects them, but it takes into account no more than their fair market value at the time of the S election if it sells them to a third party instead. Reg. § 1.1374-4(b)(3), Example (1). For long-term contracts accounted for under the completed contract method, income that would have been earned before the S election under the percentage of completion method is built-in gain. Reg. § 1.1374-4(g).

[2846] Reg. § 1.1374-3(c), Example (1).

[2847] Letter Ruling 200411015 involved the following situation:

> Franchisees pay [taxpayer] a license fee upon grant of the license and monthly royalty fees which are composed of a fixed fee portion and a variable fee portion. Except for the limited use allowed by the Agreements, [taxpayer] retains a significant power, right, or continuing interest in the franchise and terminates any Agreement in violation of the terms and conditions of the license grant. The grant or transfer of franchise rights pursuant to an Agreement does not constitute a sale or exchange of a capital asset under section 1253(a).

The ruling held:

> The income of [taxpayer] with respect to the receipt of the license fees and royalty fees from franchisees after the Conversion Date will not be treated as recognized built-in gain within the meaning of section 1374(d).
>
> We express no opinion about the tax treatment of the license fees or royalty fees under other provisions of the Code and regulations or the tax treatment of any conditions existing at the time of, or the effects resulting from, the license fees and royalty fees that are not specifically covered by the above ruling. We also express no opinion about the tax treatment under 1374 of any income or gain that may be realized by [taxpayer] during the recognition period except as specifically provided above.

[2848] Reg. § 1.1374-4(h). Also watch out for acceleration as described in part II.G.14 Limitations on the Use of Installment Sales

[2849] Reg. § 1.1374-2(a)(1).

[2850] Reg. § 1.1374-4(b)(2) provides that, generally:

> …any item of deduction properly taken into account during the recognition period is recognized built-in loss if the item would have been properly allowed as a deduction

S election should be able to offset that built-in gain by its board of directors declaring a bonus, constituting reasonable compensation, before the S election, which bonus is payable while an S corporation.[2851]

An accrual taxpayer's deductions deferred by reason of the economic performance rules count as built-in losses.[2852]

Regulations prevent avoiding this tax merely by dropping assets into a partnership.[2853] However, if the corporation owns the partnership at the time of the S election, valuation discounts might reduce the amount of built-in gain.

II.P.3.c.ii.(b). Consider S Election Even If Plan to Sell Within 5 Years

Even if one plans to sell the corporation within five years, one might find an S election useful and then revert back to a C corporation if the sale does occur during that time, if all of the following are present:

> against gross income before the beginning of the recognition period to an accrual method taxpayer (disregarding any method of accounting for which an election by the taxpayer must be made unless the taxpayer actually used the method when it was a C corporation).

Under an accrual method of accounting, a liability is incurred and generally is taken into account in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Reg. § 1.461-1(a)(2)(i). For example, if the corporation is involved in a lawsuit at the time of the S election, amounts paid as a result of the lawsuit are built-in losses only if a judgement had been awarded at the time of the S election. Reg. § 1.1374-4(b)(3), Examples (2) and (3). If an accrual method taxpayer would have been able to deduct amounts owed to related parties before making the S election and Code § 267(a)(2) suspended the deduction until after the S election was made, those expenses might be built-in losses under Reg. § 1.1374-4(c)(1). A similar rule applies to compensation appropriately accrued before the S election but suspended under Code § 404(a)(5) until after the S election was made. Reg. § 1.1374-4(c)(2).

[2851] S. Rep. No. 445, 100th Cong., 2d Sess. 65 (1988), states:

> As an example of these built-in gain and loss provisions, in the case of a cash basis personal service corporation that converts to S status and that has receivables at the time of the conversion, the receivables, when received, are built-in gain items. At the same time, built-in losses would include otherwise deductible compensation paid after the conversion to the persons who performed the services that produced the receivables, to the extent such compensation is attributable to such pre-conversion services. To the extent such built-in loss items offset the built-in gains from the receivables, there would be no amount subject to the built-in gains tax.

Eustice & Kuntz, ¶ 7.06[4][f] Computation of Tax; Use of Certain Losses and Deductions to Reduce Tax Base, Federal Income Taxation of S corporations, views this as an accurate statement of current law.

[2852] Reg. § 1.1374-4(b)(2) provides that:

> In determining whether an item would have been properly allowed as a deduction against gross income by an accrual method taxpayer for purposes of this paragraph, section 461(h)(2)(C) and § 1.461-4(g) (relating to liabilities for tort, worker's compensation, breach of contract, violation of law, rebates, refunds, awards, prizes, jackpots, insurance contracts, warranty contracts, service contracts, taxes, and other liabilities) do not apply.

[2853] Reg. § 1.1374-4(i).

- The corporate stock is not eligible for the exclusion from gain on sale of the stock under Code § 1202 described in part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation. Being an S corporation for any significant period would blow the exclusion.[2854]

- The company does not have too much inventory subject to tax under part II.P.3.c.i LIFO Recapture. Note that any tax imposed on LIFO recapture is spread over several years.

- The company does not expect to dispose of significant assets subject to built-in gain tax.[2855] If the company reports on the cash receipts and disbursements method, then its accounts receivable and other accrued income in excess of its accounts payable and other accrued expenses would be subject to built-in gain tax; however, if it is on the accrual method, the income would already have been recognized and the built-in gain tax would not apply.[2856]

Making the S election would allow the shareholders to extract earnings during that period income-tax free, whether those earnings are extracted through distributions or when selling their stock.

If stock in the company is sold as just a straight stock sale, then either the buyer keeps the S election going (and benefits from to) or terminates the S election. If the buyer requires a basis step-up on the corporation's assets as described in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, then the seller might need to revoke the S election to avoid the built-in gain tax. Either way, terminating the S election might very well be relatively straightforward so that this process of turning on and then off the S election might have few bad tax effects (if the three bullet points above work out) and are advantageous while the election is in effect. See parts II.P.3.e Conversion from S Corporation to C Corporation and II.A.2.l Terminating S Election.

II.P.3.c.iii. Excess Passive Investment Income

If a C corporation with accumulated earnings and profits (E&P)[2857] elects S status, it might be subject to a supplemental tax and lose its S status if it has excess passive investment income.[2858] The corporation can avoid this treatment by carefully planning its

[2854] See fn. 3767.
[2855] See part II.P.3.c.ii.(a) Explanation of Built-in Gain Tax on Former C Corporations under Code § 1374.
[2856] See fns. 2844-2852.
[2857] Reg. § 1.1375-1(b)(4) refers to Code § 1362(d)(3) and the regulations thereunder in determining E&P. E&P is based on C corporation principles under Code § 312 and taxed by Code § 316 when distributed. Code § 1371(c). E&P are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an S election was not in effect. Reg. § 1.1362-2(c)(3).
[2858] Code §§ 1362(d)(3), 1375. Certain S corporations may disregard pre-1983 earnings and profits. 2007 Small Business Act P.L. 110-28, Sec. 8235.

gross receipts or by distributing its E&P.[2859] Inadvertent termination relief may be available if the corporation distributes its E&P after violating the excess passive investment income test.[2860]

Some points on planning gross receipts to avoid excess passive investment income treatment include:

- Although the statute defines rent as tainted income,[2861] that characterization does not apply if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental activity.[2862] For this

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[2859] Planning before the conversion might also help. Starr and Sobol, *S corporations: Operations*, T.M. 731-2nd, suggests at IV.B:

> Comment: When a C corporation converts to an S corporation, accumulated E&P is likely to be overstated, since timing differences originating in C status will tend to reverse while in S corporation status. As a result, excessive dividend distributions will be necessary to fully deplete the account. Conversely, when an S corporation converts to a C corporation, these timing differences may prove advantageous in that the accumulated E&P would reflect the reversal in C status while not being affected by the origination of the item in S status.
>
> Instances where timing differences come into play when switching from C to S or S to C status include:
>
> - accelerated cost recovery deductions for taxable income, but straight-line for accumulated E&P;
> - installment method elected for taxable income, but not allowed for accumulated E&P; and
> - special LIFO inventory adjustments required for accumulated E&P, but generally not required for taxable income.

[2860] Letter Ruling 201710013.

[2861] Code § 1362(d)(3)(C)(i).

[2862] Reg. § 1.1362-2(c)(5)(ii)(B)(2), which provides:

> *Rents derived in the active trade or business of renting property*. Rents does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Rev. Rul. 81-197 addressed leasing aircraft. Reimbursing the renter's expenses under a one-year lease, where the tenant does all of the work, did not make rental be active. However, chartering aircraft was active, where (a) the owner provides all pilots, fuel, catering, and operating supplies, and pays for all hull and liability insurance, landing and parking fees, taxes, and governmental fees and charges, (b) pilots who are its employees have primary authority for the safety and actual operation of the aircraft, and (c) it enters into a management agreement with the aircraft manufacturer to secure assistance in maintaining the aircraft.

A corporation did not provide significant services or incur substantial costs when it provided furniture for the bungalows (used as vacation homes) and a recreation area maintained by the corporation, as well as tables and cards use in that area, sponsored bingo games for the adults and parties for the children at which small prizes were given, and sponsored parties for the adults, providing food and entertainment, all of which cost approximately 0.15% of revenue. *Feingold v. Commissioner*, 49 T.C. 461(1968). Performing decorating, repair, maintenance and purpose, "rent" does not include "income realized by a landowner under a share-farming arrangement where the landowner participates to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both,"[2863] but the payment of costs may be sufficient to cause a farm arrangement to be nonpassive under this test.[2864]

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cleaning services at the lessee's separate expense did not make active the rental of stadium suites active, but income from concessions, stadium club membership fees and dues, and electronic scoreboard advertising was active. Letter Ruling 8247052 (GCM 38915 apparently provided the underlying analysis).

Letter Ruling 201725022 held that the following medical office lease was active:

> X contracts with an independent leasing agent to assist in soliciting prospective tenants for M, negotiating leases and renewals, and overseeing post-leasing activities such as build-outs and renovations of suite space. X, with the assistance of the independent leasing agent, drafts, proposes, presents, and negotiates letters of intent to lease available suite spaces. Negotiation for leasing regularly requires the use of an independent space planner to design and tailor the spaces for prospective tenants. Once letters of intent are accepted, X, with the assistance of the independent leasing agent, prepares, finalizes, and executes the lease agreements with prospective tenants. Renewals of leases are similarly handled by X, which are often complicated by requests for concessions and renegotiation of the leasing rate. Renewals often require significant time and attention by X.
>
> X, through its employees, its agents, and the agents' employees, provides certain services in maintaining and repairing of the buildings, common areas, and grounds of M. X utilizes a standard lease agreement for its tenants, and under the lease agreements X has the obligation to provide certain services with respect to the leasing of space within M and to maintain or repair the following items: the heat and air conditioning systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup.
>
> In addition, the following specific services are provided to M and its tenants by an employee or independent contractor/worker of X: daily walk-through inspections of M to report on water breaks, lighting outage, vandalism, damage to building exteriors and certain interior spaces; sweeping, cleaning and maintaining the common areas of M such as sideways, walkways, and parking lot; routine periodic inspection of building exteriors and interiors, including foundations, roofs, exterior lighting, grounds, and parking lot and engaging in maintenance and repairs as needed; treating the roofs of the buildings for moss growth yearly; recoating and resurfacing the parking lot; routine and periodic maintenance of the numerous heating and air conditioning units; renovating vacant suites for leasing; routine and periodic maintenance of the plumbing and sewer lines, and their repair and replacement as needed; maintenance, repair and replacement of exterior lighting and selected interior lighting; janitorial services for selected units and common areas; exterior window washing; regular maintenance of grounds and lawn care, and landscaping services when necessary; seasonal snow removal and ice control; weekly trash removal; periodic pest and vermin control; and emergency response and property access for public safety.

Additional authority is in *United States Tax Reporter* ANN ¶ 13,799.27 Rents; Bittker & Eustice, ¶ 6.04. Events Terminating Election, *Federal Income Taxation of Corporations & Shareholders* (WG&L); Eustice, Kuntz & Bogdanski, ¶ 5.04[2][b] Rents, *Federal Income Taxation of S Corporations*; Christian & Grant, ¶ 11.03 Rents, *Subchapter S Taxation* (WG&L).

[2863] Rev. Rul. 61-112. See Letter Rulings 8927039, 9003056, 9514005, 200002033, 200217045, and 200739008, all cited in Thompson Coburn LLP doc. no. 6513203 (which would need to be sanitized before sharing). *Kennedy v. Commissioner*, T.C. Memo. 1974-149, held that crop-

- Gross receipts (rather than net income) of nonpassive income from partnerships in which the corporation is invested may be counted;[2865] some income from controlled foreign corporations might also count as nonpassive income.[2866] Investing in oil and gas partnerships frequently helps generate sufficient nonpassive gross receipts.[2867]

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sharing was passive rental when the corporation furnished nothing except the use of the land and the tenant furnished all the management, labor, supplies, etc.

Citing Rev. Rul. 61-112, Rev. Rul. 67-423 held that, when a corporation owns farmland it leases to a tenant under a crop-sharing arrangement that generates government payments under acreage reserve and conservation reserve programs and the landlord materially participates in the management of the farm production, the payments which the landlord receives under the foregoing programs are not "rents" for personal holding company income tax purposes. TAM 6211239430A, which also cited Rev. Rul. 61-112, held that crop-sharing payments were "rents" for personal holding company income tax purposes where the corporation did nothing and the tenant furnishes all of the equipment and performs all of the work.

GCM 35957 (1974) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted unrelated business taxable income.

GCM 35247 (1973) cited Rev. Rul. 61-112, among other authority, in analyzing whether crop-sharing constituted a business for purposes of estate tax deferral under Code § 6166.

[2864] Letter Ruling 201722019 approved as nonpassive both of the following:

> X is engaged in the business of farming and owns n acres in State. X has leased the land for sharecropping (Sharecropping Lease Arrangement) continuously beginning in Date 3. Beginning in Year, the land was leased to Y. Pursuant to the Sharecropping Lease Arrangement, all taxes, assessments or charges levied or assessed on products of the land must be paid by X and Y based in proportion to the percentage of crops to which X and Y are entitled. X and Y each pay one half of the actual cost of fertilizer and soil conditioner. X pays the cost of the power and fuel necessary to operate the drainage pumping plants as well as the cost of maintaining the irrigation and drainage canals and irrigation pipe line. X is also responsible for paying box rent and the grower's share of the state inspection fee. Any processing expenses incurred with the preparation of crops for sale, which are related to X's share of the crops, are paid by X. X also determines the percentage of Property to be farmed and the types of crops to be planted. Further, X is at risk for crop yields and marketing.
>
> In Year, X signed a new lease agreement (Rental Lease Arrangement) with Y for lease of Property. Under the lease, X's expenses are between o% and p% of X's rental income. X is responsible for providing and maintaining insurance on all improvements and fixtures owned by X. Further, X pays the costs and expenses associated with the repair, maintenance and replacement of the irrigation drainage pumps as well as the insurance, water reclamation tax, water rights fees, water coalition dues and property taxes.

[2865] Rev. Rul. 71-455; see also Reg. § 1.702-1(a)(8)(ii).

[2866] CCA 201030024.

[2867] For a summary of the issue, see 723 T.M. III.D.7.b.; see also part II.P.1.a.i Allocations of Income in Partnerships. Specific examples include Letter Rulings 200005012 (publicly traded partnership engaged in the purchasing, gathering, transporting, storage and resale of crude oil, refined petroleum products, and natural gas liquids, as well as some related activities), 200027037 (publicly traded limited partnerships engaged in the business of purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products), 200147034 (one publicly traded partnership's business consisted of purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related activities, and the other's consisted of interstate and intrastate crude oil transportation, terminalling and storage, as well as crude oil gathering and marketing activities), 200240043 (publicly traded partnerships engaged in the business of purchasing, gathering, transporting, trading, storing, and reselling crude oil and refined petroleum products), 200309021 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, storage, Any gross receipts separately stated on such a K-1 would be reflected only in a worksheet provided in the Instructions for Form 1120S.[2868]

- In the case of sales or exchanges of stock or securities, gross receipts shall be taken into account only to the extent of the gains, without deduction for losses.[2869] For other capital assets, losses are netted against gains.[2870]

The corporation can distribute its E&P. Generally, distributions from an S corporation come first as generally[2871] nontaxable distributions of its accumulated adjustments account (AAA), then are treated as dividends to the extent of E&P, and then as a return of basis and gain on sale.[2872] However, an S corporation may, with the consent of all of its affected shareholders, elect to ignore AAA with respect to all distributions made during the taxable year for which the election is made.[2873]

Generally, a distribution of E&P must be effected using a distribution of money or other property.[2874] For these purposes, a distribution is taken into account on the date the corporation makes the distribution, regardless of when the distribution is treated as received by the shareholder.[2875] AAA at the close of the taxable year is applied to distributions during the taxable and pro-rated among them if they exceed AAA.[2876]

"Property" means money, securities, and any other property, but does not include stock in the corporation making the distribution (or rights to acquire such stock).[2877] However, no distribution of property is required if an S corporation elects to distribute all or part of its E&P through a deemed dividend, in which case: [2878]

- The corporation will be considered to elected to bypass AAA for that year.

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and resale of crude oil, refined petroleum, and other mineral or natural resources), 200327004 (publicly traded partnership engaged in the purchasing, gathering, transporting, trading, marketing, storing, and reselling of crude oil, refined petroleum products, and natural gas liquids), and 200928024 (publicly traded partnerships engaged in the active trade of purchasing, gathering, transporting, trading, storage and/or resale of crude oil and refined petroleum products and related activities). It is best to document that the corporation's investment strategy is to provide for liquidity and also to diversify its investment risk.

[2868] The 2016 Instructions provide a worksheet to compute the excess net passive income tax for line 22a. The schedule computing the excess net passive income items includes+:

> *Income and deductions on lines 1, 2, and 5 are from total operations for the tax year. This includes applicable income and expenses from page 1, Form 1120S, as well as those imported separately on Schedule K.

[2869] Code § 1362(d)(3)(B)(ii).
[2870] Code § 1362(d)(3)(B)(i).
[2871] If and to the extent that the basis of a shareholder's stock is less than the shareholder's allocable AAA, the distribution of AAA would be taxed as a capital gain. Code § 1368(c)(1), (b)(2).
[2872] Code § 1368(c).
[2873] Code § 1368(e)(3)(A). Affected shareholder means any shareholder to whom a distribution is made by the S corporation during the taxable year. Code § 1368(e)(3)(B).
[2874] Code § 316(a). See Reg. § 1.1368-1(c).
[2875] Reg. § 1.1368-1(b).
[2876] Reg. § 1.1368-1(b), (c).
[2877] Code § 317(a).
[2878] Reg. § 1.1368-1(f)(3).

- The deemed dividend may not exceed the E&P on the last day of the taxable year, reduced by any actual distributions of E&P made during the taxable year.

- The amount of the deemed dividend is considered, for all tax purposes,[2879] as if it were distributed in money to the shareholders in proportion to their stock ownership, received by the shareholders, and immediately contributed by the shareholders to the corporation, all on the last day of the corporation's taxable year.

A corporation makes an election for a taxable year by attaching a statement to a timely filed (including extensions) original or amended return required to be filed for that taxable year, which statement must include the amount of the deemed dividend that is distributed to each shareholder,[2880] as well as consent by each affected shareholder.[2881]

A deemed dividend might be attractive when dividend tax rates are low, if one expects to need to take distributions in excess of AAA is a future year. However, if the shareholder might later sell the stock to a third party or wait to have the stock redeemed until it obtains a basis step-up on death, then it's possible that distributions will never exceed AAA. In that case, investing in assets that generate nonpassive gross receipts might be a lot less painful than paying tax on a deemed dividend. If the majority shareholder does not want to mess with a closely-held business or active rental, then my experience has been that investing 1-3% of the corporation's assets in oil and gas partnerships will be sufficient to generate sufficient nonpassive gross receipts.[2882]

If a corporation does not know about the possible loss of its S election under the excess passive investment income rules and terminates its S election as a result of these rules, consider applying for inadvertent termination relief in which the corporation and shareholders agree to a retroactive deemed dividend described above.[2883]

II.P.3.c.iv. Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds

Tax-exempt income does not increase AAA.[2884]

Therefore, any tax-exempt income, although not taxable to the shareholders when earned, would be taxable dividends when distributed to the shareholders to the extent that the corporation has no remaining AAA but has E&P.

Even if the corporation has plenty of AAA, a need for AAA might later arise, such as tax-free redemptions of part of a shareholder's stock.[2885]

[2879] However, the dividend deemed distributed to a qualified subchapter S trust does not constitute trust accounting income and therefore is not required to be distributed to the beneficiary. Letter Ruling 200446007.

[2880] Reg. § 1.1361-1(f)(5)(iii).

[2881] Reg. § 1.1361-1(f)(5)(ii).

[2882] See footnote 2867.

[2883] Letter Rulings 201351013, 201629001.

[2884] Code § 1368(e)(1)(A). This includes tax-free receipts beyond just muni bonds. See part II.Q.7.b.iv.(a) S Corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations and Letter Ruling 201440013.

These issues are spelled out more in part II.Q.7.b.iv.(a) S Corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

II.P.3.c.v. Conversion from S Corporation to C Corporation then Back to S Corporation

CCA 201446021 asserted that, when an S election terminates, its accumulated adjustments account (AAA) is wiped out. Therefore, the IRS reasoned, if the corporation later becomes an S corporation, its AAA starts from scratch.

However, any distribution of ***money*** by a corporation with respect to its stock during a post-termination transition period (generally, the first C corporation year after the S election terminate) is applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed AAA.[2886] So, if the S Corporation status is terminated, one should consider promptly distributing earnings (and perhaps loaning them back to the corporation if it needs the cash). If one is planning a termination, consider distributing on the last day of the last S corporation taxable year a formula note on the equal to AAA as of that date. See part II.P.3.e Conversion from S Corporation to C Corporation for discussion about additional opportunities for former S corporations whose owners at the time of revocation are the same as those on December 22, 2017.

A better strategy might be for the S corporation to do a tax-free "F" reorganization,[2887] in which the existing S corporation becomes a wholly-owned subsidiary of a new parent S corporation, which parent is owned by the original S corporation's shareholders immediately before the reorganization. The parent makes an S election, and the subsidiary elects taxation as a Qualified Subchapter S Subsidiary (QSub).[2888] The original S corporation initially is disregarded from the parent, giving the parent all of the subsidiary's AAA.[2889] Later, the subsidiary's QSub election is revoked, keeping the AAA intact at the parent level, notwithstanding that the subsidiary is now taxed as a C corporation. That way, if the subsidiary later becomes a QSub, the AAA remain to help carry out distributions to the shareholders.

II.P.3.d. Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations

Transfers from a sole proprietorship to a corporation, including a disregarded LLC electing corporate taxation,[2890] are generally nontaxable.[2891]

[2885] If a state law redemption is treated as a distribution under Code § 302(b)(2) or (3) and Code § 302(c), then it is a tax-free distribution to the extent of AAA. See part II.Q.7.b. Redemptions or Distributions Involving S Corporations.
[2886] Code § 1371(e)(1). Code § 1377(b)(1) and Reg. § 1.1377-2(b) determine the post-termination transition period.
[2887] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[2888] See part II.A.2.h Qualified Subchapter S Subsidiary (QSub).
[2889] Reg. § 1.1368-2(d)(2).
[2890] Reg. § 301.7701-3(g)(1)(iv).
[2891] See part II.M.2.a. Initial Incorporation – Generally.

However, shifting from a partnership to a corporation might cause the partners to recognize gain or lose their suspended losses.[2892]

Consider what adjustments might be required to convert a partnership interest, which might have capital accounts disproportionate to profit and loss sharing and might have profit in loss sharing that is not "straight-up," into shares, generally would have identical distribution and liquidation rights (and must have such rights in the case of an S corporation).

II.P.3.d.i. Formless Conversion

When an entity taxed as a partnership elects taxation as a corporation, the partnership is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock in the corporation; and, immediately thereafter, the partnership liquidates by distributing the stock of the corporation to its partners.[2893] The deemed transactions are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification is effective on January 1, the deemed transactions are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. Thus, the last day of the partnership's taxable year will be December 31 and the first day of the corporation's taxable year will be January 1.[2894]

A partnership can be converted directly into an S corporation; the corporation is not deemed formed until the partnership is deemed to have distributed its assets to the corporation:[2895]

- Suppose that, on January 1, 2009, X, a calendar year taxpayer, is taxed as a partnership. X elects to be taxed as a corporation for federal tax purposes, effective January 1, 2010. On February 1, 2010, X files an S election, effective January 1, 2010. Each person who held stock in X on January 1, 2010 also holds stock at the time the S election is made. When X elects to be taxed as a corporation, the following steps are deemed to occur: X contributes all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter X liquidates by distributing the stock of the association to its partners. These deemed steps are treated as occurring immediately before the close of the day before the election is effective.[2896] Thus, the partnership's taxable year ends on December 31, 2009, and the corporation's first taxable year begins on January 1, 2010. Therefore, the partnership will not be deemed to own the stock of the corporation during any portion of the association's first taxable year beginning

[2892] See part II.M.2.c Contribution of Partnership Interest to Corporation.
[2893] Reg. § 301.7701-3(g)(1)(i). Under Rev. Rul. 2004-59, when a formless conversion occurs under state law, Rev. Rul. 84-111 does not apply. Rev. Rul. 84-111 describes the differences in the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners provided the steps described are actually undertaken and the underlying assumptions and purposes for the conclusions in the revenue ruling are applicable. Except to the extent inconsistent with the above, see the text accompanying footnotes 3854-3938 for tax effects of liquidating a partnership.
[2894] Reg. § 301.770l-3(g)(3).
[2895] Rev. Rul. 2009-15.
[2896] Reg. § 301.7701-3(g)(3)(i).

January 1, 2010, and X is eligible to elect to be an S corporation effective January 1, 2010. Additionally, because the partnership's taxable year ends immediately before the close of the day on December 31, 2009, and the corporation's first taxable year begins at the start of the day on January 1, 2010, the deemed steps will not cause X to have an intervening short taxable year in which it was a C corporation.

- On January 1, 2009, Y, a calendar year taxpayer, is taxed as a partnership. Y converts into a corporation under a state law formless conversion statute, effective January 1, 2010. As a result of the conversion, Y is classified as a corporation for federal tax purposes. On February 1, 2010, Y files an S election, effective January 1, 2010. Each person who held stock in Y on January 1, 2010 also holds stock at the time the S election is made. The result is the same as above.

Of course, the simplest way would be just to make the S election, by the partnership filing IRS Form 2553.[2897]

Because S corporations can have only a single class of stock,[2898] capital accounts need to be made proportionate to interests in profits and losses before converting to an S corporation.

II.P.3.d.ii. Transfer of Partnership Assets and Liabilities to a Newly Formed Corporation in Exchange for All of its Stock

If the conversion is not a formless conversion described above, the IRS provides for three scenarios.[2899] In each situation, the steps the partners and partnerships take are parts of a plan to transfer the partnership operations to a corporation organized for valid business reasons in exchange for its stock and were not devices to avoid or evade recognition of gain. Because the federal income tax consequences of the three situations are the same, each partnership is considered to made a nontaxable contribution of its assets and liabilities to a corporation in exchange for its stock,[2900] followed by a distribution of the stock to the partners in liquidation of the partnership.[2901]

In the first situation, the partnership transfers all of its assets to newly-formed corporation in exchange for all the outstanding stock of the corporation and the assumption by the corporation of the partnership's liabilities. The partnership then terminates by distributing all the stock of the corporation to the partners in proportion to their partnership interests. The tax results are:

- No gain or loss is recognized by the partnership when it transfers all of its assets to the corporation in exchange for the corporation's stock and the assumption by the corporation of the partnership's liabilities.[2902]

[2897] See fn. 295.
[2898] See II.A.2.j Single Class of Stock Rules, for a description of the single class of stock rules and those rules' surprising flexibility.
[2899] Rev. Rul. 84-111.
[2900] Code § 351.
[2901] Rev. Rul. 70-239.
[2902] Code § 351.

- The corporation's basis in the assets received from the partnership equals their basis to the partnership immediately before their transfer to the corporation.[2903]

- The partnership's basis of the stock received from the corporation is the same as the partnership's basis in the assets transferred to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partnership.[2904]

- The corporation's assumption of the partnership's liabilities decreases each partner's share of the partnership liabilities, thus, decreasing the basis of each partner's partnership interest.[2905]

- On distribution of the stock to the partners, the partnership terminates.[2906]

- The basis of the stock distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest in the partnership.[2907]

- The partnership's holding period for the stock received in the exchange includes its holding period in the capital assets and Code § 1231 assets transferred (to the extent that the stock was received in exchange for such assets).[2908]

- To the extent the stock was received in exchange for neither capital nor Code § 1231 assets, the partnership's holding period for such stock begins on the day following the date of the exchange.[2909]

- The corporation's holding period in the assets transferred to it includes the partnership's holding period.[2910]

- When the partnership distributes the stock to its partners, the partners' holding periods includes the partnership's holding period of the stock.[2911]

In the second situation, the partnership distributes all of its assets and liabilities to its partners in proportion to their partnership interests, terminating the partnership. The partners then transfer all the assets received from the partnership to a new corporation in exchange for all the corporation's outstanding stock and the corporation's assumption of the partnership's liabilities that had been assumed by the partners. The tax results are:

[2903] Code § 362(a). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[2904] Code § 358.
[2905] See Code §§ 752 and 733.
[2906] Code § 708(b)(1)(A).
[2907] Code § 732(b),
[2908] Code § 1223(1).
[2909] See Rev. Rul. 70-598.
[2910] Code § 1223(2).
[2911] Code §§ 735(b) and 1223. Furthermore, such distribution will not violate the Code § 368(c) control requirement.

- On the transfer of all of the partnership's assets to its partners:
    - The partnership terminates.[2912]
    - The basis of the assets (other than money) distributed to the partners in liquidation of their partnership interests is, with respect to each partner, equal to the adjusted basis of the partner's interest, reduced by the money distributed.[2913]
- The decrease in the partnership's liabilities resulting from the transfer to its partners was offset by the partners' corresponding assumption of such liabilities, so that the net effect on the basis of each partner's interest in the partnership, with respect to the liabilities transferred, was zero.[2914]
- No gain or loss is recognized by the partnership's former partners when the partnership transfers its assets and liabilities to the corporation in exchange for its stock.[2915]
- The (former) partners' basis in the corporation's stock is the same as their basis in the assets received in the partnership's liquidation and the transfer to the corporation, reduced by the liabilities assumed by the corporation, which assumption is treated as a payment of money to the partners.[2916]
- The corporation's basis in the assets received from the (former) partners equals the (former) partners' basis immediately before the transfer to the corporation.[2917]
- The partners' holding periods for the assets the partnership distributes to them includes the partnership's holding period.[2918]
- The partners' holding periods for the stock received in the exchange includes the partners' holding periods in the capital assets and Code § 1231 assets transferred to the corporation (to the extent that the stock was received in exchange for such assets).[2919]
- However, to the extent that the stock received was in exchange for neither capital nor Code § 1231 assets, the holding period of the stock begins on the day following the date of the exchange.
- The corporation's holding period of the partnership's assets received in the exchange includes the partners' holding periods.[2920]

[2912] Code § 708(b)(1)(A).
[2913] Code § 732(b).
[2914] Code § 752.
[2915] Code § 351.
[2916] Code §§ 358(a) and 732(b).
[2917] Code §§ 362(a) and 732(c). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.
[2918] Code § 735(b).
[2919] Code § section 1223(1).
[2920] Code § 1223(2).

In the third situation, the partners transfer their partnership interests to a newly-formed corporation in exchange for all the corporation's outstanding stock. This exchange terminates the partnership, and all of its assets and liabilities became assets and liabilities of the corporation. The tax result is:

- No gain or loss is recognized by the partners on the transfer of the partnership interests to the corporation in exchange for the corporation's stock.[2921]

- When the transfer partners transfer their partnership interests to the corporation, the partnership terminates.[2922]

- The partners' basis of the stock received from the corporation in exchange for their partnership interests equals the basis of their partnership interests transferred to the corporation, reduced by the partnership's liabilities assumed by the corporation, the release from which is treated as a payment of money to the partners.[2923]

- The corporation's basis for the assets received in the exchange equals the basis of the partners in their partnership interests.[2924]

- The corporation's holding period includes the partnership's holding period in the assets.

- The holding period of the stock received by the former partners includes each respective partner's holding period for the partnership interest transferred,[2925] except that the holding period of the stock that was received by the partners in exchange for their interests in any unrealized receivables, inventory, or various depreciable or amortizable assets of the partnership that are neither capital assets nor Code § 1231 assets begins on the day following the date of the exchange.

II.P.3.e. Conversion from S Corporation to C Corporation

See part II.A.2.l Terminating S Election, which includes the fact that conversion from S status to C status requires an additional tax return if done mid-year and precludes an S election for 5 years.

Converting from an S corporation to a C corporation may require the corporation to switch from the cash receipts and disbursements method of accounting to the accrual method. Generally, a C corporation cannot use the cash method,[2926] unless the corporation conducts a qualified farming business,[2927] is a qualified personal service

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[2921] Code § 351.
[2922] Code § 708(b)(1)(A).
[2923] Code §§ 358 and 752(d).
[2924] Allocated under Code § 732(c).
[2925] Code § 1223(1).
[2926] Code § 448(a)(1).
[2927] Code § 448(d)(1), "Farming business," provides that a "qualified personal service corporation" is any corporation:

> (A) *In general*. The term "farming business" means the trade or business of farming (within the meaning of section 263A(e)(4)).

corporation,[2928] or has gross receipts that are no more than $25 million (after 2018 adjusted for inflation).[2929]

If a corporation was an S corporation on or before December 21, 2017, during the 2-year period beginning on December 22, 2017 revokes its S election, and the owners of the stock of which, determined on the date the revocation is made, are the same owners (and in identical proportions) as on December 22, 2017 (an "eligible terminated S corporation"), then any adjustment required by a change in accounting method under Code § 481(a)(2) which is attributable to that revocation is taken into account ratably during the 6-taxable year period beginning with the year of change.[2930]

Note that S corporation earnings might be extracted in cash tax-free in the first C corporation taxable period after the final S corporation yearend.[2931] Converting the corporation into a QSub before converting it to a C corporation might also be used to preserve the AAA of a corporation whose S election is revoked.[2932]

Additionally, after that first C Corporation taxable period, an eligible terminated S corporation's distribution is chargeable to accumulated earnings and profits, in the same ratio as the amount of such AAA bears to the amount of such accumulated earnings and profits.[2933]

(B) *Timber and ornamental trees*. The term "farming business" includes the raising, harvesting, or growing of trees to which section 263A(c)(5) applies.

[2928] Code § 448(d)(2), "Qualified personal service corporation," provides:

(A) substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and

(B) substantially all of the stock of which (by value) is held directly (or indirectly through 1 or more partnerships, S corporations, or qualified personal service corporations not described in paragraph (2) or (3) of subsection (a)) by-

- (i) employees performing services for such corporation in connection with the activities involving a field referred to in subparagraph (A),
- (ii) retired employees who had performed such services for such corporation,
- (iii) the estate of any individual described in clause (i) or (ii), or
- (iv) any other person who acquired such stock by reason of the death of an individual described in clause (i) or (ii) (but only for the 2-year period beginning on the date of the death of such individual).

To the extent provided in regulations which shall be prescribed by the Secretary, indirect holdings through a trust shall be taken into account under subparagraph (B).

[2929] Code § 448(b), (c).

[2930] Code § 481(d).

[2931] See fn. 2886, found in part II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation.

[2932] See part II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation, especially fns. 2887-2889.

[2933] Code § 1371(f).

II.P.3.f. Conversion from Qualified Subchapter S Subsidiary to Single Member LLC

The merger of a Qualified Subchapter S Subsidiary ("QSub") into an LLC wholly owned by the QSub's parent has no income tax consequences.[2934]

II.P.3.g. Conversions from Partnership to Sole Proprietorships and Vice Versa

When a sole proprietorship organized as an LLC adds a member, it becomes a partnership. If the original member sells part his or her interest in the LLC to a new member, then he or she is deemed to have sold a corresponding portion of the LLC's assets to the new member,[2935] as follows:[2936]

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.
>
> Under section 1001, A recognizes gain or loss from the deemed sale of the 50% interest in each asset of the LLC to B.
>
> Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.
>
> Under section 722, B's basis in the partnership interest is equal to $5,000, the amount paid by B to A for the assets which B is deemed to contribute to the newly-created partnership. A's basis in the partnership interest is equal to A's basis in A's 50% share of the assets of the LLC.
>
> Under section 723, the basis of the property treated as contributed to the partnership by A and B is the adjusted basis of that property in A's and B's hands immediately after the deemed sale.
>
> Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital assets and property described in section 1231 held by the LLC when it converted from an entity that was

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[2934] Reg. § 1.1361-5(b)(3), Example (2). See fn. 132 for details.

[2935] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99) and Rev. Rul. 99-5. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations *TM Memorandum* (BNA) (3/16/2009), and AICPA Comments to IRS on Rev. Rul. 99-5 on Disregarded Entities (6/5/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-5-v-6-5-13submit.pdf.

[2936] Rev. Rul. 99-5, Situation 1.

disregarded as an entity separate from A to a partnership. B's holding period for the partnership interest begins on the day following the date of B's purchase of the LLC interest from A. See Rev. Rul. 66-7, 1966-1 C.B. 188, which provides that the holding period of a purchased asset is computed by excluding the date on which the asset is acquired. Under section 1223(2), the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

However, if the new member pays the LLC for a member interest, then the old and new member are deemed to have formed a partnership, which generally qualifies as a nontaxable transaction,[2937] as follows:[2938]

> In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.
>
> Under section 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.
>
> Under section 722, B's basis in the partnership interest is equal to $10,000, the amount of cash contributed to the partnership. A's basis in the partnership interest is equal to A's basis in the assets of the LLC which A was treated as contributing to the newly-created partnership.
>
> Under section 723, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is $10,000, the amount of cash contributed to the partnership.
>
> Under section 1223(1), A's holding period for the partnership interest received includes A's holding period in the capital and section 1231 assets deemed contributed when the disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

Thus, the parties can control whether the original owner is taxed and the new owner gets an inside basis step-up, or the original owner is not taxed and the new owner does not

[2937] See T.D. 8844 (preamble to regulations on entity conversions) (11/29/99), Rev. Rul. 99-5, and part II.M.3 Buying into or Forming a Partnership (especially part II.M.3.a General Rule: No Gain on Contribution to Partnership). See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. Letter Ruling 200633019 discusses a large variety of tax issues when a trust contributes a diversified portfolio of marketable securities to a single-member LLC and then distributes LLC interests to the remaindermen; Letter Ruling 201628008 includes a more abbreviated discussion of such a transaction. See also The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations 201351018 (BNA) (3/16/2009).
[2938] Rev. Rul. 99-5, Situation 2.

get an inside basis step-up.[2939] However, the parties can have their cake and eat it, too: in the latter case, the new owner can transfer the partnership interest to another partnership (or corporation) in a tax-free transaction and get an inside basis step-up.[2940]

When an LLC with more than one member is taxed as a partnership, and the number of members later is reduced to one, it becomes a sole proprietorship for tax purposes. When one member buys out the other(s), the selling member(s) is(are) taxed based on the rules for selling a partnership interest, and the remaining member (essentially the new sole proprietor) is deemed to have bought all of the LLC's assets on that date, with no tacking of holding period for any portion of the assets.[2941] Furthermore, payments that would have been deductible by a partnership had it continued in existence are deductible by the successors to the partnership.[2942]

Pierre v. Commissioner[2943] was a reviewed opinion holding that gifts and sales of interests in a single-member limited liability company (LLC) be treated for gift tax purposes as transfers of interests in an entity rather than transfers of the underlying assets.

Initially, the transferor was the LLC's sole owner. Some LLC interests were gifted, and the rest were sold. The IRS asserted that the transfers were of the LLC's underlying assets, not interests in the LLC. It tried to apply the principles of Rev. Rul. 99-5, Situation 1, which provides:

> In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, B, purchases an interest in the disregarded entity from the owner, A. B's purchase of 50% of A's ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by A for federal tax purposes. Immediately thereafter, A and B are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

[2939] See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

[2940] See parts II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000 and II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[2941] Rev. Rul. 99-6; see also part II.Q.8 Exiting From or Dividing a Partnership; see Letter Ruling 201723009 when such a transaction is done inside a consolidated group. See Rev. Rul. 2001-61 and CCA 201351018 regarding retention of employer identification number. See also "The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations," *TM Memorandum* (BNA) (3/16/2009). For a myriad of tax issues raised in this situation, criticizing Rev. Rul. 99-6, see AICPA Comments on Revenue Ruling 99-6 on Conversions from Partnerships to Disregarded Entities (10/1/2013), found at http://www.aicpa.org/advocacy/tax/partnerships/downloadabledocuments/comments-on-rev-ruling-99-6-submit.pdf. The AICPA points to very different results when a purchaser buys 99% instead of 100%.

[2942] Rev. Rul. 75-154.

[2943] 133 T.C. 24 (2009) (http://www.ustaxcourt.gov/InOpHistoric/Pierre.TC.WPD.pdf). For income tax treatment of a gift of the entire interest in a single member LLC, see fn. 284.

The Tax Court majority rejected the application of the check-the-box rules[2944] to this gift. Those provisions apply only "where not otherwise distinctly expressed or manifestly incompatible with the intent" of other provisions in the tax law.[2945] Fundamental gift tax precepts require that one look to the bundle of rights transferred.[2946] The Tax Court held that, under state law, an LLC interest (not an interest in the underlying assets) was transferred; applying the check-the-box regulations would be manifestly incompatible with fundamental gift tax precepts.[2947]

The court distinguished between classifying the entity and describing the nature of the assets that were transferred. This fine line might breed litigation in the transfer tax area.

II.P.3.h. Rescissions, Including Rescinding Conversion of Entity

The IRS often respects rescissions for income tax purposes[2948] when a transaction is reversed in the same taxable year. The IRS explains:[2949]

[2944] Reg. §§ 301.7701-1 through 301.7701-3.

[2945] Code § 7701(a) (introductory language).

[2946] The court reasoned:

> The multistep process of determining the nature and amount of a gift and the resulting gift tax under the Federal gift tax provisions described above, i.e., (1) the determination under State law of the property interest that the donor transferred, (2) the determination of the fair market value of the transferred property interest and the amount of the transfer to be taxed, and (3) the calculation of the Federal gift tax due on the transfer, is longstanding and well established. Neither the check-the-box regulations nor the cases cited by respondent support or compel a conclusion that the existence of an entity validly formed under applicable State law must be ignored in determining how the transfer of a property interest in that entity is taxed under Federal gift tax provisions.

[2947] The court held:

> We note that Congress has enacted provisions of the Internal Revenue Code, see secs. 2701, 2703, that disregard valid State law restrictions in valuing transfers. Where Congress has determined that the willing buyer, willing seller and other valuation rules are inadequate, it expressly has provided exceptions to address valuation abuses. See chapter 14 of the Internal Revenue Code, sections 2701 through 2704, which specifically are designed to override the standard willing buyer, willing seller assumptions in certain transactions involving family members.
>
> By contrast, Congress has not acted to eliminate entity related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically. In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC.

[2948] The IRS does not have a clear policy for estate and gift tax law. However, *Neal v. U.S.*, 187 F.3d 626 (3rd Cir. 1999) allowed a rescission under Pennsylvania law and considered the gift incomplete because of it.

[2949] Rev. Rul. 80-58. Although the ruling is old, it is still viable. Rev. Proc. 2013-3, Section 5.02(1) indicated that the IRS was considering its position in the rescission area. Rev. Proc. 2014-3, Section 1.02(6) mentioned that Section 5.02(1) was deleted and that

> The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.
>
> The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes…..
>
> In Situation 1 the rescission of the sale … placed A and B at the end of the taxable year in the same positions as they were prior to the sale. Thus, … the original sale is to be disregarded for federal income tax purposes because the rescission extinguished any taxable income for that year with regard to that transaction…..
>
> In Situation 2, as in Situation 1, there was a completed sale in 1978. However, unlike Situation 1, because only the sale and not the rescission occurred in 1978, at the end of 1978 A and B were not in the same positions as they were prior to the sale….[T]he rescission in 1979 is disregarded with respect to the taxable events occurring in 1978.
>
> In both situations, the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events.

Gateway Hotel Partners, LLC v. Commissioner[2950] upheld the requirement that the transaction cannot qualify for rescission unless undone by the end of the taxable year. *Blagaich v. Commissioner*[2951] also refused to apply rescission to a payment that the

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Section 3.02(8) was added, the latter providing that whether a completed transaction can be rescinded for Federal income tax purposes is an issue on which the IRS will not issue a private letter ruling. At the May 2014 meeting of the Sales, Exchanges & Basis Committee of the American Bar Association's Section of Taxation, a government representative informally stated that withdrawing its study of the area indicates that the IRS has reaffirmed its commitment to Rev. Rul. 80-58. Materials for that meeting prepared by Section practitioner members are saved as Thompson Coburn document 6044351. For more on Rev. Rul. 80-58, see New York State Bar Association Tax Section Report on the Rescission Doctrine (Report No. 1216) (8/11/2010) at www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1216-Report.pdf, citing Sheldon I. Banoff, Unwinding or Rescinding a Transaction: Good Tax Planning or Tax Fraud, *Taxes – The Tax Magazine* (Dec. 1984) at 942; and David H. Schnabel, Revisionist History: Retroactive Federal Tax Planning (2009) (unpublished manuscript), mentioning that an earlier version is published at 60 *Tax Lawyer* 685 (2007).

[2950] T.C. Memo. 2014-5.

[2951] T.C. Memo. 2016-2, holding:

> … In general, the annual accounting period principle reflected in section 451, considered in the light of the judicially articulated claim-of-right doctrine, limits application of the rescission exception such that, without regard to subsequent events, income received by the taxpayer under a claim of right and retained by her at the close of the taxable year

taxpayer returned over three years later after payment, when she did so only after being order by a court to do so. However, in another case, a taxpayer was permitted to rescind a disclaimer based on erroneous tax advice, more than two years after the disclaimer, after joining the IRS as a party to a legal action to rescind.[2952]

The IRS approved a rescission of a conversion from partnership to corporation where everything happened in one year and the taxpayer had a good nontax reason.[2953] The IRS has also allowed a taxpayer to rescind a restructuring involving a subsidiary to

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> must be included in gross income for that year. See [*Penn v. Robertson*, 115 F.2d 167, 175 (4th Cir. 1940)]; Rev. Rul. 80-58, Situation 2, 1980-1 C.B. at 182.
>
> ….
>
> The facts show that, in 2010, petitioner took possession of the whole amount in question, $400,000, without any substantial limitations or restrictions as to its disposition. She recognized no liability and made no provision to repay that amount until nearly three years later. None of the cases petitioner cites as allowing a relaxation of the same-year requirement for rescission is factually comparable to her own, and they provide no rationale for departing from the general rule.
>
> With respect to the equitable concerns petitioner raised in her motion—The equities in this case simply do not support strict adherence to the one-year guideline in the rescission doctrine.—we note only that our statutory mandate does not permit us to decide this case on the basis of general principles of equity. See *Knapp v. Commissioner*, 90 T.C. 430, 440 (1988) (citations omitted) (The Tax Court is a court of limited jurisdiction. *** We have only the powers expressly conferred on us by Congress, and may not apply equitable principles to expand our jurisdiction beyond the limits of section 7442.), *aff'd*, 867 F.2d 749 (2d Cir. 1989).

The court rejected the taxpayer's reliance on *Hope v. Commissioner*, 55 T.C. 1020, 1030 (1971), *aff'd*, 471 F.2d 738 (3d Cir. 1973), which the court said:

> suggests that the rescission doctrine may apply even when repayment of a gain does not formally occur in the year of receipt, but only if, before the end of the year, [the] taxpayer recognizes his liability under an existing and fixed obligation to repay the amount received and makes provisions for repayment.

The court rejected the taxpayer's reliance on *Guffey v. United States*, 339 F.2d 759 (9th Cir. 1964), which case the court described:

> In *Guffey*, the installment purchasers of the Guffeys' home sued to rescind the sale contract when, in the following year, they discovered dry rot, moved out, and refused to make further payments. A settlement was reached under which the purchasers' suit was dismissed and the Guffeys obtained a quitclaim deed and retained the previously received payments as rent.…[W]hile the Court of Appeals did state that [i]t can fairly be said that the settlement with the *** [original purchasers] was, in substance, a reduction in the purchase price, *id.*, the Guffeys returned nothing to the original purchasers, the original purchasers apparently agreeing that the payments could be kept as rent. The sort of passive unwinding of the agreement that occurred in *Guffey* did not and could not occur in the case at bar; the only way Mr. Burns could be restored to status quo ante was if petitioner returned the $400,000.

[2952] *Breakiron v. Gudonis*, 106 A.F.T.R.2d 2010-5999 (D. Mass. 2010). The IRS was joined as a party when it attempted to collect gift tax. In another disclaimer case, the court dismissed the IRS as a party. *Van Vliet v. Van Vliet*, 115 A.F.T.R.2d 2015-803 (E.D. Va. 2015).

[2953] Letter Ruling 200952036.

reverse unintended adverse Federal income tax consequences.[2954] However, the IRS will not issue any more letter rulings in this area.[2955]

A taxpayer cannot unilaterally recast a transaction merely because the taxpayer decides that documenting it differently would have produced a better tax result.[2956]

For the rescission to be effective, both parties must be put back in their original positions.[2957] A January 2005 article further analyzes the rescission doctrine.[2958]

An S election may be rescinded until the last day on which the election could have been timely made.[2959] The IRS will not permit a revocation that is more retroactive than that.[2960] A corporation may rescind such a revocation at any time before the revocation becomes effective, but only with the consent of each person who consented to the revocation and each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made.[2961]

II.P.3.i. Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization

When transferring a corporation's business to a new partnership, consider doing the following:

1. The shareholders form a new corporation with ownership identical to the old corporation's ownership.

[2954] Letter Ruling 201008033.

[2955] Rev. Proc. 2017-3, Section 3.02(8), listed as a no-rule area "whether a completed transaction can be rescinded for Federal income tax purposes."

[2956] *Makric Enterprises, Inc. v. Commissioner*, TC Memo 2016-44, 119 A.F.T.R.2d ¶ 2017-580 (5th Cir. 3/27/2017).

[2957] Citing *Hutcheson v. Commissioner*, T.C. Memo. 1996-127 for that proposition, *Fitch v. Commissioner*, T.C. Memo. 2012-358, rebuffed IRS arguments in favor of rescinding a sale of a CPA practice, which was followed by a repurchase shortly thereafter when the original buyer's health deteriorated unexpectedly:

> The repurchase agreement, by its own terms, effected a sale of the C.P.A. practice from Mr. Gronke to Mr. Fitch and not an unwinding of the earlier sale. There is no evidence that Mr. Fitch and Mr. Gronke intended to abrogate, cancel, or void the sale agreement. Furthermore, we do not believe that the repurchase agreement returned them to their original positions. The C.P.A. practice continued as a dynamic, ongoing enterprise for approximately 4-1/2 months after the sale transaction, and we cannot say that Mr. Fitch received the C.P.A. practice back in the exact same condition in which he had sold it. Accordingly, we find that the sale and repurchase transactions were not rescinded.

Query whether the court was just being sympathetic to the seriously ill parties and really would set such a high bar if the taxpayers had sought to rescind the agreement.

[2958] Morehouse, The Rescission Doctrine: Tax Do-Overs, Another Roll Of the Dice, *TM Real Estate Journal* (BNA) (1/7/2015).

[2959] Reg. § 1.1362-2(a)(2)(i).

[2960] Christian & Grant, ¶32.02. Revocation, *Subchapter S Taxation* (WG&L), cites varies IRS correspondence to that effect.

[2961] Reg. § 1.1362-2(a)(4).

2. The old corporation converts or is merged into a limited liability company that is a disregarded entity.

3. Either the new corporation then transfers its member interest in the LLC to a limited partnership, or the LLC itself admits one or more additional members to convert the LLC to an entity taxed as a partnership.

To qualify as an F reorganization[2962] nontaxable for federal income tax purposes (always check state income tax rules), this or any other transaction must result in a mere change in identity, form, or place of organization of one corporation.[2963] A transaction involving an actual or deemed transfer is a mere change only if:

- Immediately after the reorganization, all the stock of the resulting corporation, including any stock of the resulting corporation issued before the reorganization, must have been distributed (or deemed distributed) in exchange for stock of the transferor corporation;[2964]

- The same person or persons must own all of the stock of the transferor corporation, determined immediately before the reorganization, and of the resulting corporation, determined immediately after the reorganization, in identical proportions;[2965]

- The resulting corporation does not hold any property or have any tax attributes[2966] immediately before the reorganization;[2967]

- The transferring corporation completely liquidates, for federal income tax purposes, in the reorganization;[2968]

[2962] Code § 368(a)(1)(F).

[2963] Reg. § 1.368-2(m)(1). For an analysis of the background to this regulation and its impact, see Kliegman and Chen, Some Ado About a Nothing: Final F Reorganization Regulations, *TM Memorandum* (BNA) (4/4/2016). The article suggests that Rev. Rul. 68-349 appears to violate the requirements of the text accompanying fns. 2964-2965; it has been suggested that informal comments at the January 2016 meeting of the American Bar Association's Section of Taxation indicate that the government might not have considered the regulations' impact on that ruling.

[2964] However, a de minimis amount of stock issued by the resulting corporation other than in respect of stock of the transferor corporation to facilitate the organization of the resulting corporation or maintain its legal existence is disregarded. Reg. § 1.368-2(m)(1)(i).

[2965] However, this requirement is not violated if one or more holders of stock in the transferor corporation exchange stock in the transferor corporation for stock of equivalent value in the resulting corporation, but having different terms from those of the stock in the transferor corporation, or receive a distribution of money or other property from either the transferor corporation or the resulting corporation, whether or not in exchange for stock in the transferor corporation or the resulting corporation. Reg. § 1.368-2(m)(1)(ii).

[2966] Including those specified in Code § 381(c).

[2967] However, this requirement is not violated if the resulting corporation holds or has held a de minimis amount of assets to facilitate its organization or maintain its legal existence, and has tax attributes related to holding those assets, or holds the proceeds of borrowings undertaken in connection with the potential F reorganization. Reg. § 1.368-2(m)(1)(iii).

[2968] However, the transferor corporation is not required to dissolve under applicable law and may retain a de minimis amount of assets for the sole purpose of preserving its legal existence. Reg. § 1.368-2(m)(1)(iv).

- Immediately after the reorganization, no corporation other than the resulting corporation holds property that was held by the transferor corporation immediately before the reorganization, if such other corporation would, as a result, succeed to and take into account the items of the transferor corporation described in Code § 381(c);[2969] and

- Immediately after the reorganization, the resulting corporation does not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as a result, succeed to and take into account the items of such other corporation described in Code § 381(c).[2970]

The last two bullet points emphasize that tax attributes cannot change in an F reorganization.[2971] Thus, when a corporation engages in an F reorganization, the part of the tax year before the reorganization and the part after constitute a single tax year,[2972] and the resulting corporation must file a single full-year return; however, if the old corporation was domestic and the new one is foreign, the F reorganization does close the tax year.[2973] In a purely domestic F reorganization, the new corporation's filing a tax return runs the statute of limitations for the old corporation's activity that was reported on the new corporation's return.[2974]

[2969] Reg. § 1.368-2(m)(1)(v). The preamble, T.D. 9739, explains:

> Thus, a transaction that divides the property or tax attributes of a Transferor Corporation between or among acquiring corporations, or that leads to potential competing claims to such tax attributes, will not qualify as a Mere Change.

[2970] Reg. § 1.368-2(m)(1)(vi). The preamble, T.D. 9739, explains:

> Thus, a transaction that involves simultaneous acquisitions of property and tax attributes from multiple transferor corporations (such as the transaction described in Rev. Rul. 58-422, 1958-2 CB 145) will not qualify as a Mere Change.

[2971] The preamble, T.D. 9739, says:

> From a federal income tax perspective, F reorganizations are generally neutral, involving no change in ownership or assets, no end to the taxable year, and inheritance of the tax attributes described in section 381(c) without a limitation on the carryback of losses. See, for example , Rev. Rul. 96-29 (discussed in section 3.B.ii. of the Background); § 1.381(b)-1(a)(2).

[2972] Reg. § 1.381(b)-1(a)(2) provides:

> *Reorganizations under section 368(a)(1)(F)*. In the case of a reorganization qualifying under section 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of section 368(a)(1)), the acquiring corporation shall be treated (for purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. Thus, the taxable year of the transferor corporation shall not end on the date of transfer merely because of the transfer; a net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer; and the tax attributes of the transferor corporation enumerated in section 381(c) shall be taken into account by the acquiring corporation as if there had been no reorganization.

[2973] Reg. § 1.367(a)-1(e).

[2974] *New Capital Fire, Inc. v. Commissioner*, T.C. Memo. 2017-177, rejecting the IRS' contention that failing to file a return for the old corporation kept the statute of limitations open. The new corporation's return properly disclosed the F reorganization. The court held:

> New Capital's 2002 return purported to and did include Old Capital's income from January 1 through December 4, 2002. Respondent has not alleged, and we do not find,

Continuity of the business enterprise and a continuity of interest are not required to qualify as an F reorganization.[2975]

Subject to certain limitations, an F reorganization might consist of a series of related transactions that together result in a mere change of one corporation.[2976]

It has been suggested that substantive changes of ownership that were not allowed before these regulations are now allowed:[2977]

> that New Capital's 2002 return was false or fraudulent with intent to evade tax as it pertains to Old Capital. It was respondent's duty to determine, within the period of limitations provided by section 6501(a), whether New Capital's 2002 return, as it pertains to Old Capital, was erroneous in any respect. The exception under section 6501(c)(3) does not apply. Accordingly, assessment of the determined deficiency and additions to tax is barred by the statute of limitations.

[2975] Reg. § 1.368-2(m)(2).

[2976] Reg. § 1.368-2(m)(3). The preamble, T.D. 9739, explains:

> In some cases, business or legal considerations may require extra steps to complete a transaction that is intended to qualify as a Mere Change. As discussed in section 3.B.i. of the Background, the Treasury Department and the IRS concluded that the words however effected in the statutory definition of F reorganization reflect a Congressional intent to treat a series of transactions that together result in a Mere Change as an F reorganization, even if the transfer (or deemed transfer) of property from the Transferor Corporation to the Resulting Corporation occurs indirectly. The Final Regulations confirm this conclusion by providing that a Potential F Reorganization consisting of a series of related transactions that together result in a Mere Change may qualify as an F reorganization, whether or not certain steps in the series, viewed in isolation, might, for example, be treated as a redemption under section 304(a), as a complete liquidation under section 331 or section 332, or as a transfer of property under section 351. For example, the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation. However, see § 1.368-2(k) for completed reorganizations that will not be recharacterized as a Mere Change as a result of one or more subsequent transfers of assets or stock, such as where a Transferor Corporation transfers all of its assets to its parent corporation in liquidation, followed by the parent corporation's retransfer of those assets to a new corporation. See also Rev. Rul. 69-617, 1969-2 CB 57 (an upstream merger followed by a contribution of all the target assets to a new subsidiary corporation is a reorganization under sections 368(a)(1)(A) and 368(a)(2)(C)).

The preamble further discussed such a reorganization's role in a larger transaction:

> As discussed in section 3.B.ii. of the Background, the Treasury Department and the IRS recognized that an F reorganization may be a step, or a series of steps, before, within, or after other transactions that effect more than a Mere Change, even if the Resulting Corporation has only a transitory existence following the Mere Change. In some cases an F reorganization sets the stage for later transactions by alleviating non-tax impediments to a transfer of assets. In other cases, prior transactions may tailor the assets and shareholders of the Transferor Corporation before the commencement of the F reorganization. Although an F reorganization may facilitate another transaction that is part of the same plan, the Treasury Department and the IRS have concluded that step transaction principles generally should not recharacterize F reorganizations because F reorganizations involve only one corporation and do not resemble sales of assets.

[2977] McMahon, Recent Developments in Federal Income Taxation of Corporations and Partnerships, 64th Annual Montana Tax Institute (10/14/2016).

- Exchanging stock for stock of equivalent value but with different terms, or
- Either the old or new corporations distributing cash or other property.

Sometimes a conversion generally involves a direct or indirect merger of a corporation into an unincorporated entity taxed as a corporation.[2978] For example, an LLC that is taxed as an S corporation can move assets comprising one line of business into a new parent LLC taxed as an S corporation that assumes its tax attributes and then under Code § 355 distribute assets comprising another line of business into another LLC taxed as an S corporation.[2979] Generally, for an S corporation, I recommend that the LLC file a

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[2978] A direct approach is found Reg. § 1.368-2(m)(4), Example (8), and the logistics are explained in Letter Ruling 200839017. See Riser, Hiding Your Stuff in Plain Sight (Without Trusts): Dr. FUnbundle (or How I Learned to Stop Worrying and Love Sec. 368(a)(1)(F)), American Bar Association Section of Real Property, Trust & Estate Law, 2009 Spring Symposia, discussing Letter Ruling 200701017. See also Rev. Ruls. 64-250, 73-256, and 2008-18 and Letter Rulings 200528021, 200622025, and 200719005. See also Kalinka, Transfer of an Interest in an LLC Taxed As an S corporation Raises Many Questions, p. 23 *Taxes-The Tax Magazine* (October 2007); Christian & Grant, ¶29.07. 'F' Reorganizations, *Subchapter S Taxation* (WG&L); and Gassman, Crotty, and O'Leary, The Estate Planner's Guide to New Parent F Reorganizations, *Estate Planning Journal* (WG&L), May 2008. These issues were discussed at the Asset Protection Committee Meeting of the American College of Trust & Estate Counsel (ACTEC) in the Fall of 2009, which included some practical materials for LLCs taxed as S corporations that are available to ACTEC Fellows. For whether a new employer identification number (IRS tax ID) is needed, see Rev. Rul. 2008-18 and part II.P.3.a Need for New Tax ID. Although Rev. Rul. 2008-18 says that the new entity retains the new entity's S election, I had suggested that the new entity file IRS Form 2553. However, Form 8869, line 14 asks, "Is this election being made in combination with a section 368(a)(1)(F) reorganization described in Rev. Rul. 2008-18, where the subsidiary was an S corporation immediately before the election and a newly formed holding company will be the subsidiary's parent?" and provides the following instructions:

> This box should be checked "Yes" if this election is being made pursuant to a reorganization under section 368(a)(1)(F) and Rev. Rul. 2008-18. This occurs when a newly formed parent holding company holds the stock of the subsidiary that was an S corporation immediately before the transaction and the transaction otherwise qualifies as a reorganization under section 368(a)(1)(F). No Form 2553, Election by a Small Business Corporation, is required to be filed by the parent. See Rev. Rul. 2008-18, 2008-13 I.R.B. 674, for details.

Letter Ruling 199947034, found in fn. 5540, ruled that Code § 2701 did not apply to such a reorganization.

See fn. 295 in part II.B Limited Liability Company (LLC) if the new entity is an LLC electing taxation as an S corporation and fn. 171 in part II.A.2.h Qualified Subchapter S Subsidiary (QSub) regarding the timing of an LLC electing S corporaton status before acquiring a QSub.

[2979] Letter Ruling 201638004. The facts were:

(1) The X members will contribute all of their X equity units to Y, a newly formed-State X limited liability company, in exchange for all of the Y equity units.
(2) X will elect to become, or by default will become, a disregarded entity or qualified subchapter S subsidiary for Federal tax purposes. After this step, Y expects to continue X's S corporation election.
(3) X will distribute the assets comprising the Retained Business to Y in a transaction that it expects to be disregarded for Federal income tax purposes. After this step, X would continue to hold the assets comprising the Distributed Business.
(4) Y will transfer all of the equity units of X to Z, a newly-formed State X limited liability company, solely in exchange for all of the Z equity units. After this step, Z will hold

new Form 2553, election to be taxed as an S corporation, which converts the LLC to a corporation and makes an S election at the same time.[2980]

Consider a different approach when the corporation has sold all of its business assets. See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

II.Q. Exiting from or Dividing a Business

II.Q.1. General Principles When Selling Ownership of a Business

A business' value is the present value of the expected future cash flows to its owners. A buyer uses these cash flows to pay the purchase price:

- ***Third-Party Financing***. A third-party lender provides cash to pay the purchase price in a lump sum. Business risk is shared between the buyer and the third-party lender, with the buyer assuming substantially all of the risk. Because the seller receives all cash up-front, the seller's risk is minimal.

- ***Seller Financing***. A series of payments from the buyer to the seller is evidenced through a promissory note. From a technical legal viewpoint, the buyer has all of the risk. However, as a practical matter, the seller is subject to business risk because the buyer is much less likely to pay if the business' cash flow is insufficient to service this debt. At any given point in time, the buyer is likely to withhold part or all of the remaining payments if the business' cash flow is less than expected. From an income tax viewpoint, the seller might be able to use the installment method to defer income tax on the gain on sale,[2981] subject to limitations if and to the extent that the

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only the equity units in X, which continues to hold the assets comprising the Distributed Business.

(5) Y will distribute pro rata all of the equity units of Z to Y's members in a transaction intended to qualify under section 355 of the Internal Revenue Code (the Distribution).

After reciting various representations, the ruling held:

(1) For purposes of determining whether Steps 1 and 2, viewed together, result in the realization of gain or loss under section 1001 (see *Weiss v. Stearn*, 265 U.S. 242 (1924)), or a reorganization under section 368(a)(1)(F) (see Rev. Rul. 72-206, 1972-1 C.B. 104), Steps 3 through 5 shall be disregarded.

(2) For U.S. Federal income tax purposes, Steps 3 through 5 will be treated as a direct transfer of the Distributed Business by Y to Z in exchange for all of the equity units of Z and the assumption of associated liabilities, followed by the pro rata distribution by Y of all of the equity units of Z to Y's members.

(3) X's S election will not terminate as a result of the completion of Steps 1 and 2, but continues for Y.

[2980] See fn. 295 and the accompanying and following text. Also consider what happens if there is some defect in Form 2553 that might make its filing invalid. Is converting into a partnership or a C corporation the lesser of two evils? If the latter, consider filing Form 8832 before Form 2553.

[2981] Even though stock was generally listed on the stock market, taxpayers who were affiliates as defined in Rule 144 under the 1933 Act and could not sell their unregistered shares of stock in Company on the Market, except pursuant to the volume limitations and other restrictions imposed by Rule 144 could sell their shares on the installment method. Letter Ruling 9803021. Furthermore, stock in an S corporation was eligible for installment sale treatment even though it held marketable securities. Letter Ruling 9306003 reasoned:

business interest sold is a partnership interest with "hot assets,"[2982] as well as acceleration in various events.[2983]

- ***Equity Financing***. The seller receives payments based on the business' performance over a short period of time following the transfer, or the timing of buyer's payments depends on the business' profitability. The taxation of contingent sales proceeds in the corporate arena[2984] is more uncertain than in the partnership arena.[2985]

When the buyer uses debt to pay for the business, two layers of tax are imposed:

- First, the buyer pays income tax on the earnings used to repay the debt.
  - For a partnership or S corporation, if owners are taxed on income from operations at a 46% ordinary federal and state income tax rate, the business must earn $185 of profits to fund a $100 principal payment on the debt.[2986]
  - A C corporation structure exacerbates this. If dividends are taxed at a 30% combined federal and state income rate, a $143 dividend generates $100 after tax. To distribute $143 to its shareholders, a C corporation that is subject to taxes on income from operations at a 40% ordinary federal and state income tax rate must generate over $238 of income. Thus, over $238 of business earnings are required to fund a $100 principal payment on the debt.
  - The interest component is easier to finance, assuming the interest is fully deductible.[2987] For a partnership or S corporation, only $100 of earnings is necessary to make a $100 interest payment. However, for a C corporation that is

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> Application of section 453(k)(2) to the S Common Stock is inappropriate. The flush language of section 453(k) provides the Secretary with the authority to provide for the application of section 453(k) in whole or in part for transactions in which the rules of the section would be avoided through use of related parties, pass-thru entities, or intermediaries. Because the Secretary has not issued regulations pursuant to this authority, however, the flush language may not be applied to the sale of the S Common Stock. Thus, because the S Common Stock is neither traded on an established securities market nor convertible into such publicly traded property, section 453(k)(2) does not apply to the sale of the S Common Stock.

However, the legislative history to the Tax Reform Act of 1986, PL 99-514, authorized the issuance of retroactive regulations disallowing the avoidance of the rules regarding publicly traded stock through use of related parties or other intermediaries.

[2982] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.

[2983] See part II.G.14 Limitations on the Use of Installment Sales.

[2984] Skinner, Earn-Outs in Public Company Acquisitions: New CVRs Raise Unsettled Tax Issues, Journal of Taxation (Dec 2010).

[2985] See part II.Q.8.b.ii, Partnership Redemption – Complete Withdrawal Using Code § 736.

[2986] However, if the owner is a partner who must pay self-employment tax on the earnings, additional earnings are required to pay the self-employment tax. Holding the partnership interest through an S corporation should avoid this issue.

[2987] See part III.A.3 Trusts Holding Stock in S Corporations, for a discussion of various types of trusts that can hold stock in an S corporation, including part III.A.3.e.iii Comparing QSSTs to ESBTs, which addresses deducting interest on a loan to buy such stock in footnotes 4604-4550.

subject to taxes on income from operations at a 40% ordinary federal and state income tax rate, earnings of $167 are required to pay a $100 dividend.[2988]

- The seller pays tax on the sale. For example, if the seller has a combined 30% federal and state income tax rate, the seller nets $70 on every $100 of purchase price that constitutes capital gain. However, the seller would pay ordinary income tax on any interest component, so that $100 of interest payments would net only $50 to a seller subject to taxes on income from operations at a 50% ordinary federal and state income tax rate. Note that, although capital gain rates apply to the sale of stock in a C corporation or an S corporation, ordinary income tax rates apply to the portion of the sale of a partnership interest attributable to "hot assets."[2989]

From these examples, some principles emerge:

- ***Paying Principal***. Principal payments can require from $167[2990]-$238[2991] of income to be generated to provide the seller with $70[2992]-$100[2993] after tax. Thus, the tax cost of principal payments represents 48%-66% of the earnings.

- ***Paying Interest***. Interest payments require $100[2994]-$167[2995] to provide the seller with $50 after tax. Thus, the tax cost of interest payments represents 50%-70% of the earnings.

- ***Efficiency of Entity***. The tax cost is lowest for:

  - Interest or other deductible payments on the sale of a partnership or S corporation, or

  - Principal payments to the extent of the seller's basis.

[2988] If an individual buyer/shareholder itemizes deductions, the buyer would deduct the interest as investment interest expense. Investment interest expense is deductible to the extent of net investment income. Code § 163(d). Preferably, the buyer would have ordinary interest or nonqualified dividends sufficient to generate this net investment income. Otherwise, the qualified dividends would need to be taxed at ordinary rates to constitute investment income; however, investment interest deducted at ordinary income tax rates generally would offset dividend income taxed using ordinary income tax rates. This comparison is not totally accurate, however, in that the dividend income is included in adjusted gross income (AGI) and can result in reduced itemized deductions and have other adverse AGI-related tax effects. If the buyer is a C corporation, these concerns are not present, and the corporation may also benefit from a dividends received deduction that can reduce or eliminate the tax on the dividends; however, the buyer's own shareholders would be taxed when the buyer distributes whatever return it receives on its investment.
[2989] See part II.Q.8.e.ii.(b) Character of Gain.
[2990] For a partnership or S corporation.
[2991] For a C corporation.
[2992] For the gain component of principal payments, net of capital gain tax.
[2993] For the portion of principal payments representing a return of basis.
[2994] For a partnership or S corporation.
[2995] For a C corporation.

II.Q.1.a. Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis

To minimize a sale's tax bite illustrated below, as discussed in the discussion after the illustrations tax planners seek structures with characteristics similar to interest or other deductible payments on the sale of a partnership or S corporation.[2996] The discussion below shows that seller-financed sales of partnership interests can avoid capital gain tax relative to a sale of stock in an S corporation (or a C corporation). Furthermore, the partnership sale structure allows goodwill to be sold later subject to capital gain rates, whereas a sale of goodwill generates slow deductions and may cause disadvantages for the future sale of that goodwill.[2997]

Note, however, that some or all of up to $10 million[2998] of the gain on the sale of C corporation stock might be excluded from taxable income under part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

Further below is a discussion of special opportunities to shift towards a partnership structure,[2999] which generally is the best overall structure,[3000] the structure of which[3001] and a summary of ways to shift[3002] were described earlier in these materials.

[2996] This is a little simplistic, in that partnerships also have unique benefits (earlier use of basis in installment sales; if considering such a sale, see part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests) and detriments (look at partnership's underlying assets to determine the character of gain on sale). See II.Q.8 Exiting From or Dividing a Partnership, especially II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736 and II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.
[2997] For more details, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.
[2998] Or ten times the stock's basis, if greater. Code § 1202(b)(1)(B).
[2999] See II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, regarding how a corporation might shift future appreciation to a partnership.
[3000] See part II.E.2.b Converting from S Corporation to C Corporation
See part II.P.3.e Conversion from S Corporation to C Corporation for short-term planning. Ideas include:

A conversion may be taxable, with the main issue being that an S corporation that was on the cash method that may be required to convert to the accrual method.

Additional steps may be needed to preserve or distribute the S corporation's accumulated adjustment account (which generally lets S corporations distribute its reinvested taxable earnings later without taxing it shareholders – see part II.Q.7.b Redemptions or Distributions Involving S Corporations). Note that, if the corporation distributes a note before converting, interest income on the note will be taxable at its shareholders' full ordinary income rates and subject to net investment income tax, which together combine to impose a 40.8% federal tax rate, whereas the corporation may receive (see part II.G.19.a Limitations on Deducting Business Interest Expense) a deduction at a 21% federal rate.

However, one always needs to consider what if that decision needs to be reversed when a new Congress changes the income tax paradigm. See parts II.P.3.c Conversion from

For now, let's focus on ways to extract value that any entity can try to use.

II.Q.1.a.i. Scenario for Moderate State Tax

Consider the portion of the business' equity representing internally generated goodwill, and assume the following tax rates, which might or might not be attained:

An individual in a top bracket might be taxed at a rate of 34.6%-45.8%, consisting of:

- 29.6%-37% ordinary income tax (depending on whether the Code § 199A 20% deduction is available)

C Corporation to S corporation and II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation.

Converting a C Corporation to an S Corporation

A C corporation that revoked its S election must wait 5 years to convert back to an S corporation. See part II.A.2.l Terminating S Election.

See part II.P.3.c Conversion from C Corporation to S corporation, including II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation. Issues discussed there include the following:

Generally, an asset sold within 5 years after converting from a C corporation to an S corporation will be taxed at the entity level and again to the shareholders. See part II.P.3.c.ii Built-in Gain Tax on Former C Corporations under Code § 1374. Therefore, before converting, one might sell assets that are likely to sold within 5 years. If the taxpayer uses the cash receipts and disbursements method of accounting, consider switching to accrual before convertings, so that accoutns receiveable do not get hit with this tax.

Although an S corporation that has accumulated earnings and profits from when it was a C corporation cannot have excess passive investment income, that issue is easily managed through the corporation's investment mix – if one considers the issue and plans for it. See part II.P.3.c.iii Excess Passive Investment Income, especially fns 2865-2868.

Also, an S corporation that has accumulated earnings and profits from when it was a C corporation should not invest in tax-exempt investments, the income from which does not generate AAA and therefore may trigger a taxable dividend when distributed. See part II.P.3.c.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

If the corporation maintains an inventory, converting from a C corporation to an S corporation may incur tax. See part II.P.3.c.i LIFO Recapture.

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[3001] See parts II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and II.E.6 Recommended Partnership Structure – Flowchart.

[3002] See part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure.

- zero-3.8% net investment income tax (working in the business may avoid this tax, and exceptions to SE tax may apply as well), and

- 5% state income tax.

The individual in a top bracket is assumed taxed at a rate of 28.8%, consisting of 20% capital gain tax, 3.8% net investment income tax, and 5% state income tax.

Sale of Goodwill - Assumptions

C corp. income tax rate:	26.0%	federal and state
Individual capital gain rate:	20.0%	federal
	5.0%	state
	3.8%	NII tax
	28.8%	
Pass-through income rate:	29.6%-37%	federal income tax
	5.0%	state
	Zero-3.8%	NII or SE tax
	34.6%-45.8%	

The capital gain rate for individuals might be overstated when a person sells stock in an S corporation, because the 3.8% tax on net investment income would not apply with respect to the business assets allocable to that stock when a shareholder who is active in the business sells the stock.[3003] The partnership income tax rate might be overstated, either if the partner is a limited partner not subject to self-employment tax[3004] or if the payment is neither self-employment income[3005] nor attributable to business assets allocable to the partnership interest when a partner who is active in the business sells the partnership interest.[3006]

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

[3003] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[3004] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner, which one might apply to avoid self-employment tax using the structure described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart.
[3005] See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.
[3006] See parts II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income and II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

	Capital Gain to Seller	Ordinary Income to Seller
Profit	$ 153-185	$109-131
Tax to Buyer	-(53-85)	-0
	$ 100	$109-131
Tax to Seller	- 29	38-60
Net to Seller	$ 71	$ 71

The tax in the right-hand column assumes that the buyer deducts payments to the seller, which is essentially what happens when one pays off a seller by allocating current partnership income to the seller.

The following pages illustrate this concept, showing that it takes a C corporation $189 in earnings to do a cross-purchase (one owner sells to another)[3007] and $135 to do either a redemption (entity buys from seller)[3008] or a cross-purchase using an exclusion that applies to the sale of certain stock,[3009] an S corporation $153-185 in earnings,[3010] and a partnership only $109-131 in earnings[3011] to get $71 to the seller.

[3007] See part II.Q.1.a.i.(a) C Corporation Triple Taxation

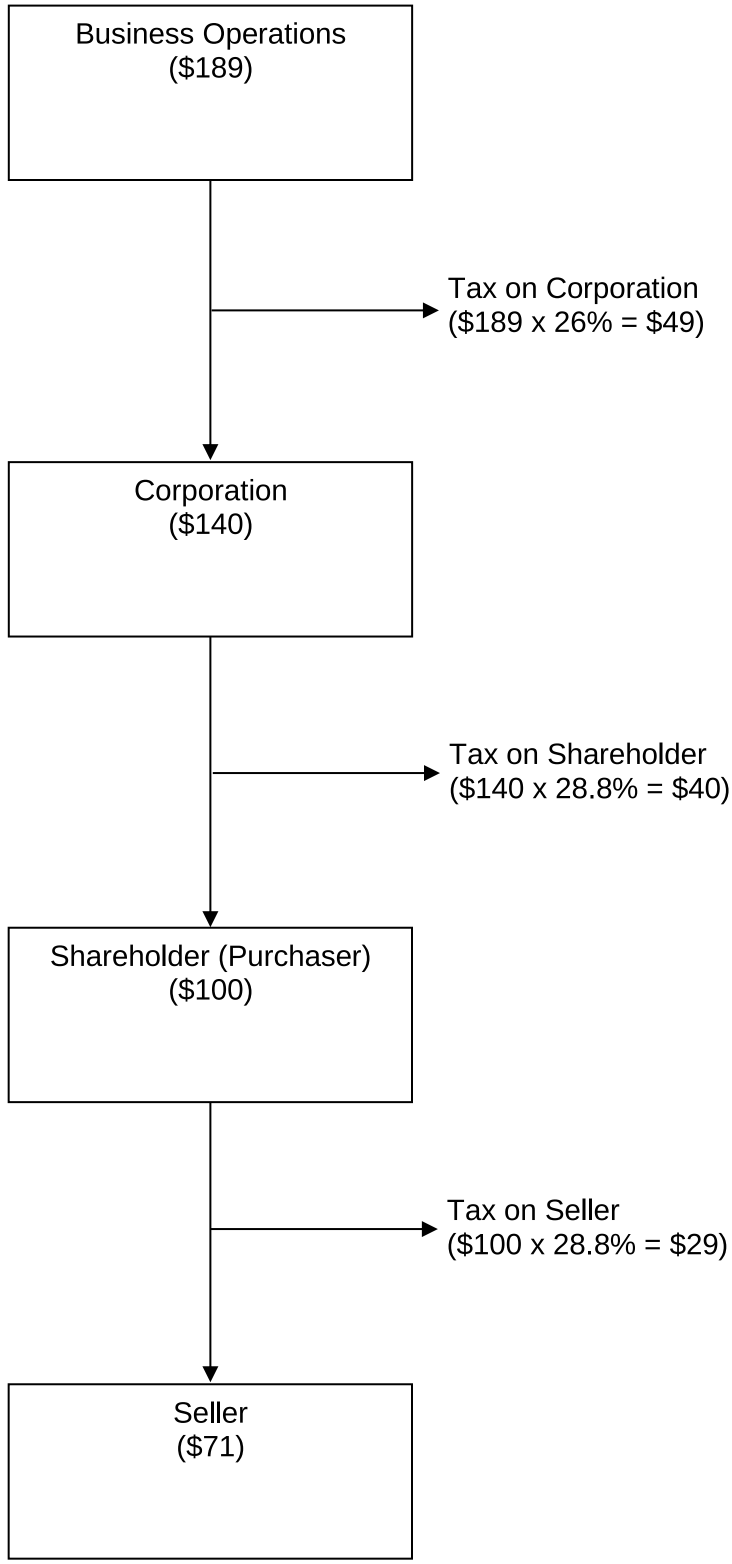
[3008] See part II.Q.1.a.i.(b) C Corporation Redemption. Redeeming the seller entirely might work if buying out one owner and increasing the other owners' interests in proportion to each other. However, if the sole owner is selling, or if the remaining owners are not increased in proportion to each other, then a cross-purchase or a stock issuance is needed to get the remaining owners' interests in the correct proportion, followed by the redemption. For approval of combining a cross-purchase with a redemption, see part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders.

[3009] See part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

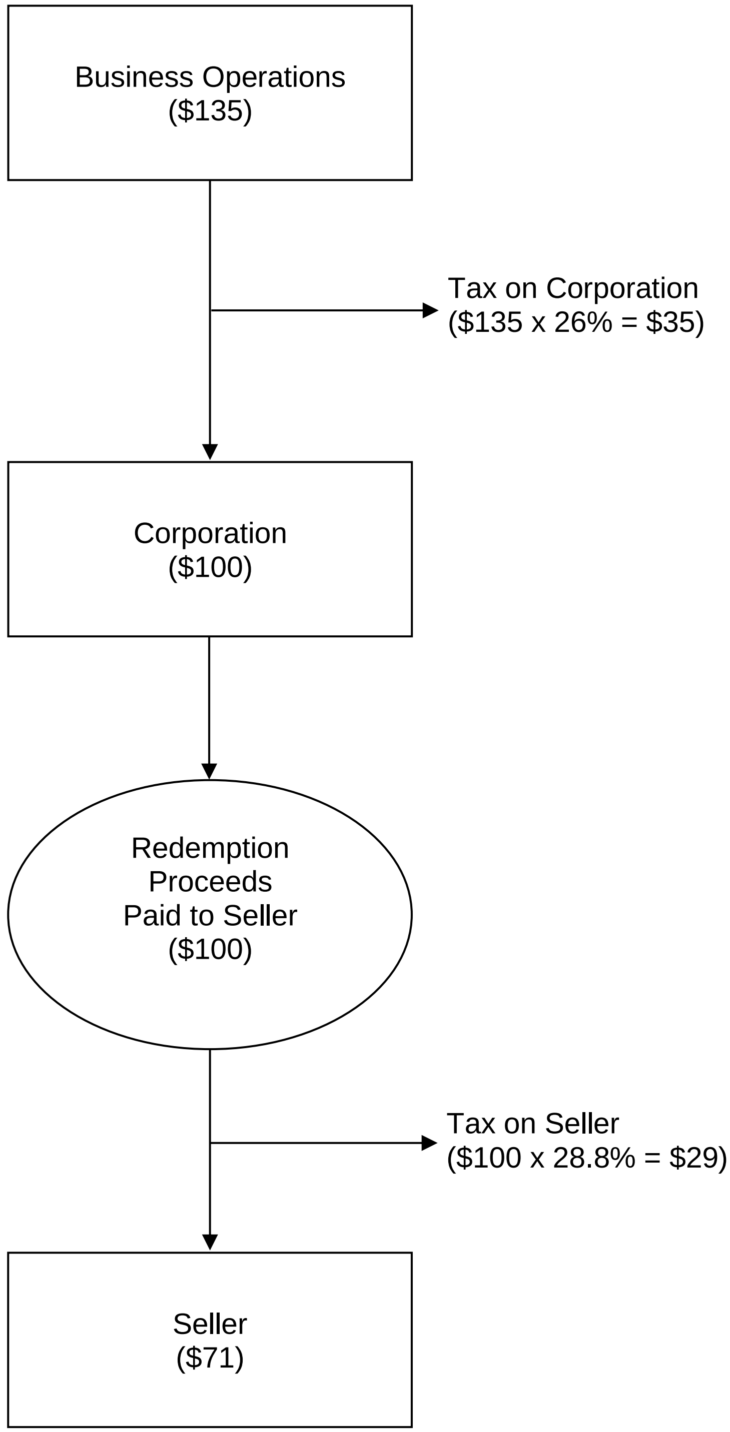
[3010] See part II.Q.1.a.i.(d) S Corporation Double Taxation.

[3011] See part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill.

II.Q.1.a.i.(a). C Corporation Triple Taxation

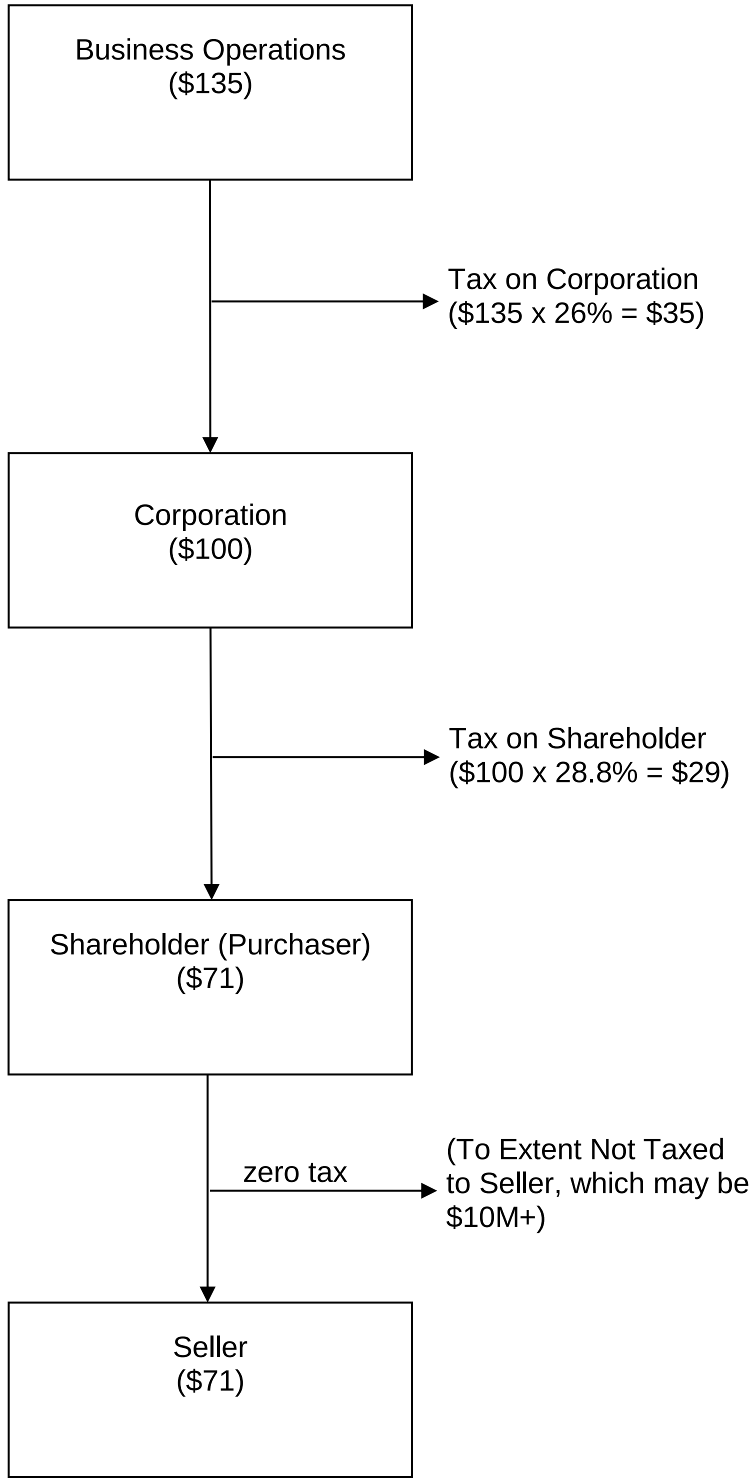


II.Q.1.a.i.(b). C Corporation Redemption



See part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders. The buyer may benefit more from buyer's future sale if buys from corporation more than two years before the seller is redeemed.

II.Q.1.a.i.(c). C Corporation Double Taxation Under Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation



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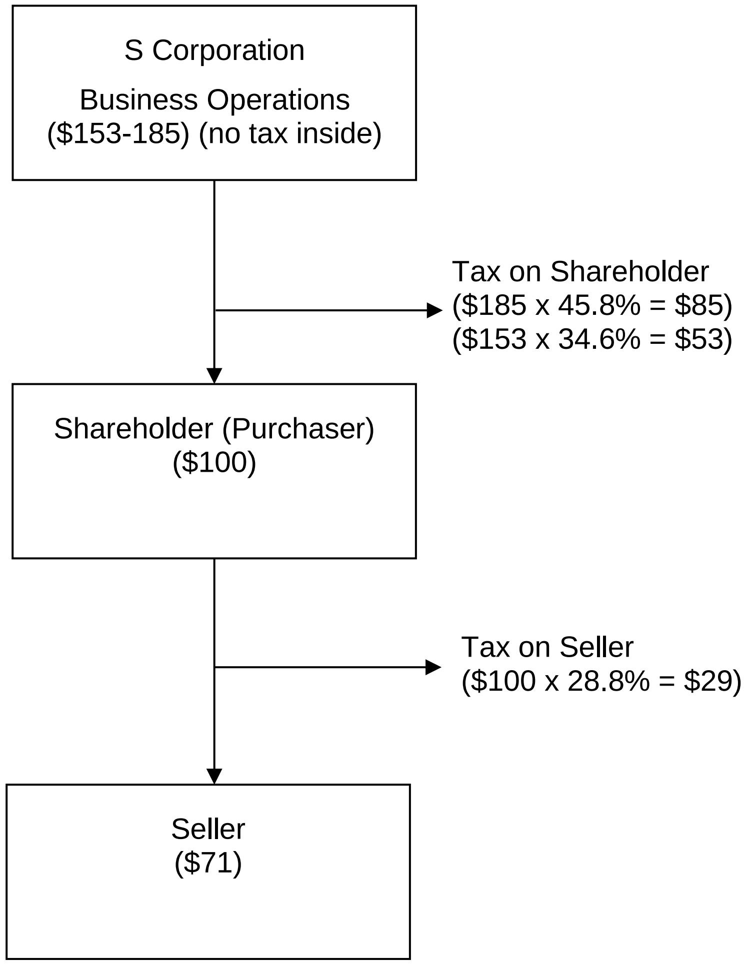
II.Q.1.a.i.(d). S Corporation Double Taxation



Notes:

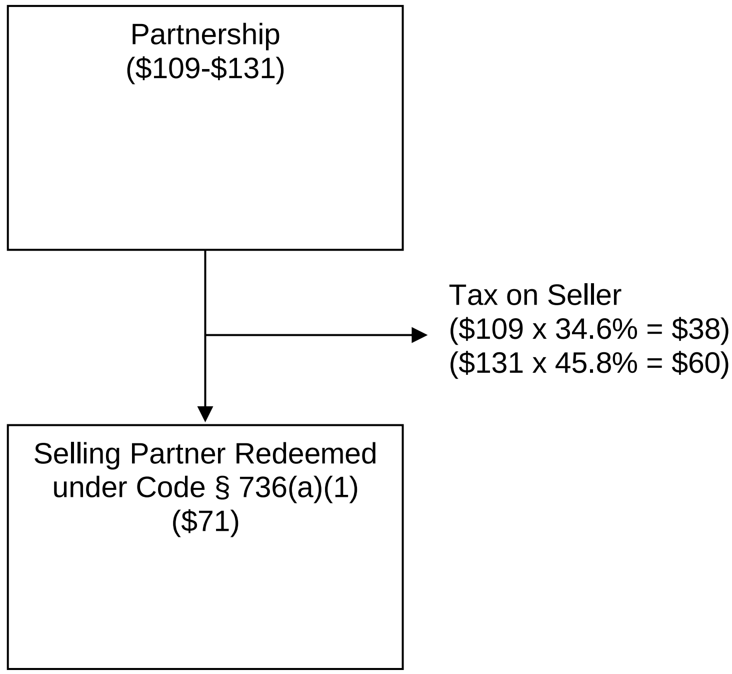
The buyers might very well have lower income tax rates than the seller, resulting in a decreased amount of earnings needed to buy out the seller. For example, a 40% income tax rate would require only $167 of earnings (40% of $167 is $67 tax).

Although an S corporation buyout might be perceived as the same as a Code § 736(b) buyout, it is not. Each year's Code § 736(b) payment creates a new goodwill asset that can amortized over 15 years. This option is not available to S corporations.

This scenario assumes corporate goodwill. Personal goodwill can be dealt with more effectively than corporate goodwill.

If and to the extent sale price is based on accumulated earnings rather than goodwill, sale price is not taxable and exclusion under part II.Q.1.a.i.(c) is not more favorable.

II.Q.1.a.i.(e). Partnership Single Taxation of Goodwill



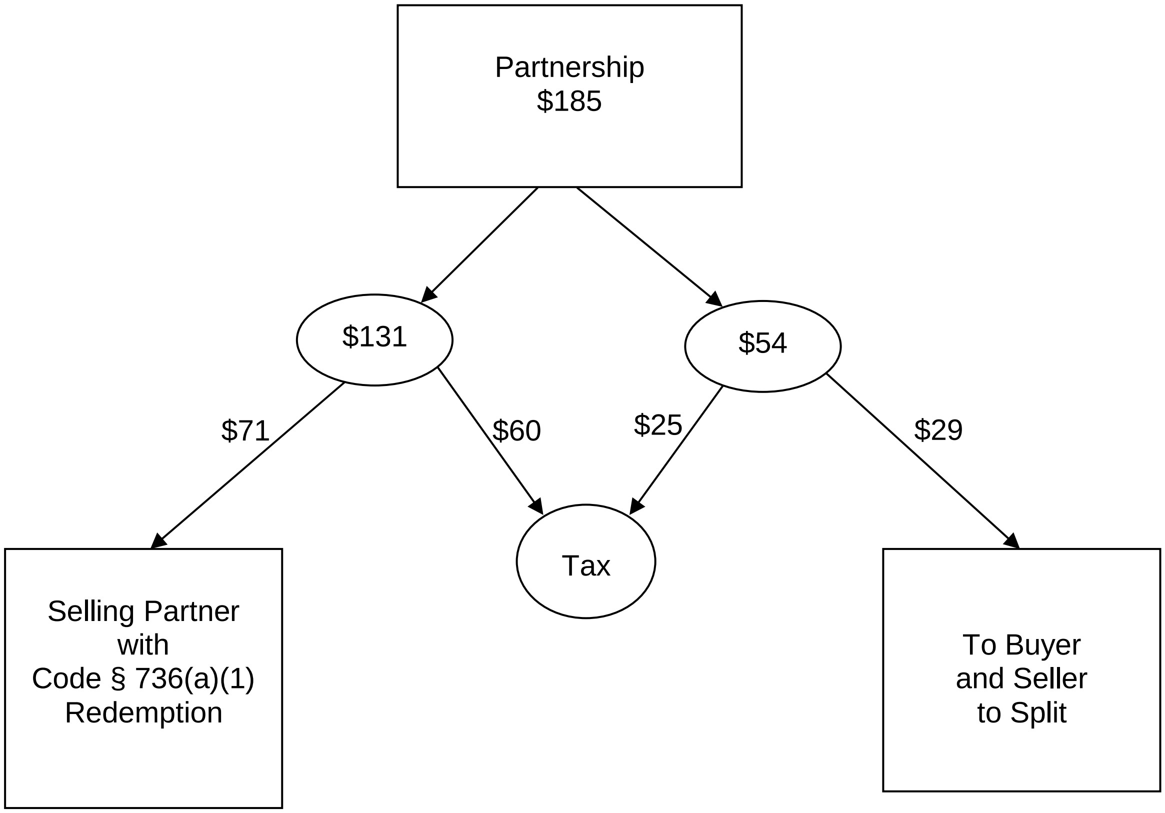
For more details on the tax and nontax benefits of this structure, see part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, as well as part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, which includes allowing income to be taxed to the seller under Code § 736(a).

See part II.Q.8.b.ii.(b) Flexibility in Choosing between Code § 736(a) and (b) Payments (including in fns. 3986-3988 the requirement that, to obtain Code § 736(a) treatment with respect to unrealized receivables and goodwill, a retiring partner must be a general partner and capital cannot be a material income-producing factor).

If the partnership is not a service partnership, one might need to use a preferred profits interest instead of Code § 736(a) payments. However, consider whether such a reallocation of profits might constitute a shifting of goodwill that should be reflected in capital accounts and therefore might constitute a taxable shift of a capital account.[3012]

[3012] See fn. 412 in part II.C.6 Shifting Rights to Future Profits.

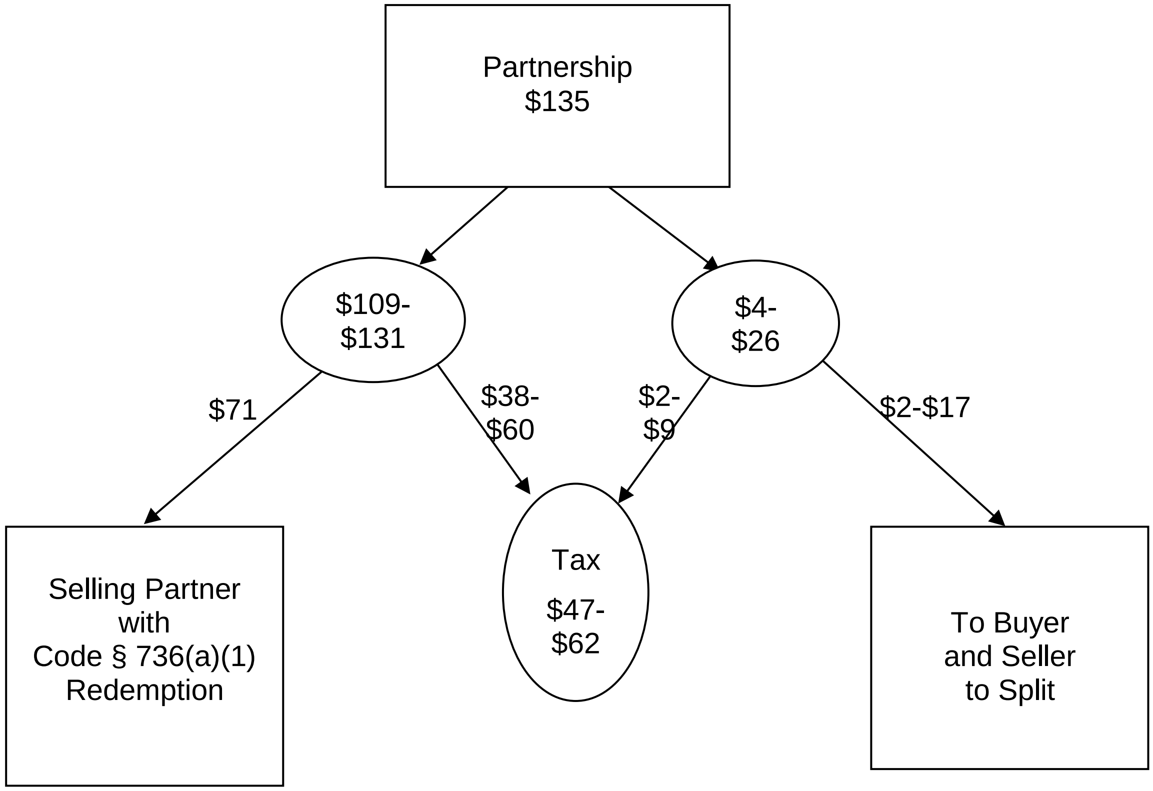
II.Q.1.a.i.(f). Partnership Use of Same Earnings as S Corporation in Sale of Goodwill



Notes:

- This scenario uses the income from the scenario II.Q.1.a.i.(d) S Corporation Double Taxation and applies the concepts from part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill. The left side of the flowchart duplicates the partnership scenario, with $131 of earnings and $71 of tax. The right side of the flowchart takes the $185 from the S corporation double taxation scenario and subtracts from it the $131 from the partnership scenario, resulting in $54 extra earnings in the partnership scenario not needed to generate $71 for the seller. However, these $54 of extra earnings are subject to $25 of income tax, so that only $29 is left, net after-tax.
- The $29 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 29% after-tax dollars that the parties can allocate.
- In either scenario, $185 is subjected to ordinary income tax.

II.Q.1.a.i.(g). Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill



Notes:

- This scenario uses the income ($135) from the scenario in in part II.Q.1.a.i.(b) C Corporation Redemption or part II.Q.1.a.i.(c) C Corporation Double Taxation Under Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation and applies the concepts from part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill. The left side of the flowchart duplicates the partnership scenario, with $109-$131 of earnings and $38-$60 of tax. The right side of the flowchart takes the $135 from the C corporation scenario and subtracts from it the $109-$131 from the partnership scenario, resulting in $4-$26 extra earnings in the partnership scenario not needed to generate $70 for the seller. However, these $4-$26 of extra earnings are subject to $2-$9 of income tax, so that only $2-$17 is left, net after-tax.
- The $2-$17 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 4%-17% after-tax dollars that the parties can allocate.
- In either scenario, $135 is subjected to ordinary income tax.

II.Q.1.a.ii. California Scenarios (not yet updated for 2017 federal tax changes)

Consider the portion of the business' equity representing internally generated goodwill, and assume the following tax rates, which might or might not be attained:

Sale of Goodwill - Assumptions

C corp. income tax rate:	35.0%	federal
	8.8%	state
	43.8%	
Individual capital gain rate:	20.0%	federal
	13.3%	state
	3.8%	supplemental
	1.2%	various phase-outs
	38.3%	
S corporation income rate:	39.6%	federal
	1.5%	state entity level
	13.3%	state individual level
	1.2%	various phase-outs
	55.6%	
Self-employment income rate:	39.6%	federal
	13.3%	state
	3.8%	self-employment
	1.2%	various phase-outs
	57.9%	

The capital gain rate for individuals might be overstated when a person sells stock in an S corporation, because the 3.8% tax on net investment income would not apply with respect to the business assets allocable to that stock when a shareholder who is active in the business sells the stock.[3013] The partnership income tax rate might be overstated, either if the partner is a limited partner not subject to self-employment tax[3014] or if the payment is neither self-employment income[3015] nor attributable to business assets allocable to the partnership interest when a partner who is active in the business sells the partnership interest.[3016]

The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

[3013] See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
[3014] See part II.L.4 Self-Employment Tax Exclusion for Limited Partner.
[3015] See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.
[3016] See parts II.I.8.d Partnership Structuring in Light of the 3.8% Tax on Net Investment Income and II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.

	Capital Gain to Seller	Ordinary Income to Seller
Profit	$ 225	$ 147
Tax to Buyer	-125	- 0
	$ 100	$ 147
Tax to Seller	- 38	- 85
Net to Seller	$ 62	$ 62

The tax in the right-hand column assumes that the buyer deducts payments to the seller, which is essentially what happens when one pays off a seller by allocating current partnership income to the seller.

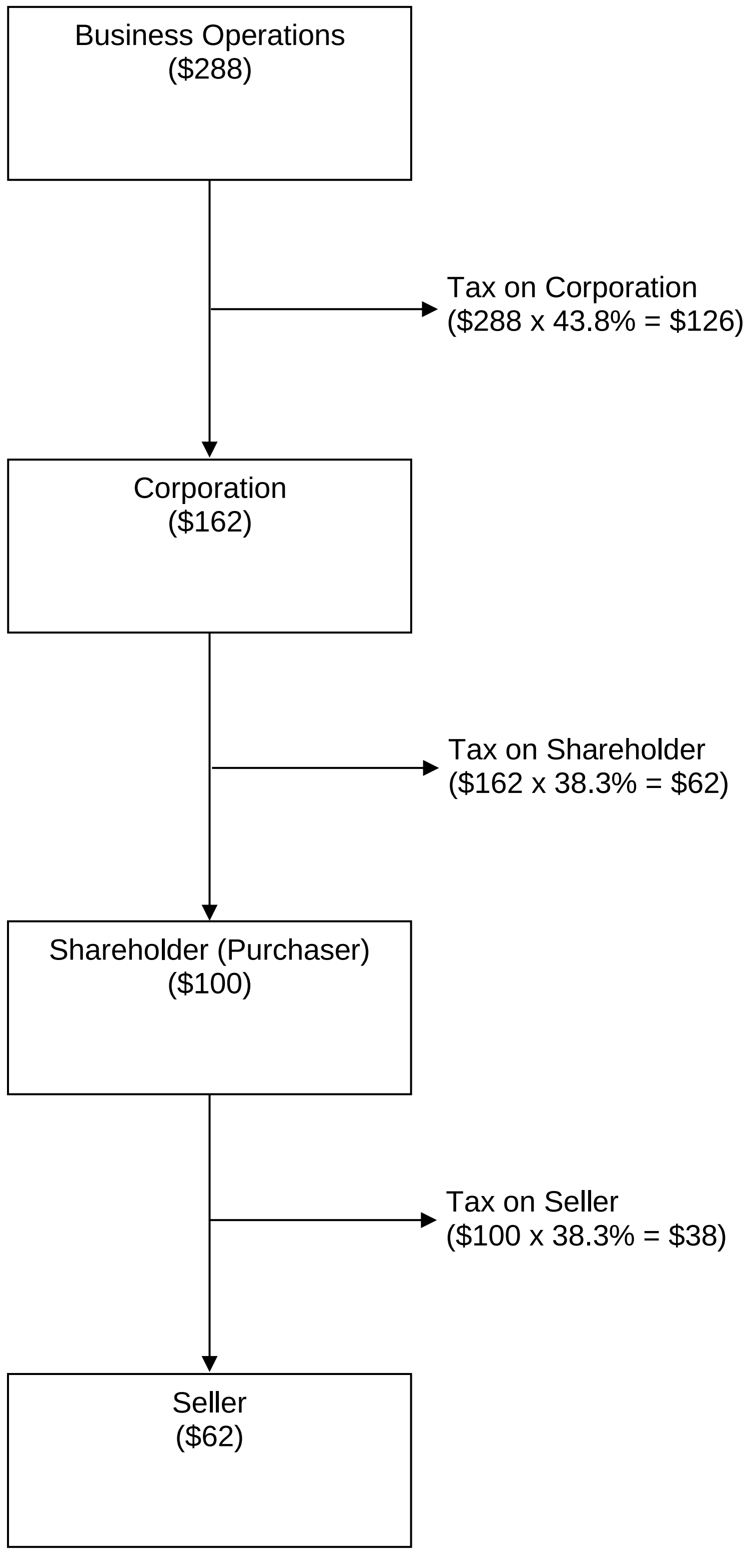
The illustrations ignore the California LLC tax of up to nearly $12K that applies to an LLC taxed as a partnership. If the partnership uses the structure recommended in part II.E Recommended Structure for Entities:

- This tax of up to nearly $12K would be imposed on each LLC subsidiary annually,
- Self-employment tax would not apply, and
- California's 1.5% entity-level tax on S corporations would apply to the general partner's 1% annual income and any profit from its management fee it excess of salaries paid to the owners.

The following pages illustrate this concept, showing that it takes a C corporation $288 in earnings to do a cross-purchase (one owner sells to another)[3017] and $225 to do either a redemption (entity buys from seller)[3018] or a cross-purchase using an exclusion that applies to the sale of certain stock,[3019] an S corporation $218 in earnings,[3020] and a partnership only $147 in earnings[3021] to get $62 to the seller.

[3017] See part II.Q.1.a.ii.(a) C Corporation Triple Taxation (California).
[3018] See part II.Q.1.a.ii.(b) C Corporation Redemption (California). Redeeming the seller entirely might work if buying out one owner and increasing the other owners' interests in proportion to each other. However, if the sole owner is selling, or if the remaining owners are not increased in proportion to each other, then a cross-purchase or a stock issuance is needed to get the remaining owners' interests in the correct proportion, followed by the redemption. For approval of combining a cross-purchase with a redemption, see part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders.
[3019] See part II.Q.1.a.ii.(c) C Corporation Double Taxation Under Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation (California).
[3020] See part II.Q.1.a.ii.(d) S Corporation Double Taxation (California).
[3021] See part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California).

II.Q.1.a.ii.(a). C Corporation Triple Taxation (California)



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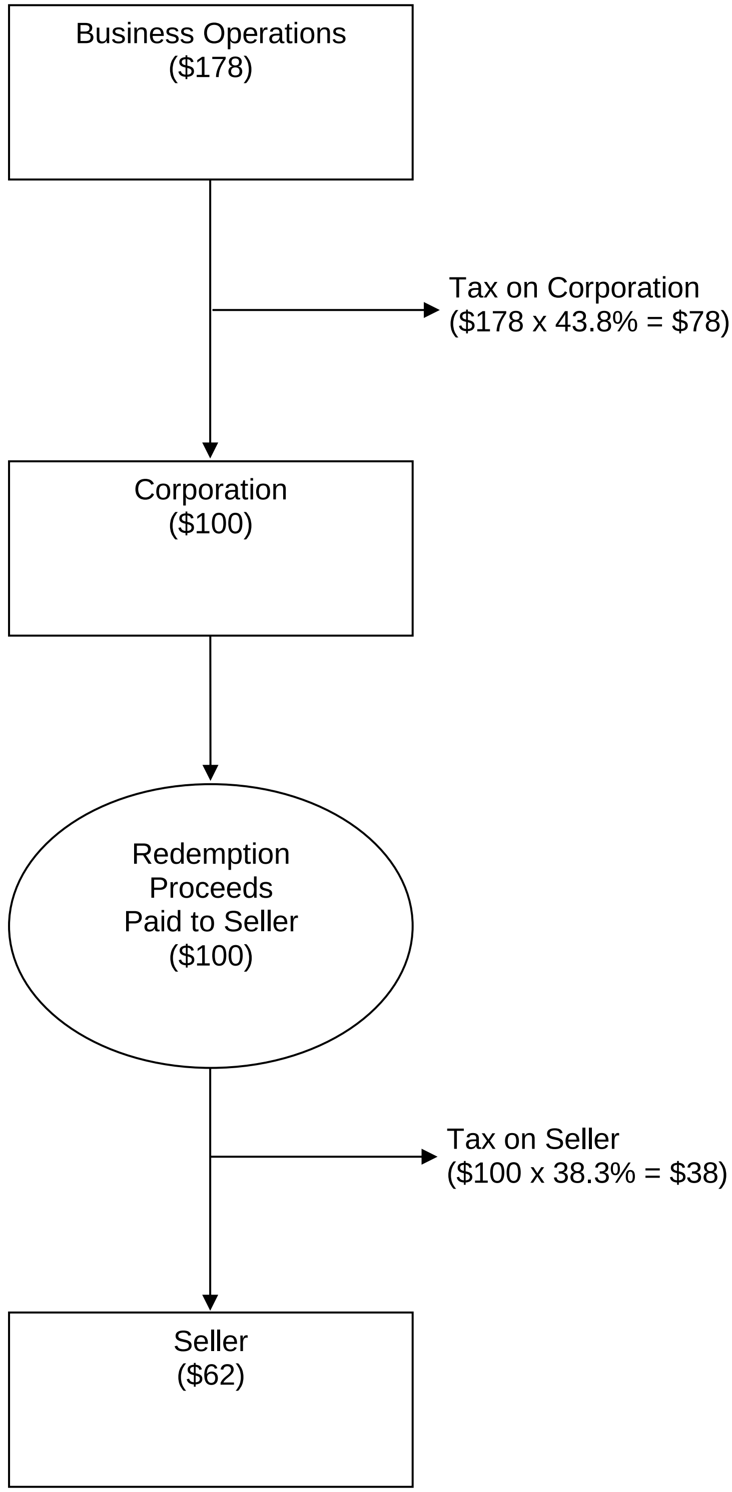
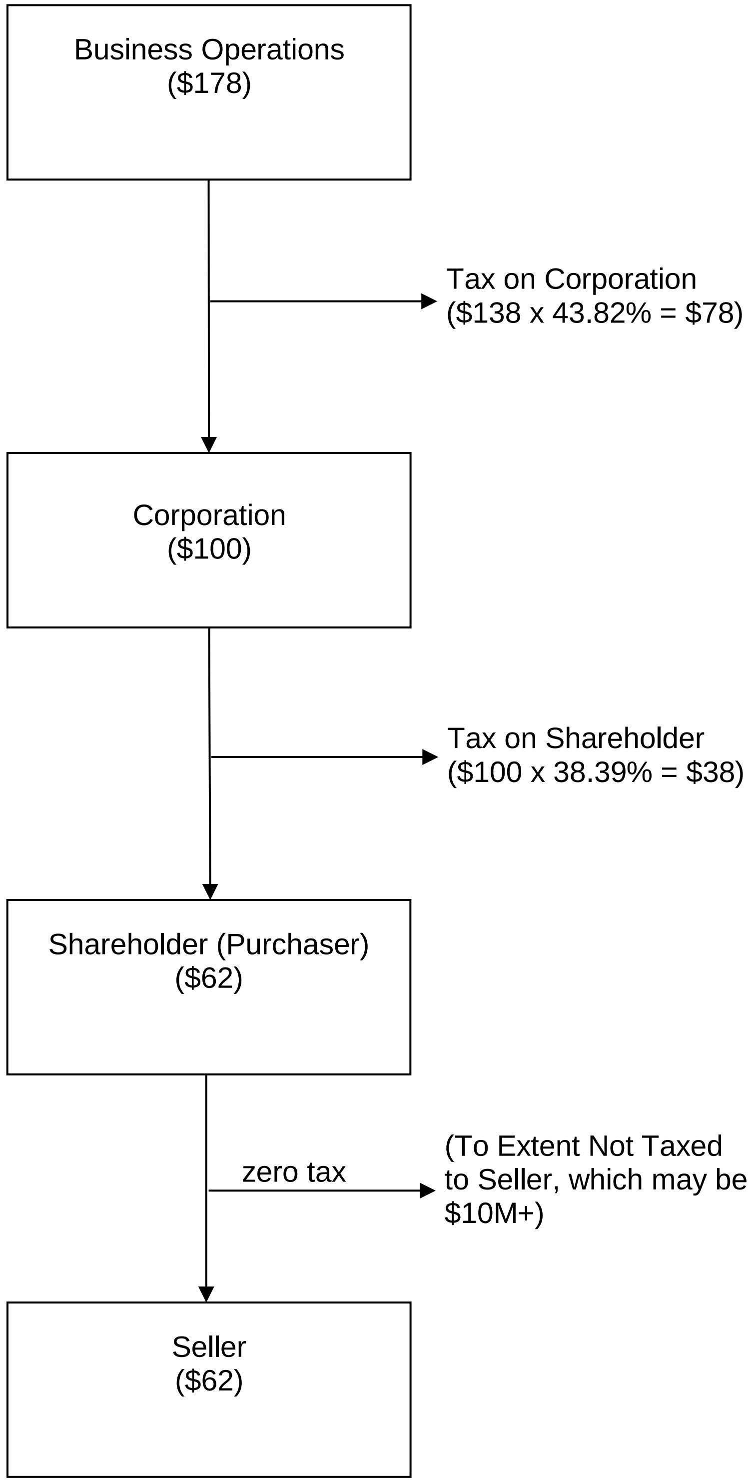
II.Q.1.a.ii.(b). C Corporation Redemption (California)

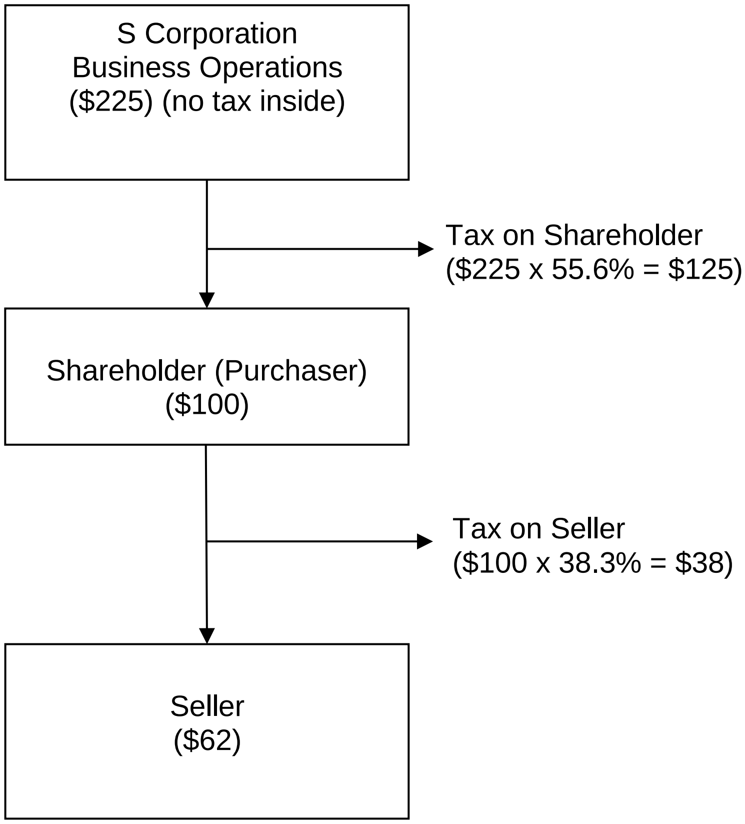


See part II.Q.7.a.ii Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders. The buyer may benefit more from buyer's future sale if buys from corporation more than two years before the seller is redeemed.

II.Q.1.a.ii.(c). C Corporation Double Taxation Under Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation (California)



II.Q.1.a.ii.(d). S Corporation Double Taxation (California)



<u>Notes</u>:

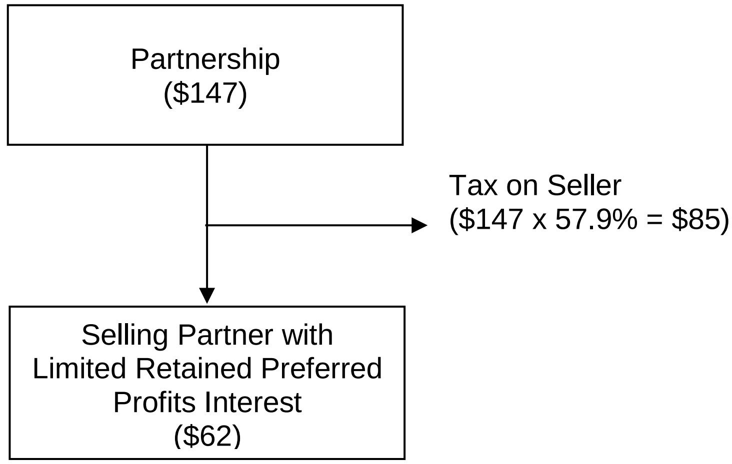
The buyers might very well have lower income tax rates than the seller, resulting in a decreased amount of earnings needed to buy out the seller. For example, a 40% income tax rate would require only $167 of earnings (40% of $167 is $67 tax).

Although an S corporation buyout might be perceived as the same as a Code § 736(b) buyout, it is not. Each year's Code § 736(b) payment creates a new goodwill asset that can amortized over 15 years. This option is not available to S corporations.

This scenario assumes corporate goodwill. Personal goodwill can be dealt with more effectively than corporate goodwill.

If and to the extent sale price is based on accumulated earnings rather than goodwill, sale price is not taxable and exclusion under part II.Q.1.a.ii.(c) is not more favorable.

II.Q.1.a.ii.(e). Partnership Single Taxation of Goodwill (California)



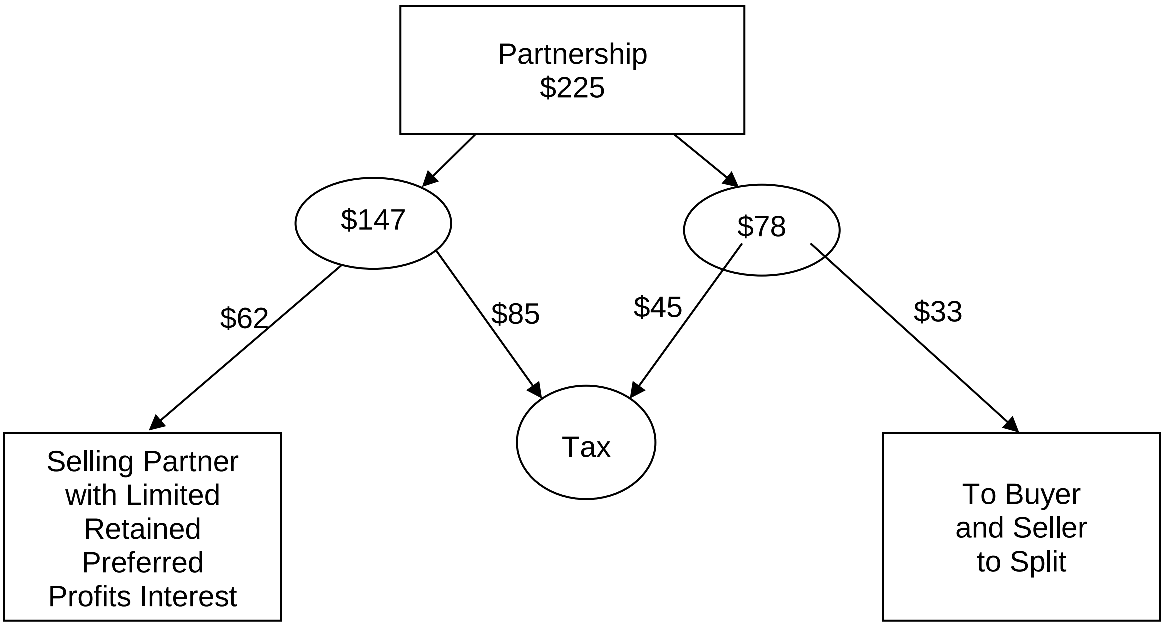
For more details on the tax and nontax benefits of this structure, see part II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill, as well as part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, which includes allowing income to be taxed to the seller under Code § 736(a).

See part II.Q.8.b.ii.(b) Flexibility in Choosing between Code § 736(a) and (b) Payments (including in fns. 3986-3988 the requirement that, to obtain Code § 736(a) treatment with respect to unrealized receivables and goodwill, a retiring partner must be a general partner and capital cannot be a material income-producing factor).

If the partnership is not a service partnership, one might need to use a preferred profits interest instead of Code § 736(a) payments. However, consider whether such a reallocation of profits might constitute a shifting of goodwill that should be reflected in capital accounts and therefore might constitute a taxable shift of a capital account.[3022]

[3022] See fn. 412 in part II.C.6 Shifting Rights to Future Profits.

II.Q.1.a.ii.(f). Partnership Use of Same Earnings as S Corporation in Sale of Goodwill (California)

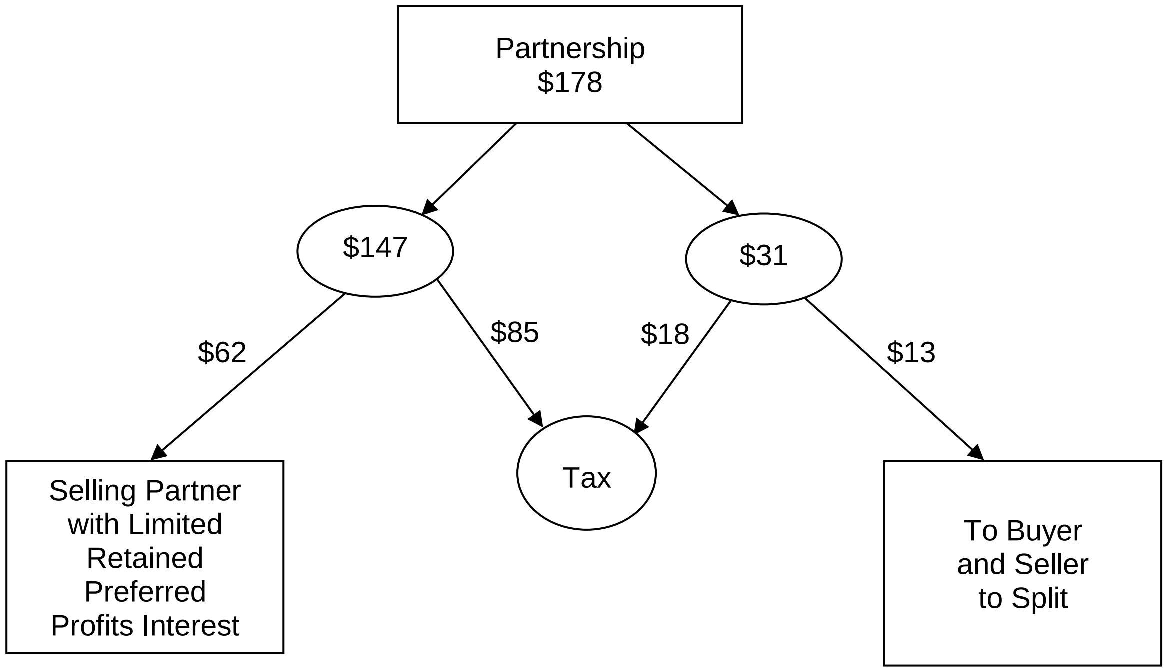


- This scenario uses the income from the scenario in part II.Q.1.a.ii.(d) S Corporation Double Taxation (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, with $147 of earnings and $85 of tax. The right side of the flowchart takes the $225 from the S corporation double taxation scenario and subtracts from it the $147 from the partnership scenario, resulting in $78 extra earnings in the partnership scenario not needed to generate $62 for the seller. However, these $78 of extra earnings are subject to $45 of income tax, so that only $33 is left, net after-tax.
- The $33 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 33% after-tax dollars that the parties can allocate.
- In either scenario, $225 is subjected to ordinary income tax. The S corporation ordinary income tax rate is lower because it is assumes that the buyer materially participates and is therefore not subject to the 3.8% tax on net investment income, whereas the partnership scenario assumes self-employment tax (which can be avoided if one uses the structure described in part II.E.5 Recommended Long-Term Structure for Pass-Throughs – Description and Reasons and illustrated in part II.E.6 Recommended Partnership Structure – Flowchart.

<u>Notes</u>:

- This scenario uses the income from the scenario II.Q.1.a.ii.(d) S Corporation Double Taxation (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, which $147 of earnings and $85 of tax. The right side of the flowchart takes the $225 from the S corporation scenario and subtracts from it the $147 from the partnership scenario, resulting in $78 extra earnings in the partnership scenario not needed to generate $62 for the seller. However, these $78 of extra earnings are subject to $45 of income tax, so that only $33 is left, net after-tax.
- The $33 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 33% after-tax dollars that the parties can allocate.

II.Q.1.a.ii.(g). Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill (California)



<u>Notes</u>:

- This scenario uses the income from the scenario in part II.Q.1.a.ii.(b) C Corporation Redemption (California) or in part II.Q.1.a.ii.(c) C Corporation Double Taxation Under Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation (California) and applies the concepts from part II.Q.1.a.ii.(e) Partnership Single Taxation of Goodwill (California). The left side of the flowchart duplicates the partnership scenario, with $147 of earnings and $85 of tax. The right side of the flowchart takes the $178 from the C corporation double tax scenario and subtracts from it the $147 from the partnership scenario, resulting in $31 extra earnings in the partnership scenario not needed to generate $62 for the seller. However, these $31 of extra earnings are subject to $18 of income tax, so that only $13 is left, net after-tax.
- The $13 net after-tax is based on an original $100 purchase price, meaning that the partnership scenario nets 13% after-tax dollars that the parties can allocate.

In either scenario, $178 is subjected to ordinary income tax.

II.Q.1.a.iii. Migrating to a Partnership Structure

For what might be an ideal partnership structure, see part II.E Recommended Structure for Entities.

Parts II.E.7 Migrating into Partnership Structure and II.E.9 Real Estate Drop Down into Preferred Limited Partnership explain how to get there.

II.Q.1.b. Leasing

Some assets used in a business might be held outside of the business and then leased to the business. The buyer continues to lease these assets from the seller. Such lease payments are deductible to the buyer and taxable to the seller, and the seller is not necessarily at risk in that the seller might be able to sell the property to a third party. If a partnership holds the business, the partnership that conducts business operations can save its owners self-employment tax by leasing property instead of owning it.[3023] Note, however, that Florida and perhaps other states impose a tax on gross rents.

If a long-term lease provides rent above the property's fair rental value, a lease termination payment is deductible as an ordinary business expense, even if the tenant buys the property;[3024] however, be prepared for a fight with the IRS and to go to District Court, because the Tax Court will require the taxpayer to capitalize the lease termination fee outside of the Sixth Circuit.[3025] On the other hand, amounts a lessee receives for the cancellation of a lease are considered as amounts received in exchange for that lease;[3026] although this exchange treatment does not affect whether the lease is a capital asset as to the lessee,[3027] it very well may be.[3028]

[3023] Real estate rental income received on a long-term basis is not subject to self-employment tax, Reg. § 1.1402(a)-4(a) (see part II.L.2.a.ii Rental Exception to SE Tax, especially fn. 2378), whereas the rent deduction would reduce self-employment income, if any, of the operating business. In early years of owning the real estate, rent deductions might not produce much saving relative to depreciation, interest expense, insurance and taxes; in later years, however, the saving might be significant. Although rental income generally is subject to the 3.8% tax on net investment income (NII), rental to a business with sufficient common ownership is not NII. See part II.I.8.c Application of 3.8% Tax to Rental Income.

[3024] *ABC Beverage Corporation v. U.S.*, 756 F.3d 438 (6th Cir. 2014) (of $9M purchase price, $6.25M allocated to lease termination expense).

[3025] *Union Carbide Foreign Sales Corp. v. Commissioner*, 115 T.C. 423 (1993) (holding that Code § 167(c)(2) compelled that result). Code § 167(c)(2) provides:

> If any property is acquired subject to a lease-
> (A) no portion of the adjusted basis shall be allocated to the leasehold interest, and
> (B) the entire adjusted basis shall be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease.

The Sixth Circuit's opinion in fn. 3024 pointed out that the purchase extinguished the lease; because the lease did not continue after the purchase, the property was not acquired subject to the lease.

[3026] Code § 1241.

[3027] Reg. § 1.1241-1(a).

[3028] In Letter Ruling 200045019, the tenant entered into a commercial lease, then later claimed that the rent that it paid was too high because it used the property primarily for residential purposes. After stating that the local housing authority ruled in the tenant's favor, the Ruling continued:

> City's rent control law gives a tenant the right to continued possession of a property and establishes the maximum rent that may be charged. This right of possession is for an indefinite time period. The landlord may evict such a tenant only under specific circumstances as listed in the Statute.
>
> As a result of the determination that the Premises were subject to the rent control law, the landlord agreed to pay Taxpayer $s in return for Taxpayer surrendering all lease and statutory rights to the Premises. This agreed sum represents $m plus $n to cover estimated taxes. The estimated tax amount was determined under the assumption that

> Taxpayer's gains from the transaction would be treated as capital gains. Further, the landlord agreed to pay an additional amount, up to $u, plus interest and penalties, if the Internal Revenue Service determines that the gain is ordinary. Finally, the landlord agreed to pay $v to a law firm to cover Taxpayer's legal fees.

In finding that the lease termination payment was capital gain, the Ruling reasoned:

> We note that section 1231, rather than section 1221, may apply to the instant case because the facts indicate that Taxpayer's leasehold may have been used in part, or for a portion of the lease period, for the conduct of Taxpayer's business. Business use of real property precludes that property from receiving capital asset treatment under section 1221(2). However, we do not need to determine whether the leasehold is excluded under section 1221(2) because it will either be a section 1221 capital asset or a section 1231 asset. In either case, the gain recognized on the exchange of the leasehold will be capital, rather than ordinary.
>
> In Rev. Rul. 72-85, 1972-1 C.B. 234, the Service determined that a leasehold of land used in a trade or business is section 1231 property, even if it is of indefinite duration. This revenue ruling clarified Rev. Rul. 56-531, 1956-2 C.B. 983, which holds, in part, that the Service acquiesces in *McCue Bros. & Drummond, Inc. v. Commissioner*, 19 T.C. 667 (1953), *acq.* 1956-2 C.B. 7, *aff'd*, 210 F.2d 752 (2d Cir. 1954), *cert. denied*, 348 U.S. 829 (1954).
>
> The petitioner in *McCue Bros.* leased a hat shop in New York City. For a portion of his occupancy, the petitioner held the property under a written lease. However, after the lease expired, the petitioner continued to occupy the property under a "statutory tenancy" by virtue of the New York rent control laws that had taken effect shortly before the end of the written lease. In affirming the Tax Court in *McCue Bros.*, the Second Circuit stated that it was immaterial whether the petitioner held the property under a lease or through the rent control laws. The court stated, "we think the right of possession under a lease or otherwise, is a ...substantial property right which does not lose its existence when transferred. If it is sold by the tenant to a third person, the gain derived therefrom is a capital gain." 210 F.2d at 753. The court further stated that the holding period began when the statutory right of possession attached. *Id.* at 754.
>
> In *Stotis v. Commissioner*, T.C. Memo. 1996-431, the Tax Court came to a similar result in the case of a residential leasehold. Mr. Stotis, the petitioner, leased space in an apartment building that he used as a residence. The landlord, desiring to use the real estate for other purposes, entered into a surrender agreement with the petitioner whereby the petitioner exchanged his right in the property for a cash payment. The Tax Court held that the petitioner's leasehold interest in a residence was a capital asset, and that the petitioner's sale of the leasehold interest constituted a sale or exchange, taxable as capital gain.
>
> The facts of this case are not clear as to whether the property in question is properly treated as real property used in the trade or business for purposes of sections 1221 and 1231. If it is not real property used in the trade or business, the leasehold interest is a capital asset under section 1221. If it is real property used in the trade or business, any gain attributable to the sale or exchange of the leasehold interest is treated as long-term capital gain under section 1231. Taxpayer's holding period began with the vesting of the statutory right of occupancy on c. Therefore, Taxpayer held the property for more than one year. Additionally, under Rev. Rul. 72-85, the fact that Taxpayer's leasehold interest under the rent control laws was for an indefinite period does not preclude section 1231 long-term capital gain treatment.
>
> Under section 1241, amounts received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), are considered as amounts received in exchange for such lease or agreement.
>
> Based on the foregoing, we conclude that the amounts received by Taxpayer are considered amounts received in exchange for Taxpayer's leasehold interest in the

Generally, real property should not be held in the entity that conducts the business. As discussed above, for self-employment tax purposes it should not be owned by a partnership that has business operations. Because appreciated real estate cannot be distributed from a corporation without triggering either premature (in the case of an S corporation) or double (in the case of a C corporation) taxation under Code § 311,[3029] usually real estate should not be held in a corporation (see footnote 302 for some of the issues, including basis step-up issues, involved in whether real estate should be in a corporation).

II.Q.1.c. Personal Goodwill and Covenants Not to Compete

II.Q.1.c.i. Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation

If the business entity does not require its key employees to agree not to compete, the key employees might leave and take their contacts with them. Thus, in such situations the key employees really "own" the business' goodwill. When the business is sold, the buyer would buy goodwill from the person who owns the goodwill, pay key employees not to compete, pay the key employees to work in the business, or a combination of any of these.

When self-created goodwill is sold, generally the seller receives favorable capital gain treatment and the buyer deducts over 15 years the sum of the payments.[3030] (Also

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> Premises. Further, we conclude that Taxpayer realized long-term capital gain on the sale of the leasehold interest. Taxpayer's interest in the Premises is either a capital asset under section 1221 or real property used in the trade or business under section 1231. In either event, gain realized from the sale of the leasehold interest is treated as long-term capital gain. Payments of the legal fees and income taxes are part of the purchase price to the extent that such payments are given in exchange for Taxpayer's leasehold interest and not for Taxpayer abandoning some other legal right or property not related to the transaction in question.

Note, however, that, gain from the sale of a Code § 1231 asset may be different than gain from the sale of a capital asset. If the taxpayer had Code § 1231 losses in a prior year, those losses may have converted the gain to ordinary income. See part II.G.5.a Code § 1231 Property, especially fns. 967-968.

[3029] Code § 311 provides that, when a corporation distributes property, the distribution constitutes a sale or exchange by the corporation. See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Together with the rules governing income taxation of shareholders:

- For an S corporation, generally this means that the shareholders are taxed on the exchange (with favorable capital gain rates often available), receive an increased tax basis in their stock equal to the gain reported, reduce the basis of their stock to the extent of the value of the property that was distributed, and adjust to fair market value the basis of the property that was distributed.
- For a C corporation, generally this means that the corporation pays income tax (with favorable capital gain rates not available) and the shareholders are taxed on the distribution as a dividend, thus generating two layers of tax. However, as with an S corporation, the distributed property's basis is adjusted to fair market value.

[3030] *Horton v. Commissioner*, 13 T.C. 143 (1949) (income from the sale of goodwill is capital gain, whereas income from a noncompete agreement is ordinary income); Code § 197(a), (d)(1)(A) (deduction for amortizing goodwill). Although Reg. § 1.197-2(d)(2) disallows amortization goodwill that is not being amortized and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[3031]) However, ordinary income treatment to apply on the sale to a related party,[3032] which applies whether or not the goodwill was being amortized.[3033] Furthermore, the amortization of goodwill causes it to lose its status as a capital asset, which in some circumstances can cause part or all of the gain on sale to lose capital treatment.[3034]

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deductions for self-created goodwill, it allows amortization when the taxpayer buys the goodwill (including from someone who bought it from the taxpayer). *Fitch v. Commissioner*, T.C. Memo. 2012-358 rebuffed an IRS attack on repurchased goodwill using a very simple contract. But for Code § 197, goodwill is not amortizable. Reg. § 1.167(a)-3(a).

[3031] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 4155. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 4310 in part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.

[3032] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

[3033] See text accompanying fn. 3678.

[3034] Letter Ruling 200243002 ruled that the sale of goodwill that has not been amortized is taxed as a capital gain, but goodwill that is being amortized is not a capital asset and therefore was subject to tax at ordinary income rates. However, amortizable goodwill may be eligible for capital gain treatment as described in part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, especially fn. 962. Because capital gain treatment in that situation arises solely by reason of Code § 1231, any Code § 1231 gain is taxed as ordinary income if and to the extent the taxpayer has unrecaptured Code § 1231 losses. Code § 1231 losses are ordinary losses generated by the sale of Code § 1231 property (property used in a trade or business).
Elaborating on the above, Letter Ruling 200243002 reasoned:

> It is well settled that prior to enactment of § 197, goodwill and going concern value were considered to be intangible and nonamortizable capital assets within the meaning of § 1221, by both the Service and the courts. Rev. Rul. 65-180, 1965-2 C.B. 279; Rev. Rul. 55-79, 1955-1 C.B. 370; *UFE, Inc. v. Commissioner*, 92 T.C. 1314, 1323 (1989) ("[g]oing-concern value is an intangible, nonamortizable capital asset that is often considered to be part of goodwill"); *Patterson v. Commissioner*, 810 F.2d 562, 569 (6th Cir. 1987) (stating that "any amount paid for goodwill, since it does not waste, becomes a nonamortizable capital asset," and "amounts received by a seller for the goodwill or going concern value of the business are taxed at the more favorable capital gains rates"); *Better Beverages, Inc. v. United States*, 619 F.2d 424, 425 n. 2 (5th Cir. 1980) ("goodwill is a capital asset"); *Dixie Finance Co. v. United States*, 474 F.2d 501, 506 n. 5 (5th Cir. 1973) (goodwill is a capital asset and amounts received therefor in excess of the seller's basis are treated as capital gains, but represent a nonamortizable capital investment resulting in no corresponding deduction for the purchaser); *Commissioner v. Killian*, 314 F.2d 852, 855 (5th Cir. 1963) ("[i]t is settled that goodwill, as a distinct property right, is a capital asset under the tax laws "); *Michaels v. Commissioner*, 12 T.C. 17 (1949) ("[w]e entertain no doubt that goodwill and such related items as customers' lists are capital assets").
>
> Prior to enactment of § 197, goodwill and going concern value were not considered property used in the trade or business of a character which is subject to the allowance for depreciation provided in § 167, and thus were not excluded from the definition of capital asset by reason of § 1221(a)(2) of the Code. Under § 197, an amortizable section 197 intangible is treated as property of a character which is subject to the allowance for depreciation under § 167. Thus, goodwill and going concern value which are amortizable section 197 intangibles are not capital assets for purposes of § 1221, but if used in a

Also, the sale and subsequent amortization of goodwill turns it into a "hot" asset, reducing opportunities for deferral on its sale.[3035] Whether or not goodwill is being amortized, a controlled corporation's sale or distribution of goodwill might generate ordinary income,[3036] as would a sale involving a partnership.[3037]

When a covenant not to compete is involved, generally the seller receives ordinary income treatment and the buyer deducts the present value of the payments over 15 years.[3038]

Thus, compensation for current services, which is deductible in full when paid, is much more beneficial to buyers than either of the above alternatives. Taxpayers tend to assign consideration in a sale to whatever produces the fastest deduction – ongoing services, office equipment, etc. Note that assigning a low value to goodwill or a non-

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trade or business and held for more than one year, gain or loss upon their disposition generally qualifies as § 1231 gain or loss. Taxpayer has questioned whether enactment of § 197 has changed the treatment of goodwill and going concern value as capital assets for goodwill and going concern value that do not qualify as amortizable section 197 intangibles.

In this case, Taxpayer represents that at the time of each sale of the c, the Goodwill is either self-created Goodwill of the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) or Goodwill acquired by the selling entity (or a subsidiary of the selling entity acquired by the selling entity in a stock transaction) from third parties prior to August 11, 1993. While it is possible that a selling entity acquired the Goodwill after July 25, 1991, and prior to August 11, 1993, Taxpayer also represents that no retroactive election was made under § 1.197-1T. These representations are material representations. Based solely on Taxpayer's representations with respect to the Goodwill, we conclude that the Goodwill is not an amortizable section 197 intangible, and furthermore is not subject to depreciation under § 167. Thus, the Goodwill is not property that is of a character subject to the allowance for depreciation provided in § 167.

Because we conclude the Goodwill is not an amortizable section 197 intangible and is not property that is of a character subject to the allowance for depreciation provided in § 167, we further conclude that the Goodwill sold by Taxpayer qualifies as a capital asset under § 1221. Although § 197 now provides that goodwill and going concern value that is an amortizable section 197 intangible are not capital assets for purposes of § 1221, it does not address the treatment of goodwill and going concern value that is not an amortizable section 197 intangible, nor does it change prior law treatment of goodwill and going concern value.

[3035] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 4128, referring to part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

[3036] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially fns. 3675-3679.

[3037] See part II.Q.8.c Related Party Sales of Non-Capital Assets By or To Partnerships.

[3038] Code § 197(a), (d)(1)(E), (f)(3) (buyer's deduction); Rev. Rul. 69-643 (seller's income); *Kinney v. Commissioner*, 58 T.C. 1038 (1972). *Recovery Group Inc. v. Commissioner*, T.C. Memo. 2010-76, held that payments under a one-year covenant not to compete agreed to in connection with the redemption of an employee's stock were deductible over 15 years. The IRS and taxpayer contested the meaning of entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof. The court agreed with the IRS that 'thereof' modifies 'trade or business', and that 'interest' means an ownership interest of any percentage, large or small. The court held alternatively that the employee's 23% stock ownership was substantial.

compete agreement can have very practical effect – reducing or eliminating damages[3039] – if the agreement is broken, so the buyer is trading deductions for economic risk.

Even if goodwill is taxed to the seller at capital gain rates, deferred compensation[3040] is more tax-efficient than a payment for goodwill; however, the deferred compensation agreement constitutes a liability on the company's balance sheet that might impair its ability to obtain credit. The benefit of the immediate deduction for compensation for personal services is likely to be of so much benefit to the buyer that the buyer should be willing to pay extra to the seller so that the seller's proceeds after ordinary income tax exceed what the seller would have received for goodwill net of capital gain tax. For example, suppose the seller receives $100 for zero basis goodwill. If the seller's combined federal and state capital gain rate is 20%, the seller receives $80 net of tax. If the buyer pays 40% federal and state tax, the buyer must generate $167 of ordinary income to pay the $100 that it pays the seller. Thus, the buyer needs to earn $167 so that the seller receives $80 net of tax. However, if the buyer and seller both have 40% combined federal and state income taxes, then the seller would need just over $133 in ordinary income to net the same $80 after taxes. Thus, with a compensation payment of $134-$166, both the seller and buyer are better off (ignoring the deduction[3041] the buyer receives for capitalized goodwill in a purchase-of-goodwill scenario). A seller needs "strong proof" that a payment is for goodwill taxable as capital gain rather than a covenant not to compete taxable as ordinary income.[3042]

II.Q.1.c.ii. Consulting Agreement in Lieu of Covenant Not to Compete

Given that payments to the person selling goodwill are presumed ordinary income[3043] and that they are amortizable over 15 years if for goodwill or covenants not to compete,[3044] consider retaining the seller on a consulting agreement. The buyer might very well need the seller's cooperation to transitions employees, customers, and vendors. If the purchase is amicable, hiring the seller to a lucrative consulting contract can provide not only valuable business benefits but also immediate income tax deductions.

Beware, however, that a consulting contract might very well prevent the seller from having a separation from service that might be needed under Code § 409A. Although that provision is generally viewed as applying to deferred compensation, various

[3039] A result reported to have happened in *Healthcase v. Orr*, 2016 Cal. App. Unpub. LEXIS 440 (1/20/2016) per *Business Valuation Update*, vol. 22, no. 4 (4/2016).
[3040] Before working in this area, consider reading part II.Q.1.d Nonqualified Deferred Compensation, especially part II.Q.1.d.i IRS Audit Guide for Nonqualified Deferred Compensation..
[3041] Although the deduction is valuable, the discounted present value is relatively small, considering that discount rates are high when the sale of a closely-held business is involved. For example, if $100 were capitalized and deducted over 15 years with a 40% tax saving, the extra tax benefit would be $2.67 per year, compared with an immediate tax saving of $20 in not having capital gain on the sale of goodwill. At a 20% discount rate, the present value of these deductions would be $12.48; at a 33% discount rate, the present value would be $7.98.
[3042] *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009); *Kinney*, fn. 3038.
[3043] See fn. 3042.
[3044] See part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

payments or noncash benefits triggered by a change in job status might constitute deferred compensation that might require a "separation from service" to avoid imposition of the harsh consequences of Code § 409A.[3045]

II.Q.1.c.iii. Does Goodwill Belong to the Business or to Its Owners or Employees?

For purposes of valuing a business:[3046]

> In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.

"Goodwill is often defined as the expectation of continued patronage by existing customers."[3047] Generally, if a business subjects its owners or employees to a covenant not to compete, the business owns the related goodwill; otherwise, generally the owners or employees own the goodwill.[3048] Personal goodwill reflects the owners' relationships

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[3045] See parts II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules and II.Q.1.d Nonqualified Deferred Compensation.

[3046] Rev. Rul. 59-60, Section 4.02(f).

[3047] *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155, citing *Network Morning Ledger Co. v. United States*, 507 U.S. 546, 572-573 (1993).

[3048] Shin, Lightened Taxpayer Burdens in the Sale of Personal Goodwill After *H&M, Inc. v. Commissioner*, *Tax Lawyer*, Vol. 67, No. 2 (Winter 2014), saved as Thompson Coburn LLP doc. no. 6177834; *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189 (1998); *Norwalk v. Commissioner*, T.C. Memo. 1998-279; *Bross Trucking, Inc.. v. Commissioner*, T.C. Memo. 2014-107 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; owner's sons developed relationships with owner's customers when owner shut down owner's business due to regulatory hassles and sons started new corporation; workforce intangible not deemed transferred when only 50% of the employees of the old corporation worked for the new corporation); *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; customers did business with owner's son because they trusted the son personally; son was qualified to run the business). Conversely, goodwill generated while a covenant not to compete is in place is owned by the business entity, even though it was generated by the professional who was the sole owner of a personal service corporation. *Howard v. U.S.*, 106 A.F.T.R.2d 2010-5533 (E.D. Wash. 2010), *aff'd* 108 AFTR.2d 2011-5993 (9th Cir. 2011); *Kennedy v. Commissioner*, T.C. Memo. 2010-206 (payments were consideration for services rather than goodwill; payments varied based on success of seller's efforts to transition customers to buyer; part of payments were for non-compete; taxpayer failed to prove economics of allocation, the court finding that goodwill was a tax-motivated afterthought that occurred late in the negotiations) (distinguished from *Martin Ice Cream*) (self-employment tax imposed; reliance on tax advisor avoided negligence penalty); *H &*

with customers; to prove that these relationships had value, the purchasing business should hire the sellers and not just sign a covenant not to compete with them.[3049] Sometimes a variety of factors reduce a company's goodwill, and having the next generation start a new company without so much baggage creates a viable company without making a gift of goodwill.[3050]

If the business is inside an entity taxed as a C or an S corporation, paying for the business' going concern value (of which goodwill tends to be a very significant part) results in short-term double or triple taxation.[3051] If the entity has only one owner, one can set the stage for a more tax-advantaged exit strategy by ***not*** subjecting the owner to a covenant not to compete. For a multiple-owner entity, the business reasons might trump the tax issues, so one might more strongly consider migrating to the ideal business structure[3052] so that one can put these protections in place as soon as possible without complicated issues. The problem with migrating from a corporation to a pass-through entity is that the IRS will argue that goodwill is being distributed from the corporation to the owners and then into the new entity, and a distribution from a corporation to its owners is a taxable event.[3053] If the owners of the new entity are different from but are the natural objects of the bounty of the owners of the original entity, the IRS might also argue that the deemed distribution and transfer constitute a gift.[3054]

M, Inc. v. Commissioner, T.C. Memo. 2012-290 (insurance agent's name and talents were more highly valued than his incorporated insurance agency's name, so compensation payments to agent were not disguised payments to his agency followed by dividends to him; characterization as goodwill or compensation was not raised). See Kliegman and Turkenich, Goodwill Games: Determining the Existence And Ownership of Goodwill In a Closely Held Business, *T.M. Memorandum* (BNA) (9/22/2014).

For more details on sending business as a gift, see fn., part III.B.1.a.v Sending Business.

[3049] *Solomon v. Commissioner*, T.C. Memo. 2008-102, held:

> The *Martin Ice Cream* case is distinguishable from this case. First, the record does not persuade us, nor do we find as a fact, that the value of Solomon Colors in the market was attributable to the quality of service and customer relationships developed by Robert Solomon or Richard Solomon. Rather, the record reflects our finding that Solomon Colors, as a business of processing, manufacturing, and sale, rather than one of personal services, did not depend entirely on the goodwill of its employees for its success. See *Schilbach v. Commissioner*, T.C. Memo. 1991-556; *cf. Longo v. Commissioner*, T.C. Memo. 1968-217. Second, unlike the founder of Haagen-Dazs in *Martin Ice Cream*, who signed an agreement with Strassberg in his personal capacity, Robert Solomon and Richard Solomon were not named as the sellers of any asset but were included in the sale in their individual capacities solely to guarantee that they would not compete with Prince. Third, the fact that Prince required noncompete agreements, but not employment or consulting agreements, of Robert Solomon and Richard Solomon makes it unlikely that Prince was purchasing the personal goodwill of these individuals.

[3050] See part II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).

[3051] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

[3052] See parts II.E Recommended Structure for Entities, II.Q.7.h Distributing Assets; Drop-Down into Partnership and II.Q.8.b.iii Partnership Alternative to Seller-Financed Sale of Goodwill.

[3053] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[3054] See part III.B.1.a.v Sending Business. Taxpayers won, but it cost them significant legal fees.

A sole proprietorship or partnership does not face these concerns. A sole proprietorship can convert into a partnership tax free by granting the new owner a profits interest in the partnership.[3055] The partnership can then engage in a redemption that obtains the most income tax-efficient result. Thus, a sole proprietorship or partnership is free to enter into covenants not to compete without complicating income tax exit strategies.

II.Q.1.c.iv. Goodwill Anti-Churning Rules

Generally, an anti-churning rule provides that goodwill and going concern value are not amortizable if:[3056]

1. The intangible was held or used at any time on or after July 25, 1991, and on or before such date of enactment by the taxpayer or a related person,

2. The intangible was acquired from a person who held such intangible at any time on or after July 25, 1991, and on or before such date of enactment, and, as part of the transaction, the user of such intangible does not change, or

3. The taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time on or after July 25, 1991, and on or before such date of enactment.

For purposes of these rules, a person is "related" to any person only if the related person bears a relationship to such person specified in Code § 267(b) or 707(b)(1), or the related person and such person are engaged in trades or businesses under common control.[3057] In applying Code § 267(b) or 707(b)(1) to this test, use 20% instead of 50%.[3058] A person shall be treated as related to another person if such relationship exists immediately before or immediately after the acquisition of the intangible involved.[3059]

However, if the ant-churning rule applies only because the related party's ownership is more than 20% instead of more than 50%, then this rule is subject to an exception.[3060] To qualify for the exception, the person from whom the taxpayer acquired the intangible must elect to recognize gain on the disposition of the intangible and to pay a tax on such gain which, when added to any other income tax on such gain under this title, equals such gain multiplied by the highest income tax rate applicable to such person.[3061] If this exception applies, then the goodwill or concern value is prevented from being amortized

[3055] See part II.M.4.f Issuing a Profits Interest to an Employee. The new owner can also contribute capital to the new business, which generally is tax-free (see part II.M.3 Buying into or Forming a Partnership), but be wary of part II.M.3.e Exception: Disguised Sale.
[3056] Code § 197(f)(9)(A).
[3057] Code § 197(f)(9)(C)(i). The common control test used is that provided in Code § 41(f)(1)(A) and (B).
[3058] Code § 197(f)(9)(C)(i).
[3059] Code § 197(f)(9)(C)(ii).
[3060] Code § 197(f)(9)(B)(i).
[3061] Code § 197(f)(9)(B)(ii).

only to the extent that the taxpayer's adjusted basis in the intangible exceeds the gain recognized.[3062]

Also, the anti-churning rule does not apply to the acquisition of any property by the taxpayer if the basis of the property in the taxpayer's hands is determined under Code § 1014(a) (basis adjustment by reason of death).[3063]

Reorganizing a tiered structure using nontaxable contributions under Code § 721[3064] and nontaxable distributions under Code § 731[3065] may avoid triggering the anti-churning rules.[3066]

With respect to any increase in the basis of partnership property under Code § 732, 734, or 743, determinations under the anti-churning rules are made at the partner level, and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets.[3067]

Code § 197 also does not permit amortization of any intangible acquired in a transaction, one of the principal purposes of which is to avoid the anti-churning rules.[3068]

II.Q.1.d. Nonqualified Deferred Compensation

For draconian measures that can apply to compensation paid in a year different from the year is which it was earned (as well as detrimental balance sheet effects), see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

II.Q.1.d.i. IRS Audit Guide for Nonqualified Deferred Compensation and Other Noncash Compensation (other than fringe benefits)

In "Nonqualified Deferred Compensation Audit Techniques Guide (June 2015)," the IRS explained its view on deferred compensation and similar tools and described audit techniques.[3069]

3062 Code § 197(f)(9)(B).
3063 Code § 197(f)(9)(D).
3064 See part II.M.3 Buying into or Forming a Partnership, especially part II.M.3.a General Rule: No Gain on Contribution to Partnership.
3065 See part II.Q.8.b.i Distribution of Property by a Partnership, especially part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
3066 Letter Ruling 201709003.
3067 Code § 197(f)(9)(E). For details, see Reg. § 1.197-2(h)(12); see also fn. 2766, found in part II.P.1.a.i Allocations of Income in Partnerships. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 4310 in part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.
3068 Code § 197(f)(9)(E). This provision also prevents amortization of any asset acquired in a transaction that was postponed to avoid the requirement that the intangible be acquired after the date of the enactment of Code § 197.
3069 LB&I-04-0615-005, found at http://www.irs.gov/Businesses/Corporations/Nonqualified-Deferred-Compensation-Audit-Techniques-Guide.

II.Q.1.d.ii. Using Nonqualified Deferred Compensation to Facilitate a Sale

II.Q.1.d.ii.(a). Income Tax Issues when Using Nonqualified Deferred Compensation to Facilitate a Sale

A common tactic had been to pay the seller compensation for past services rendered. The theory was that, during its formative years, the business did not have the financial ability to compensate the owner for all that the owner did to develop the business into the successful operation it is today. When the business would be sold, finally the business would have sufficient resources to express its gratitude for the owner's past services. The business might pay the owner all at once; or, it might pay this bonus over time to provide the owner with a nice stream of retirement income. This compensation could be paid by the buyer or the seller. If the buyer makes the payments, it deducts them as it makes them and reduces the purchase price to take into account the present value of the payments. If the seller makes the payments, the seller would want to deduct the payments against the sale proceeds or against the interest or income equity component of any deferred sale proceeds.[3070]

Under 2017 tax reform, the service recipient may have a lower rate as a C corporation or as a pass-though entity than the service provider. See part II.E.1 Comparing Taxes on Annual Operations of C Corporations and Pass-Through Entities. This has always been a problem when the compensation paid exceeds ordinary taxable income, but now it may apply regarding most or all of the deferred compensation payments.

Also, under Code § 409A, one is required to have a written plan in place as soon as a legally binding right to nonqualified deferred compensation exists.[3071] Thus, if at the time of sale compensating the owner for past services is reasonable and necessary,[3072] and the entity can show that a legally binding right to compensation for past services did not exist until that time, then the strategy described in the preceding paragraph may be

[3070] The seller would not want to liquidate the entity that owned the business until after these payments are made. Otherwise, the payments would constitute an additional capital loss or reduction of capital gain rather than a deduction against ordinary income. *Arrowsmith, Exec. v. Commissioner*, 344 U.S. 6 (1952).

[3071] A plan is any arrangement or agreement providing for a deferral of compensation. Code § 409A(d)(1), (3). If the payment is reasonable because it relates to past services, then it constitutes deferred compensation, and its material terms must be documented in writing to satisfy Code § 409A. Reg. § 1.409A-1(c)(3)(i). The written plan must be in place when the service provider obtains a legally binding right to the compensations. Reg. § 1.409A-1(a)(1). One might argue that compensation was earned in a prior year, but there was no legally binding right to payments based on that service, and now it is necessary and reasonable to pay for those past services to retain the employee. *Aries Communications Inc. v. Commissioner*, T.C. Memo. 2013-97 (comparing actual amounts paid in prior years against what was shown to have been higher reasonable compensation for those years), following the factors in *Elliotts* in fn. 28 as well the independent investor test of *Metro Leasing & Dev. Corp. v. Commissioner*, 376 F.3d 1015, 1019 (9th Cir. 2004), *aff'g* 119 T.C. 8 (2002). Although the author would make such an argument regarding past services on audit, the author would prefer to have more certainty when planning in light of Code § 409A's expansive reach. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[3072] See part II.A.1.b.i Compensating Individuals, especially fn. 28.

used. Absent a prior written plan, however, convincing a court that the owner was undercompensated might be very difficult.[3073]

A more conservative approach would be to have a plan in place when the business is doing well but is not yet sold, which plan vests over time. That strategy is described later.[3074] Alternatively, consider paying an immediate lump sum if a plan is not already in place and the payor has enough income to absorb the deduction.[3075] An immediate lump sum payment often is very unattractive to the buyer (who has cash flow issues and might not need that much deduction in a single year) or seller (who might rather receive payments over time to avoid accelerating income tax if adequate safeguards are in place to protect the payment).

Deferred compensation in an S corporation will not raise second-class of stock issues unless a principal purpose of the agreement is to circumvent the single class of stock rules.[3076]

II.Q.1.d.ii.(b). Balance Sheet Effects of Deferred Compensation

Before establishing a deferred compensation agreement, ask the company's outside CPA to determine what the balance sheet effect is going to be.

Then have the client take that information to the company's lenders to discuss the impact on balance sheet loan covenants. Same with any companies that provide construction bonds, etc., if the company is in such a line of business.

[3073] *PK Ventures, Inc. v. Commissioner*, T.C. Memo. 2006-36, *aff'd sub nom. Rose v. Commissioner*, 101 A.F.T.R.2d 2008-1888 (11th Cir. 2008), disallowed deductions for such deferred compensation beyond what the IRS conceded. *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*, T.C. Memo. 2013-10, found credible testimony that compensation was intended as catchup compensation – payment of back salaries that were not paid in prior years due to insufficient cash flow. However, the court applied the independent investor test (see fn. 28) to determine that the catch-up compensation was unreasonably high.

[3074] See part III.B.7.c.vi Deferred Compensation.

[3075] A special exception to Code § 409A applies to payments that occur immediately after the payment becomes vested if the taxpayer can prove that the payment was contingent on continuing to provide services from the date the service had been performed until the date that occurred during the current year. Reg. § 1.409A-1(b)(4)(i). The preamble to the final regulations, T.D. 9321, rejected cross-referencing existing rules:

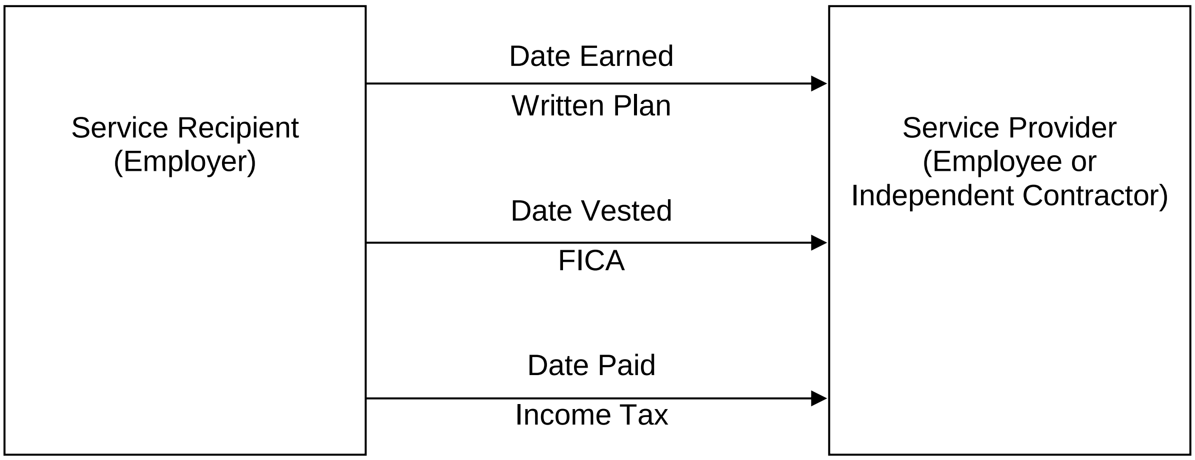
> The final regulations generally adopt the definition of substantial risk of forfeiture set forth in the proposed regulations. Several commentators requested that the definition of substantial risk of forfeiture be the same as the definition of substantial risk of forfeiture in § 1.83-3(c). However, the definition of substantial risk of forfeiture for purposes of compensatory transfers of property under section 83 reflects different policy concerns from those involved in section 409A, and there are also practical differences between transfers of restricted property and promises to pay deferred compensation. This is reflected in the provisions of section 409A(e)(5), directing the Secretary of the Treasury Department to issue regulations disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of section 409A. Accordingly, the final regulations do not adopt this suggestion.

[3076] See part II.A.2.j.iv Providing Equity-Type Incentives without Violating the Single Class of Stock Rules, especially fns. 221-222.

I have seen the balance sheet liability cause deferred compensation agreements to be killed.

II.Q.1.d.iii. Timeline for FICA and Income Taxation of Deferred Compensation

Here is a timeline for FICA and income taxation of deferred compensation when the service recipient is not a tax-exempt entity:



Date Earned. Need to have written plan in place before service provider obtains legally enforceable rights – either required or best practice to be in place before performing service.

Date Vested. "Vested" corresponds to no further obligation to perform services. FICA will be due on present value[3077] and will not be due when the benefits are paid.[3078] This vesting is often beneficial when employee's compensation, for the year in vesting occurs, exceeds the taxable wage base ($128,400 in 2019) because it is taxed at 2.9% (1.45% x 2) or 3.8% (for compensation in excess of $200,000 for a single person or $250,000 for a married person filing jointly) instead of 15.3% (7.65% x 2).[3079] The employer and employee can negotiate whether the employer should pay the employee

[3077] Reg. § 31.3121(v)(2)-1(c)(2).

[3078] Code § 3121(v)(2)(B). Reg. § 31.3121(v)(2)-1(d)(2) provides how much income on this initially taxed is also excluded from FICA wages when paid.

[3079] FICA tax (for employer and employee combined, or for self-employment tax purposes) is 15.3% on annual income up to the taxable wage base (TWB) and 2.9% on all annual income above the TWB until $200,000 (single) or $250,000 (married), above which it is 3.8%. FICA consists of Old-Age, Survivors, and Disability Insurance benefits (OASDI) and Medicare's Hospital Insurance program (HI). The OASDI tax is 6.2% for employer and 6.2% for employee, for a total of 12.4%, imposed only up to the TWB. The HI tax is 1.45% for employer and 1.45% for employee, imposed on all FICA wages. See http://www.ssa.gov/OACT/COLA/cbb.html for the past and current TWB; see also part II.L.2.a.i General Rules for Income Subject to Self-Employment Tax. Most of the FICA tax on the present value will be at the lower 2.9% or 3.8% rate. When payments are made in future years, they will not be subject to FICA tax. This could save around $15,959 of FICA tax each year ($128,700 TWB for 2018, multiplied by the 12.4% spread between 15.3% and 2.9%; if wages were taxed at 3.8% the savings would be $14,801). The savings is slightly less than indicated, because it does not consider that the employer receives a deduction for the employer's one-half portion of FICA.

an additional bonus to cover the additional FICA withholding in the year of vesting. On one hand, the employee might not have the cash flow to pay the FICA, since the employee has not been paid this deferred amount. On the other hand, the employee's share of FICA is properly taxed to the employee, and it is taxed at a lower rate than it would be if the plan had not been in effect, so it's only fair for the employee to pay this additional FICA. Note, however, that the FICA deferred compensation regulations do not provide a discount for the credit risk (that the employer might not be able to pay) that the employee assumes,[3080] and the employee cannot get the FICA back if the employer defaults.[3081]

Date Paid. Income tax is due when paid or constructively received, but FICA is not due since that was already paid.[3082] Code § 409A places strict limits on events that accelerate payment and events that delay payment.

[3080] Reg. § 31.3121(v)(2)-1(c)(2)(ii) provides:

> For purposes of this section, the present value must be determined as of the date the amount deferred is required to be taken into account as wages under paragraph (e) of this section using actuarial assumptions and methods that are reasonable as of that date. For this purpose, a discount for the probability that an employee will die before commencement of benefit payments is permitted, but only to the extent that benefits will be forfeited upon death. In addition, the present value cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. Nor is the present value affected by the possibility that some of the payments due under the plan will be eligible for one of the exclusions from wages in section 3121(a).

[3081] *Balestra v. U.S.*, 803 F.3d 1363 (Ct. Fed. Cl. 2014), holding:

> Sections 3101(b) and 3121(v)(2) required these benefits to be calculated and taxed when he retired, but do not require the use of a risk-adjusted discount rate nor a refund corresponding to the benefits plaintiff never received.

The Federal Circuit, at 803 F.3d 1363 (2015), affirmed the Court of Claims, validating Reg. § 31.3121(v)(2)-(1)(c)(2)(ii):

> Treasury's path to calculating the amount deferred in terms of the compensation's present value without consideration of an employer's financial condition is reasonably discernable. Treasury explained that it sought simple, workable, and flexible rules when valuing future benefits. It devised a regulation that satisfied these goals while comporting with the governing statute. This is neither arbitrary nor capricious. It may seem unfair in a specific instance such as this, but in balancing the desire for simplicity against the ideal of ultimate comprehensiveness, the agency must be allowed a reasonable degree of discretion. We cannot say that this one example of consequent unfairness by the agency results in invalidating the rule-making.

[3082] However, if an amount deferred is required to be taken into account in a particular year, but the employer fails to pay the additional FICA tax resulting from that amount, then the amount deferred and the income attributable to that amount must be included as wages when actually or constructively paid. Reg. § 31.3121(v)(2)-1(d)(1)(ii)(A). An employer that fails to withhold upfront and then causes the employees to pay more FICA when they retire is liable to the employees. *Davidson v. Henkel Corporation*, 115 A.F.T.R.2d ¶ 2015-321 (D. Mich. 2015). AM 2017-001 clamps down to an extent when employers do not follow the rules:

> As noted above, § 31.3121(v)(2)-1(d)(1)(ii) describes the steps to be taken if an employer fails to use the special timing rule as required for part or all of the amounts an employee

One might also consider whether FICA tax rates might increase in the future as Social Security and Medicare payments for the Baby Boomers increase. Vesting no later than December 31, 2012 should be considered to avoid the additional 0.9% tax on wages in excess of $250,000 (joint return) or $200,000 (single returns) that was added by the 2010 health care act.[3083]

Furthermore, the state in which the service provider worked may not subject the deferred compensation to tax except to the extent paid to the service provider while he or she is a resident of that state.[3084]

Because various tax-exempt entities have no incentive to accelerate income, the present value of the future payments is taxed when vested instead of when paid.[3085] Such an employer includes a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a governmental unit) exempt from income tax.[3086] When the employee receives the deferred payments, the payments are exempt from FICA (as described above)[3087] but, to the extent of the interest component arising from the present value

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defers under a NQDC plan. If an employer fails to pay FICA tax on amounts deferred as required under § 3121(v)(2), the employer is required to adjust its employment tax returns for any years for which the period of limitations has not expired to report and pay the additional FICA tax attributable to the amounts deferred and required to be included under the special timing rule. See § 6205 and § 31.6205-1(a) and (b) of the regulations with regard to making interest-free adjustments of underpayments. If the employer does so, the nonduplication rule will apply to the payment of the deferred compensation. However, the general timing rule will apply to any amounts deferred and income attributable to those amounts deferred for closed years that cannot be adjusted.

Upon discovery that they have not correctly applied the special timing rule under § 3121(v) to pay FICA tax when required under the regulations, some employers have requested a closing agreement to permit them to pay FICA tax in a subsequent year that is prior to the year of payment in order to reduce the amount of total FICA taxes that would otherwise be due under the general timing rule if FICA tax was applied at the time of payment of the wages. The employer may also want to avoid application of the allocation rule in § 31.3121(v)(2)-1(d)(1)(ii)(B) that imposes FICA tax on a portion of each payment if the employer took some portion (but not all) of the NQDC into account for FICA tax under the special timing rule.

Because the applicable regulations provide the mechanism for the payment of FICA taxes in the case of NQDC which is not timely taken into account under the special timing rule in § 31.3121(v)(2)-1(a)(2), as a policy matter, a closing agreement should not be entered into if it that has the effect of avoiding application of this regulatory mechanism. The existence of the special transition rule in the regulations for years for which the period of limitations had expired at the time the regulations were finalized reinforces the importance of adhering to the rules contained in § 31.3121(v)(2)-1(d)(1)(ii) for determining the FICA tax due upon payment of amounts that were deferred in prior years and that should have been taken into account under § 3121(v)(2) in such prior years but for which the period of limitations has since expired.

[3083] Code § 3101(b)(2).

[3084] See part II.Q.8.b.ii.(g) Code § 736 Payments As Retirement Income – Possible FICA and State Income Tax Benefits, fns. 4032-4035.

[3085] Code § 457(f)(1)(A), which applies to payments made by an eligible employer.

[3086] Code § 457(e)(1).

[3087] See fn. 3078.

calculation, would be subject to income tax.[3088] If deferring payments is important to the employer, then the employer should consider paying up-front enough to pay for the employee's up-front taxes and deferring most or all of the rest. Note that the arrangement saves FICA relative to what otherwise might have been the parties' expectations,[3089] so they might want to consider that savings when negotiating the deferred compensation arrangement.

II.Q.2. Consequences of IRS Audit Exposure for Prior Years' Activities

Consider the impact of part II.G.18 IRS Audits and whether the buyers might want a price adjustment if such audits occur:

- C Corporation. An audit changing a prior year's tax position results in the new shareholders paying the tax.

- S Corporation. An audit changing a prior year's tax position results in the former shareholders paying the tax, except to the extent that the change relates to C corporation years,[3090] built-in gain tax,[3091] tax on excess net passive income,[3092] or any other taxes or penalties (for example, payroll taxes) imposed on the entity itself.

- Partnership. Depending on the situation, tax imposed by reason an audit changing a prior year's tax position might be paid by the partnership or by the former partners. Of course, taxes or penalties (for example, payroll taxes) other than income tax might be imposed on the entity itself.

II.Q.3. Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future

If one expects to sell a business interest for all cash in a few years and would like to defer capital gain on the sale of a business interest, consider selling the business interest in an installment sale to a nongrantor trust. The note might be interest-only for a few years, with principal payments beginning some time after the business interest is expected to be sold. The trust receives basis for the full amount of the promissory note and can sell the business interest tax-free to the extent of that basis.

Similar principles apply to the sale of land or other property that is not depreciable or amortizable.

[3088] Code § 457(f)(1)(B).

[3089] See discussion accompanying fns. 3077-3081.

[3090] Changes to C corporation years might result not only in more tax but also more earnings & profits (E&P); for the latter, see part II.Q.7.b Redemptions or Distributions Involving S Corporations (effect of E&P on taxation of distributions).

[3091] See part II.P.3.c.ii Built-in Gain Tax on Former C Corporations under Code § 1374.

[3092] See part II.P.3.c.iii Excess Passive Investment Income.

Potential pitfalls include the following:

- If the trust is a related person (which usually is the case) and it re-sells the business interest within two years, the original seller's deferred gain is accelerated.[3093]

- The original seller's death will not generate a basis step-up in the note.[3094] If the original seller had simply held the business interest until death, part or all of the gain would be eliminated by basis step-up. Consider buying term insurance against the risk of loss of the financial benefit of the basis step-up.

- Be sensitive to possible acceleration of the deferred gain if the original seller later transfers the installment note, including by gift (or transfer to or from a nongrantor trust),[3095] or pledges the note.[3096]

- Beware of the possible need to pay interest on the deferred tax liability if the sale exceeds $5 million.[3097]

- The part of the gain on the sale of a partnership interest attributable to "hot assets" is not eligible for installment sale treatment.[3098]

- The direct or indirect sale of depreciable or amortizable assets to a related party (the nongrantor trust) might trigger ordinary income tax.[3099]

Dealers cannot use the installment method with respect to:[3100]

> (A) *Personal property*. Any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on the installment plan.
>
> (B) *Real property*. Any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

When entities disposed of real properties that were held for sale to customers in the ordinary course of their trades or businesses, they were not permitted to use the

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3093 Code § 453(e).
3094 Code § 1014(c).
3095 See part II.G.14 Limitations on the Use of Installment Sales for that or other accelerating events.
3096 Code § 453A(d).
3097 Code § 453A(c)(4).
3098 See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests.
3099 See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
3100 Code § 453(b)(2)(A). The quoted language is from Code § 453(*l*)(1) and is subject to exceptions in Code § 453(*l*)(2).

installment method to account for their sales of real properties made by contract for deed.[3101]

See also part II.G.25 Real Estate Dealer vs. Investor.

II.Q.4. Consequences of a Buy-Sell Agreements Not Dependent on Choice of Entity

II.Q.4.a. Funding the Buy-Sell

Insurance is by far the most common method by which a buy-sell agreement is funded, whichever form of agreement is used. Special rules apply if the beneficiary is two generations (or the equivalent) younger than the insured.[3102] If a business owner has a parent with an estate tax problem, that parent's estate tax problem might lend itself to a special opportunity to pay for the policies that fund the buy-sell.[3103]

Not enough attention is focused on disability insurance, which can protect the business' cash flow due to the interruption caused and might also help fund buyouts. To the extent disability is to benefit the disabled person, one should avoid the draconian Code § 409A rules,[3104] which have a stringent disability provision,[3105] and instead pay the key employee compensation sufficient for that person to buy his or her own disability policy.

Having life insurance proceeds paid directly to the selling shareholder does not make the sale tax-free; rather, the payment is treated just as would be any other payment to a seller[3106] (which might be tax-free if the seller has sufficient basis, for example because of a basis step-up in the business interest).

Funding with life insurance under a cross-purchase plan will require that each shareholder own a life insurance policy on the life of every other shareholder. If there are more than three owners, however, policy ownership can become complicated and a stock redemption agreement may make better sense. One alternative to a stock redemption agreement may be a trusteed agreement whereby the trustee would act as custodian of the policies and purchase one life insurance policy for each shareholder. This avoids the need for multiple policies when there are more than two shareholders. If a stock redemption arrangement is employed, the corporation purchases a life insurance policy on each shareholder. Upon the shareholder's death, the beneficiary then uses the

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[3101] See *SI Boo, LLC v. Commissioner*, T.C. Memo. 2015-19; see fn. 2388 and the accompanying text for this case's facts and analysis.

[3102] If the policy proceeds are $250,000 or more, the life insurance company will need to verify with the beneficiary that the beneficiary is not a skip person receiving a payment subject to generation-skipping transfer (GST) tax; otherwise the insurance company might need to file relevant forms reporting and paying GST tax. See the Examples under Reg. § 26.2662-1(c)(2)(vi).

[3103] This tool, generational split-dollar, is described as it was approved in fns. 3214-3216 in part II.Q.4.f.ii.(b) Treatment of Split-Dollar Arrangement under Reg. § 1.61-22.

[3104] See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

[3105] See part III.B.7.c.vi Deferred Compensation, especially fn. 5618.

[3106] For an analogous situation, see Rev. Rul. 70-254, which is based on *Landfield Finance Company v. U.S.*, 418 F. 2d 172 (7th Cir. 1969), which in turn is based on Reg. § 1.101-1(b)(4).

proceeds to purchase the decedent's shares. Similarly, as described in a Letter Ruling, the shareholders could form a limited liability company to own life insurance on each other, with the manager of the LLC retaining the proceeds until the parties agree on proper application of the proceeds.[3107] Also note that split-dollar life insurance arrangements[3108] are subject to Code § 409A rules restricting the events upon which deferred compensation can be paid, the violation of which trigger significant tax, penalties, and interest.[3109] When drafting a shareholder agreement using life insurance, consider authorizing transfers of the policy to the insured for fair market value to avoid Code § 409A risks; defining the value as cash surrender value might not be sufficient, particularly because features, such as no-lapse guarantees (which is the equivalent of prepaid insurance that is not revealed on annual insurance policy statements), provide additional value that is tracked through the life insurance company's internal "shadow account" that can provide surprising results when the insurance company issues IRS Form 712.[3110] Also, make sure that any rights an insured might have to purchase a policy others hold on his life arise only as a collateral consequence of acts or events of independent significance,[3111] so that they do not constitute an incident of ownership.[3112]

[3107] See part II.Q.4.i Life Insurance LLC.

[3108] Split-dollar is a cash value life insurance financing arrangement described in Reg. §§ 1.61-22 and 1.7872-15, with cross-references found in Reg. §§ 1.83-6(a)(5) (income tax treatment on rollout of employee split-dollar), 1.301-1(q) (shareholder arrangements), and 1.1402(a)-18 (self-employment tax issues). See part II.Q.4.f Split-Dollar Arrangements.

[3109] Notice 2007-34 sets forth transition rules. See part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules, for a discussion of Code § 409A, including the permissible triggering events. Events that terminate pre-2005 split-dollar agreements often do not comply with these permissible triggering events, so a review of pre-2005 split-dollar agreements is a good idea. See Zaritsky, Aghdami & Mancini, ¶8.02. Life Insurance Funding, *Structuring Buy-Sell Agreements: Analysis With Forms*.

[3110] For income tax valuation of policies, see fn. 3122. In the case of a split-dollar arrangement entered into on or before September 17, 2003, and which is not materially modified after that date, only the cash surrender value of the contract is considered to be property. Reg. § 1.83-3(e). Reg. §§ 20.2031-8 and 25.2512-6 determine the value for estate and gift tax purposes - based primarily on interpolated terminal reserve as a measure of the replacement value; see fn. 3123 for more information on this authority.

[3111] See part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

[3112] Letter Ruling 8049002 held that no incidents of ownership existed when a shareholder agreement gave the decedent the option to purchase policies at a price equal to the transfer value (cash surrender value), which option was exercisable only if decedent terminated his shareholder relationship with the corporation by offering all stock to the corporation and/or the other principal. This first-refusal option would become operative when a shareholder receives a bona fide offer, a shareholder terminates employment, or a shareholder becomes totally and permanently incapacitated. At date of death, although the option was still outstanding, the decedent had not terminated his shareholder relationship or acted in any way to exercise his option with respect to the insurance policies. The ruling was based on Rev. Ruls. 72-307, 75-50, and 79-46, from which the IRS gleaned an absence of incidents of ownership because the decedent could not independently initiate the events which would enable him to gain control over the policies (except, perhaps, by terminating employment, and, even then, he would not control the corporation's decision to repurchase). Thus, he lacked not only the practical ability to exercise any power with respect to these policies but also any power over the policies. Letter Ruling 9233006 also found no incidents of ownership when shareholders could buy policies on their respective lives and, thus, prevent cancellation of these policies only if the corporation redeems their stock interests in the event that the insured is disabled for a prescribed period of

If a shareholder is uninsurable, a sinking fund may be used to accumulate funds for premium payments or at least to provide a down payment. The remainder of the purchase price can be subject to an installment agreement whereby the payments can be spread out over a long time period.

In a redemption agreement, the value of the insurance on the decedent's life will not be includable in the decedent's gross estate for federal estate tax purposes if the corporation is the owner and beneficiary of the policy,[3113] and the insurance proceeds received by the corporation will not be subject to income tax.[3114] Unless a valid agreement that satisfies Code § 2703[3115] provides otherwise, the insurance proceeds will, however, be considered in valuing the decedent's interest in the business,[3116] but perhaps offset by the buy-sell obligation.[3117] Insurance premiums used to fund the agreement are not deductible by the corporation.[3118]

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time, the insured declines to participate in the sale of the corporation to a third party, or the insured declines to participate in a public offering of the corporation's stock. Thus, the right to acquire the insurance policies and thus, prevent cancellation would arise as a collateral consequence of acts or events of independent significance. That ruling also cited Rev. Ruls. 84-130 and 80-255. *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976), held that the ability to cancel a death benefit by divorcing one's spouse does not generate Code § 2038(a)(1) inclusion.

[3113] Rev. Rul. 82-85, relying on Reg. § 20.2042-1(c)(6). If the decedent controls the entity that owns the policy and the insurance proceeds are not payable to the corporation or otherwise used for a valid business purpose (such as in satisfaction of a business debt of the corporation) so that the net worth of the corporation is increased by the amount of such proceeds, then the proceeds are includible in the decedent's estate. Reg. § 20.2042-1(c)(6). For purposes of determining whether a decedent controlled stock, the decedent will not be attributed ownership of a trust that the decedent did not create with respect to which the decedent was not the deemed owner under the grantor trust income tax rules. Letter Rulings 9808024 (decedent not deemed owner of trust and therefore not attributed stock ownership), 9511046 (decedent attributed stock ownership as deemed owner of QSST). Also, Code § 2035 causes inclusion if the life insurance proceeds are payable to a third party for other than a Reg. § 20.2042-1(c)(6) business purpose and: (a) the corporation, for less than adequate and full consideration, assigns an insurance policy on the stockholder's life and the stockholder then disposes of control of the corporation, or (b) within three years of death the stockholder had a controlling interest in a corporation that owns a life insurance policy on the stockholder's life. Rev. Rul. 90-21. Situation (2) of Rev. Rul. 90-21 reasoned that a shareholder who holds a non-controlling interest would not hold incidents of ownership; however, the facts did not indicate whether the shareholder had any authority to exercise any control over the policy.

[3114] Code § 101(a)(1). However, the death benefit might trigger significant alternative minimum tax (AMT), because book-tax differences generate an AMT preference. See part II.Q.7.a.v Redemptions and Alternative Minimum Tax.

[3115] See part II.Q.4.h Establishing Estate Tax Values.

[3116] Reg. § 20.2031-2(f); *Newell v. Commissioner*, 66 F.2d 102 (7th Cir. 1933).

[3117] In the *Blount* case, cited in footnote 3253, the Tax Court included the life insurance in the business' value, but the 11th Circuit reversed, holding that the buy-sell obligation offset the inclusion in the company's value.

[3118] Code § 264(a)(1). Interest on premiums to buy life insurance is disallowed under Code § 264(a)(4), but it reduces earnings and profits if the payor is a C corporation. Rev. Rul. 2009-25.

A cross-purchase generally would constitute a taxable sale, treated as a capital gain.[3119] In many cases, a cross-purchase or a redemption that is paid over time can qualify for tax deferral as an installment sale.[3120] However, tax deferral on installment sales can be limited,[3121] so do not assume that it is available without our first having the rules thoroughly researched.

In a cross-purchase arrangement, the value of life insurance owned on the decedent's life by a surviving shareholder will not be included in the decedent's estate for federal estate tax purposes, but the decedent's gross estate will include the value of life insurance the decedent owned on the lives of the surviving shareholders. Premiums paid by the shareholders to fund the agreement are not deductible by the shareholders, and the insurance proceeds paid to the surviving shareholders will not be subject to income tax. Generally, a transferred policy would be valued for income tax purposes at its fair market value, rather than its Form 712 value.[3122] For estate and gift tax purposes, the IRS Form 712 value is usually, but not always, appropriate.[3123]

[3119] However, in a partnership, part of the sale might constitute ordinary income under Code § 751. See part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.

[3120] Code § 453.

[3121] Code § 453A.

[3122] *Matthies v. Commissioner*, 134 T.C. 141 (2010 regarding tax years 2000 and 2001), rejected the taxpayer's attempt to used interpolated terminal reserve for income tax purposes, although the rejection appears to have responded to the taxpayer's failure to prove value when engaging in what many people call a pension rescue plan that the court considered to be a scheme. The case also held that, if and to the extent that cash surrender value is used, the value does not consider charges imposed on a surrender of the policy. Rev. Proc. 2005-25 applies generally in the context of valuing compensation under Code §§ 79, 83 and 402. Except for split-dollar arrangements and except for employee trusts and annuity plans subject to Code §§ 402(b) and 403(c), Reg. § 1.83-3(e) provides:

> In the case of a transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, or any undivided interest therein, the policy cash value and all other rights under such contract (including any supplemental agreements thereto and whether or not guaranteed), other than current life insurance protection, are treated as property for purposes of this section.

For qualified retirement plan purposes, see Reg. § 1.402(a)-1(a)(2), the preamble to which is T.D. 9223, which does a good job of explaining how that rule changed. Reg. § 1.402(a)-1(a)(2) requires that surrender charges be ignored in calculating the amount of a distribution from a qualified retirement plan. However, for a nonexempt employee trust (a trust established to fund payments of compensation to be made in the future), surrender charges are considered. *Schwab v. Commissioner*, 136 T.C. 120 (2011) (when surrender charges exceeded cash value, policies valued based on prepaid death benefit when no other evidence of value was introduced), *aff'd* 715 F.3d 1169 (9th Cir. 2013), and *Lowe v. Commissioner*, T.C. Memo. 2011-106. *Lowe* summarized the holding of the Schwab Tax Court opinion, contrasting the qualified retirement plan concept of entire cash value against the nonexempt employee trust concept of entire value:

> We concluded that while the entire cash value of a life insurance policy is determined without regard to surrender charges, the entire value of a life insurance policy is determined by its fair market value, which may include surrender charges. We thus rejected the simple proposition that surrender charges should never count or that they should always count, instead reading section 402(b) to require a court to consider the payment of surrender charges as part of a more general inquiry into the policy's fair market value.

Lowe pointed out that the Tax Court denied the IRS' motion for reconsideration of *Schwab*. In denying the IRS' motion for summary judgment, the *Lowe* court held:

> The facts of the instant case are virtually identical to those presented in *Schwab*. The policies were variable universal life insurance policies with steep premiums, and both were distributed from nonexempt employee trusts in late 2003. Both policies carried surrender charges that rendered the accumulated value of the policy zero or less than zero. In Schwab we decided that the fair market values of the policies the taxpayers received were less than their accumulated values. Here, we are unable to determine the fair market value of Mr. Lowe's policy because the record does not allow us to do so.

Thus, the Tax Court appears to heavily weigh surrender charges in determining the value of a policy for income tax purposes, if a specific rule does not apply to override that. Specific rules to the contrary include qualified retirement plans (discussed above) and split-dollar arrangements (Reg. § 1.61-22(d)(4)(i)). Reg. § 1.83-3(e) provides further:

> However, in the case of the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, which was part of a split-dollar arrangement (as defined in § 1.61-22(b)) entered into (as defined in § 1.61-22(j)) on or before September 17, 2003, and which is not materially modified (as defined in § 1.61-22(j)(2)) after September 17, 2003, only the cash surrender value of the contract is considered to be property. Where rights in a contract providing life insurance protection are substantially nonvested, see § 1.83-1(a)(2) for rules relating to taxation of the cost of life insurance protection.

[3123] Reg. § 25.2512-6(a) provides:

> The value of a life insurance contract or of a contract for the payment of an annuity issued by a company regularly engaged in the selling of contracts of that character is established through the sale of the particular contract by the company, or through the sale by the company of comparable contracts. As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when the gift is of a contract which has been in force for some time and on which further premium payments are to be made, the value may be approximated by adding to the interpolated terminal reserve at the date of the gift the proportionate part of the gross premium last paid before the date of the gift which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such approximation is not reasonably close to the full value, this method may not be used.

Reg. § 20.2031-8(a)(1), (2) provide:

> (1) The value of a contract for the payment of an annuity, or an insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of contracts of that character is established through the sale by that company of comparable contracts. An annuity payable under a combination annuity contract and life insurance policy on the decedent's life (e.g., a retirement income policy with death benefit) under which there was no insurance element at the time of the decedent's death (see paragraph (d) of § 20.2039-1) is treated like a contract for the payment of an annuity for purposes of this section.
>
> (2) As valuation of an insurance policy through sale of comparable contracts is not readily ascertainable when, at the date of the decedent's death, the contract has been in force for some time and further premium payments are to be made, the value may be approximate by adding to the interpolated terminal reserve at the date of the decedent's death the proportionate part of the gross premium last paid before the date of the decedent's death which covers the period extending beyond that date. If, however, because of the unusual nature of the contract such an approximation is not reasonably close to the full value of the contract, this method may not be used.

Rev. Rul. 78-137 held:

> In general, the replacement cost of a single premium policy will determine the value of the policy for gift tax purposes. *United States v. Ryerson*, 312 U.S. 260 (1941), Ct. D. 1488, 1941-1 C.B. 447. The replacement cost is based upon the single premium cost of a

In a cross purchase funded by life insurance, consider not only the transfer for value but also income tax rules when an owner enters or exits the ownership group. How will policies on the existing owners be transferred to the new owner? How will policies that a departing owner owns be transferred when that person leaves, and how will policies on that person's life be transferred from the other owners? Consider not only income tax but also Code § 409A nonqualified deferred compensation issues. One might use a Life Insurance LLC to minimize these potentially adverse tax consequences – particularly when new insurance can be obtained.[3124]

Using split-dollar arrangements[3125] to fund a cross-purchase might also help when unwinding the arrangement. The insured pays the premiums and is deemed the policy owner under the split-dollar regulations,[3126] but the other business owners are entitled to the term insurance component of the death benefit and hold title and all other incidents of ownership with respect to the policy.[3127] If the insured leaves the business, the policy is transferred to the insured (or, preferably, an irrevocable grantor trust established by the insured); the transfer of the policy to the insured is not deemed a transfer for income tax purposes because the insured was already deemed to be the owner.

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comparable policy. *Candler v. Allen*, 43 F.Supp. 435 (M.D. Ga. 1942). Generally, the estate tax and gift tax provisions are in *pari materia*. *Sanford Estate v. Commissioner*, 308 U.S. 39 (1939), Ct. D. 426, 1939-2 C.B. 340.

In order for an insurance policy to qualify as a comparable contract within the meaning of section 20.2031-8(a), the policy must provide the same economic benefits as the policy owned by the decedent. *Candler v. Allen*, above at 437. The economic benefits of a single premium life insurance policy consist of an entire bundle of rights including the right to surrender the policy, the right to retain it for investment virtues, the right to borrow the cash surrender value of the policy and the right to payment of the face amount on the death of the insured. *Guggenheim v. Rasquin*, 312 U.S. 254 (1941), Ct. D. 1487, 1941-1 C.B. 445; *Candler v. Allen*, above at 437. All of the economic benefits of the decedent's policy must be taken into consideration. To single out one economic benefit of the decedent's policy and to disregard the others is, in effect, to substitute a different property interest for the one that was owned by the decedent. *Cf. Guggenheim v. Rasquin*, above at 257.

Since the cash surrender value of the replacement policy is less than the cash surrender value of the decedent's policy, the replacement policy does not reflect all of the economic benefits of the policy owned by the decedent. Therefore, the replacement policy is not a comparable contract within the meaning of section 20.2031-8(a) of the regulations. Accordingly, in the present case, the value of the policy owned by A on the life of A's child shall be determined, for Federal estate tax purposes, by reference to a comparable contract that reflects all of the economic benefits of the decedent's policy. If, however, information pertaining to a comparable contract is not obtainable, the value of the policy shall be determined by reference to the interpolated terminal reserve value of the policy pursuant to section 20.2031-8(a)(2) of the regulations, quoted above.

¶ 3.02[2][a][iii] of Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L), provides an interesting discussion. Also see Anoia, Mendelsohn, and Slane, Complexities of Life Insurance Policy Valuation, *Estate Planning Journal* (June 2014), especially for some insightful analysis of valuing no-lapse guarantee policies.

[3124] See part II.Q.4.i, Life Insurance LLC.

[3125] See part II.Q.4.f Split-Dollar Arrangements.

[3126] Reg. § 1.61-22(c).

[3127] To avoid estate tax inclusion under Code § 2042.

II.Q.4.b. Transfer for Value Rules; Basis

If life insurance policies can be transferred among the shareholders or from the corporation to the shareholders, the transfer for value rules must be examined. The transfer-for-value rules state that if consideration is given for the transfer of an insurance policy, then the proceeds of the policy will be taxed as income to the owner-beneficiary upon the insured's death.[3128] The IRS has taken the position that, when an insured transfers a policy on his life to his business co-owner, and his co-owner does the same, the transfer for value rules apply, and the death proceeds will be exempt only to the extent of the new premiums paid after the transfer, with the balance of the proceeds being taxed as ordinary income.[3129] The transfer for value rules do not apply to transfers made to the insured, a corporation in which the insured is an officer or stockholder, a partner of the insured,[3130] a partnership in which the insured is a partner, or where the new owner's basis is determined in whole or in part by reference to the transferor's basis.[3131] A transfer of an interest in a partnership that owns a life insurance policy is not

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[3128] Code § 101(a)(2) provides, subject to certain exceptions:

> In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

Code § 101(a)(1) is the general rule that death benefits are not taxable.

[3129] Letter Ruling 7734048. For additional discussion of the transfer for value rules, see Zaritsky & Leimberg, ¶2.07. The Transfer-For-Value Rule Causing the Loss of Tax-Free Status, *Tax Planning With Life Insurance: Analysis With Forms* (WG&L).

[3130] Not surprisingly, Letter Ruling 200120007 treated an LLC as a partnership in applying this rule. That LLC was formed to hold stock in a C corporation. The ruling also treated as having no adverse transfer-for-value effects:

- The transfer of a second-to-die policy to a trust deemed owned by one of the insureds.
- The transfer of a policy from a trust deemed owned by husband to a trust deemed owned by wife (due to Code § 1041 make it a substituted basis transaction).

[3131] Code § 101(a)(2)(A), (B). Rev. Rul. 2007-13 posited the following situations:

> Situation 1. TR1 and TR2 are grantor trusts, both of which are treated as wholly owned by G under subpart E of Part I of subchapter J of the Internal Revenue Code. TR2 owns a life insurance contract upon the life of G. TR2 transfers the life insurance contract to TR1 in exchange for cash.
>
> Situation 2. The facts are the same as in Situation 1, except that TR2 is not a grantor trust.

It held:

> The grantor who is treated for federal income tax purposes as the owner of a trust that owns a life insurance contract on the grantor's life is treated as the owner of the contract for purposes of applying the transfer for value limitations of § 101(a)(2). Accordingly, in Situation 1, the transfer of a life insurance contract between two grantor trusts that are treated as wholly owned by the same grantor is not a transfer for a valuable consideration within the meaning of § 101(a)(2); in Situation 2, the transfer of a life insurance contract to a grantor trust that is treated as wholly owned by the insured is a transfer to the insured within the meaning of § 101(a)(2)(B) and is therefore excepted from the transfer for value limitations under § 101(a)(2).

Note that Rev. Proc. 2011-3, Section 3.01(7) states that the IRS will not issue letter rulings on:

> Section 101.—Certain Death Benefits.— Whether there has been a transfer for value for purposes of § 101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's

subject to the transfer for value rules if the transfer does not constitute a termination of the partnership.[3132] Similarly, contributing a life insurance policy to a partnership in a Code § 721 nontaxable transfer[3133] is a substituted basis transaction that is not subject to the transfer for value rules.[3134]

Special rules apply to a "reportable policy sale," which is "the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract."[3135] "Indirectly" includes "the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract."[3136] Special rules for a reportable policy sale include:

- The exceptions to the transfer for value rule described above, all of which are Code § 103(a)(2)(A) or (B), do not apply. Thus, the death benefit generally is taxable, to the extent described in fn 3128.

> income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§ 673 to 677.

However, that did not stop the IRS from issuing Letter Ruling 201423009, which including the following facts and conclusions:

> Individual A and his spouse, Individual B, are the grantors of the AC Trust. The AC Trust, as amended, is represented to be a grantor trust for federal income tax purposes owned by Individual A and Individual B. The AC Trust, as amended, owns and is currently the beneficiary of Number Y life insurance contracts on the joint lives of Individual A and Individual B and the Number X policy on Individual B (collectively, the life insurance contracts which total Number Z policies).
>
> The movement of the life insurance contracts from the AC Trust to the AB Trust has two aspects. The first aspect is that, pursuant to the rationale of Rev. Rul. 85-13, Individual A, as a grantor of the AC Trust, as amended, proposes to transfer the life insurance contracts to the AB Trust of which Individual A is the grantor. Thus, this aspect of the transaction cannot be recognized as a sale or exchange for tax purposes because Individual A is treated for income tax purposes as owning the purported consideration both before and after the transaction. The second aspect of the transaction is that Individual B's interest in the AC Trust (in which she is a grantor) is being moved to the AB Trust in which Individual B's husband, Individual A, is the grantor. This action has the result, under § 1041(a), as being treated as a gift to her husband, Individual A, who pursuant to § 1041(b) receives a carryover basis in the life insurance contracts from his wife, Individual B.

[3132] Letter Ruling 200826009. Note, however, that Rev. Proc. 2011-3, Section 3.01(8) states that the IRS will not issue letter rulings on:

> Sections 101, 761, and 7701.—Definitions. — Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under §§ 761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of § 101, when substantially all of the organization's assets consists or will consist of life insurance policies on the lives of the members.

[3133] See part II.M.3.a General Rule: No Gain on Contribution to Partnership.

[3134] Letter Ruling 201308019.

[3135] Code § 101(a)(3)(B).

[3136] Code § 101(a)(3)(B).

- Various reporting requirements apply when the death benefit is paid.[3137]

Rev. Rul. 2009-13 took the position that the basis of a policy that is sold to a person other than the issuer is not equal to the premiums paid.[3138] Effective for transactions entered into after August 25, 2009 (coinciding with the effective date of the IRS' position), section 13521 of the 2017 tax reform act reversed the IRS' position,[3139] adding Code § 1016(a)(1)(B), which provides:

> Proper adjustment in respect of the property shall in all cases be made for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract.

II.Q.4.c. Income Tax Issues in Transferring Life Insurance Used in Cross-Purchase Agreements

When transferring policies as buy-sell needs and the identities of owners change:

1. Generally, income tax applies when buying, selling, or swapping policies. Generally, Code § 1035 nonrecognition of gain when swapping policies applies only when the policies have the same insureds.[3140] If one insured in a second-to-die policy has

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[3137] Code § 6050Y.

[3138] See Rev. Ruls. 2009-13 and 2009-14. Commentators disagree with the IRS' position.

[3139] The Senate report stated:

> The provision provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance"). This reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

[3140] Rev. Rul. 90-109 examined a contract that allowed the insured to change (highlighting added):

> A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one. *Cf.* Rev. Rul. 69-135, 1969-1 C.B. 198 (recognition of realized gain or loss under former section 1002 where bonds of one corporation are converted into stock of another corporation pursuant to an option contained in the bonds). See also Rev. Rul. 79-155, 1979-1 C.B. 153 (addition of new parent as obligor is a change which, together with other changes, constitutes a material change for purposes of section 1001).
>
> In the present situation, X exercised an option in its key person insurance policy that permitted it to change the insured from A, the original insured under the policy, to B, the new insured. This resulted in a change in the fundamental substance of the original contract because the essence of a life insurance contract is the life that is insured under the contract. Thus, X's exercise of the change-of-insureds option is substantively the same as an actual exchange of contracts and is a sale or other disposition for purposes of section 1001.
>
> Section 1.1035-1 of the regulations expressly excludes from the application of section 1035 exchanges of policies that do not relate to the same insured and thus prevents policy owners from deferring indefinitely recognition of gain with respect to the policy value. Had X actually assigned a life insurance policy on A to the insurance company as consideration for a new life insurance policy on B, any gain realized on the

died, Code § 1035 may apply to the exchange of that policy for a policy on the life of only the surviving insured.[3141] However, Code § 1035 does not apply to changing from having two insureds under a second-to-die policy to one insured under a policy or from one insured under a policy to two insureds under a second-to-die policy.[3142]

> exchange would have been ineligible for nonrecognition treatment under section 1035 of the Code. X cannot avoid the same-insured limitations of section 1035 simply by placing terms in its original documents that obviate the need for an actual exchange but nevertheless effect a de facto exchange of the original contract for a new contract on a different insured. For example, the result would be the same if X insured a person holding a particular position and, thus, no formal substitution is made when a new person occupies that position.

It held:

> The exercise of an option in an insurance policy to change the insured constitutes a sale or other disposition under section 1001 of the Code, and this disposition does not qualify as a tax-free exchange of insurance policies under section 1035.

[3141] Consistent with Letter Ruling 9248013, Letter Ruling 9330040 reasoned and held:

> The legislative history of section 1035 of the Code indicates that Congress viewed nonrecognition treatment as appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954).
>
> Trust's proposed assignment of Policy to the issuer of New Policy and its receipt of New Policy will qualify as an exchange of one contract of life insurance for another contract of life insurance under section 1035(a)(1) of the Code. At the time of the proposed exchange, the sole remaining insured on Policy will be A. The sole insured on New Policy will also be A. Therefore, the proposed exchange does not involve a change of insured, which would disqualify the transaction from nonrecognition treatment under section 1035.
>
> Accordingly, under section 1035 of the Code no gain or loss will be recognized by Trust upon the exchange of Policy solely for New Policy. Further, the basis of New Policy in the hands of Trust will, as provided in section 1031(d), be the same as Trust's basis in Policy.
>
> We express no opinion on whether section 1035 of the Code applies to the exchange of a survivorship or "second to die" life insurance contract for a single life insurance contract prior to the death of either of the insureds under the survivorship contract. We also express no opinion on whether Policy or New Policy qualifies as a life insurance contract under section 7702(a).

[3142] Letter Ruling 9542037 rejected the application of Code § 1035 in all of the following situations:

> Taxpayer has inquired as to several situations involving exchanges by Taxpayer's policyholders who are spouses. In Situation 1, Spouse A exchanges a life insurance contract insuring solely his own life for a second-to-die life insurance contract covering the lives of both Spouse A and Spouse B. In Situation 2, Spouse A exchanges two life insurance contracts, one of which insures the life of Spouse A and one of which insures the life of Spouse B, for a second-to-die life insurance contract which covers the lives of both Spouse A and Spouse B. In Situation 3, Spouse A and Spouse B jointly exchange separate life insurance contracts each of which insures solely the life of one spouse for a jointly owned second-to-die life insurance contract which covers the lives of both Spouse A and Spouse B. In Situations 4A and 4B respectively, the facts are the same as in Situations 1 and 2 except that a trust is the owner and exchanger of the life insurance contracts involved. In none of the Situations do Spouse A, Spouse B or the trust receive any money or other property not permitted to be transferred without the recognition of gain or loss.

2. The transfer for value rules might cause the death benefit to be subject to income tax.[3143]

When life insurance is sold in a taxable transaction, the IRS' position is that:[3144]

It held:

> In each of the Situations described above, the individual insured under each contract given up in the exchange is not the sole individual insured under the contract received in the exchange. As the contracts do not relate to the same insured, any gain realized on the exchange is ineligible for nonrecognition under section 1035 of the Code.

[3143] See text accompanying fns. 3128-3134.

[3144] Rev. Rul. 2009-13, Situation 2 provides the following facts and analysis, which works from Situation 1:

> **Situation 1**
>
> On January 1 of Year 1, A, an individual, entered into a life insurance contract (as defined in § 7702 of the Internal Revenue Code (Code)) with cash value. Under the contract, A was the insured, and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract in A's hands was not property described in § 1221(a)(1)-(8).
>
> On June 15 of Year 8, A surrendered the contract for its $78,000 cash surrender value, which reflected the subtraction of $10,000 of cost-of-insurance charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, A had paid premiums totaling $64,000 with regard to the life insurance contract. A had neither received any distributions under the contract nor borrowed against the contract's cash surrender value.
>
> A determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of Year 8, A was not a terminally ill individual, nor a chronically ill individual, within the meaning of § 101(g)(4).
>
> **Situation 2**
>
> The facts are the same as in Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for $80,000 to B, a person unrelated to A and who would suffer no economic loss upon A's death.
>
> ….
>
> **Law and Analysis**
>
> ….
>
> In Situation 2, A paid total premiums of $64,000 under the life insurance contract through the date of sale, and $10,000 was subtracted from the contract's cash surrender value as cost-of-insurance charges. Accordingly, A's adjusted basis in the contract as of the date of sale under §§ 1011 and 1012 and the authorities cited above was $54,000 ($64,000 premiums paid less $10,000 expended as cost of insurance).
>
> Accordingly, A must recognize $26,000 on the sale of the life insurance contract to B, which is the excess of the amount realized on the sale ($80,000) over A's adjusted basis of the contract ($54,000).
>
> **Character of income recognized on sale of the life insurance contract**
>
> Unlike Situation 1, which involves the surrender of the life insurance contract to the issuer of the contract, Situation 2 involves an actual sale of the contract. Nevertheless some or all of the gain on the sale of the contract may be ordinary if the substitute for ordinary income doctrine applies.
>
> The Supreme Court has held, under the so-called substitute for ordinary income doctrine, that property within the meaning of § 1221 does not include claims or rights to ordinary income. Instead, the Court has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves

1. The taxpayer's gain is:

   - Ordinary income to the extent that it does not exceed the excess of the policy's cash value over the taxpayer's "investment in the contract" (this excess referred to later as the "inside build-up"),[3145] and

   - Capital gain to the extent of the balance.

2. The selling taxpayer's basis is reduced by the cost of insurance.[3146]

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properly attributable to income. *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). *See also Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958) (consideration received on the sale of a working interest in an oil well represented a substitute for what would have been received in the future as ordinary income, therefore taxable as ordinary income and not capital gain); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217, n. 5 (1988) (noting that the substitute for ordinary income doctrine had no application to that case). Thus, ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange. *See also Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004); *Davis v. Commissioner*, 119 T.C. 1 (2002) (applying the substitute for ordinary income doctrine after the Arkansas Best decision).

The substitute for ordinary income doctrine has been applied to characterize the profit on a sale of an annuity contract or life insurance contract as ordinary income. For example, in *Gallun*, 327 F.2d 809, 811 (7th Cir. 1964), the court stated:

> The question presented has been considered by other courts. Uniformly, they have held that the assignment of income doctrine . . . should be applied and the profits realized from the sale or the surrender value of an annuity or life insurance contract should be treated as ordinary income rather than capital gain. These cases are: *First Nat'l Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); *Rolf v. Commissioner*, 304 F.2d 450 (3d Cir. 1962); *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960); *Arnfeld v. United States*, 163 F.Supp. 865, 143 Ct. Cl. 277 (1958).

Application of the substitute for ordinary income doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract). Hence, if the income recognized on the sale or exchange of a life insurance contract exceeds the inside build-up under the contract, the excess may qualify as gain from the sale or exchange of a capital asset. *See*, *e.g.*, *Commissioner v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960).

In Situation 2, the inside build-up under A's life insurance contract immediately prior to the sale to B was $14,000 ($78,000 cash surrender value less $64,000 aggregate premiums paid). Hence, $14,000 of the $26,000 of income that A must recognize on the sale of the contract is ordinary income under the substitute for ordinary income doctrine. Because the life insurance contract in A's hands was not property described in § 1221(a)(1)-(8) and was held by A for more than one year, the remaining $12,000 of income is long-term capital gain within the meaning of § 1222(3).

[3145] Although the IRS did not expressly say so, this policy result is required to preserve the integrity of the system described in part II.Q.4.d Income Tax on Distributions or Loans from Contract (Including Surrender of Policy), which also explains why this policy result is required in the text preceding fn. 3159.

[3146] Commentators strongly disagree with the IRS' position, accusing it of cherry-picking authority. See, *e.g.*, "Ouch, My Head Hurts – Treasury Rules That 'Basis' Is Lower Than 'Investment in the Contract,'" Northwestern Mutual *Advanced Planning Bulletin*, June 2009, citing cases regarding life insurance, including *Arnfeld v. U.S.*, 163 F.Supp. 865 (Ct. Cl. 1958); *Commissioner v. Phillips*, If the policy is a term policy, then the IRS asserts that the basis is any unexpired premiums and the gain is purely capital gain.[3147] Rev. Rul. 2009-14 discusses tax consequences to the purchaser of a term life insurance policy.

Using a life insurance LLC might solve most or all of these issues.[3148]

II.Q.4.d. Income Tax on Distributions or Loans from Contract (Including Surrender of Policy)

To the extent that the distributions are nontaxable death benefits,[3149] the rules described below do not apply.[3150]

Generally, distributions (other than tax-free death benefits) from life insurance contracts are not taxable "the extent allocable to the investment in the contract."[3151] Dividends used to pay premiums are not taxable.[3152] Furthermore, loans generally are also not subject to income tax (without reference to the investment in the contract) while the borrower continues to hold the policy[3153] and are treated as distributions when those exceptions apply.[3154] However, distributions and loans generally are taxable if the policy is a "modified endowment contract," which generally apply when a policy's premiums are paid too quickly in its initial years.[3155]

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275 F.2d 33 (4th Cir. 1960); *Roff v. Commissioner*, 304 F.2d 450 (3rd Cir. 1962); *First National Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); and *Gallun v. Commissioner*, 327 F.2d 809 (7th Cir. 1964). The *Advanced Planning Bulletin* also cited authority regarding capitalizing expenditures generally, including Reg. § 1.263(a)-4; *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992); and *Federal Express Corp. v. Commissioner*, 412 F.3d 617 (6th Cir. 2005). The *Advanced Planning Bulletin* was also published as Finn, Revenue Rulings 2009-13 & 2009-14 - More on Income Tax Consequences of Surrender and Sale of Life Insurance Policies, *Steve Leimberg's Estate Planning Email Newsletter* as Archive Message #1493 (7/23/2009). Newsletters #1457 (Zaritsky), 1459 (Mancini and Brody), and 1462 (Blattmachr and Gans) also discus Rev. Ruls. 2009-13 and 2009-14. If a life insurance company demutualizes, none of the policy's basis is allocated to the stock that policyholders receive. *Dorrance v. U.S.*, 807 F.3d 1210 (9th Cir. 2015).

3147 Rev. Rul. 2009-13, Situation 1.

3148 See parts II.Q.4.i Life Insurance LLC, II.M.3 Buying into or Forming a Partnership, and II.Q.8 Exiting From or Dividing a Partnership.

3149 Code § 101(a)(1).

3150 Reg. § 1.72-2(b)(1)(i) provides:

> In general, the amounts to which section 72 applies are any amounts received under the contracts described in paragraph (a)(1) of this section. However, if such amounts are specifically excluded from gross income under other provisions of chapter 1 of the Code, section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured and are excludable from gross income under section 101(a). See also sections 101(d), relating to proceeds of life insurance paid at a date later than death, and 104(a)(4), relating to compensation for injuries or sickness.

3151 Code §§ 72(e)(1), 72(e)(2)(B)(ii).

3152 Code § 72(e)(4)(B).

3153 Code § 72(e)(4)(A) includes various exceptions.

3154 Code § 72(e)(4)(A) includes various exceptions.

3155 Code § 72(e)(10), using the definition of modified endowment contract in Code § 7702A.

Any distributions in excess of "investment in the contract" constitute ordinary income.[3156] However, Code § 1234A might be used to argue that income on surrender should be all capital gain.[3157]

"Investment in the contract":[3158]

as of any date is-

(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus

(B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws.

What constitutes "other consideration paid for the contract"? Code § 72(g) tells us what to do when the policy is sold:

(g) **Rules for transferee where transfer was for value**. Where any contract (or any interest therein) is transferred (by assignment or otherwise) for a valuable consideration, to the extent that the contract (or interest therein) does not, in the hands of the transferee, have a basis which is determined by reference to the basis in the hands of the transferor, then—

(1) for purposes of this section, only the actual value of such consideration, plus the amount of the premiums and other consideration paid by the transferee after the transfer, shall be taken into account in computing the aggregate amount of the premiums or other consideration paid for the contract;

(2) for purposes of subsection (c)(1)(B), there shall be taken into account only the aggregate amount received under the contract by the transferee before the annuity starting date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws; and

(3) the annuity starting date is January 1, 1954, or the first day of the first period for which the transferee received an amount under the contract as an annuity, whichever is the later.

For purposes of this subsection, the term "transferee" includes a beneficiary of, or the estate of, the transferee.

[3156] Code § 72(e)(2).
[3157] At the 2015 Heckerling Institute, Larry Brody reported having settled a Tax Court case on this basis. See part II.G.6 Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A. Rev. Rul. 2009-13 asserted, without explanation, that Code § 1234A does not apply to a surrender.
[3158] Code § 72(e)(6).

Code § 72(g)(2) does not apply, because our income is based on Code § 72(e)(6), not Code § 72(c)(1)(B).

Consider the following potential abuse:

1. Policy owner sells the policy and receives capital gain treatment.

2. Buyer receives a new "investment in the contract" under Code § 72(g).

3. Buyer cashes in the policy, tax-free.

Given that the buyer has no risk, a policy owner could easily find a straw man to help the policy owner cash in the policy and receive capital gain treatment, avoiding the ordinary income treatment provided by Code § 72(e)(1). Rev. Rul. 2009-13, Situation 2,[3159] prevents this potential abuse.

Thus, if one sells a policy in a taxable transaction:

1. If and to the extent one has gain, the first tier of this gain is ordinary income.[3160]

2. All of the gain on the sale translates into increased "investment in the contract" against which distributions can be taken tax-free.

3. Be careful to fit within an exception to the transfer for value rules[3161] if the buyer expects to receive death benefit in excess of investment in the contract.

II.Q.4.e. Income Tax Issues When the Owner Who Is Not the Insured Dies

Generally, property an individual owns (including indirectly through a partnership[3162]) receives a new tax basis when that individual dies if that property is included in that individual's estate for estate tax purposes.[3163]

The discussion below focuses on if and the extent to which a life insurance might not get a basis adjustment on the death of an owner who is not insured and then explores practical issues in implementing any basis adjustment that is available.

II.Q.4.e.i. Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured

However, "annuities described in section 72" do not receive a new basis.[3164] Although Code § 72 governs distributions from life insurance companies to policy owners, this provision appears to be aimed at annuity contracts and not life insurance contracts.

[3159] See fn. 3144.
[3160] See text accompanying fn. 3144.
[3161] Code § 101(a)(2).
[3162] Generally, the partnership need to have a Code § 754 election in place for the partnership's taxable year in which the individual dies or in certain situations when that person's interest in the partnership is later transferred. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[3163] Code § 1014, which applies to more than just what this sentence describes.

Of greater concern is whether the internal build-up in a cash value life insurance contract constitutes "income in respect of a decedent" (IRD) ineligible for a basis adjustment.[3165] Regulations provide:[3166]

> **General definition.** In general, the term "income in respect of a decedent" refers to those amounts to which a decedent was entitled as gross income but which were not properly includible in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent. See the regulations under section 451. Thus, the term includes-
>
> (1) All accrued income of a decedent who reported his income by use of the cash receipts and disbursements method;
>
> (2) Income accrued solely by reason of the decedent's death in case of a decedent who reports his income by use of an accrual method of accounting; and
>
> (3) Income to which the decedent had a contingent claim at the time of his death.

Income is "accrued" when "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."[3167]

IRD does not include "items which are excluded from gross income under subtitle A."[3168]

When the owner who is not the insured dies, we do not know whether the policy's value in excess of "investment in the contract" (such excess, the "inside build-up") is going to be includible in income (if taken out before the insured dies)[3169] or excluded from income (if received as a nontaxable death benefit).[3170] In other words, it is not true that "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Therefore, the inside build-up has not "accrued" upon that owner's death and cannot constitute IRD.

This analysis is consistent with a test the Tax Court formulated for determining whether proceeds from a sale contract are IRD. The test considers:[3171]

> (1) whether the decedent entered into a legally significant arrangement regarding the subject matter of the sale,[5]

[3164] Code § 1014(b)(9); Reg. § 1.1014-2(b)(3)(i).
[3165] Code § 1014(c).
[3166] Reg. § 1.691(a)-1(b).
[3167] Reg. § 1.451-1(a). On the deduction side, see *U.S. v. General Dynamics Corp.*, 481 U.S. 239 (1987); U*.S. v. Hughes Properties, Inc.*, 476 U.S. 593 (1986); Rev. Rul. 78-212; *Giant Eagle, Inc. v. Commissioner*, 822 F.3d 666 (3rd Cir. 2016), *rev'g* T.C. Memo. 2014-146. In addition to the all events test, the Code § 461(h) economic performance rules may defer deductions.
[3168] Reg. § 1.691(a)-1(c).
[3169] Code § 72(e).
[3170] See fns. 3149-3150.
[3171] *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981), summarizing the Tax Court's holding.

(2) whether the decedent performed the substantive (nonministerial) acts required as preconditions to the sale,[6]

(3) whether there existed at the time of the decedent's death any economically material contingencies which might have disrupted the sale,[7] and

(4) whether the decedent would have eventually received the sale proceeds if he or she had lived.[8]

74 T.C. at 639-41.

[5] As noted by the Tax Court, "[t]his arrangement may take a variety of forms: an express executory contract of sale [as in *Trust Co. v. Ross*, *supra*, 392 F.2d 694]; an implied contract for sale [A delivers apples to Y, Y accepts the apples, A dies before Y can pay for them]; or a contractual arrangement with a cooperative marketing association [as in *Commissioner v. Linde*, *supra*, 213 F.2d 1 (no contract or sale, just delivery of grapes to marketing cooperative; proceeds held income in respect of a decedent when received)]." *Estate of Peterson v. Commissioner*, 74 T.C. 630, 639 (1980) (parentheticals substituted and expanded). *See also Halliday v. United States*, 655 F.2d 68, 72 (5th Cir. 1981) (the right to income need not be legally enforceable).

[6] "One indicium of whether a decedent has performed the applicable substantive acts is whether he has delivered, or somehow placed, the subject matter of the sale beyond his control prior to his death." *Estate of Peterson v. Commissioner*, *supra*, 74 T.C. at 640. *Compare* M. Ferguson, J. Freeland & R. Stephens, *Federal Income Taxation of Estates and Beneficiaries*, *supra*, 180-84 ("[E]vend where the property has been made the subject of a binding, executory contract of sale, if the benefits and hazards of ownership are still possessed by the decedent at his death, the property is entitled to a § 1014(a) basis in the hands of his estate, and his negotiated profit will not be taxed to his estate (or to anyone) under § 691 when the sale is completed after his death.") (footnote omitted), with Gordon, Income in Respect of a Decedent and Sales Transactions, 1961 *Wash. U.L.Q.* 30, 37 (§ 691 should apply to sale proceeds from sales which at the time of the decedent's death are incomplete "only as to delivery of the *res* and receipt of the purchase price").

[7] *Cf. Keck v. Commissioner*, *supra* 415 F.2d at 534 (sale of stock was contingent upon Interstate Commerce Commission approval; proceeds held not income in respect of decedent where ICC approval not granted at time of the decedent's death).

[8] *See* 26 C.F.R. § 1.691(a)-2(b) (Ex. 4) (buy-sell agreement effective at date of death; proceeds not income in respect of a decedent because the decedent could not have received the proceeds if he had lived).

The Tax Court in that case held:[3172]

> Although three of the four requirements tend to support a conclusion opposite to the one reached, all four elements are necessary to support a finding that the decedent possessed a right to the sale proceeds as of his date of death. [fn. omitted] Accordingly, the absence of one of these requirements precludes the applicability of section 691.

In analyzing the requirement that was missing, the Tax Court said:[3173]

> The fourth requirement is that the decedent, himself, would have eventually received (actually or constructively) the sale proceeds if he had lived. This situation may be best exemplified by a typical date-of-death buy-sell agreement between a decedent and his corporation; since, by its terms, the sale is only effective upon the decedent's death, the decedent could not have received the sale proceeds if he had lived. Therefore, the proceeds from such a sale are not income in respect of a decedent.

Applying the Tax Court's fourth requirement to the insurance policy analysis, would the decedent have received taxable income from the policy if the decedent/policy owner had lived? The answer is not necessarily – if the insured died while the policy owner was living, the policy owner would have received a tax-free death benefit. The answer would be different if the policy owner had submitted the appropriate forms to cash out the policy before the policy owner died and the insurance company simply had not cut the check before the policy owner died. Thus, if the policy owner has not, before the policy owner's death, submitted whatever documentation is required to cash in the policy, then the events fixing the policy's tax consequences have not occurred before the policy owner's death and the internal cash build-up obtains a basis step-up because it does not constitute IRD.

Insurance companies remain concerned because they view the inside build-up as vested untaxed earnings. Although this argument seems untenable for contracts whose cash value might later decrease, for fully paid whole-life they understandably view it as absolute earnings that will never decrease. Rev. Rul. 2009-13 takes the position that, on the sale of a life insurance contract, the gain on sale is ordinary income to the extent that it does not exceed the inside build-up.[3174] The substitute-for-income doctrine, under which the IRS states that the asset is not a capital asset to the extent that the doctrine applies, makes them view the inside build-up as IRD. What they do not take into account is that assets that generate ordinary income on sale, such as inventory (which is not a capital asset),[3175] do not constitute IRD unless actually sold before death; an

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[3172] 74 T.C. at 643-44.

[3173] 74 T.C. at 641. In a case involving a similar issue, farm inputs deducted on the decedent's final returns received a basis step-up at death and could be deducted by his widow on her return, even though their expected use was obvious. See fn. 1385.

[3174] See fn. 3144.

[3175] Code § 1221(a)(1) provides:

> For purposes of this subtitle, the term capital asset means property held by the taxpayer (whether or not connected with his trade or business), but does not include … stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by

asset's character as an ordinary income asset has nothing to do with IRD characterization unless the income is "accrued"[3176] or is a specified class of assets subject to IRD, neither of which applies to a life insurance contract. If and to the extent that a policy might not constitute a capital asset, that classification is irrelevant, because the Code § 1014 basis step-up rules apply to more than just capital assets.[3177] Furthermore, Rev. Rul. 2009-13 does not say that inside build-up creates gain; it merely says that inside build-up recharacterizes part or all of the gain on sale of the policy as ordinary income.

Thus, although the potential ordinary income taxation of inside build-up might make one inclined to view it as IRD, that view has no basis in the law, although I found one probably irrelevant and unsound source that the IRS might try to seize upon in the event of an audit.[3178]

> the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Note that real estate might or might not constitute inventory. See part II.G.12 Future Development of Real Estate, especially fn. 1042.

[3176] Rev. Rul. 58-436. However, crop shares or livestock received as rent by a decedent, who had employed the cash method of accounting, before the decedent's death, and owned by the decedent at the time of the decedent's death, as well as crop shares or livestock which the decedent had a right to receive as rent at the time of the decedent's death for economic activities occurring before the decedent's death, constitute income in respect of a decedent which is required to be included in gross income, for Federal income tax purposes, in the year in which the crop shares or livestock are sold, or otherwise disposed of. Rev. Rul. 64-289. *Friedman v. Commissioner*, 41 T.C. 428 (1965), *aff'd* 346 F.2d 506 (6th Cir. 1965) and Rev. Rul. 69-102 were disturbed when a taxpayer sought a charitable deduction for the full value of life insurance policies and therefore taxed the taxpayer on ordinary income on the policies' inside build-up based on a combination of the assignment-of-income principle and the taxpayers realizing a benefit (charitable deduction) for that income; Code § 170(e) and Reg. § 1.170A-4(a) address this issue by not permitting a deduction on the portion of the policy that would constitute ordinary income if the policy were sold, so presumably these authorities are obsolete in light of Rev. Rul. 2009-13. Rev. Rul. 69-102 involved an endowment policy, which typically provides for a payout of the accrued income on a specified maturity date, so before the gift all events had occurred that would require the payout of the inside build-up. Once a policy has been annuitized, an assignment triggers the assignment of income doctrine, *Jones v U.S.*, 395 F.2d 938 (6th Cir. 1968), but that should not apply to a policy passing by reason of death to the extent that the policy had not been annuitized.

[3177] For example, nobody has ever suggested that a depreciable building used in a business is not eligible for a new basis under Code § 1014, even though Code § 1221(a)(2) provides that such a building is not a capital asset. See*, e.g.*, Reg. §§ 1.1245-2(c)(1)(iv) and 1.1250-3(b)(2)(i), providing that Code § 1014 can wipe out depreciation recapture when such property is included in the deceased owner's estate. See also the quotes from the U.S. Supreme Court and Tax Court in fn. 1385, found in part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[3178] Rev. Rul. 75-125 (which the Rev. Rul. 92-47 cited as being good law) took the position that stock, which has net unrealized appreciation (NUA) that was not taxed when distributed from a qualified retirement, does not receive a basis step-up at death to the extent of that NUA. This ruling preceded *Peterson* (fn. 3171), and I believe it is simply wrong in light of *Peterson*, because there is no assurance that the gain will ever be realized, and the ruling did not cite any particular support in reaching the conclusion it did. It is also philosophically inconsistent with the IRS' failure to assert assignment of income principles or otherwise impose any taint when NUA

II.Q.4.e.ii. Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured

The only direct immediate practical use of a stepped-up basis is avoiding gain on sale. After all, the death benefit is tax-free if one avoids the transfer for value rules (see part II.Q.4.a Funding the Buy-Sell). The remaining big question is any effect on distributions of inside build-up, the taxation of which depends on the "investment in the contract" under Code § 72(g).

The estate of the decedent who is not the insured does not appear to receive a new "investment in the contract" because the contract was not transferred to it "for a valuable consideration." However, if that estate later sold the policy for full value to a different taxpayer:

- The estate would have a stepped-up basis.
- The transferee would have a new "investment in the contract."
- The transferee would need to make sure that the "transfer for value" rules[3179] do not make the death benefit taxable.[3180]

Before buying a cash value policy to be includible in the estate of a person who is not the insured or that might be transferred in a taxable sale (perhaps one that avoids the transfer for value rules), consider asking the insurance company its procedures in this area. Results from that inquiry include the following:

- "We never undertake to make a Code § 72(g) adjustment, because we don't want to be bothered with it." If the insurance company answers that way, ask whether they will honor a request to check the box "taxable amount not determined" so that the taxpayer is not required to disprove what otherwise would be an incorrect Form 1099.
- "We don't want to undertake to make a Code § 72(g) adjustment, but we will do it if a sale violates the transfer for value rules; in that case, we need to tell the IRS the taxable amount at death, so it is worth it to track this." To obtain that Form 1099 reporting, the policy owner's estate might sell the policy in a transaction that violates the transfer for value rules. One might follow that transfer by a transfer to the insured, which would cleanse the transfer for value taint (perhaps other cleansing opportunities are available as well). For example, Dad owns policy on Daughter's life. Dad dies. Dad's estate sells the policy to Son, violating the transfer for value rules (unless an exception applies) and triggering the insurance company tracking the new "investment in the contract." Then Son sells the policy to Daughter (the insured); this transaction would not generate any gain to the extent of Son's basis

property was given to charitable remainder trusts in Letter Rulings 200038050, 200202078, 200215032, 200302048, and 200335017.

[3179] See part II.Q.4.a Funding the Buy-Sell, especially fns. 3128-3134.

[3180] Nothing in Code § 72(g) or Reg. § 1.72-10 suggests that an exception to the transfer for value rules (other than a substituted basis transaction) would make the contract not transferred for a valuable consideration.

due to his purchase from Dad's estate, and Daughter's purchase cleanses the transfer-for-value taint because she is the insured. However, one might decide that taking all these steps is not worth the effort and simply ask whether the insurance company will honor a request to check the box "taxable amount not determined."

II.Q.4.f. Split-Dollar Arrangements

II.Q.4.f.i. Split-Dollar Generally

A split-dollar arrangement is an arrangement in which one party pays part or all of the premiums and one or more of the economic rights to the policy (cash value, death benefits, etc.) are divided. An employer cannot bundle together a number of such arrangements and call them deductible welfare benefit plans; doing so subjects the employer to penalties.[3181] The IRS has an audit techniques guide on split-dollar arrangements.[3182]

The IRS created split-dollar rules before the U.S. Supreme Court found that interest could be imputed on loans and before Code § 7872 was enacted. During that period, the employer would retain the premiums it paid when the arrangement terminated (whether by death or by unwinding the arrangement – the latter referred to as a "rollout"), and the employee's beneficiary (or employee on rollout) would receive the death benefit (or cash value in the case of a rollout) after reimbursing the premiums paid.[3183] It needed a mechanism to tax long-term interest-free loans, which is what split-dollar was essentially at that time, but without a promissory note. Under that system, the employer was treated as owning the policy and providing taxable economic benefits to the employee each year equal to the value of one year of life insurance protection. This treatment applied whether the employer or employee owned the policy. To avoid estate tax on the death benefit, an irrevocable life insurance trust ("ILIT") would own the policy, so that each year's imputed income to the employee was also a gift to the trust. Eventually, the arrangement would be undone before the employee's death, whether because the annual life insurance protection became too high as the employee got older, because the parties wanted to simplify the arrangement, or termination of employment. Often, the policy's cash value exceeded the premiums paid; and some taxpayers took the position that receipt of the life insurance policy, which had a cash

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[3181] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. 1 (2015). This case involved seven taxpayers, and the parties in approximately 40 other cases agreed to be bound by the result of this case. Notice 2007-83 announced that the IRS would target welfare benefit plans funded by life insurance. Notice 2007-84 announced that the IRS would target certain multi-employer welfare benefit plans. Program Manager Technical Advice 2015-11 explains how to apply the 30% accuracy-related penalty under Code § 6662A(c), to taxpayers who didn't follow the requirement of Notice 2007-83 to disclose participation in a listed transaction that used cash value life insurance policies to provide welfare benefits in a purported Code § 419 plan. The IRS successfully penalized Keller Tank Services II, Inc., one of the employers in the *Our Country Home Enterprises* case, for failure to report its participation in the plan as a "listed transaction" on its tax return. *Keller Tank Services II, Inc. v. Commissioner*, 119 A.F.T.R.2d 2017-XXXX (10th Cir. 4/20/2017).

[3182] See http://www.irs.gov/Businesses/Corporations/Split-Dollar-Life-Insurance-Audit-Technique-Guide-(03-2005) and www.irs.gov/businesses/corporations/article/0,id=136548,00.html.

[3183] The reimbursement obligation was nonrecourse – paid only out of the policy and not personally by the employee.

value in excess of the premiums reimbursed to the employer on rollout, was not a taxable event, because the employee (or life insurance trust) already had legal title to the policy. The government was not happy with the taxpayer using the tax fiction of the employer owning the policy before rollout and then ignoring that tax fiction at rollout and responded by promulgating the regulatory regime described below.

Now split-dollar arrangements are governed by Reg. § 1.7872-15, under which premium payments generally are treated as loans[3184] generally requiring an election,[3185] or Reg. § 1.61-22 (the "economic benefit regime"), under which generally one person is treated as owning all of the policy's cash value and the other person pays, or is treated as paying, for one-year term life insurance to the extent of the death benefit not allocated to the owner or deemed owner.

In the economic benefit regime, generally the owner and non-owner receive tax-free death benefits. The owner applies Code § 72 to any distributions that are not death benefits; even a deemed owner is treated as the real owner under Code § 72. See part II.Q.4.f.ii.(b) Treatment of Split-Dollar Arrangement. The other version involves the premium payor being treated as making loans to the policy owner; this requires additional documentation to be filed with the IRS if the loans are the equivalent of nonrecourse loans, the deadline for which is eligible for Code § 9100 relief in appropriate circumstances (see Letter Ruling 201041006, summarizing the deadline as well as the issue and then granting relief).

For the treatment of the economic benefit regime before Reg. § 1.61-22 was promulgated, agreements entered into on or before September 17, 2003 are instead subject to IRS Notices 2001-10 and 2002-8[3186] and Rev. Rul. 2003-105, so long as they

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[3184] Stated interest that is not payable annually triggers the Code § 1272 original issue discount (OID) rules. See Reg. §§ 1.7872-15(a)(1) (referring to OID rules as potentially applying), 1.1273-1(a) (OID is the excess of a debt instrument's stated redemption price at maturity over its issue price), 1.1273-1(b) (stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments), and 1.1273-1(c)(1)(i) (qualified stated interest payments must be made at least annually).

[3185] If and to the extent that a split-dollar loan is repayable solely out of life insurance cash values, part or all of the interest might be considered contingent interest that is disregarded, leading to a below-market loan. Reg. § 1.7872-15(d), (j). To avoid that consequence, one might consider making a Reg. § 1.7872-15(d)(2) election when the first loan is made under the split-dollar agreement. In appropriate circumstances, Code §9100 relief might extend the deadline for filing the election; see, *e.g.*, Letter Ruling 201041006 and other rulings.

[3186] Notice 2002-8 discusses the extent to which changes in the IRS' view might affect arrangements then in effect:

> **VI. Effect On Other Documents**
>
> Notice 2001-10 is revoked. Notwithstanding that revocation, Rev. Rul. 55-747 remains revoked, and Rev. Rul. 64-328, 1964-2 C.B. 11, and Rev. Rul. 66-110 remain modified to the extent that those rulings indicate that an employer's premium payments under a split-dollar life insurance arrangement may not be treated as loans.
>
> Except for Part III (Revised Standards for Valuing Current Life Insurance Protection), no inference should be drawn from this notice regarding the appropriate Federal income, employment and gift tax treatment of split-dollar life insurance arrangements entered into before the date of publication of final regulations. However, taxpayers may rely on this notice (including a reasonable application of the rules to be proposed as described in

are not "materially modified." Reg. § 1.61-22(j) lists some unenlightening safe harbors for what does not constitute a material modification. "Material modification" for this purpose includes changes that would not constitute a material modification under Code § 101(j) (employer-owned life insurance)[3187] or 264(f) (limiting deductions for interest expense allocable to unborrowed policy cash value).[3188]

The economic benefit regime might also trigger the harsh nonqualified deferred compensation rules of Code § 409A.[3189] Although the Code § 409A risk described in fn. 3189 is much smaller under Reg. § 1.61-22 than under prior law, be careful to consider it in either case.[3190]

All split-dollar arrangements require an exit strategy. For the loan regime, somehow the loans must be repaid; however, they do not need to be repaid until the insured's death, so the exit strategy might be easy. For the economic benefit regime, the deemed term portion becomes prohibitively expensive when the insured reaches a certain age, and it is not unusual for the parties not to have planned for how the non-owner obtains ownership for tax purposes (even though they should have).

The loan regime can be somewhat unwieldy, in that each year's premium requires a separate loan. Furthermore, the economic benefit regime tends to be most beneficial to the non-owner in the policy's early years, in which the premiums paid tend to exceed the policy's cash value. Considering these issues, one might consider starting with the economic benefit regime and the switching to the loan regime when cash value approaches premium paid. This switching approach avoids administering and accruing interest on multiple loans in the policy's early years and allow cash value increases after that point to benefit the party that originally was the non-owner. By the time the switch occurs, the policy might very well be earning enough dividends to pay premiums, perhaps avoiding the need to administer multiple loans to pay for those future premiums.

> Part II) or Notice 2001-10 for split-dollar life insurance arrangements entered into before the date of publication of final regulations.

I am aware of a taxpayer who took the position of no income or gift on rollout, filed Form 8275, received a brief question from the IRS, and then heard nothing before the statute of limitations passed. See Thompson Coburn doc. 6348842 (email from an outside lawyer to that effect).

[3187] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance, especially part II.Q.4.g.i Analysis of Code § 101(j).

[3188] Notice 2008-42.

[3189] See text accompanying fns. 3109-3110.

[3190] Reg. § 1.409A-1(b)(1) provides:

> A legally binding right to an amount that will be excluded from income when and if received does not constitute a deferral of compensation, unless the service provider has received the right in exchange for, or has the right to exchange the right for, an amount that will be includible in income….

Generally, for post-2003 split-dollar agreements, the employee will have to pay for the policy's value under part II.Q.4.f.ii.(b) Treatment of Split-Dollar Arrangement under Reg. § 1.61-22; however, one might want to clarify that the employee will need to pay the greater of the amount provided under the regulations or the policy's fair market value, which as a practical matter would likely to be the value on Form 712. For pre-2003 agreements that are not materially modified, the employee paying the cash surrender value would suffice; see fn. 3122. Given that these older arrangements might not require the employee to pay the cash surrender value, one should look to Notice 2007-34 to try to make the policy qualify for being grandfathered from Reg. § 1.61-22 and comply with Code § 409A.

If the original non-owner is an irrevocable trust, during the economic benefit phase (and of course later) the grantor can make annual exclusion gifts to the trust and perhaps even use leveraged estate planning techniques[3191] to grow the trust so that the trust can afford to pay future premiums and perhaps even retire the split-dollar loans.

II.Q.4.f.ii. Technical Details of the Split-Dollar Economic Benefit Regime

II.Q.4.f.ii.(a). Is the Arrangement a Split-Dollar Arrangement?

Generally, in the split-dollar economic benefit regime, the idea is give only pure term protection to the "non-owner" and all other right to the actual or deemed "owner."

Reg. § 1.61-22(b)(1) provides:

> *In general*. A split-dollar life insurance arrangement is any arrangement between an owner and a non-owner of a life insurance contract that satisfies the following criteria-
>
> (i) Either party to the arrangement pays, directly or indirectly, all or any portion of the premiums on the life insurance contract, including a payment by means of a loan to the other party that is secured by the life insurance contract;
>
> (ii) At least one of the parties to the arrangement paying premiums under paragraph (b)(1)(i) of this section is entitled to recover (either conditionally or unconditionally) all or any portion of those premiums and such recovery is to be made from, or is secured by, the proceeds of the life insurance contract; and
>
> (iii) The arrangement is not part of a group-term life insurance plan described in section 79 unless the group-term life insurance plan provides permanent benefits to employees (as defined in § 1.79-0).

Even if the above requirements are not met, any arrangement between an owner and a non-owner of a life insurance contract is treated as a split-dollar life insurance arrangement if it qualifies as a certain compensatory arrangement or shareholder arrangement.[3192]

The following constitutes a split-dollar compensatory arrangement:[3193]

> (A) The arrangement is entered into in connection with the performance of services and is not part of a group-term life insurance plan described in section 79;[3194]

[3191] See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.
[3192] Reg. § 1.61-22(b)(2)(i).
[3193] Reg. § 1.61-22(b)(2)(ii).
[3194] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015), discussed this requirement in depth, including the requirement of Reg. § 1.79-1(a)(4) that a group term arrangement not involve individual selection:

(B) The employer or service recipient pays, directly or indirectly, all or any portion of the premiums; and

(C) Either-

(1) The beneficiary of all or any portion of the death benefit is designated by the employee or service provider or is any person whom the employee or service provider would reasonably be expected to designate as the beneficiary; or[3195]

> Guardian and Minnesota Life required that the Our Country and Environmental shareholder/employees tender information on their health, traveling tendencies, and/or driving traits. The need to submit that type of personal information as a condition to receiving the insurance strongly suggests, and we find, that the insurers were exercising underwriting judgment with respect to at least the Our Country and Environmental shareholder/employees in connection with the issuance of the life insurance related to them. This finding is further strengthened by the fact that, in the case of Guardian at least, Guardian specifically rated each of Our Country's participating employees for purposes of setting the premiums payable on their policies and offered to try to find a way to reduce the premium attributable to the Blake policy. The mere fact that an insurer such as Guardian or Minnesota Life may add up the premiums that apply to separate policies that it sells on a specific group of insureds and then tender the total as the amount due on a group policy does not necessarily recharacterize the separate policies as part of a single group term life insurance plan. Instead, as we have stated, the exercise of underwriting judgment with respect to the specific persons in a group is indicative of the issuance of individual insurance policies rather than group policies. We hold that the insurance policies at hand are not group term life insurance policies for Federal income tax purposes.

In contrast, if a group-term policy allows employees to buy additional pure term insurance on an after-tax basis without any such purchases affecting the employer-provided group plan, the employees' independent choices do not affect the employer-provided group plan's qualification as such. Letter Ruling 201542003.

[3195] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015), discussed this requirement in depth:

> The shareholder/employees named the beneficiaries of the death benefits payable under their insurance policies by designating through the Sterling Plan the individuals who would receive the death benefits under the plan, which, in turn were the death benefits under the policy. In addition, those shareholder/employees were assured that their designated beneficiaries would receive any death benefits payable on those policies to the extent that the shareholder/employees died while participants in the plan. Petitioners seek a contrary holding essentially by looking at the life insurance policies through the wider end of a telescope towards its narrower end and seeing that the Sterling Plan is named as the beneficiary on the policies. They conclude from this view that none of the individuals who the participating employees designate to receive the death benefits payable by the Sterling Plan is [t]he beneficiary of all or any portion on the death benefit for purposes of section 1.61-22(b)(2)(ii)(C), Income Tax Regs. We, on the other hand, look telescopically at the life insurance benefit from the narrower end towards the wider end, as one commonly does, and see the ultimate recipient of the death proceeds as the person designated by the shareholder/employees. The fact that the death proceeds from the life insurance policies are funneled through the Sterling Plan to each of the ultimate recipients does not blur our view (or our conclusion) that each of those recipients is the beneficiary of the death benefit for purposes of section 1.61-22(b)(2)(ii)(C), Income Tax Regs. *Cf. Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945) (To permit the

(2) The employee or service provider has any interest in the policy cash value of the life insurance contract.[3196]

The following constitutes a split-dollar shareholder arrangement:[3197]

(A) The arrangement is entered into between a corporation and another person in that person's capacity as a shareholder in the corporation;

(B) The corporation pays, directly or indirectly, all or any portion of the premiums; and

(C) Either-

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true nature of a transaction to be disguised by mere formalisms *** would seriously impair the effective administration of the tax policies of Congress.); *Minn. Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (A given result at the end of a straight path is not made a different result because reached by following a devious path.). The light at the end of the tunnel brightly illuminates our conclusion, given that the Sterling Plan would pay no death benefit were it not for the life insurance policies, and the employee to whom a policy relates, rather than the Sterling Plan, is assured of receiving the entire amount that is payable under the terms of the policy.

[3196] *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015), discussed this requirement in depth:

> We also conclude that the shareholder/employees of Our Country and Environmental had interests in the their life insurance policies and the cash values thereof. This conclusion is supported by at least five facts. First, each life insurance policy and any funds related thereto were intended to be received by the corresponding employee or his or her designee(s) and no one else, and those employees were the only ones who had the right to receive or otherwise to redirect to someone else the cash value of the life insurance policies related to them. Second, the employees could elect to receive their policies upon retiring from employment with the employer. Third, the funds in the Sterling Plan could not be accessed by either the employer or by the employer's creditors, and Our Country and the Environmental employees, upon retiring or alternatively upon their employers' ceasing participation in the Sterling Plan, were certain to get those funds in the form of the policies that then passed to the employees. Fourth, a participating employee, before actually receiving the funds in his or her account, could be allowed to direct the investment of those funds and thus enjoy the benefit of any investment gain or suffer the detriment of any investment loss. Fifth, if the participating employee were to die while his or her insurance policy was in force, then the death benefit under that policy would ultimately be paid to his or her beneficiary in accordance with the terms of the policy.
>
> We also find important to our just-stated conclusion that the plan benefits were set to be fully vested either when a shareholder/employee satisfied the vesting requirements that he or she chose (or possibly could choose) in the name of the employer or when the employer terminated the plan. And as to vesting, the shareholder/employees were not necessarily bound by the vesting requirements that were initially set in their plans. Instead, at their whim they could accelerate or otherwise change the vesting requirements to their preference. In the case of Mr. Blake, for example, he executed an adoption agreement on July 30, 2006, retroactive to January 1, 2005, that lowered the normal retirement age for the employee participants in the Our Country plan and accelerated his complete vesting to the then-present time.

[3197] Reg. § 1.61-22(b)(2)(iii).

(1) The beneficiary of all or any portion of the death benefit is designated by the shareholder or is any person whom the shareholder would reasonably be expected to designate as the beneficiary; or

(2) The shareholder has any interest in the policy cash value of the life insurance contract.

II.Q.4.f.ii.(b). Treatment of Split-Dollar Arrangement under Reg. § 1.61-22

The rules below apply for purposes of the income tax, the gift tax, the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA), and the Self-Employment Contributions Act of 1954 (SECA).[3198] Generally, the split-dollar economic benefit regime[3199] applies to any arrangement that is not subject to the split-dollar loan regime.[3200] It also applies to a loan arrangement if the following requirements of Reg. § 1.61-22(b)(3)(ii) apply:

(A) The arrangement is entered into in connection with the performance of services, and the employer or service recipient is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(1) of this section); or

(B) The arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(2) of this section).

Generally, "[w]ith respect to a life insurance contract, the person named as the policy owner of such contract generally is the owner of such contract.[3201]

However:[3202]

(1) An employer or service recipient is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into in connection with the performance of services if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section; and

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[3198] Reg. § 1.61-22(a)(1) provides the purposes.
[3199] The regulatory framework for the split-dollar economic benefit regime is valid. *Our Country Home Enterprises, Inc. v. Commissioner*, 145 T.C. No. 1 (2015).
[3200] Reg. § 1.61-22(b)(3)(i).
[3201] Reg. § 1.61-22(c)(1)(i), which further provides:

> If two or more persons are named as policy owners of a life insurance contract and each person has, at all times, all the incidents of ownership with respect to an undivided interest in the contract, each person is treated as the owner of a separate contract to the extent of such person's undivided interest. If two or more persons are named as policy owners of a life insurance contract but each person does not have, at all times, all the incidents of ownership with respect to an undivided interest in the contract, the person who is the first-named policy owner is treated as the owner of the entire contract.

[3202] Reg. § 1.61-22(c)(1)(ii)(A).

(2) A donor is treated as the owner of a life insurance contract under a split-dollar life insurance arrangement that is entered into between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is current life insurance protection as described in paragraph (d)(3) of this section.

Note that (1) above does not prevent an employee from setting up an endorsement arrangement with the employer, in which the employee owns the policy (including cash surrender value) and pays the premiums and the employer pays for some current life insurance protection. In such an arrangement, the employee's interest in the cash value means that current life insurance protection is not the employee's only interest in the policy; therefore, the employee's being named as the policy owner also makes the employee the owner for tax purposes.

Similarly, in a donor-donee economic split-dollar agreement, if the donee is designated the owner of the life insurance policy, then the donee will be treated as the owner for tax purposes if the donee has any interest other than current life insurance protection. Although the donee having actual ownership of the policy would seem risky for this reason, such an arrangement might save estate tax if the donor is not the insured, as described in part II.Q.4.f.iii Estate Tax Consequences of Split-Dollar Agreements.[3203]

For these purposes:[3204]

> the amount of the current life insurance protection provided to the non-owner for a taxable year (or any portion thereof in the case of the first year or the last year of the arrangement) equals the excess of the death benefit of the life insurance contract (including paid-up additions thereto) over the total amount payable to the owner (including any outstanding policy loans that offset amounts otherwise payable to the owner) under the split-dollar life insurance arrangement, less the portion of the policy cash value actually taken into account under paragraph (d)(1) of this section or paid for by the non-owner under paragraph (d)(1) of this section for the current taxable year or any prior taxable year.

In applying these rules, the "non-owner (and the owner for gift and employment tax purposes) must take into account the full value of all economic benefits …, reduced by the consideration paid directly or indirectly by the non-owner to the owner for those economic benefits."[3205]

[3203] Especially fns. 3214-3216.

[3204] Reg. § 1.61-22(d)(3)(i).

[3205] Reg. § 1.61-22(d)(1). Furthermore:

> Depending on the relationship between the owner and the non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character. Further, depending on the relationship between or among a non-owner and one or more other persons (including a non-owner or non-owners), the economic benefits may be treated as provided from the owner to the non-owner and as separately provided from the non-owner to such other person or persons (for example, as a payment of compensation from an employer to an employee and as a gift from the employee to the employee's child).

The requirement that the non-owner receive only current life insurance protection means that the non-owner cannot have any other economic benefits, such as current or future access to cash value.[3206] Policy cash value excludes surrender charges or other similar charges or reductions and includes policy cash value attributable to paid-up additions.[3207] A non-owner has current access to that portion of the policy cash value (A) to which the non-owner has a current or future right and (B) that currently is directly or indirectly accessible by the non-owner, inaccessible to the owner, or inaccessible to the owner's general creditors.[3208] Note that the policy's being inaccessible to the owner is not enough to attribute cash value to the non-owner; the non-owner must also have a current or future right to the cash value.[3209]

See text accompanying fn. 3206 for the economic benefits described in this regulation.

[3206] Reg. § 1.61-22(d)(2) provides:

> *Value of economic benefits*. The value of the economic benefits provided to a non-owner for a taxable year under the arrangement equals—
>
> (i) The cost of current life insurance protection provided to the non-owner as determined under paragraph (d)(3) of this section;
>
> (ii) The amount of policy cash value to which the non-owner has current access within the meaning of paragraph (d)(4)(ii) of this section (to the extent that such amount was not actually taken into account for a prior taxable year); and
>
> (iii) The value of any economic benefits not described in paragraph (d)(2)(i) or (ii) of this section provided to the non-owner (to the extent not actually taken into account for a prior taxable year).

[3207] Reg. § 1.61-22(d)(4)(i).

[3208] Reg. § 1.61-22(d)(4)(ii).

[3209] See fns. 3214-3216, in which the cash value seemed to be as inaccessible to the donor as it could possibly be, and the court dismissed out-of-hand arguments about inaccessibility because the non-owner had no current or future right to any part of the cash value. The split-dollar agreement provided:

> **Section 2.01. Policy Ownership.**
>
> (a) The Trust be the sole and absolute owner of the Policy. and may exercise all ownership rights granted to the owner thereof under the term of the Policy, except as otherwise provided in and limited by this Agreement.
>
> (b) It is the intention of the parties to this Agreement and the purpose of the Collateral Assignment that the Trust shall retain all rights that the Policy grants to the owner thereof, except as otherwise provided in and provided by this Agreement. The sole right of the Donor under this Agreement and under the Collateral Assignment shall be to be repaid the amount due to Donor under this Agreement. Specifically, but without limitation, the Donor shall neither have nor exercise any right as collateral assignee of the Policy that could in any way defeat or impair the Trust's right to receive the Policy Cash Value or the death benefit of the Policy in excess of the total amount due to the Donor under this Agreement. All provisions of this Agreement and of the Collateral Assignment shall be construed so as to carry out such intention and purpose.
>
> **Section 2.02. Dividends.** All dividends declared and paid on the Policy shall be applied as the Trust shall deem appropriate.

Section 6.01 of the split-dollar agreement said that the agreement is to be interpreted such that the only economic benefit is the current life insurance protection. Query whether the IRs and court assumed that this savings clause meant that the dividends could not be paid to the trust – rather that the trust merely had discretion how to apply the dividends to the policy's cash value; I do not recall them addressing the issue. Note that the trust having a right to be receive dividends itself would have violated the Reg. § 1.61-22(c)(1)(ii)(A)(2) rule that the only right to the policy be current life insurance protection and the consequence of violating that rule would have been that the trust would be deemed the owner for gift tax purposes.

Now that we have established that the non-owner receives only the term portion and the owner receives everything else, let's discuss how to treat money received with respect to the subject life insurance contract.

For death benefits (noting that Code § 101(a) exempts death benefits from income taxation except to the extent that the transfer for value rules apply, if at all):[3210]

(i) *Death benefit proceeds to beneficiary (other than the owner)*. Any amount paid to a beneficiary (other than the owner) by reason of the death of the insured is excluded from gross income by such beneficiary under section 101(a) as an amount received under a life insurance contract to the extent such amount is allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

Paragraph 2 of the collateral assignment (also not mentioned in the court's opinion) provided as follows:

> 2. It is expressly agreed that the Assignee's interest in the Policy under and by virtue of this Assignment shall be limited to die following specific rights, and no others: (a) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount directly from the Insurer out of the net death proceeds of the Policy; upon the death of the Insured; and (b) the right to be paid the amount due to the Assignee under the Agreement by recovering said amount from the Assignor out of the Policy Cash Value (as defined in the Agreement), in the event the Policy is surrendered or cancelled by the Assignor or m the event the Agreement is terminated during the Insured's lifetime. The Assignee shall have no other rights or powers in and to the Policy as a result of the assignment of the Policy to the Assignee hereunder, and specifically shall not have the right or power to borrow against or obtain loans or advances on the Policy, make withdrawals from the Policy, nor cancel or surrender the Policy.
>
> 3. Except as otherwise provided in this Assignment and the Agreement, the Assignor shall specifically retain all incidents of ownership in and to the Policy, .including, but not limited to: (a) the sole right to cancel or surrender the Policy at any time provided by the terms of the Policy and at such other times as the Insurer may allow; (b) the sole right to collect and receive all distributions or shares of surplus, dividend deposits or additions to the Policy now or hereafter made or apportioned thereto, and to exercise any and all options contained in the Policy with respect thereto; (c) the sole right to exercise all non forfeiture rights permitted by the return of the Policy or allowed by the Insurer and to receive all benefits and advantages derived therefrom; (d) the sole right to designate and change the beneficiary of the Policy (for any amount in excess of the amount to the .Assignee under the Agreement); (e) the sole right to elect any optional mode of settlement permitted by the Policy or allowed by the Insurer; and (c) the sole right to collect directly from the Insurer that portion of the net death proceeds of the Policy in excess of those proceeds payable to the Assignee under the Agreement; *provided, however,* in no event shall the Assignor possess the right or power to receive loans or other advances respecting the Policy from the Insurer or any other lender; *provided, further,* all of the foregoing rights retained by the Assignor in the Policy hereunder shall be subject to the terms and conditions of the Agreement.

I view the collateral assignment as being limited by the split-dollar agreement.

Notwithstanding any of the above possible interpretations, I recommend making it clear that the donee is not entitled to dividends. This particular policy was variable life insurance but paid dividends presumably because it was a mutual insurance company.

[3210] Reg. § 1.61-22(f)(3).

(ii) *Death benefit proceeds to owner as beneficiary*. Any amount paid or payable to an owner in its capacity as a beneficiary by reason of the death of the insured is excluded from gross income of the owner under section 101(a) as an amount received under a life insurance contract to the extent such amount is not allocable to current life insurance protection provided to the non-owner pursuant to the split-dollar life insurance arrangement, the cost of which was paid by the non-owner, or the value of which the non-owner actually took into account pursuant to paragraph (d)(1) of this section.

Except for death benefits:[3211]

> [A]ny amount received under a life insurance contract that is part of a split-dollar life insurance arrangement … is treated, to the extent provided directly or indirectly to a non-owner of the life insurance contract, as though such amount had been paid to the owner of the life insurance contract and then paid by the owner to the non-owner. The amount received is taxable to the owner in accordance with the rules of section 72. The non-owner (and the owner for gift tax and employment tax purposes) must take the amount described in paragraph (e)(3) of this section into account as a payment of compensation, a distribution [from a corporation],[3212] a contribution to capital, a gift, or other transfer depending on the relationship between the owner and the non-owner.

The owner is the only party who is credited with "investment in the contract" under Code § 72(e)(6).[3213]

Reg. § 1.61-22(g) provides rules for unwinding the arrangement so that the non-owner becomes the owner.

II.Q.4.f.iii. Estate Tax Consequences of Split-Dollar Agreements

Note that the split-dollar economic benefit regime regulations do not apply for estate tax purposes. Apparently taking advantage of this gap, *Estate of Morrissette v. Commissioner*[3214] upheld a taxpayer's heavily discounted generational split-dollar

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[3211] Reg. § 1.61-22(e)(1).

[3212] The actual text refers to Code § 301.

[3213] Reg. § 1.61-22(f)(2)(ii) provides:

> *To owner*. Any premium paid by an owner under a split-dollar life insurance arrangement subject to the rules of paragraphs (d) through (g) of this section is included in the owner's investment in the contract under section 72(e)(6). No premium or amount described in paragraph (d) of this section is deductible by the owner (except as otherwise provided in § 1.83-6(a)(5)). Any amount paid by a non-owner, directly or indirectly, to the owner of the life insurance contract for current life insurance protection or for any other economic benefit under the life insurance contract is included in the owner's gross income and is included in the owner's investment in the life insurance contract for purposes of section 72(e)(6) (but only to the extent not otherwise so included by reason of having been paid by the owner as a premium or other consideration for the contract).

[3214] 146 T.C. 171 (2016). For a complete discussion, see S. Gorin & H. Zaritsky, Tax Court Approves Some Key Issues with Intergenerational Split-Dollar Arrangements, 28 Probate Practice Reporter 1 (June 2016). For a link to various selected documents filed with the Tax Court, including the split dollar agreement and appraisal the IRS viewed as representative of the arrangements, see http://tcinstitute.com/rv/ff002894cb41394cda173f9fe7469759eae604bd. In agreement[3215] when the decedent bequeathed her interest to the other party in the split-dollar arrangement.[3216] In that case, the mother funded life insurance owned by

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Estate of Cahill v. Commissioner, Tax Court Docket No. 10451-16, a petition filed May 3, 2016 indicates issues relating to valuation, Code §§ 2036, 2038 and 2703, among others – issues that the *Morrissette* court did not discuss; on December 29, 2016, the parties filed memoranda setting forth the issues that they say need to be resolved in the case; see https://www.ustaxcourt.gov/UstcDockInq/DocketDisplay.aspx?DocketNo=16010451. In *Estate of Levine v. Commissioner*, Tax Court docket no. 9345-15, a July 13, 2016 order granted summary judgment to the taxpayer because the parties agreed that *Morrissette* controlled, with the IRS preserving its right to appeal, indicating that it continued to disagree with *Morrissette*.

3215 Under the split-dollar rules, the decedent was the deemed owner of policies on younger insureds. Such an arrangement is referred to as generational because the insured is expected to outlive the decedent by a significant number of years. That the decedent's estate has to wait for many years to collect what it is owed and must also continue to expend funds during that time might cause the value of the decedent's economic rights to be discounted. However, the decedent's estate would benefit from the growth in the policy's cash value and would not bear the mortality charge (except to the extent that the mortality charge exceeded the rates under the IRS' Table 2001 rates), so it is unclear how much the policy should be discounted.

3216 The IRS apparently argued that bequeathing the decedent's split-dollar interest to the other party to the contract made the restrictions illusory. From the opinion:

> Respondent argues that the Dynasty Trusts had a direct or indirect right in the cash values of the insurance policies by virtue of the terms of the 2006 Amendment to the CMM Trust. Under that amendment, the CMM Trust's interest in the cash values of the policies would pass to the Dynasty Trusts or directly to Mrs. Morrissette's sons or their heirs upon her death. However, because the CMM Trust was a revocable trust with respect to Mrs. Morrissette, she retained an absolute right to alter the CMM Trust throughout her lifetime. Accordingly, the Dynasty Trusts did not have a legally enforceable right to the cash values of the policies during the lifetime of the grantor. Furthermore, the split-dollar life insurance arrangements did not require the CMM Trust to distribute the receivables to the Dynasty Trusts. Rather, Mrs. Morrissette retained the right to receipt of the receivables.

The decedent's ability to amend her revocable trust was pure legal fiction, which legal fiction this case takes to the extreme. From the finding of facts:

> [The decedent's sons] Arthur, Donald, and Kenneth petitioned the Circuit Court of Fairfax County, Virginia (Fairfax court) for appointment of a conservator for Mrs. Morrissette's estate and asked the conservator to transfer additional assets to the CMM Trust. On August 18, 2006, the court found Mrs. Morrissette to be permanently incapacitated and appointed Cathleen A. Hatfield, an employee of the Interstate Group, to serve as the conservator. The Fairfax court granted Ms. Hatfield broad authority to act on Mrs. Morrissette's behalf. The conservatorship expired on October 20, 2006.

The conservator did the following during that 2-month period:

1. Established Dynasty Trusts,
2. Amended the revocable trust to authorize entering into the split-dollar agreements and bequeathing the revocable trust's interest in each split-dollar agreement to the other party to the split-dollar agreement, and
3. Entered into a buy-sell agreement requiring the life insurance.

Then, the Dynasty Trusts bought the policies and together with the revocable trust (of which the sons were co-trustees), entered into the split-dollar agreements.

The idea that this arrangement would ever be modified was ludicrous, given that the sons orchestrated this entire transaction for their benefit, using as the conservator an employee of the company that they directly or beneficially owned, to set up a multi-million dollar transaction in a compressed period of time.

The following facts might have helped the estate's case:

irrevocable life insurance trusts ("ILITs") to fund cross purchase buy-sell obligations that her children had to each other. Because the mother had to wait until her children died to receive cash on the split-dollar receivables and the ILITs had full control over the policies, the mother's estate tax return reported that her right to receive the almost $30 million she invested was worth only approximately $7.5 million. Because the split-dollar receivable would have a low basis, repayment would have generated significant income tax; by bequeathing the receivable to the other party the agreement, the mother might have prevented that result.[3217]

Also consider potential estate tax inclusion when the insured also controls an employer that is a party to the split-dollar agreement. Because part of the death benefit is not payable to the employer,[3218] the IRS might argue that the insured has incidents of ownership over the policy that is subjected to the split-dollar arrangement. To avoid such an argument, the split-dollar agreement and any collateral assignments might limit the employer's rights to just those provided in the split-dollar agreement.[3219] Although

- The purchase of the policies was for a legitimate and significant nontax reason [my assumption that the *Bongard* test might have been in the court's mind] – to fund a buy-sell agreement.
- The donor lived 4 years after the arrangement was made.
- The gift tax returns used the IRS' Table 2001 rates instead of any alternative term rates provided by the insurance company.

3217 Presumably the bequest of the receivable or even a note under the loan regime would not generate income tax. Bequeathing a note (other than a note received in an installment sale) does not trigger cancellation of indebtedness income to the debtor; see fn. 5360, found in part III.B.5.a Promissory Notes.

3218 If all of the death benefit is payable to the employer or used for the employer's business purpose, the insurance policy is not included in the insured's estate by reasons of incidents of ownership, although the death benefit might very well affect the employer's value that is included in its deceased owner's estate. See part II.Q.4.a Funding the Buy-Sell, especially fn. 3113.

3219 For example, Letter Ruling 9651017 held:

> Under the split-dollar agreement in the present case, X is expressly prohibited from borrowing against any part of the policy. In addition, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the trustee of Trust. Accordingly, we conclude, that X will possess no incidents of ownership in the policy acquired by the Trust. See Rev. Rul. 76-274, 1976-2 C.B. 278, modified by Rev. Rul. 82-145, 1982-2 C.B. 213.

Letter Ruling 9651030 had the same or similar language. Letter Ruling 9511046 elaborated:

> Under the split-dollar agreement in the present case, the corporation will, however, hold no incidents of ownership. The corporation will have no defacto ability to force the trustee to borrow against the policy because the corporation is required to make the necessary premium payments for the duration of the trust. The power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy or to revoke an assignment, and the power to pledge the policy for a loan or to obtain from the insurer a loan against the surrender value of the policy are vested in the third party trustee of the irrevocable trust and are not attributable to the corporation. Accordingly, although the surviving spouse will hold control of the corporation for purposes of section 20.2042-1(c)(6), the corporation will hold no incidents of ownership in the second-to-die life insurance policy, and, thus, no incidents of ownership in the policy will be attributable to the surviving spouse.

Letter Ruling 9348009 held:

that approach would work for the split-dollar loan regime, it might not work so well for the economic benefit regime. The economic benefit regime provides that the non-owner is deemed to have current access to that portion of the policy cash value to which the non-owner has a current or future right and that currently is inaccessible to the owner.[3220] In other words, if the employer is generally the deemed owner but cannot access the cash value, the other party to the split-dollar agreement is deemed to benefit from that cash value if the other party has a current or future right to part of the cash value. Thus, the approach suggested in fn. 3219 risks being recharacterized as being owned by the employee (and therefore the employer's premium being considered paid to the employee to the extent not attributable to the employer's retained rights to absolutely control cash value) unless the split-dollar agreement is absolutely tight about the employer being entitled to the full cash value. For those less than absolutely confident that the agreement, when using the economic benefit regime consider making the case that the entire arrangement is for the employer's business purpose – the employer receives the employer's portion of the death benefit, and the balance of the death benefit was provided through reasonable compensation for valuable services that the insured provided to the employer or through sharing the premium. However, *Morrissette*'s approval of a split-dollar policy as being solely owned by the premium payer (other than current life insurance protection) will boost the confidence of practitioners regarding the ability to draft agreements without risking the named owner being treated as the owner for income and gift tax purposes; see fn. 3214.

For donor-donee arrangements on the life of the insured, naming the donor as owner is not available. If the donor is the insured, one must draw up an absolutely tightly woven split-dollar agreement preventing the donor from having incidents of ownership, if using the economic regime (as in fn. 3214); those who are risk averse should use the loan regime. If the donor is not the insured, preventing the donor from having incidents of ownership is not important; one can then either name the donor as owner to take a conservative approach or, using a tightly woven split-dollar to try to secure valuation discounts,[3221] name the donee as the owner.

Lee Slavutin suggests the following guidelines for drafting generational split dollar agreements:[3222]

1. Clearly state that the purpose of the split dollar agreement is to "fund a permanent life insurance policy for estate liquidity or business succession, for example."

> The facts in this case indicate that the Company's economic interest in the policy is limited to that of irrevocably designated beneficiary of that portion of the proceeds that is equal to the cash surrender of the policy. Additionally, we assume that no agreement or other factors exist that would cause the value of the decedent's stock holdings in the corporation not to be taken into account for purposes of section 2031. Under these circumstance, because the Company possesses no rights the exercise of which would impact that portion of the proceeds payable to a beneficiary other than the Company, the Company cannot be said to possess any incidents of ownership in the policy of the type that would be attributable to the surviving spouse under section 20.2042-1(6) of the regulations.

3220 Reg. § 1.61-22(d)(2)(ii) - see fns. 3206 and 3208 for text of the relevant regulations.

3221 See fns. 3214-3216.

3222 A Post-*Morrissette* Roadmap for Drafting Intergenerational Split Dollar Agreements, *Steve Leimberg's Estate Planning Email Newsletter* - Archive Message #2414 (5/12/2016).

2. Add a preliminary recital that the agreement is intended to qualify as an economic benefit arrangement under Reg. § 1.61-22 and that the ONLY benefit intended to be provided to the "donee" trust is life insurance protection.

3. Do NOT give the donee trust the right to borrow against the cash value.

4. At termination or death, make sure that the donor gets the GREATER of cash value or premiums paid.

5. The donor should be REQUIRED to pay all premiums. The donee has no obligation to pay premiums. If premiums are prepaid, there will be no additional benefit to the donee trust.

6. Do not mention the disposition of the receivable at death. Otherwise, it might be construed as an additional benefit to the donee trust.

II.Q.4.g. Income Tax Trap for Business-Owned Life Insurance

II.Q.4.g.i. Analysis of Code § 101(j)

Beware that an employer-owned life insurance contract might not qualify for the usual exclusion from regular income tax.[3223] An "employer-owned life insurance contract" (a term that applies to much more than one would think) does not receive the exclusion unless certain notice and consent requirements are met.[3224]

An "employer-owned life insurance contract" is a life insurance contract that (i) is owned by a person engaged in a trade or business and under which such person (or certain related party) is directly or indirectly a beneficiary under the contract, and (ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.[3225] An "applicable policyholder" means, with respect to any employer-owned life insurance contract, the person described in the preceding sentence who owns the contract[3226] at the time it is issued.[3227]

"Employee" includes a "highly compensated employee" under Code § 414(q),[3228] and Code § 414(q)(1)(A) pulls in people who own at least 5% of the company.[3229] Thus, an

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[3223] Code § 101(j).
[3224] Code § 101(j)(1), (2).
[3225] Code § 101(j)(3)(A).
[3226] Code § 101(j)(3)(B)(i).
[3227] The qualification at the time it is issued is not mentioned in any particular authority but appears to be implicit in the statutory scheme. See the text accompanying fn. 3231.
[3228] Code § 101(j)(5).
[3229] Notice 2009-48, A-8 provides:

> Section 101(j)(4) provides no exception that would excuse a wholly-owned corporation and its employee-owner from the notice and consent requirements that otherwise apply, nor can actual knowledge alone substitute for the statutory requirement that notice and consent be 'written.' Moreover, the requirement that notice and consent be written avoids factual controversies that otherwise could result where, for example, the sole owner of a corporation delegates financial matters to an employee.

owner who is not an employee is an "employee" for purposes of this rule by being a 5% owner.

The notice and consent requirements are met if, before the issuance of the contract, the employee (A) is notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued, (B) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (C) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.[3230] The only way that this requirement makes any sense is if the policy was issued to the person treated as the insured's employer under these rules - this requirement would be impossible to satisfy if it was issued to the insured or someone else because the person treated as an employer might not even know about the policy. Thus, "applicable policyholder" should mean the person to whom the policy is issued when the insured is an "employee" of that person.[3231]

In addition to the notice and consent requirements, either the insured must have a qualifying relationship with the company or the death benefit must be put to certain uses:

- A qualifying relationship includes the insured being an employee, director, or 5% owner at any time during the 12-month period before the insured's death.[3232]

- Another qualifying relationship is if, when the contract is issued, the insured is a director, certain highly compensated employees, or a 5% owner.[3233] (Note that Code § 101(j) does not apply unless the insured is an employee with respect to the trade or business of the applicable policyholder when the contract is issued, so the concern for the qualifying relationship or qualifying use applies only when the insured is an employee who does not satisfy this bullet point when the contract is issued.)[3234]

- A qualifying use is being paid to a member of the family of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured.[3235]

3230 Code § 101(j)(4).

3231 Notice 2009-48, A-1, further below, clarifies that the person to whom this sentence refers generally is the entity that employs the insured rather than an owner of the entity and that the entity is treated as owning a policy owned by a grantor trust with respect to which the entity is the deemed owner.

3232 Code § 101(j)(2)(A)(i). The reference to director comes from Code § 101(j)(5), and a 5% owner is described in the text accompanying fns. 3228-3229.

3233 Code § 101(j)(2)(A)(ii). The reference to a 5% owner is described in the text accompanying fns. 3228-3229. The highly compensated employees are those described in Code § 414(q) (without regard to Code § 414(q)(1)(B)(ii)) or Code § 105(h)(5) (except that 35% is substituted for "25 percent" in Code § 105(h)(5)(C).

3234 See text accompanying fns. 3225-3227.

3235 Code § 101(j)(2)(B)(i). "Family member" refers to Code § 267(b)(4).

- Another qualifying use is the purchase of an equity (or capital or profits) interest in the applicable policyholder from any person described in the preceding bullet point.[3236] Beware of the proceeds exceeding this use.

A life insurance-funded buy-sell agreement might be structured to comply with these rules, in case the parties forget to do the required notice and consent.[3237] It also would guard against error in my suggestion that "applicable policyholder" is limited to being the person to whom the policy is issued when the insured is an "employee" of that person.

These rules impose various notice and other requirements that in most cases will not be a practical obstacle to implementing buy-sell agreements if signed <u>before</u> the application is signed.[3238] The employer might be able to cure a failure before the due date of its return for the year in which the policy was issued if the insured has not died yet.[3239]

[3236] Code § 101(j)(2)(B)(ii).

[3237] One might consider provisions such as that found in part II.Q.4.g.ii Consent Integrated into Operating Agreement. The sample is an attempt to be a catch-all in case clients do not follow the recommended procedure. Letter Ruling 201217017 approved what appears to have been a similar provision in a corporate buy-sell agreement:

> … the Agreement provides that Taxpayer will obtain life insurance on the life of each Shareholder, and that Taxpayer will be the owner and beneficiary of such life insurance. If the Agreement is terminated, or a Shareholder disposes of his interest in Taxpayer as allowed by the Agreement, a Shareholder has the right to purchase from Taxpayer any Taxpayer-owned life insurance covering his life. If the life insurance was not purchased, Taxpayer retained the right to surrender or otherwise dispose of the life insurance.

The ruling concluded:

> …considering all of Taxpayer's documentation as a whole, for the Contracts listed in the Appendix, all of the requirements of § 101(j)(4) were met before the issuance of the Contracts:
>
> a) through the Agreement and the Application, each Shareholder was notified in writing that Taxpayer intended to insure the Shareholder's life;
> b) through the Application, each Shareholder was notified in writing of the maximum face amount for which the Shareholder could be insured at the time the Contract was issued, in dollars;
> c) by signing both the Agreement and the Application, each Shareholder consented to being insured under the Contract;
> d) by signing the Agreement, each Shareholder consented that such coverage may continue after the Shareholder terminates employment; and
> e) through the Agreement and the Application, each Shareholder was informed in writing that Taxpayer will be a beneficiary of any proceeds payable upon the death of the Shareholder.

[3238] Leimberg and Zaritsky, IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance, 36 *Estate Planning*, No. 8, 3 (August 2009).

[3239] Notice 2009-48, A-13 provides:

> Section 101(j) does not contain a provision for correcting an inadvertent failure to satisfy the notice and consent requirements of § 101(j)(4). The Service will not, however, challenge the applicability of an exception under § 101(j)(2) based on an inadvertent failure to satisfy the notice and consent requirements if the following conditions are met: (1) the applicable policyholder made a good faith effort to satisfy those requirements, such as by maintaining a formal system for providing notice and securing consents from new employees; (2) the failure to satisfy the requirements was inadvertent; and (3) the failure to obtain the requisite notice and consent was discovered and corrected no later than the due date of the tax return for the taxable year of the applicable policyholder in

Another cure would be to transfer the policy to the insured, then the insured transfers the policy back to the company (generally, transfers from the insured to the company are not subject to the rule, except with respect to increases in coverage);[3240] step transaction concerns might suggest that the insured transfer the policy into a life insurance LLC[3241] instead of waiting long enough (whatever that means) to avoid the step transaction doctrine.

Clients should obtain the insured's written consent before the life insurance application is signed.

Consider having the maximum face amount in that consent provide a cushion in excess of the largest amount that the parties can conceive of that death benefit being (including increased death benefits due to investing the cash value very successfully).

An insurance agent might provide such a consent form, which counsel should consider reviewing, or counsel could provide his/her own consent form to the client. Although some agents understand these issues, many agents do not know (or think they know but actually misunderstand) these rules. Accordingly, tax advisors should consider warning their clients that the tax advisors need to be involved before any policy is issued.

Every applicable policyholder owning one or more employer-owned life insurance contracts issued after August 17, 2006 is required to file IRS Form 8925 each year.[3242] "Applicable policyholder" and "employer-owned life insurance contract" are defined for purposes of this reporting rule the same way they are for determining whether a policy is subject to the notice and consent rules.[3243]

These rules for life insurance contracts issued or materially changed after August 17, 2006.[3244] Notice 2009-48 elaborates on the rules described above, as well

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which the employer-owned life insurance contract was issued. Because § 101(j)(4)(B) requires that the employee's consent be written, failure to obtain such consent cannot be corrected after the insured employee has died.

[3240] Notice 2009-48, Q/A-8 provides:

> Q-8. Is notice and consent required with regard to an existing life insurance contract that an employee irrevocably transfers to an employer?
>
> A-8. No. The actual transfer of an existing life insurance contract by an employee to an employer is sufficient to satisfy the requirements that the employee be notified in writing of the intention to insure and the maximum face amount of insurance, that written consent be secured, and that the employee be notified that the employer will be a beneficiary upon his or her death. In the event the employer subsequently increases the face amount of the contract, however, written notice and consent must be secured to establish the requisite notice to the employee and consent to the new face amount.

[3241] See part II.Q.4.i Life Insurance LLC.

[3242] Code § 6039I(a) is the general reporting requirement, and Reg. § 1.6039I-1 specifies the form.

[3243] Code § 6039I(c).

[3244] P.L. 109-280, Sec. 863(a). Changing a split-dollar agreement without changing the underlying policy will not constitute a material modification under Code § 101(j), although it might very well affect other tax treatment. Notice 2008-42, discussed in part II.Q.4.f.i Split-Dollar Generally, especially the text accompanying fns. 3188-3190.

as providing rules for what constitutes a material modification,[3245] including guidance on tax-free exchanges.[3246]

As to buy-sell agreements, Notice 2009-48 provides that a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner – in other words, a cross-purchase - is not subject to these rules.[3247] However, if the business owns it,[3248] the following rules apply (emphasis added):[3249]

> **Exceptions to the Application of § 101(j)(1)**
>
> Section 101(j)(2) provides several exceptions to the application of § 101(j)(1), ***provided the notice and consent requirements of § 101(j)(4) are met***. Specifically, under § 101(j)(2)(A), § 101(j)(1) does not apply if the insured either was an employee at any time during the 12-month period before death, or was a director, highly compensated employee or highly compensated individual, as defined, at the time the contract was issued. Under § 101(j)(2)(B), § 101(j)(1) does not apply to any amount received by reason of the death of an insured to the extent the amount is paid to or used to purchase an equity (or capital or profits) interest from a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary, or the estate of the insured.

[3245] Notice 2009-48, A-14 provides:

> The following changes are not treated as material changes for purposes of determining whether an existing contract is treated as a new contract for purposes of § 101(j): (1) increases in death benefit that occur as a result of either the operation of § 7702 or the terms of the existing contract (provided the insurer's consent to the increase is not required); (2) administrative changes; (3) changes from general account to separate account or from separate account to general account; or (4) changes as a result of the exercise of an option or right granted under the contract as originally issued. Thus, for example, a death benefit increase does not cause a contract to be treated as a new contract if the increase is necessary to keep the contract in compliance with § 7702, or if the increase results from the application of policyholder dividends to purchase paid-up additions, or if the increase is the result of market performance or contract design with regard to a variable contract. Notice and consent are required if a contract is treated as a new contract by reason of a material increase in death benefit or other material change, unless a valid consent remains in effect with regard to the insured.

[3246] Notice 2009-48, A-15 provides:

> Section 863(d) of the PPA provides that § 101(j) generally does not apply to a contract issued after August 17, 2006 in an exchange described in § 1035 for a contract issued on or before that date. Section 863(d) also provides that, for purposes of determining when a contract is issued, a material increase in the death benefit or other material change generally causes the contract to be treated as a new contract. A § 1035 exchange that results in a material increase in death benefit or other material change (other than a change in issuer) is treated as the issuance of a new contract after August 17, 2006 for purposes of determining whether § 101(j) applies to the contract.

[3247] A-1.

[3248] Including through a grantor trust that the business established, per A-1.

[3249] After A-3 and before Q-4.

If plans do change, the Notice allows consent to be given before the death benefit exceeds the amount shown in the consent. The Notice also provides for a change in the employer.

The Notice further provides:

Q-1. Can a contract be an employer-owned life insurance contract if it is owned not by a person engaged in a trade or business, but by a related person who is not engaged in a trade or business?

A-1. No. A contract is an employer-owned life insurance contract only if it is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). Thus, a contract that is owned by the owner of an entity engaged in a trade or business (such as for purposes of financing the purchase of an equity interest of another owner), or by a qualified plan or VEBA that is sponsored by an entity engaged in a trade or business, is not an employer-owned life insurance contract. A contract, however, that is owned by a grantor trust (such as a rabbi trust), assets of which are treated as assets of a grantor that is engaged in a trade or business, is an employer-owned life insurance contract if the contract is otherwise described in § 101(j)(3).

Q-2. Can a contract be an employer-owned life insurance contract if it is subject to a split dollar arrangement?

A-2. Yes. A contract that is subject to a split dollar arrangement is an employer-owned life insurance contract if the contract is owned by a person engaged in a trade or business and is otherwise described in § 101(j)(3). See § 1.61-22(c)(1) (defining the owner of a contract subject to a split dollar arrangement to be the person named as the policy owner of the contract). Under § 101(j)(2)(B), however, the general rule of § 101(j)(1) does not apply to the extent any amount received by reason of the death of the insured is paid to a family member of the insured, an individual who is a designated beneficiary, a trust established for the benefit of a family member or designated beneficiary.

Q-3. Is a contract an employer-owned life insurance contract if it is owned by a partnership or sole proprietorship that is engaged in a trade or business; the partnership or sole proprietorship is directly or indirectly a beneficiary under the contract; and, the contract covers the life of an insured who is an employee with respect to the trade or business on the date the contract is issued?

A-3. Yes. If a life insurance contract is otherwise described in § 101(j)(3), ownership of the contract by a partnership or sole proprietorship does not prevent the contract from being treated as an employer-owned life insurance contract. A life insurance contract that is owned by a sole proprietor on his or her own life is not, however, an employer-owned life insurance contract.

Q-4. Under § 101(j)(2)(A) and (j)(4), when is a contract treated as "issued" for purposes of determining whether the notice and consent are timely, or whether the insured is a director, a highly compensated employee, or a highly compensated individual at the time the contract is issued?

A-4. Generally, the issue date of a contract is the date on the policy assigned by the insurance company, which is on or after the date the application was signed. Solely for purposes of § 101(j)(2)(A) and (j)(4), an employer-owned life insurance contract is treated as "issued" on the later of (1) the date of application for coverage, (2) the effective date of coverage, or (3) the formal issuance of the contract. Thus, if an employer-owned life insurance contract is effective for a limited period of time before formal issuance of the contract (such as to complete underwriting), the notice and consent requirements may be satisfied during the period between the effective date of coverage and formal issuance of the contract. In addition, an employer-owned life insurance contract may be treated as a new contract, and thus newly "issued," by reason of a material increase in death benefit or other material change in the contract. See A-14, this Notice.

Q-5. For purposes of § 101(j), is the term "employee" limited to common law employees?

A-5. No. Section 101(j)(5)(A) provides that the term "employee" includes an officer, director, and highly compensated employee (within the meaning of § 414(q)). A director is an independent contractor in his or her capacity as a director.

Section 414(q) contains special rules relating to certain former employees and self-employed individuals. For example, a former employee is treated as a highly compensated employee (within the meaning of § 414(q)) if the individual was a highly compensated employee when he separated from service, or was a highly compensated employee at any time after attaining age 55. In addition, the term "employee" for purposes of § 414(q) includes an individual who is a self-employed individual who is treated as an employee pursuant to § 401(c)(1).

Although policies used to fund redemptions are subject to the notice and consent rules if the insured is either an employee or holds at least 5% ownership, an exception applies if and to the extent that the company uses the policy to redeem the insured's stock shortly after death:

A-6. In order to know whether an amount received as a death benefit under an employer-owned life insurance contract is eligible for exclusion from gross income under § 101(a), or is ineligible for exclusion under the general rule of § 101(j)(1), it is necessary to determine the availability of the exception for amounts used to purchase an equity (or capital or profits) interest in the applicable policyholder. Accordingly, an amount must be so paid or used by the due date, including extensions, of the tax return for the taxable year of the applicable policyholder in which the applicable policyholder is treated as receiving a death benefit under the contract.

I insist on notice and consent - even for redemption arrangements - because the purchase might not be completed within that deadline, the parties might later all agree that the money would be better used in the business, or the death benefit might exceed the purchase price.

II.Q.4.g.ii. Consent Integrated into Operating Agreement

As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below. See fn. 3237 for authority for relying on such a provision; however, I recommend obtaining a separate notice and consent for more direct evidence to show the IRS. The rest of this part II.Q.4.g.ii is the sample:

The Company or Members may from time to time obtain life insurance policies on the lives of the Members. In the event those policies fall within the definition of "employer-owned life insurance policies" as defined in Code section 101(j), it is intended that the policies qualify for an exclusion from those rules (and thus the proceeds will be income tax-free) and that this Operating Agreement comply with the notice and consent requirements necessary to obtain that exclusion. Therefore, each Member is hereby given written notice that the Company or Members intend to insure his or her life by purchasing life insurance policy(ies) in the maximum face amount of $___________, and that the Company or Members will be the owner and beneficiary of that policy and of any proceeds payable on such Member's death. Each Member (by signing this Operating Agreement) hereby gives advance written consent to being insured under such policy(ies) and to the continuation of the policy(ies) after such Member ceases to have an Interest in the Company or otherwise terminates employment (as defined in Code section 101(j)(4)(B)) with the Company (and no inference is intended that a Member is an "employee" for any purposes other than the possible application of Code section 101(j)). The Members also agree to enter into a specific notice and consent containing these terms with regard to each policy obtained before the issuance of that policy.

II.Q.4.g.iii. Consent for Owner Who Is Not an Employee

As mentioned in part II.Q.4.g.i, a person owning at least 5% of a company is treated as an employee for purposes of this rule, even if that person not an employee. The rest of this part II.Q.4.g.iii is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _____ Owner

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ______________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______. Although the Employer does not employ me, I understand that my ownership in the Employer makes me considered an "employee" for purposes of I.R.C. Section 101(j). Therefore:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I no longer own an interest in the Employer or otherwise terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.g.iv. Consent for an Employee

The rest of this part II.Q.4.g.iv is a sample. As with any sample, consultation with a qualified tax advisor and a lawyer are required before using the sample below.

Notice and Consent

For _______ Employee

Under I.R.C. Section 101(j)(4)

I acknowledge notification that ____________ (the "Employer") intends to obtain a policy insuring my life with a maximum face amount of $_______, and:

(A) I acknowledge that the Employer intends to insure my life regarding the death benefits listed in the attached schedule.

(B) I consent to being insured under these contracts and that such coverage may continue after I terminate employment.

(C) I understand that the Employer will be a beneficiary of any proceeds payable upon my death.

[add signature line and date, dated on before policy issuance]

II.Q.4.h. Establishing Estate Tax Values

For estate tax purposes, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[3250] If a decedent owns voting and nonvoting shares, the shares are valued together as a single block.[3251]

[3250] Reg. § 20.2031-1(b). Rev. Rul. 59-60 and its progeny discuss valuation principles.
[3251] *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981).

Regarding buy-sell agreements:[3252]

> **(h) Securities subject to an option or contract to purchase.** Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. See section 2703 and the regulations at §25.2703 of this chapter for special rules involving options and agreements (including contracts to purchase) entered into (or substantially modified after) October 8, 1990.

Thus, a buy-sell or similar agreement must apply during a decedent's life as well as after death before it might be given effect. Recent cases have reaffirmed this requirement.[3253]

For purposes of gift, estate and GST tax, Code § 2703(a) provides that the value of any property shall be determined without regard to:

(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or

(2) any restriction on the right to sell or use such property.

Thus, when a parent transfers an equity interest to a child pursuant to a legally binding stock option or buy-sell agreement, generally for gift, estate and GST tax purposes the

[3252] Reg. § 20.2031-2(h).

[3253] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Blount*, T.C. Memo. 2004-116, *aff'd* in part, *rev'd* in part, 428 F.3d 1338 (11th Cir. 2005) (life insurance included in valuing company, but the Eleventh Circuit treated the buy-sell obligation as offsetting the inclusion); *Smith III v. U.S.*, 96 A.F.T.R.2d 2005-6549 (W.D. Pa. 2005). In a case citing *True* but taking an unusual tack, in *Huber v. Commissioner*, T.C. Memo. 2006-96, the IRS tried to use a buy-sell agreement against a taxpayer, but Judge Goeke ruled that a right of first refusal in the agreement did not increase the value of the subject stock. Not mentioned in the Huber opinion is that, according to one of the taxpayer's counsel, prior gift tax audits had accepted the taxpayer's appraisals or settled very close to it, so the IRS' posture was radically different than before. In *Estate of Cartwright v. Commissioner*, 183 F.3d 1034 (9th Cir. 1999), *aff'g* in part and *rev'g* in part T.C. Memo. 1996-286, life insurance proceeds did not increase the value of the decedent's interest in the law firm to which he had belonged, except as necessary to take into account advanced client costs and work in process pursuant to the buy-sell agreement.

parent is deemed to make a taxable transfer to the extent that the equity interest's value exceeds the payment under that agreement. These rules extend to all sorts of arrangements:[3254]

> A right or restriction may be contained in a partnership agreement, articles of incorporation, corporate bylaws, a shareholders' agreement, or any other agreement. A right or restriction may be implicit in the capital structure of an entity.

A waiver of the right to partition art was disregarded under Code § 2703(a)(2).[3255]

However, Code § 2703(b) provides that the above rules shall not apply to any option, agreement, right, or restriction which meets each of the following requirements:

(1) It is a bona fide business arrangement.[3256]

[3254] Reg. § 25.2703-1(a)(3).

[3255] *Elkins v. Commissioner*, 140 T.C. No. 5 (2013).

[3256] *Holman v. Commissioner*, 130 T.C. 170 (2008) held:

> We believe that [the transfer restrictions] were designed principally to discourage dissipation by the children of the wealth that Tom and Kim had transferred to them by way of the gifts. The meaning of the term bona fide business arrangement in section 2703(b)(1) is not self-apparent. As discussed supra, in *Estate of Amlie v. Commissioner*, T.C. Memo. 2006-76, we interpreted the term bona fide business arrangement to encompass value-fixing arrangements made by a conservator seeking to exercise prudent management of his ward's minority stock investment in a bank consistent with his fiduciary obligations to the ward and to provide for the expected liquidity needs of her estate. Those are not the purposes of [the transfer restrictions]. There was no closely held business here to protect, nor are the reasons set forth in the Committee on Finance report as justifying buy-sell agreements consistent with petitioners' goals of educating their children as to wealth management and disincentivizing them from getting rid of Dell shares, spending the wealth represented by the Dell shares, or feeling entitled to the Dell shares.

The court had cited this portion of the legislative history (an informal report of the Senate Committee on Finance):

> [Buy-sell agreements] are common business planning arrangements … that … generally are entered into for legitimate business reasons…. Buy-sell agreements are commonly used to control the transfer of ownership in a closely held business, to avoid expensive appraisals in determining purchase price, to prevent the transfer to an unrelated party, to provide a market for the equity interest, and to allow owners to plan for future liquidity needs in advance….

The Eighth Circuit affirmed, 601 F.3d 763 (2010):

> Here that context shows that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions. Simply put, in the present case, there was and is no business, active or otherwise. The donors have not presented any argument or asserted any facts to distinguish their situation from the use of a similar partnership structure to hold a passbook savings account, an interest-bearing checking account, government bonds, or cash. We and other courts have held that maintenance of family ownership and control of [a] business may be a bona fide business purpose. *St. Louis County Bank*, 674 F.2d at 1207; see also *Estate of Bischoff v. Commissioner*, 69 T.C. 32, 39–40 (1977). We have not so held, however, in the absence of a business. [footnote described below]
>
> That is not to say we necessarily believe it will always be easy to apply § 2703(b)(1) or that investment-related activities cannot satisfy the subsection (b)(1) test. When the restrictions at issue, however, apply to a partnership that holds only an insignificant fraction of stock in a

highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy, we do not view this determination as difficult. See, e.g., *Higgins v. Commissioner*, 312 U.S. 212, 217–18 (1941) (holding in another context that merely keeping records and collecting interest and dividends did not amount to carrying on a business); *Estate of Thompson v. Commissioner*, 382 F.3d 367, 380 (3d Cir. 2004) (Other than favorable estate tax treatment resulting from the change in form, it is difficult to see what benefit could be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations.).

In footnote 3 discussing the *St. Louis County Ban*k case, 674 F.2d 1207 (8th Cir. 1982), the court pointed out:

In *St. Louis County Bank*, for example, the transferred interests were shares in a family company that had started out as a moving, storage, and parcel-delivery business and evolved into a real estate management company. *St. Louis Bank*, 674 F.2d at 1208–09. When engaged in the moving and storage business, the company had created a stock-purchase agreement based on a valuation formula keyed to income. *Id*. At 1209. Later, the family exited the moving and storage business but kept the business structure as a vehicle for renting real estate. *Id*. With this new activity, the formula resulted in a dramatically lower value. *Id*. We stated, We have no problem with the District Court's findings that the stock-purchase agreement provided for a reasonable price at the time of its adoption, and that the agreement had a bona fide business purpose—the maintenance of family ownership and control of the business. Courts have recognized the validity of such a purpose. *Id*. at 1210.

Judge Beam offered a strong dissent:

Here, the Tax Court made the express factual determination that the partnership agreement restrictions were designed principally to protect family assets from dissipation by the Holman daughters. *Holman*, 130 T.C. at 195 (emphasis added). In other words, the Tax Court determined that the restrictions were designed primarily to serve a non-tax purpose. Notably, the Tax Court did not find that the Holmans merely paid lip service to legitimate business purposes for the restrictions while, in reality, using the restrictions for the primary purpose of avoiding taxes. [footnote omitted] Additionally, the Tax Court did not find that the restrictions failed to match the partnership's legitimate, non-tax goals. [footnote omitted] The underlying purposes of § 2703 are not served where, as here, the bona fide business arrangement test is applied in a manner that discourages partners in family partnerships from creating restrictions principally to achieve non-tax, economic goals. Thus, I would hold that the Holman partnership agreement restrictions are bona fide business arrangements because they were not created for the primary purpose of avoiding taxes, and they served the following legitimate business purposes: (1) maintaining family control over the right to participate as a limited partner; (2) maintaining family control over the right to receive income from the partnership's investment assets; (3) protecting partnership assets from creditors and potential future ex-spouses; and (4) preserving the partners' fundamental right to choose who may become a partner….

Having determined that the partnership restrictions satisfy § 2703(b)(1), I now turn to § 2703(b)(2)'s device test. Under this test, the Holman partnership restrictions must not be a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. I.R.C. § 2703(b)(2) (emphasis added). Treasury Regulation § 25.2703-1(b)(1)(ii) excises the phrase members of the decedent's family found in § 2703(b)(2) and substitutes in its place the phrase natural objects of the transferor's bounty, apparently because the Secretary of the Treasury interprets § 2703(b)(2) to apply to both inter vivos transfers and transfers at death. Holman, 130 T.C. at 195–96. Applying this regulation, the Tax Court held that the Holman partnership restrictions operate as a device to transfer property to the natural objects of the Holmans' bounty. The Holmans argue that Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it fails to give effect to § 2703(b)(2)'s plain language. I agree. [discusses Chevron deference] The parties primarily dispute whether § 2703(b)(2) is ambiguous. The Holmans assert that the term decedent unambiguously refers to a deceased person and, therefore, § 2703(b)(2) asks only whether

(2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

(3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

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restrictions operate as a device to transfer property to family members at death. The Holmans point out that only the term decedent, not the broader term transferor, is used throughout § 2703(b)(2)'s legislative history. Conversely, the Commissioner argues that the term decedent is ambiguous due to § 2703's location in the Internal Revenue Code. Specifically, § 2703 is located in Subtitle B of the Code, which includes three transfer taxes—the estate, gift and generation-skipping transfer taxes. More precisely, § 2703 is located in Subtitle B, Chapter 14. In Chapter 14, § 2703 joins a set of special valuation rules targeting transfer tax avoidance schemes. It is clear that the phrase members of the decedent's family unambiguously limits § 2703(b)(2)'s application to transfers at death. First, the term decedent is itself unambiguous. *Black's Law Dictionary* 465 (9th ed. 2009) plainly defines decedent as [a] dead person. Moreover, the phrase members of decedent's family is not ambiguous when read in the greater context of Chapter 14. While Congress used the term decedent in § 2703(b)(2), it used the broader term transferor in Chapter 14's other valuation statutes. See I.R.C. §§ 2701(a)(1) & 2702(a)(1). And, as the Holmans point out, the term decedent consistently appears in § 2703(b)(2)'s legislative history. Finally, I find it telling that members of Congress have failed in their attempts to amend § 2703(b)(2) by substituting the legislative phrase members of the decedent's family with the Commissioner's phrase natural objects of the transferor's bounty. See *Smith v. United States*, No. C.A. 02-264 ERIE, 2004 WL 1879212, at 6 n.3 (W.D. Pa. June 30, 2004). Thus, although Congress enacted Chapter 14 to generally address transfer tax avoidance schemes, § 2703(b)(2) applies specifically to transfers at death. Therefore, Treasury Regulation § 25.2703-1(b)(1)(ii) is invalid because it does not give effect to the plain language of § 2703(b)(2). Since the Holmans are living persons, they are, by definition, not decedents and § 2703(b)(2)'s device test is satisfied.

…Under § 2703(b)(3)'s comparable terms test, the Holman partnership restrictions' terms must be comparable to similar arrangements entered into by persons in an arms' length transaction. While the Tax Court did not decide whether the restrictions satisfied the comparable terms test, it noted that both parties' experts agree that transfer restrictions comparable to those found in [the Holman partnership agreement] are common in agreements entered into at arm's length. [footnote omitted] Holman, 130 T.C. at 198–99. The Tax Court explained that this would seem to be all that [the Holmans] need to show to satisfy section 2703(b)(3). Id. at 199. I agree, and I would hold that the Holman partnership restrictions satisfy § 2703(b)(3)'s comparable terms test. Thus, because the partnership restrictions satisfy all three of § 2703(b)'s tests, I would reverse and remand to the Tax Court for a valuation of the limited partnership interests that does not disregard the partnership restrictions.

The U.S. District Court for the Southern District of Indiana, following *Holman*, held that holding undeveloped land did not constitute a business that could qualify for the Code § 2703 safe harbor. *Fisher v. U.S.*, 106 A.F.T.R.2d 2010-6144. The court later ruled that the taxpayer could not introduce into evidence the discounts that the IRS had used on audit, ruling that the IRS' audit determination was irrelevant to determining the actual value. 106 A.F.T.R.2d 2010-6144.

For an in-depth discussion of the facts of some of these cases, see Aghdami, Mancini, & Zaritsky, *Structuring Buy-Sell Agreements*, ¶ 6.02[4] Restriction on Lifetime Transfer.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles:[3257]

> A right or restriction is considered to meet each of the three requirements … if more than 50 percent by value of the property subject to the right or restriction is owned directly or indirectly (within the meaning of § 25.2701-6) by individuals who are not members of the transferor's family. In order to meet this exception, the property owned by those individuals must be subject to the right or restriction to the same extent as the property owned by the transferor. For purposes of this section, members of the transferor's family include the persons described in § 25.2701-2(b)(5) and any other individual who is a natural object of the transferor's bounty. Any property held by a member of the transferor's family under the rules of § 25.2701-6 (without regard to § 25.2701-6(a)(5)) is treated as held only by a member of the transferor's family.

If the entity does not satisfy this non-family-controlled test, then one must satisfy each of the above three exceptions separately. The Code § 2703(b)(3) comparability test, which is the main test that Code § 2703 added to pre-1990 law, uses the following principles:[3258]

> (i) In general. A right or restriction is treated as comparable to similar arrangements entered into by persons in an arm's length transaction if the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. This determination generally will entail consideration of such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the arrangement, and the adequacy of any consideration given in exchange for the rights granted.
>
> (ii) Evidence of general business practice. Evidence of general business practice is not met by showing isolated comparables. If more than one valuation method is commonly used in a business, a right or restriction does not fail to evidence general business practice merely because it uses only one of the recognized methods. It is not necessary that the terms of a right or restriction parallel the terms of any particular agreement. If comparables are difficult to find because the business is unique, comparables from similar businesses may be used.

[3257] Reg. § 25.2703-1(b)(3).
[3258] Reg. § 25.2703-1(b)(4).

The Tax Court, convinced that the taxpayer's buy-sell agreement was arrived upon in a manner intended to arrive at fair market value, applied the comparability test in *Estate of Amlie*:[3259]

> For the reasons discussed below, we conclude that the estate has satisfied section 2703(b)(3). By its terms, the statute requires only a showing that the agreement's terms are "comparable" to similar arrangements entered at arm's length. While the regulations caution against using "isolated comparables", we believe that in context the regulations delineate more of a safe harbor than an absolute requirement that multiple comparables be shown.

Even if the above rules are not complied with, obligations do tend to affect a stock's marketability,[3260] in that they cloud the business' future operations.[3261]

Keeping a pre-1990 agreement outside of the application of Code § 2703 would avoid the statute's imposition of the comparability test. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in a significant change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification that's would subject it to this test.[3262] If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless updating would not have resulted in a substantial modification.[3263] Adding any family member as a party to a right or restriction is a substantial modification unless either the terms of the right or restriction require the addition or the added family member is assigned to a generation no lower than the lowest generation occupied by individuals already party to the right or restriction.[3264] However, a substantial modification does not include a modification required by the terms of a right or restriction, a discretionary modification of an agreement conferring a right or restriction if the modification does not change the right or restriction, a modification of a capitalization rate used with respect to a right or restriction if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate, or a modification that results in an option price that more closely approximates fair market value.[3265] Amending an agreement to extend the number of years of payment, to clarify that the prime rate is to be established semi-annually, and to update the name of the banking institution from the original bank's name to its successor's name was not a substantial modification.[3266]

[3259] T.C. Memo. 2006-76.

[3260] Rev. Rul. 77-287 explains valuation adjustments due to stock being restricted from resale pursuant to Federal securities laws.

[3261] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004), citing *Estate of Lauder v. Commissioner*, T.C. Memo. 1994-527, for the concept that, even if a provision does not bind the IRS as to estate tax value, it can still affect its value; *Estate of Blount*, 428 F.3d 1338 (11th Cir. 2005), *rev'g* T.C. Memo. 2004-116.

[3262] Reg. § 25.2703-1(c)(1).

[3263] Reg. § 25.2703-1(c)(1).

[3264] Reg. § 25.2703-1(c)(1).

[3265] Reg. § 25.2703-1(c)(2).

[3266] Letter Ruling 201313001.

Issuing nonvoting shares proportionately to the owners of voting stock in an S corporation was not a substantial modification.[3267]

Finally, many of the buy-sell restrictions in partnership agreements are no more restrictive than would otherwise apply under state law, so the application of Code § 2703 would not have a significant impact on the valuation. Yet the IRS makes a big deal of these issues on audit and acts as if some of the cases cited above give it a major advantage. Consider asking the appraiser to expressly state that (s)he is ignoring any provisions in the agreement that are more restrictive than otherwise applicable state law. That way, when the IRS makes a big deal about Code § 2703, one might respond that one has already assumed that Code § 2703 applied, so that issue is off the table.

II.Q.4.i. Life Insurance LLC

Wouldn't it be nice to avoid using a lot of policies, minimize life insurance income tax consequences to owners coming and going,[3268] and keep the life insurance policies in a safer environment? One solution is to place the policies in a limited liability company (LLC) taxed as a partnership. The owners of the business entity also would be the members (owners) of the LLC. A trust company could serve as manager, taking charge of the policies and ensuring that the proceeds are used as intended. Each owner would have an interest in policies insuring the other partners' lives. I obtained Letter Ruling 200747002, which approved such a strategy.

II.Q.4.i.i. The Facts of Letter Ruling 200747002

The flowcharts in the Appendices A and B illustrate the situation. Appendix A illustrates trusts that were set up. Appendix B explains the Insurance LLC's structure. Appendix C illustrates some creative planning described below.

In this case, an S corporation had three shareholders: Child A (Brother), Child B (Sister), and BA. BA was an unrelated shareholder. Although the ruling does not disclose the percentage ownership, in fact BA owned 5% of the stock, and Brother and Sister owned the rest in roughly equal amounts.

The grantor, parent of Brother and Sister, set up an irrevocable trust, Trust 2A, for Brother ("Brother's Irrevocable Trust"). This was a typical flexible generation-skipping trust. Brother was trustee and could make distributions under an ascertainable standard to Brother and Brother's descendants. Brother also had the power to appoint Brother's

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[3267] Letter Ruling 201536009, reasoning:

> In this case, the stock split and amendment to the Articles will apply to all of the common shares (whether voting or nonvoting). Because each shareholder will receive c shares for every common share he or she currently holds, the beneficial interests in Company will not be affected by the stock split, amendment, and share dividend.
>
> Likewise, because the number of authorized voting shares will continue to be x, the shareholders' voting rights will remain unchanged.
>
> Consequently, the stock split, amendment to the Articles, and share dividend will not affect the quality, value or timing of any rights under the Articles, and the changes will not be a substantial modification of the Articles for purposes of § 25.2703-1(c). Accordingly, the Articles will remain exempt from the application of chapter 14.

[3268] See text accompanying fns. 3132-3134 regarding certain transfers involving partnerships.

Irrevocable Trust's assets at Brother's death to anyone except to Brother, Brother's creditors, Brother's estate or the creditors of Brother's estate. The grantor had allocated GST exemption to Brother's Irrevocable Trust, and Brother's Irrevocable Trust was not subject to the rule against perpetuities. Thus, Brother's Irrevocable Trust provides Brother with flexibility to use its assets during life and pass them to practically anyone at death. The grantor also set up Trust 2B for Sister with similar terms ("Sister's Irrevocable Trust").

Under a buy-sell agreement, Brother would buy Sister's and BA's stock at their deaths. Brother owned policies on their lives to fund this purchase. Brother also had the right to assign Brother's purchase rights and obligations to Brother's Irrevocable Trust or other trusts controlled by Brother. Brother would then transfer these policies to the LLC. Brother and Brother's Irrevocable Trust would contribute premiums to the LLC and receive the right to death benefits from Policies on Sister's and BA's lives in proportion to the premiums that Brother and Brother's Irrevocable Trust made these premium contributions. The goal was to maximize Brother's Irrevocable Trust's proportion of contributions, because Brother's Irrevocable Trust and any trusts created under it are excluded from the estate tax system. However, given the uncertainties of cash flow and the impracticality of frequently changing beneficiary designations, being flexible in sharing premiums was important and the LLC's use of partnership accounting seemed to be the best way to accomplish that. Brother and Sister had virtually identical goals regarding the buy-sell arrangement.

The LLC had some other features. The manager was a corporate trustee. Using a corporate trustee as manager provided security to ensure that no party to the buy-sell agreement would use the life insurance proceeds improperly. The manager was instructed to retain all life insurance proceeds until the parties agreed on their application toward the cross-purchase. Thus, the manager's roles were essentially the equivalent of a combination of trustee of an irrevocable life insurance trust before a shareholder's death and escrow agent for the buy-sell agreement after a shareholder's death.

The LLC's activity required special partnership accounting provisions. Each member had a separate capital account for each policy the member owned on a shareholder. Also, the members needed to contribute cash to pay the LLC's administrative expenses, requiring an additional set of capital accounts.

II.Q.4.i.ii. Summary of Estate Tax Rules Governing Life Insurance Payable to a Business Entity

Code § 2042 provides that a decedent's gross estate includes insurance proceeds from a policy on a decedent's life if the decedent, at his or her death, possessed any incidents of ownership over such policy, exercisable either alone or in conjunction with any other person.[3269] The term "incidents of ownership" includes more than ownership of the

[3269] Letter Ruling 200314009 found no incidents of ownership where a grantor had the power to name as a successor trustee anyone except himself or any party related or subordinate to (under Code § 672(c) – see fn. 1751) the grantor when the two designated trustees are unavailable to act as trustee or are removed; however, the grounds for removal were not spelled out. The IRS pointed out that Reg. § 20.2042-1(c)(4) provides that:

> A decedent is considered to have an incident of ownership in an insurance policy on his life held in trust if, under the terms of the policy, the decedent, (either alone or in

policy in the technical legal sense. Generally, it refers to the right of the insured or the insured's estate to the economic benefits of the policy. It also includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy. If Code § 2042 applies, then generally the decedent must include all of the insurance proceeds in his or her gross estate.

Simple cross-purchase agreements avoid these issues. Rev. Rul. 56-397 ruled that when each of two business associates owns, is the beneficiary of and pays all premiums for an insurance policy on the other business associate, neither of the business associates possesses incidents of ownership in the policy on his or her respective life.

II.Q.4.i.ii.(a). Trust Ownership of Policy

Reg. § 20.2042-1(c)(4) provides, "A decedent is considered to have an 'incident of ownership' in an insurance policy on his life held in trust if, under the terms of the policy, the decedent…has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust." Does being the trustee of a trust containing an insurance policy on the trustee's life, with the trustee having no beneficial interest in the trust, results in estate tax inclusion under Code § 2042? The *Skifter* case[3270] held that the insured as trustee would not have an includable incident of ownership unless the insured had transferred the policy to the trust, implying this requirement into the regulation, which otherwise would not have complied with the statute. GCM 39317 followed this case. However, *Rose v. U.S.*[3271] held that there was no transfer requirement. Rev. Rul. 84-179 held:

> An insured decedent who transferred all incidents of ownership in a policy to another person, who in an unrelated transaction transferred powers over the policy in trust to the decedent, will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2) of the Code, provided that the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for personal benefit. The result is the same where the decedent, as trustee, purchased the policy with trust assets, did not contribute assets to the trust or maintain the policy with personal assets, and could not exercise the powers for personal benefit.

> conjunction with another person or persons) has the power (as trustee or otherwise) to change the beneficial ownership in the policy or its proceeds, or the time or manner of enjoyment thereof, even though the decedent has no beneficial interest in the trust.

The IRS looked to Rev. Rul. 77-182 (no Code § 2036 inclusion where decedent could appoint a successor corporate trustee if the original trustee resigned or was removed by judicial process) and 95-58 (no Code § 2036 inclusion where decedent could remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (under Code § 672(c) – see fn. 1751).

[3270] 468 F.2d 699 (2nd Cir. 1972).

[3271] 511 F.2d 259 (5th Cir. 1975).

Citing Rev. Rul. 84-179 with approval, Letter Ruling 9602010 reasoned and held:

> In the present case, the Indenture of Trust vests the trustees of the separate trusts with all rights, title, and interest in and to the policies and prohibits the trustees from distributing any portion of a life insurance policy or its proceeds to the insured daughter. In addition, neither A nor B can serve as a trustee under the Indenture of Trust. Therefore, we need not address specifically the problems concerning the application of 2042(2) where the insured holds powers over the life insurance policies in a fiduciary capacity. Instead, we must consider A and B's powers over the maintenance and distribution of the assets held in their separate trusts. The ability to control these assets may indirectly give A and B or their estates powers over the economic benefits of the life insurance policies.
>
> Although A and B are the income beneficiaries of their respective separate trusts and each has the right to receive distributions of principal, their rights to distributions of principal are subject to the trustees absolute discretion. Neither A nor B can direct corpus to be distributed to themselves.
>
> Under the Indenture of Trusts, the separate trusts were created by A and B's father. The annual premiums on the life insurance policies will be paid from the principal of the separate trusts. Neither A nor B can transfer assets to their separate trusts. Therefore, neither A nor B can maintain any life insurance policies held by their separate trusts with personal assets.
>
> Although both A and B have special powers of appointment to cause the trustees of their separate trusts to distribute principal of their separate trusts to such beneficiaries (other than the daughter, her creditors, her estate, or the creditors of her estate) as they designate, these powers of appointment are effective only when there are no life insurance policies on the life of the beneficiary included in trust assets. Generally, an inter vivos exercise of a special power of appointment could reduce the principal of a trust so that there are insufficient funds to pay the premiums on the life insurance policies. In addition, a testamentary exercise of a special power of appointment could result in a reversionary interest in the life insurance policies. In this case, the special powers of appointment are not effective when insurance policies on the life of the beneficiary-daughter are among trust assets. Therefore, A and B cannot exercise their special powers of appointment to gain any economic benefits of the life insurance policies.
>
> Based on the facts and representations made in your request for rulings and your subsequent submissions, we conclude that neither A nor B will possess any incidents of ownership over life insurance policies on their lives held by the trustees of their irrevocable trusts and that the proceeds of the policies will not be includible in their gross estates under section 2042(2).
>
> We express no opinion at this time with respect to the gift tax consequences to A or B where the trustees of their separate trusts invest in a nonincome-producing life insurance policy on their lives.

A decedent's right to veto a change in the transfer of a policy, where the decedent could gain no economic benefits from the veto power, did not constitute incidents of ownership.[3272]

The mere right to the dividends, by itself, is not an incident of ownership that would cause the value of the insurance proceeds to be included in Decedent's gross estate under Code § 2042(2).[3273] This conclusion was based on the view that dividends represent a return of premiums[3274] and did not address whether dividends in excess of premiums would be treated differently.

II.Q.4.i.ii.(b). Corporate Ownership of Policy

However, redemptions require further analysis, as do arrangements for cross-purchase agreements when all of the parties hold policies on each other through an entity. If a decedent is the sole or controlling shareholder of a corporation that owns an insurance policy on the decedent's life, then the decedent will not be deemed to possess incidents of ownership as a result of the decedent's stock ownership so long as the proceeds of the policy are payable to the corporation.

II.Q.4.i.ii.(c). Partnership Ownership of Policy

Neither Code § 2042 nor its Regulations specifically address the issues raised by insurance owned by a partnership in which the insured is a partner. However, case law and IRS rulings have analyzed these issues. The Tax Court has held that a general partner does not possess incidents of ownership in a policy that names a general partnership as the owner and beneficiary if the policy was purchased in the partnership's ordinary course of business and the insured partner owned less than a 50% interest in the general partnership.[3275] Rev. Rul. 83-147 held that a partner does possess incidents of ownership if the policy on the partner's life is owned by the partnership, designates a member of the partner's family as the beneficiary, and premiums were paid by the partnership in partial satisfaction of the partner's share of partnership income. The ruling stated that the result was different than the Tax Court case because the beneficiary was not the partnership.

In a number of Letter Rulings, the IRS has addressed Code § 2042 with respect to a partnership that owns and is designated as the beneficiary of an insurance policy on the life of one of its partners.

Letter Ruling 9623024 held that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement states that the proceeds, once received by the partnership, can be distributed to the remaining partners in proportion to

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[3272] *Estate of Rockwell v. Commissioner*, 779 F.2d 931 (3rd Cir. 1985).

[3273] CCA 201328030.

[3274] CCA 201328030 cited *Estate of Bowers v. Commissioner*, 23 T.C. 911, 917 (1955) (the right to dividends, which may be applied against a current premium, is nothing more than a reduction in the amount of premiums paid rather than a right to the income of the policy) and *Estate of Jordahl v. Commissioner*, 65 T.C. 92, 99 (1975) (since dividends are merely a reduction in the amount of premiums paid, the right to dividends is not an incident of ownership).

[3275] *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq*. in result, 1959-1 C.B. 4, *aff'd* on another issue 244 F.2d 436 (4th Cir.), *cert. denied*, 355 .S. 827 (1957).

their interests to the extent that the proceeds from the policy were not needed to pay the partnership's obligations. The IRS reasoned that the value of the deceased partner's interest would include his pro rata portion of the proceeds and therefore inclusion under Code § 2042 would amount to unwarranted double counting of the proceeds.

Letter Rulings 9625022 and 9625023 ruled that life insurance proceeds would not be included in the estate of a member in a limited liability company (that was taxed as a partnership) who could not participate in decisions regarding a policy insuring the member's life held. Letter Rulings 9625013-9625019 had the same result and also involved using the proceeds to fund the purchase of a deceased owner's share of a related corporation and also of the limited liability company, which held real estate that it rented to the corporation.

Letter Rulings 9843024 and 200111038 held that the insured limited partner does not possess incidents of ownership in the policy if the partnership agreement precludes the limited partners from exercising any control over the partnership's management and investment activities.

Letter Ruling 200017051 ruled that the insured general partner does not possess incidents of ownership in the policy if the partnership agreement expressly states that an insured partner "had no right or power to exercise or to otherwise participate in the exercise of any of the incidents of ownership with respect to such policy or policies."[3276]

In Letter Ruling 200214028, the IRS ruled that the insured general partner did not possess incidents of ownership because the proceeds were payable to or for the benefit of the partnership. In that case, the partnership agreement required that the proceeds be used to redeem the insured partner's interest in the partnership.

TAM 200432015 dealt with Code section 2042 and the transfer of insurance policies to a limited liability company. The TAM deals with Code §§ 2035 and 2042 and involves an insured who transferred an insurance policy on his own life to a limited liability company. If none of the insureds own policies on their own lives that they transfer to a limited liability company, the TAM would not apply.

II.Q.4.i.iii. IRS' Response to Request that Resulted in Letter Ruling 200747002

In response to my ruling request, Letter Ruling 200747002 held that none of the insureds possessed incidents of ownership on the policies that the others contributed to the LLC.

However, the IRS requested some modifications to the LLC's operating agreement. The IRS limited the members' ability to make decisions regarding the LLC's holding of policies. Not mentioned in the ruling is that the operating agreement originally allowed the members voting rights customarily given in a manager-managed LLC, limiting them only to the extent that no member could vote regarding insurance on that member's life. The IRS was concerned that the members could collude in a manner akin to the reciprocal trust doctrine, so it required that the operating agreement preclude members

[3276] I did not think to cite cases involving trust-owned insurance on a beneficiary's life, where no incidents of ownership were attributed to the beneficiary. Letter Rulings 9602010 and 9748020. Rev. Rul. 84-179 might also be helpful.

from voting on anything relating to any life insurance policy. Similarly, the IRS required that the operating agreement not expressly authorize amendments by the members, preferring that applicable state law defaults control the situation.

The ruling did not address the effect of the members' assigning their interests in the LLC to others. Although the IRS was not troubled by the prospect of that occurring, it did not wish to consider situations that might arise by reason of such an assignment.

An issue with respect to with a ruling was not sought is the transfer-for-value rules, which make death benefits taxable if policies are transferred in various taxable transactions.[3277] Formation of the LLC should not implicate these rules, because formation is a nontaxable transfer.[3278] Similarly, a Member receiving an increased ownership percentage of a policy due to an increased contribution is also a nontaxable transfer.[3279] In our case, the Members also participated in other LLCs that held rental real estate; because they were partners for income tax purposes, the transfer-for-value rules do not apply to transfers of policies between them.[3280]

II.Q.4.i.iv. Significance of Letter Ruling 200747002

The ruling has other implications. Using a corporate trustee to hold the policies as manager of the LLC provides security that the proceeds will be used as intended. As mentioned, one of the disadvantages of a cross-purchase is that a shareholder's creditors might be able to prevent application of the proceeds. Depending on applicable state law, the insurance being in an LLC might make a charging order the exclusive remedy. A charging order allows creditors to receive any distributions that belong to the debtor but does not allow the creditor to force the LLC to make distributions. The manager's duty to the other members would prevent the proceeds from being distributed without the consent of the deceased shareholder's beneficiaries.

The operating agreement's original restrictions on members' voting rights generally should be sufficient to avoid estate inclusion. The additional restrictions should be placed in the operating agreement only if seeking a Letter Ruling or advising a client who is willing to sacrifice flexibility to be as close as possible to the letter ruling's facts.

Letter Ruling 200747002 is not geared towards a policy with cash values. However, through a split-dollar arrangement, one might carve out the term portion for the LLC and make other arrangements with the cash value.[3281] Although the term portion eventually becomes uneconomic, one could use a variety of estate-planning techniques with the cash value portion before that happens so that, ultimately, the insurance arrangement becomes sustainable.

The ruling also held that Brother's Irrevocable Trust was a grantor trust, in which Brother was treated as owning Brother's Irrevocable Trust's assets for income tax purposes under Code § 678; Sister was similarly treated as the owner of Sister's Irrevocable Trust. This was critically important to allow Brother's Irrevocable Trust and Sister's Irrevocable

[3277] Code § 101(a)(2).
[3278] Code §§ 101(a)(2)(A), 721(a).
[3279] Code § 721(a).
[3280] Code § 101(a)(2)(B).
[3281] See footnote 3108 for a summary of how split-dollar arrangements work.

Trust to own stock in the S corporation. Brother initially had a withdrawal right in Brother's Irrevocable Trust that had since lapsed; the same tool was used for Sister and Sister's Irrevocable Trust. Although such withdrawal rights are usually used to obtain the gift tax annual exclusion, in this case a significant purpose of granting withdrawal rights was to obtain grantor trust status treating the beneficiary as the owner. Based on more recent informal conversations with a representative of the government, my understanding is that, although the IRS has no plans to change its approach toward Code Sec. 678 when it issues Letter Rulings, it also has no plans to issue a formal pronouncement upon which taxpayers can generally rely.

The above issues are as far as was the ruling was sought to cover. However, this structure has uses far beyond the issues discussed in the ruling.

First, Trusts 2A and 2B were originally funded with modest gifts that they invested in LLCs that used bank financing to buy real estate. These LLCs leased the real estate to the S corporation. The net cash flow from the rental operations would be used to pay the life insurance premiums through the insurance LLC. Thus, the income tax goal of holding real estate in partnerships was married with leveraging gifts to generation-skipping trusts.

Second, Trusts 2A and 2B were ideal for the tactic of selling stock to an irrevocable grantor trust.[3282] For example, Brother could sell S stock to Brother's Irrevocable Trust in exchange for a promissory note. No income tax would result during Brother's life, because Brother is treated for income tax purposes as owning Brother's Irrevocable Trust. If the IRS determined that the stock's value was too high and that therefore Brother made a gift, Brother would pay no gift tax because the gift is an incomplete gift due to Brother's power to appoint the trust's assets at death. If Brother's Irrevocable Trust were thinly funded, Brother and other trusts created by Grantor for Brother could guarantee the promissory note to provide additional economic reality to the sale.

If Brother dies during the term of the note, Sister and BA would use the insurance to buy Brother's Irrevocable Trust's stock, thus providing cash to retire the note to Brother.

If the sale of S stock to Brother's Irrevocable Trust generates cash flow in excess of the note payments, the excess cash could be used to pay premiums through the insurance LLC, allowing Brother's Irrevocable Trust to participate more in the buy-sell than it would have been able to do with just the net rental proceeds.

Note that Brother has access to the excess funds for Brother's support. The excess funds could also be used to help Brother's children when they are no longer legally dependents, without being limited by the annual gift tax exclusion or using Child 2A's applicable exclusion amount.

What if the parties had used a cash value policy subject to a split-dollar arrangement instead of term policies? After Brother's Irrevocable Trust fully repays the note on the sale of stock, it should have plenty of cash flow to repay the split-dollar obligations.

Sister would use the same strategy.

[3282] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

II.Q.4.i.v. Practical Logistics for Life Insurance LLC

First, keep in mind that any person who is at least a 5% owner of the LLC would be considered an employee whose notice and consent are required, as described in part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance. Whether the parties transfer the life insurance to the LLC or the LLC buys original issue insurance, the parties will probably use a notice and consent along the lines of part II.Q.4.g.iii Consent for Owner Who Is Not an Employee. However, the operating agreement might also include notice and consent as a safety valve.[3283]

Often, the operating business will pay the premiums on behalf of the owners – just to make sure it gets done so that the business' succession plan is funded as expected.

If the operating business is a C corporation, it would account for the premium payments as compensation (as an officer or director), because dividends are nondeductible to the company and taxable to the shareholders.

If the operating business is an S corporation, it would account for the premium payments as compensation or as a distribution. Compensation tends to be the more popular choice, in that it can be non-pro rata, but the parties' economic deal might make distributions more attractive, and any temporary timing differences of distributions should not cause problems with the S corporation single class of stock rules.[3284]

When the operating company is taxed as a partnership, it might consider setting up a separate distribution account for premiums paid on behalf of each owner. That way, the distributions can be reconciled more easily against what the life insurance LLC is doing.

When the operating company pays a term premium, the life insurance LLC would credit the relevant owner's capital account with a contribution and debit premium expense, with the premium expense separately allocated to the relevant owner.

II.Q.4.i.vi. Letter Ruling 200947006

The IRS has also ruled that an insured who was a partner in a partnership had no incidents of ownership. In Letter Ruling 200947006, the insured had direct and indirect ownership of a partnership that held a policy on his life.[3285] That partnership and other partnerships (in which the insured had direct or indirect ownership) were beneficiaries. The arrangement was restructured so that the insured had no right to make decisions on behalf of a trust that owned the partnership, and the insured's other direct or indirect interest in the partnership was terminated. The IRS ruled that the insured not only had no incidents of ownership after the transaction but also (to avoid Code § 2035) had no incidents of ownership before the transaction.

[3283] See fn. fn. 3237, which is found in part II.Q.4.g.i Analysis of Code § 101(j); for an example, see part II.Q.4.g.ii Consent Integrated into Operating Agreement.

[3284] See part II.A.2.j.ii Temporary Timing Differences.

[3285] See also Letter Rulings 200948001 and 200949004, which appear to be companion rulings.

II.Q.4.i.vii. Conclusion

The Insurance LLC provides security for the owners, facilitates flexibility in making premium payments, and demonstrates a model for reducing the number of policies that must be used in a cross-purchase. Convincing the business owners' parents to set up generation-skipping perpetual trusts to buy real estate used in the business can help the business owners continue to enjoy the business' financial success while moving the business outside of the estate tax system.

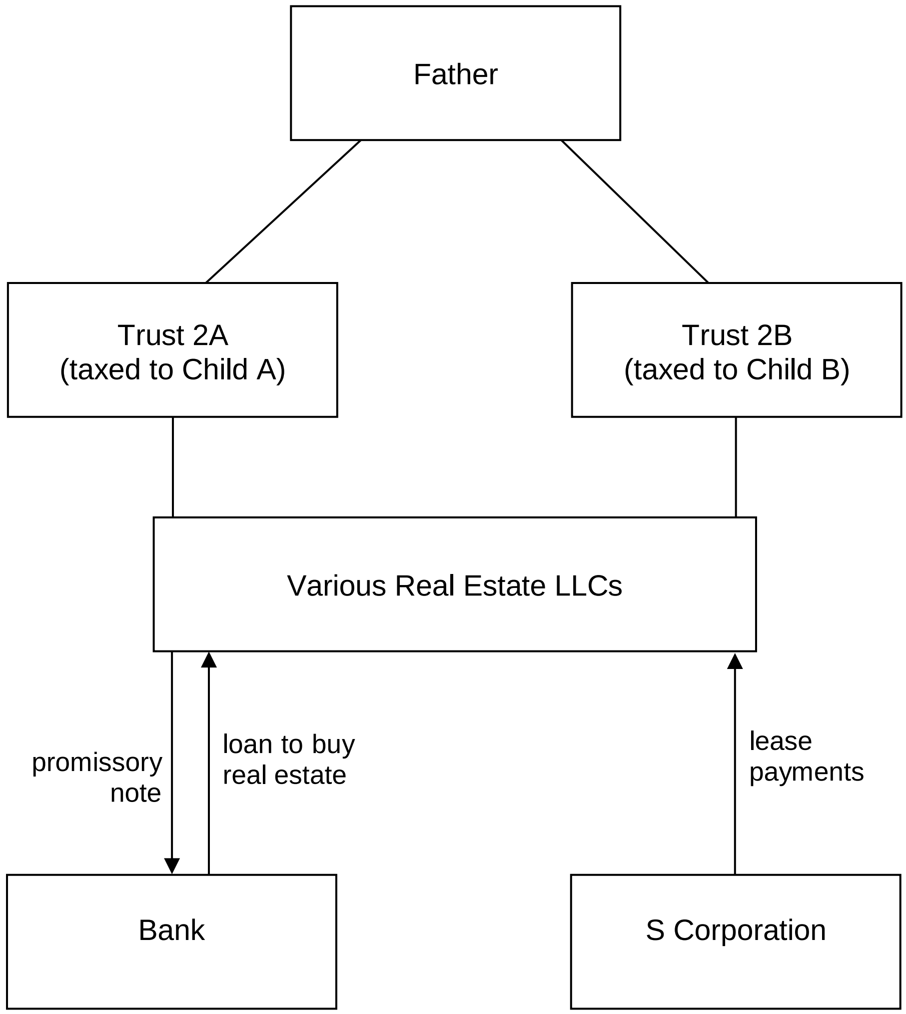
For income tax issues generally, see parts II.Q.4.e Income Tax Issues When the Owner Who Is Not the Insured Dies. If a life insurance policy owned on a surviving owner receives a new basis when the beneficial owner predeceases the surviving owner,[3286] consider whether this new basis increases the "investment in the contract" and, if not, whether additional steps should be taken to effectuate that increase.[3287]

[3286] For basis changes when a partner dies, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. For basis changes on the death of an owner other than the insured, see part II.Q.4.e.i Life Insurance Basis Adjustment On the Death of an Owner Who Is Not the Insured.

[3287] See part II.Q.4.e.ii Practical Issues In Implementing Any Basis Adjustment On the Death of an Owner Who Is Not the Insured.

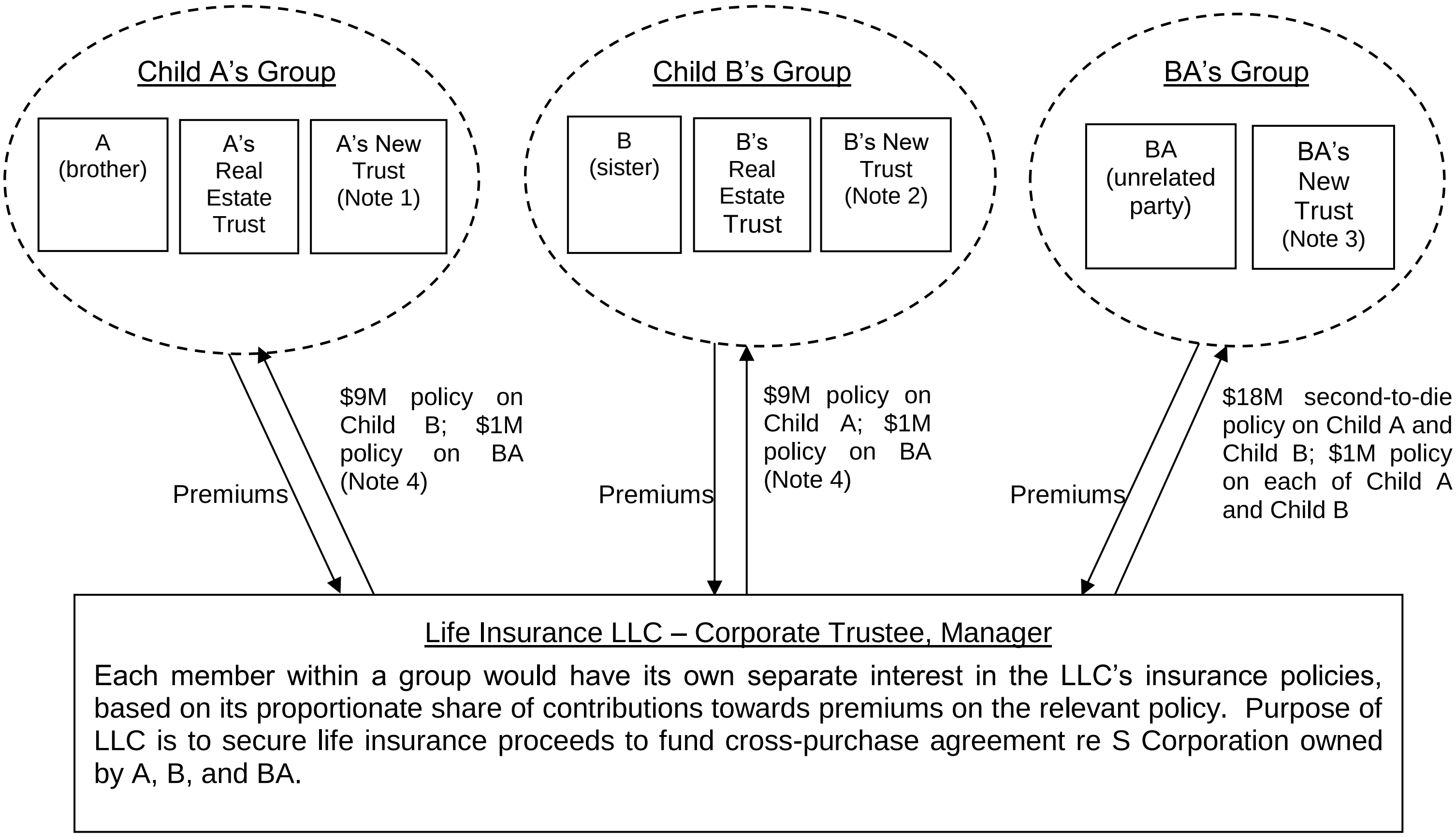
Appendix A

Prior Formation of Trusts



Appendix B

Insurance LLC Structure



Note 1: Child A would be the grantor and trustee of this irrevocable trust for his spouse's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

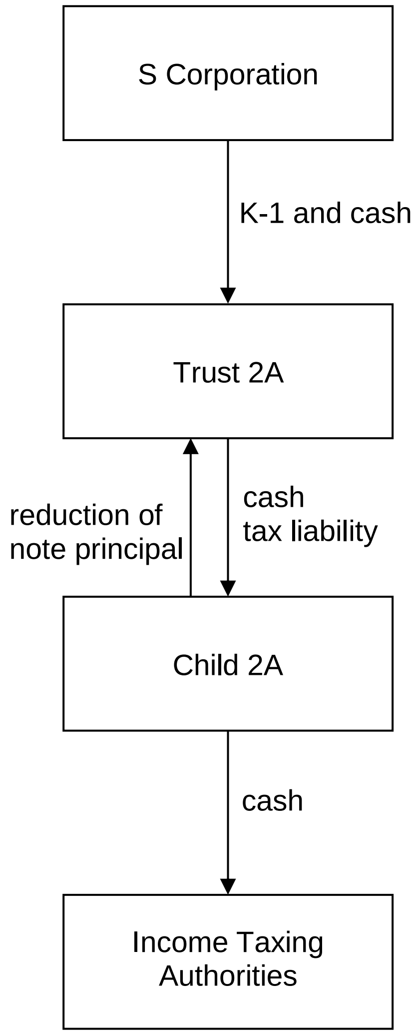
Note 2: Child B would be the grantor and trustee of this irrevocable trust for her descendants' support. (Her children are adults.) Her grandchild would be cut out, but her son could include him.

Note 3: BA would be the grantor and trustee of this irrevocable trust for his wife's and their descendants' support, with appropriate prohibitions against discharging any support obligations.

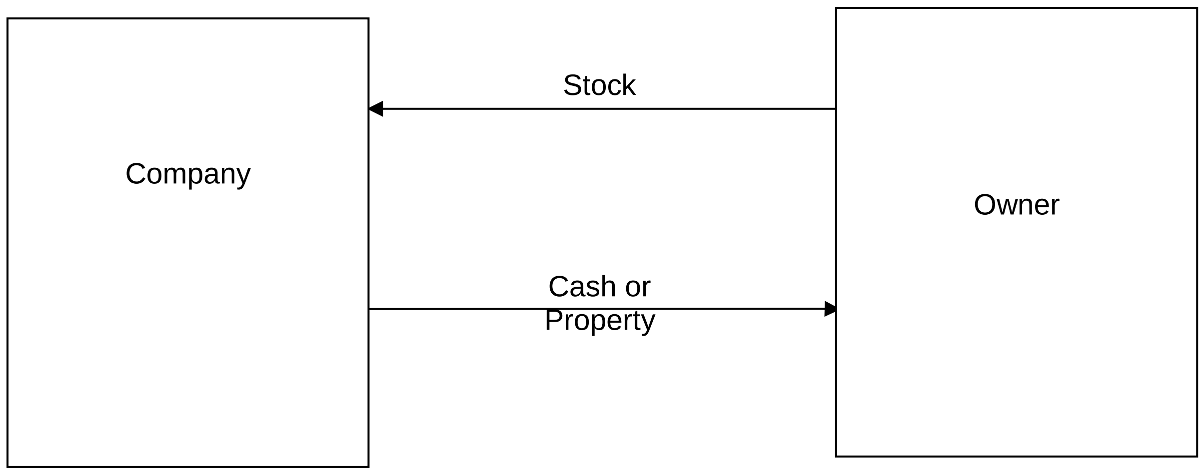
Note 4: If Child A dies first, Child B's group would become the premium payer with respect to Child A's group's policy on BA's life. If Child B dies first, Child A's group would become the premium payer with respect to Child B's group's policy on BA's life.

Appendix C

Later Sale of S Corporation Stock to Irrevocable Grantor Trust



II.Q.5. Dividing a Business Using a Redemption - Corporation vs. Partnership



II.Q.5.a. Corporations Generally

Code § 302 provides a number of rules determining whether a redemption for state law purposes is treated as a sale or exchange of the stock or as a distribution for income tax purposes.

Sale or exchange treatment has the following benefits:

- Possible installment sale deferral.

- Capital gain treatment.

- Use of a pro rata share of basis.

Distributions are treated as the following (generally):

1. Reduction in basis (no gain) to the extent of S corporation accumulated adjustments account (AAA), if applicable. If and to the extent that state-law redemption of S corporation stock is reclassified as a distribution, the redemption uses basis dollar-for-dollar rather than prorating basis.

2. Taxable dividend (no offset for basis, no installment sale deferral) to the extent of C corporation earnings and profits (E&P), if a C corporation or if an S corporation that had been a C corporation.

3. Return of basis.

4. Gain from the sale or exchange of stock.

No deferral applies if the corporation's issuance of a note is treated as a distribution.[3288]

Corporate redemptions are discussed in more detail at part II.Q.7.a Corporate Redemption.

II.Q.5.b. Partnerships Generally

Partnerships do not have a rule equivalent to Code § 302.

Subject to certain exceptions, distributions to a partner are not taxable to the extent of basis in the partner's partnership interest.[3289] Basis includes the partner's allocable share of the partnership's debt, a rule that does not apply to C or S corporations.

Partnership distributions are described generally in part II.Q.8 Exiting From or Dividing a Partnership.

Partnership redemptions use basis to offset payments (except to the extent of certain "hot assets") dollar-for-dollar until exhausted, whereas corporate redemptions often pro-rate basis or sometimes don't use basis at all (to the extent taxed as a dividend). Furthermore, if the seller dies while installments are being made, the gain is already locked in if a sale of corporate (S or C) stock, whereas arguably a basis step-up applies to a partnership interest being redeemed. See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736, especially part II.Q.8.b.ii.(h) Interaction of Death with Code § 736 Payments.

II.Q.5.c. Distribution of Property

When a C corporation or an S corporation distributes property, it is deemed to have sold the property to its shareholders in a taxable transaction. In a C corporation, shareholders are taxed on dividend or partial or total liquidation. If a corporation contributes assets to charity, the contributed assets must not constitute substantially all of the corporation's assets, because a corporation recognizes gain if it conveys substantially all of its assets to a tax-exempt entity.[3290]

Generally, when a partnership distributes property, no tax consequences apply to anyone. Exceptions include:

- Property contributed no more than 7 years before distribution that is distributed to a partner other than the partner who contributed may generate a deemed sale by the contributing partner, the recipient partner, or both (but no double taxation). Code §§ 704(c)(1)(B), 737.

- A distribution of marketable securities might be deemed a distribution of cash. Code § 731(c).

[3288] See part II.Q.7.a.iii Redemption Taxed Either As Sale of Stock or Distribution; Which Is Better When, especially fn. 3453.
[3289] See part II.Q.8.b.i Distribution of Property by a Partnership.
[3290] Reg. § 1.337(d)-4(a)(1).

Partnership distributions of property are described in II.Q.8.b.i Distribution of Property by a Partnership.

II.Q.6. Contributing a Business Interest to Charity

After reading part II.Q.6.a General Concepts, see discussion of various issues, which are summarized below:

- •Part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity. Transferring a partnership interest in a way that reduces the donor's share of the partnership's liabilities constitutes a bargain sale that may trigger income tax. Also, the amount of any charitable contribution is reduced by the amount of gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).

- Part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust. A charitable remainder trust pays a 100% tax on any unrelated business taxable income generated from any actual or deemed sale of a partnership interest and or from any K-1 it receives from holding a partnership. Additionally, that income is taxed to the beneficiary when the trust makes distributions.

- Part II.Q.6.d Unrelated Business Income (UBTI) Particular UBTI topics are described below.

  - Part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship. UBTI can arise from the partnership's business operations or from income generated by acquisition indebtedness. Partnership debt may make the entire gain on the sale of the partnership interest constitute unrelated business income (UBI) in ways that may surprise advisors. Discussion includes whether UBI includes non-debt-financed income from operations and gain on sale.

  - Part II.Q.6.d.ii UBTI Related to an S Corporation. UBTI automatically includes items on a K-1 issued by an S corporation and gain on the sale of S corporation stock, even if the S corporation invests only in items that otherwise would not constitute UBI.

  - Part II.Q.6.d.iii Charitable Deduction Against UBTI. An entity that receives UBI can deduct against it charitable distributions to the extent of 10% if the entity is a corporation or 50% if the entity is a trust. To use this deduction, a donation for the benefit of an operating public charity should pass through a donor-advised fund taxed as a trust (or perhaps a supporting organization for the benefit of the charity).

- Part II.Q.6.e Assignment of Income on Property Being Sold. If property is subject to a legally binding obligation to sell before being donated, the donor will be taxed on the sale. However, careful drafting of the related letter of intent that typically is signed when negotiations open will avoid this issue.

- Part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibitions:
    - Part II.Q.6.f.i Completed Gift Requirement. A gift to charity must be complete for gift tax purposes to qualify for an income tax deduction.
    - Part II.Q.6.f.iiForced Sale to Related Party for Note. When the donee was required to sell to a related party for a note, the IRS asserted that the donation was in substance the donation of a note, which is not deductible until paid.
    - Part II.Q.6.f.iii Charitable Partial Interest Prohibition. Most people are aware that split-interest gifts must be qualified charitable remainder or charitable lead trusts or qualify for other exceptions to be eligible for a charitable deduction. However, depending on the situation, slicing and dicing economic or control rights may also violate these rules.

II.Q.6.a. General Concepts

Contributions to public charities can work well, although any income from an S corporation K-1 or from the sale of S corporation stock constitutes unrelated business income subject to tax (regardless of the nature of the corporation's assets).[3291] Contributions of closely-held business interests to private foundations can be deducted only to the extent of the contributed property's basis.[3292] One might consider whether the entity should make the contribution instead of the owner making a contribution.[3293] For substantiation requirements, see part II.J.4.c Charitable Distributions.[3294]

To increase the deduction for C corporation stock, consider contributing it to a charitable remainder unitrust (CRUT),[3295] in which the donor's retained interest is worth only the 10% minimum.[3296] After the CRUT sells the stock, it will have cash, and the donor can contribute his or her unitrust interest to the charity. Thus, 90% of the donation will be of an interest in cash, valued without discounts and without the basis limitation, but it should be done more than one year after the contribution was made to the CRUT to make the unitrust interest be a long-term capital asset; also, be sure to avoid a step transaction, which the IRS might use to assert that the partial interest disallowance

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[3291] See part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity.

[3292] Code § 170(e)(1)(B)(ii).

[3293] See parts II.G.3.d.ii Basis Limitations on Deducting Charitable Contributions Made by an S Corporation or a Partnership and II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction. For a comparison of S corporations donating business assets compared to donating S corporation stock when the donor owns all of the S corporation, see text accompanying fn. 3531.

[3294] Although part II.J.4.c is geared toward charitable deductions for fiduciary income tax purposes, fns. 1774-1775 and the accompanying text discuss substantiation requirements.

[3295] A CRUT may begin life as an income-only unitrust and then switch to a trust that pays the unitrust without regard to income (a flip unitrust). Reg. § 1.664-3(a)(1)(i)(c). A flip CRUT is often used when the assets contributed do not generate enough income to pay the unitrust. For those clients who have sufficient liquidity, rather than doing a flip CRUT they might consider doing a straight CRUT and then contribute cash to the CRUT so that it has enough money to pay them, thereby obtaining an additional charitable deduction with respect this additional gift to the CRUT.

[3296] Code § 664(d)(1)(D) requires the actuarial value of the charitable remainder interest to be at least 10% of the value of the property contributed to the trust.

applies.[3297] Also, if the sale turns out to generate fewer proceeds than expected, the donor might decide to keep part or all the unitrust interest.[3298] Deductions for contributions of partnership interests or S corporation stock may be reduced by the business entity's hot assets.[3299]

Charitable remainder trusts cannot hold stock in an S corporation;[3300] however, an S corporation may donate property to a charitable remainder trust.[3301] Also, generally they should not hold an interest in an entity taxed as a partnership, if the partnership has business income[3302] or debt-financed income,[3303] because their unrelated business taxable income is taxed at 100%.[3304]

Contributions of business interests can cause self-dealing issues (although bequests might be less likely to cause self-dealing issues)[3305] and might be subject to rules limiting the period in which a charity may own a significant part of a closely-held business.[3306]

3297 See part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibition, especially fns. 3404-3405.

3298 A donation may not be made too close to a sale, as described in part II.Q.6.e Assignment of Income (but this concern tends to be overstated).

3299 See part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity, especially fns. 3315-3320 (fn. 3320 explaining that the rules limiting the charitable deduction for partnership interests apply to S corporation stock as well).

3300 For what types of trusts can own stock in an S corporation, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. An election small business trust (ESBT) is the only type of trust described there into which a charitable remainder trust (CRT) might fit, but Code § 1361(e)(1)(B)(iii) prohibits a CRT from qualifying as an ESBT.

3301 See part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

3302 Code § 512(a)(1), referring to Code § 513. However, note that Code § 512(b) excludes various items, such as interest and dividends, as well as real estate rental income. For more on UBTI, see part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, especially fn 3335 and the accompanying text, some of which goes beyond the context of a partnership interest.

3303 Code § 512(b)(4), which is reproduced in fn. 3344 in part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship. Part II.Q.6.d.i discusses the scope of attributing debt to the sale of a partnership interest.

3304 Code § 664(c)(2)(A).

3305 Code § 4941. For example, Reg. § 53.4941(d)-2 mentions the sale or exchange of property, leasing, lending, furnishing of goods, services, or facilities, payment of compensation, or transfer or use of the income or assets of a private foundation as acts of self-dealing. However, Letter Ruling 201407023 held that the distribution from the donor's estate, revocable trust, or spouse's estate and retention by Foundation of non-voting units in an LLC following the death of the survivor of the donor's and the donor's spouse will not constitute indirect acts of self-dealing pursuant to Reg. § 53.4941(d)-1(b)(5), (6) and therefore will not violate Code § 4941 even though the LLC's sole assets will be the note and income generated by a note issued by the donor's daughter. See also Letter Rulings 200635017, 201446024, and 201723005, the latter of which reasoned:

> As holder of the nonvoting interests, Foundation will have no management rights or right to vote on the manager of New LLC. Revocable Trust (which will have become irrevocable at Founder's death) will own all of the voting interests, giving Revocable Trust the right to select and remove the manager of New LLC. As a holder of nonvoting interests, Foundation will have a right to receive distributions only if New LLC dissolves or chooses to make current distributions, but the timing and amount of such distributions will

Generally, the donor should contribute either all of the donor's interest in the business or an undivided interest in every right the donor has, including voting and other noneconomic rights.[3307] However, donating nonvoting stock and keeping voting stock would work.[3308] Similarly, one might create an LLC to control the sale of the donated partnership interest.[3309]

II.Q.6.b. Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity

When a partner transfers a partnership interest, any reduction in liabilities allocated to that partner is considered sale proceeds.[3310]

Similarly, if contributing a partnership interest results in the partner being relieved of liabilities[3311] (even nonrecourse liabilities)[3312] previously allocated to that partner, the

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> be uncertain and could not be compelled by Foundation. Only Revocable Trust as the holder of the voting interests may elect or remove the manager of New LLC, and such manager will have the sole power to manage the affairs of New LLC and determine the timing and amount of distributions. Thus, Foundation and Foundation's managers (acting only in such capacity) will not have sufficient votes or positions of authority to cause New LLC to engage in a transaction.
>
> Additionally, Foundation will not have the power to compel dissolution of New LLC since New LLC may only be dissolved with written approval of all members, including Revocable Trust. The power associated with the nonvoting interests of New LLC as a necessary party to vote on the liquidation of the LLC is not considered equivalent to a "veto power" within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5) because the power cannot be exercised over an action relevant to any potential act of self-dealing.
>
> Accordingly, Foundation's receipt from Revocable Trust upon Founder's death of nonvoting interests in New LLC will not constitute a loan or extension of credit between a private foundation and a disqualified person within the meaning of section 4941(d)(1) and Treas. Reg. § 53.4941(d)-2(c) because Foundation will not acquire an interest in the promissory note; instead, Foundation will acquire nonvoting interests in New LLC, with respect to which it will not have any management rights or control over distributions.

[3306] Code § 4943.

[3307] See part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibition.

[3308] See fn. 3410 part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibition. But donating voting stock and keeping the voting rights would not work. See fn. 3408.

[3309] See the paragraph of text accompanying fn. 3426 in part II.Q.6.f.iii Charitable Partial Interest Prohibition

[3310] Rev. Rul. 74-40, quoted in full in fn. 3859, found in part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions. See also Rev. Rul. 77-402 (similar result when grantor trust status terminates with respect to a partnership interest), discussed in fn. 4974, found in part III.B.2.a Tax Basis Issues When Using Irrevocable Grantor Trusts.

[3311] See part II.C.3 Allocating Liabilities (Including Debt).

[3312] Letter Ruling 9533014 commented:

> We also note certain other consequences of the proposed transaction. A proposes to transfer to Y by gift an interest in X. The transfer of a partnership interest subject to nonrecourse liabilities to a charitable remainder trust is treated as a sale or exchange for purposes of section 1011(b) of the Code. See section 1.1001-2(c), Example (4) of the regulations; Rev. Rul. 75-194, 1975-1 C.B. 80; *Guest v. Commissioner*, 77 T.C. 9 (1981), *acq.*, 1982-1 C.B. 1. Under sections 752(d) and 1011(b) of the Code, the amount of A's share of partnership liabilities at the time of the transfer corresponding to the partnership interest transferred constitutes an amount realized by A. Consequently, in determining

donor has made a bargain sale.[3313] (Contributing various properties subject to debt, rather than a partnership interest, would result in the bargain sale rules applying to each property separately.[3314])

Also, the amount of any charitable contribution is reduced by the amount of gain which would not have been long-term capital gain[3315] if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution).[3316]

A's gain, A's basis must be apportioned as required by section 1011(b) of the Code and 1.1011-2(b) of the regulations. It is not known whether section 751 of the Code applies to the transfer to require that part of the gain be treated as ordinary income (e.g., through the application of the recapture rules of section 1250). If section 751 applies, the amount of the charitable contribution may be reduced under section 170(e)(5) (applying to contributions of ordinary income property). In determining whether a charitable contribution is allowable, section 170(e)(5) is to be applied without regard to section 1011(b) and the amount by which the contributed portion of the property must be reduced is the amount determined by taking into account the amount of gain which would have been ordinary income or long-term capital gain if the contributed portion of the property had been sold by the donor at its fair market value at the time of the sale or exchange. See section 1.1011-2(a)(1) of the regulations. Finally, we note that although the liability is nonrecourse, the charity must take the liability into account in determining the net fair market value of the trust assets for calculating the unitrust amount.

[3313] Rev. Rul. 75-194 includes the following facts and conclusion:

> L became a limited partner in a partnership on its formation in 1971. In 1974, L contributed his entire limited partnership interest to a charitable organization described in section 170(c) of the Internal Revenue Code of 1954. On that date all of the partnership liabilities were liabilities on which neither L, the other partners, nor the partnership had assumed any personal liability. Also on that date, L's proportionate share of the value of the partnership assets was greater than his proportionate share of the partnership liabilities and because of partnership losses L's adjusted basis for his partnership interest was less than his proportionate share of the partnership liabilities. At the time of the contribution the partnership had no unrealized receivables or inventory items described in section 751.
>
> [Citations to Code §§ 170(a), 741, 752(c), 752(d), and 1011(b) and to Reg. §§ 1.170A-1(c), 1.752-1(e), 1.752-1(e), 1.170A-4(c)(2)(iii), 1.170A-4(c), and 1.1011-2 (including Reg. § 1.1011-2(a)(3)) follow.]
>
> Since the value of L's share of the partnership assets at the time he transferred his partnership interest exceeded his share of partnership liabilities at that time, a charitable contribution deduction is allowable under section 170 of the Code, subject to the reductions and limitations set forth therein. At the same time, pursuant to sections 752(d) and 1011(b), the amount of L's share of partnership liabilities at the time of the transfer constitutes an amount realized by L. Based on the foregoing, a bargain sale within the meaning of sections 170 and 1011(b) has occurred.
>
> Accordingly, in the instant case, L has a recognized gain on the transfer equal to the excess of the amount realized by L over that portion of the adjusted basis of L's partnership interest (at the time of the transfer) allocable to the sale under section 1011(b) of the Code. Since the partnership had no unrealized receivables or appreciated inventory items described in section 751, the gain is considered a gain from the sale of a capital asset under section 741.

[3314] Letter Ruling 201709001.

[3315] Determined without regard to Code § 1221(b)(3).

[3316] Code § 170(e)(1)(A).

Although the sale of a partnership interest generally is taxed as a capital gain[3317] (which might be long- or short-term), certain underlying assets might convert part or all of the gain to ordinary income.[3318] However, the partnership's holding of certain assets that otherwise might have severe limitations on deductions[3319] does not appear to taint the deduction for the partnership interest.[3320]

II.Q.6.c. Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust

Letter Ruling 9705013 approved a charitable remainder trust (CRT) investing in an in an investment partnership. However, contributing a partnership interest to a CRT is very complex and might not be worthwhile if the partnership operates a business or has significant debt-financed property. Below are some issues.

First is a possible gain on sale, as described in part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity, especially fn. 3312.

3317 Code § 741; see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fns. 4124-4126 (look to partnership interest itself absent statutory authority to look through to the partnership's assets).

3318 See parts II.Q.8.b.i.(f) Code § 751 – Hot Assets and II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), the latter including fn. 3681 the sale of partnership interests to a controlled corporation.

3319 Code § 170(e)(1)(B) reduces the deduction regarding contributions:

- (i) of tangible personal property—
  - (I) if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in subsection (c)), or
  - (II) which is applicable property (as defined in paragraph (7)(C), but without regard to clause (ii) thereof) which is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the contribution was made and with respect to which the donee has not made a certification in accordance with paragraph (7)(D),
- (ii) to or for the use of a private foundation (as defined in section 509(a)), other than a private foundation described in subsection (b)(1)(F),
- (iii) of any patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property, or
- (iv) of any taxidermy property which is contributed by the person who prepared, stuffed, or mounted the property or by any person who paid or incurred the cost of such preparation, stuffing, or mounting

3320 The flush language of Code § 170(e)(1), provides that, for purposes of applying Code § 170(e)(1) to the charitable contribution of stock in an S corporation, rules similar to those in fn. 3318 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer. If the rules of Code § 170(e)(1)(B) looked through the partnership, presumably they would also look through an S corporation, which they do not.

Second, a charitable remainder trust (CRT) pays a 100% tax on any unrelated business taxable income (UBTI).[3321] The beneficiary also pays tax on this income (along with the rest of the CRT's income) when distributed to the beneficiary.[3322] A gift of any partnership interest that has significant debt risks significant UBTI – a risk that is probably too high for a CRT, given this 100% tax.[3323] One might avoid the UBI issue if the donor keeps part of the partnership interest and contractually assumes the burden of the partnership's debt;[3324] whether that idea is practical or too complex depends on the situation.

[3321] Code § 664(c)(2)(A); Reg. § 1.664-1(c). The latter refers to UBTI as defined in section 512, determined as if part III, subchapter F, chapter 1, subtitle A of the Internal Revenue Code applied to such trust.

[3322] Code § 664(b); Reg. § 1.664-1(c). The latter provides, Such excise tax shall be allocated to corpus and, therefore, is not deductible in determining taxable income distributed to a beneficiary.

[3323] See part II.Q.6.d Unrelated Business Income, especially fns. 3354-3364.

[3324] The TAM's holding regarding the escrow fund to reallocate nonrecourse debt, which was described in fn. 3355, together with its reference to Code § 752 (see fn. 3354). See 735 T.M. *Private Equity Funds*, part VIII.H.1., suggesting:

> A fund that allows its tax-exempt investors to replace their share of any fund level debt with a capital contribution should allocate the debt to the other investors. *See* TAM 9651001 (applying § 752 to determine portion of partnership debt allocable to tax-exempt partner).

For the assumption of liabilities when transferring a partnership interest to which liabilities have been allocated, see fn. 4975, found in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[3] Nonassumed Debt, direct the reader to GCM 39486 (1986), in which the IRS internally had asked:

> If an organization exempt from tax under section 501(a) is a limited partner in a partnership that lends money under or acquires wrap-around mortgages, are the wrap-around mortgages debt-financed property of the exempt organization?

Relying on Rev. Rul. 75-99, the GCM concluded:

> A wrap-around mortgage acquired by the partnership as an investment solely by advancing its own funds is not debt-financed property merely because the wrap-around note is for an amount in excess of the funds advanced by the partnership.

Rev. Rul. 75-99 involved the following:

> An unincorporated trust, qualifying as a real estate investment trust under section 856 of the Internal Revenue Code of 1954, invested in a wrap-around loan. In the wrap-around loan in this case a party owning real estate encumbered by a senior mortgage executed a note to the trust for the total of the unpaid principal balance of the senior mortgage, plus cash advanced by the trust. The borrower also executed a mortgage to the trust encumbering the real estate described in the senior mortgage. The trust agreed to look solely to the mortgaged property for the payment of the indebtedness and agreed not to seek or obtain any deficiency or other money judgment in respect thereof. The borrower received from the trust that sum by which the principal amount of the wrap-around loan exceeded the unpaid principal balance of the senior mortgage.
>
> The trust is not liable to the senior mortgagee on the underlying note. However, the trust agreed with the mortgagor-owner to make the periodic payments of principal and interest due on the senior obligation, provided, however, that if the mortgagor defaults on its payments on the note to the trust, the trust is relieved of its obligation to make payments on the senior mortgage. For purposes of making payments on the senior mortgage and performing other obligations required under the mortgage, the borrower appointed the trust its attorney-in-fact.

Consider whether, instead of contributing a partnership interest to a CRT, one might place the partnership interest in a corporation and contribute the corporation to the CRT. Such a corporation is commonly referred to as a blocker. Any partnership liabilities from which the donor is deemed to be relieved might trigger income on formation of the corporation.[3325] The CRT would not receive any UBTI; however, the corporation would pay tax on its share of the partnership's income and on any gain on sale of the partnership. If the partnership has little or no debt-financed property, then the corporation might save little tax and might even cost more tax; if it has much debt-financed property, then the corporation might produce a significant benefit. The benefit of forming the corporation would be taxing income at regular rates instead of 100% while getting the benefit of the deduction of the full value of the corporation (which presumably would be reduced by tax paid on the expected upcoming sale of the partnership interest). However, the corporation's sale of the partnership interest would be subject to income tax at corporate rates, whereas the CRT's sale of a partnership interest it owns

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> In the wrap-around loan in this case, the trust determined that certain property with a 300x dollar senior mortgage bearing interest at 7 percent per annum was of sufficient value to support a wrap-around loan to the owner in the amount of 400x dollars at 8 percent per annum. The borrower executed a note, and a mortgage securing the note, in the amount of 400x dollars at 8 percent per annum. The trust advanced 100x dollars to the borrower, the amount by which the wrap-around loan exceeded the principal of the senior mortgage. The borrower periodically pays to the trust an amount equal to interest at the rate of 8 percent on the 400x dollar note, together with principal thereon.

Rev. Rul. 75-99 held:

> Section 856(c)(2) and (3) of the Code provides that for a trust to qualify as a real estate investment trust, certain percentages of its gross income must be derived from specified sources, including interest and interest on obligations secured by mortgages on real property.
>
> For purposes of section 856(c)(2) and (3) of the Code, the indebtedness between the trust and the borrower giving rise to an obligation to pay interest is not the total amount of the wrap-around loan. See *Mindlin v. Davis*, 74 So.2d 789 (Fla. 1954). Although the borrower signs a note for 400x dollars, the trust actually loans the borrower 100x dollars. Payments made by the trust on the senior obligation are considered to be made on behalf of the borrower from payments received from the borrower on the 400x dollar note. Accordingly, it is held that only the interest on 100x dollars, the amount of the cash advanced by the trust, is includible in the trust's gross income.

Analogizing, GCM 39486 reasoned:

> Here, as in Rev. Rul. 75-99, there is no indication that the contract between the partnership and the borrower creates a debtor-creditor relationship between the partnership and the lender under the first mortgage. The partnership does not contract with the lender under the first mortgage for liability for repayment of the first mortgage. Thus, it cannot be said, on these facts, that the partnership has borrowed the amount of the first mortgage in order to advance the funds to the borrower. Accordingly, there is not any acquisition indebtedness.
>
> The same conclusion is reached by analyzing the property acquired. In this case, the partnership acquires a note secured by an interest in property subordinate to one or more other mortgages or similar interests in the property. The partnership does not acquire the borrower's property that is subject to these senior obligations. Thus, the property acquired is not, in our opinion, subject to any acquisition indebtedness, rather, the property acquired (the note) is an obligation to pay secured by the borrower's encumbered property. Thus, we think it is clear that a wrap-around note acquired by the partnership solely by advancing its own funds is not debt-financed property.

[3325] See part II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities.

directly would defer or avoid income tax on gain on the sale, if and to the extent that the sale would not generate UBTI. Furthermore, if the CRT sold its shares in the corporation, a purchaser would reduce the price to take into account the partnership's built-in gain, especially if the purchaser would have been able to benefit from depreciation or amortization deductions if it had bought the partnership interest directly.[3326] So, the blocker concept, although avoiding UBTI issues, might not save much money, and a donor concerned about UBTI might consider just selling the partnership interest and donating the proceeds.

Another way a CRT could avoid UBTI from a partnership is to contribute to a blocker any portion of the partnership interest that would generate UBTI. If the partnership interest is about to be sold and the sale itself would not generate UBTI, then the blocker can avoids UBTI on current income without subjecting the sale proceeds to the corporate tax regime. To avoid the prohibition described in part II.Q.6.f Incomplete Gift and Charitable Partial Interest Prohibition, the donor should contribute to the CRT a vertical slice of everything the donor owns in the partnership, and then the CRT contributes to the blocker the portion of the partnership interest that generates UBTI.

In either CRT scenario, the UBTI would be taxed at the corporate level and again when the CRT distributes the dividend to the recipient, rather than being taxed to the donor at the donor's ordinary income tax rates (which usually are higher than corporate rates but lower than corporate rates and capital gain rates combined), so the sale not taking place would increase the annual income tax burden. On the other hand, the charitable deduction might offset this tax disadvantage to a certain extent. Note also that distributions to the recipient, which are based on a percentage (5% or more) of the value of the CRT's assets, would likely be smaller than the annual distributions from the partnership.

Also note that the donor being compensated for services to the partnership or otherwise engaging in transactions with the partnership might be limited by self-dealing rules:[3327] Payment of compensation by a private foundation directly or indirectly to a disqualified person is self-dealing.[3328] One may be a disqualified person with respect to a CRT by being a "substantial contributor" to the CRT[3329] or a trustee of the CRT.[3330] The payment of compensation to a disqualified person by a partnership owned by the CRT is not direct self-dealing because the payment is not being made by the CRT to the recipient. Instead, one would look to rules governing indirect self-dealing[3331] between a disqualified person and an organization controlled[3332] by a private foundation.

[3326] See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[3327] See Letter Ruling 9533014.
[3328] Code § 4941(d)(1)(D).
[3329] A substantial contributor is the creator of a charitable trust and any donor who gives more than $5,000 to the private foundation if the amount given is more than 2% of the total contributions in the taxable year. Code §§ 4946(a)(2) and 507(d)(2).
[3330] Code § 4946(a)(1).
[3331] Reg. § 53.4941(d)-1(b), which provides the indirect self-dealing rules and various exceptions.
[3332] Reg. § 53.4941(d)-1(b)(5).

Also, if the partnership is unmarketable,[3333] then any required valuation (at initial contribution and annually for a unitrust) must be performed exclusively by an independent trustee or determined by a current qualified appraisal from a qualified appraiser.[3334]

II.Q.6.d. Unrelated Business Income (UBTI)

II.Q.6.d.i. UBTI Related to a Partnership or Sole Proprietorship

UBTI can arise from business operations[3335] or from income generated by acquisition indebtedness. If a trade or business regularly carried on by a partnership of which an

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[3333] Reg. § 1.664-1(a)(7)(ii) provides:

> *Unmarketable assets*. Unmarketable assets are assets that are not cash, cash equivalents, or other assets that can be readily sold or exchanged for cash or cash equivalents. For example, unmarketable assets include real property, closely-held stock, and an unregistered security for which there is no available exemption permitting public sale.

[3334] Reg. § 1.664-1(a)(7)(i).

[3335] Code § 512(a)(1). Citing Code § 513(a), (c) and Reg. § 1.513-1(a), Letter Ruling 201626004 reasoned:

> Therefore, unless one of the specific exceptions of sections 512 or 513 is applicable, gross income of an exempt organization subject to the tax imposed by section 511 is includible in the computation of unrelated business taxable income if:
> (1) it is income from a trade or business;
> (2) such trade or business is regularly carried on by the organization; and
> (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

The Letter Ruling reviewed Reg. § 1.513-1(c)(1):

> Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be regularly carried on if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

After reviewing Reg. § 1.513-1(d) (see fn. 3370 in part II.Q.6.d.i UBTI Related to a Partnership or Sole Proprietorship) for whether an activity is substantially related (other than through the production of funds) to the purposes for which exemption is granted, it reviewed case law:

> In *United States v. American Bar Endowment*, 477 U.S. 105 (1986), the Supreme Court held that a section 501(c)(3) organization's insurance program constituted both the sale of goods and the performance of services and, therefore, was a trade or business for purposes of the tax on unrelated business income. The organization was the group policyholder and administrator of insurance policies offering life, disability and medical coverage. Its activities included compiling a list of its members and soliciting their insurance business.
>
> In *Ohio Farm Bureau Federation, Inc., v, Commissioner*, 106 T.C. 222 (1996), the Tax Court concluded that a covenant not to compete did not constitute a trade or business. The Tax Court declined to treat the absence of activity as equivalent to the affirmative conduct of a trade or business in the context of unrelated business income.

The Letter Ruling addressed a donation of accounts receivable bequeathed to a foundation:

> At the time of Decedent's death, the Company's primary assets were receivables related to legal services provided by the Company in connection with certain lawsuits (the receivables). The receivables represent the Company's share of the remaining unpaid balance of the attorney's fees awarded upon settlement of the lawsuits. The fees due to the Company were determined under various settlement agreements and, under the terms of the settlement, payment of fees was deferred over time. Payments are expected

organization is a member is an unrelated trade or business with respect to the organization, the organization in computing its UBTI must, subject to the exceptions, additions, and limitations contained in Code § 512(b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income.[3336] For UBI purposes, generally a trust looks to "any trade or business regularly carried on by such trust or by a partnership of which it is a member."[3337] Conversely,

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> to continue for approximately x additional years. The Company's ownership in its share of the attorney's fees payable wholly vested when the lawsuits finally settled, which was prior to Decedent's death. Currently, none of the Estate, the Foundation, or the Company provides any services in relation to the legal services generating the receivables. Furthermore, the Foundation represents that it will not perform any act (including administrative acts) with respect to the receivables other than receiving payments related to satisfaction of the receivables.
>
> The Foundation represents that the receivables:
>
> - Are comprised solely of income from services previously provided by the Company, including Decedent;
> - Are not debt-financed property within the meaning of section 514(b); and
> - Are not gains or losses from the sale or exchange or other disposition of any property or gains or losses from the lapse or termination of options to buy or sell securities.

The Letter Ruling concluded:

> However, the Company completed provision of the legal services prior to Decedent's death. The Foundation represents that none of the Estate, the Foundation, or the Company currently provides any services in relation to the receivables and, further, that the Foundation will not perform any act (including administrative acts) other than receiving payments related to satisfaction of the receivables. The Foundation is merely the distributee of the assets of the Estate and the recipient of the payments. The Foundation is performing no activity, similar to the organization in *Ohio Farm Bureau Federation, Inc.*, *supra*, other than receiving payments. The Foundation is neither selling goods nor performing any services in order to receive income from the receivables, unlike the organization in *United States v. American Bar Endowment*, *supra*, that was engaged in a trade or business. See section 513(c); Treas. Reg. Sec. 1.513-1(b). Therefore, the income resulting from the receivables is not unrelated business income within the meaning of section 512(a) and will not be subject to the tax on unrelated business income described in section 511(a).

[3336] Code § 512(c)(1).

[3337] Code § 513(b) provides:

> The term "unrelated trade or business" means, in the case of—
>
> (1) a trust computing its unrelated business taxable income under section 512 for purposes of section 681 ; or
>
> (2) a trust described in section 401(a) , or section 501(c)(17) , which is exempt from tax under section 501(a);
>
> any trade or business regularly carried on by such trust or by a partnership of which it is a member.

Reg. 1.512(c)-1 provides:

> In the event an organization to which section 511 applies is a member of a partnership regularly engaged in a trade or business which is an unrelated trade or business with respect to such organization, the organization shall include in computing its unrelated business taxable income so much of its share (whether or not distributed) of the partnership gross income as is derived from that unrelated business and its share of the deductions attributable thereto. For this purpose, both the gross income and the deductions shall be computed with the necessary adjustments for the exceptions, additions, and limitations referred to in section 512(b) and in § 1.512(b)-1. For example,

when a foundation collects accounts receivable that the decedent had earned and bequeathed to it but the foundation did not conduct the business from which the accounts receivable arose, income from collecting the accounts was not UBI.[3338]

Although dividends,[3339] interest,[3340] annuity payments,[3341] royalties,[3342] rent from real property or from personal property incidental to the real property rental,[3343] and capital

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> if an exempt educational institution is a partner in a partnership which operates a factory and if such partnership also holds stock in a corporation, the exempt organization shall include in computing its unrelated business taxable income its share of the gross income from the operation of the factory, but not its share of any dividends received by the partnership from the corporation. If the taxable year of the organization differs from that of the partnership, the amounts included or deducted in computing unrelated business taxable income shall be based upon the income and deductions of the partnership for each taxable year of the partnership ending within or with the taxable year of the organization.

[3338] Letter Ruling 201626004 reasoned:

> At the time of Decedent's death, the Company's primary assets were receivables related to legal services provided by the Company in connection with certain lawsuits (the receivables). The receivables represent the Company's share of the remaining unpaid balance of the attorney's fees awarded upon settlement of the lawsuits. The fees due to the Company were determined under various settlement agreements and, under the terms of the settlement, payment of fees was deferred over time. Payments are expected to continue for approximately x additional years. The Company's ownership in its share of the attorney's fees payable wholly vested when the lawsuits finally settled, which was prior to Decedent's death. Currently, none of the Estate, the Foundation, or the Company provides any services in relation to the legal services generating the receivables. Furthermore, the Foundation represents that it will not perform any act (including administrative acts) with respect to the receivables other than receiving payments related to satisfaction of the receivables.
>
> The Foundation represents that the receivables:
>
> - Are comprised solely of income from services previously provided by the Company, including Decedent;
> - Are not debt-financed property within the meaning of section 514(b); and
> - Are not gains or losses from the sale or exchange or other disposition of any property or gains or losses from the lapse or termination of options to buy or sell securities.

The Letter Ruling concluded:

> However, the Company completed provision of the legal services prior to Decedent's death. The Foundation represents that none of the Estate, the Foundation, or the Company currently provides any services in relation to the receivables and, further, that the Foundation will not perform any act (including administrative acts) other than receiving payments related to satisfaction of the receivables. The Foundation is merely the distributee of the assets of the Estate and the recipient of the payments. The Foundation is performing no activity, similar to the organization in *Ohio Farm Bureau Federation, Inc.*, *supra*, other than receiving payments. The Foundation is neither selling goods nor performing any services in order to receive income from the receivables, unlike the organization in *United States v. American Bar Endowment*, *supra*, that was engaged in a trade or business. See section 513(c); Treas. Reg. Sec. 1.513-1(b). Therefore, the income resulting from the receivables is not unrelated business income within the meaning of section 512(a) and will not be subject to the tax on unrelated business income described in section 511(a).

[3339] Code § 512(b)(1).

[3340] Code § 512(b)(1).

gains (and gain from certain other property) generally do not constitute unrelated business income (UBI) if the donee does not engage in business activity, but if they arise from debt-financed property then they may constitute UBI.[3344] Below is a discussion of gain on sale without considering debt-financing, then debt-financing is addressed.

The exclusion of gains, Code § 512(b)(5), provides:

> There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than-
>
> (A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or
>
> (B) property held primarily for sale to customers in the ordinary course of the trade or business.

[3341] Code § 512(b)(1). Letter Ruling 200425027 held that bequests relating to the following were not UBI:

> In addition to receiving the residue of the Decedent's estate, Trust will be funded by a distribution from Decedent's Plan 1 and Decedent's Plan 2 (the "Plans"). In addition, Trust will be funded by a distribution from Decedent's Annuity. It is represented that (1) the Plans are qualified plans under section 401; (2) the Annuity is not a qualified plan under section 401 or an individual retirement account (IRA), but is a tax-sheltered annuity that was purchased by Decedent as an investment; and (3) the Decedent's basis in the Annuity was greater than the fair market value of the Annuity at the date of Decedent's death.

Similarly, Letter Ruling 200234019 held that bequests relating to the following, that an estate assigned to charity, were not UBI:

> Decedent's Estate included four contracts, represented as being annuities described in § 403(b), and three individual retirement accounts (IRAs), represented as being qualified IRAs described in § 408. Decedent was also the beneficiary of a custodial account held in the name of the Decedent's late spouse, represented as being an account described in § 403(b)(7).

[3342] Code § 512(b)(2).

[3343] Code § 512(b)(3). Short-term rentals involving significant services constitute UBI. Rev. Rul. 76-402 (ten-week summer tennis camp, in which a school provided tennis courts, furnished dormitory rooms, linens, maid service, meals, and dining facilities for use by the individual in conducting the camp), amplified Rev. Rul. 80-297; Rev. Rul. 80-298 (professional football team leases stadium from university for practice during several months of the year, with university providing heat, light, water, dressing room, linen, significant stadium security services, and maintenance of playing surface and all other ground.). The IRS' web page, at https://www.irs.gov/charities-non-profits/exclusion-of-rent-from-real-property-from-unrelated-business-taxable-income, provides an informal brief overview in "Exclusion of Rent from Real Property from Unrelated Business Taxable Income."

See also part II.L.2.a.ii Rental Exception to SE Tax, especially fns. 2379-2387, comparing the rental exception for self-employment tax to the rental exception for UBTI purposes (the latter being set forth in fn. 2384).

[3344] Superseding Code § 512(b)(5) and other exceptions, Code § 512(b)(4) provides:

> Notwithstanding paragraph (1), (2), (3), or (5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

> There shall also be excluded all gains or losses recognized, in connection with the organization's investment activities, from the lapse or termination of options to buy or sell securities (as defined in section 1236(c)) or real property and all gains or losses from the forfeiture of good-faith deposits (that are consistent with established business practice) for the purchase, sale, or lease of real property in connection with the organization's investment activities. This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

This provision does not protect various depreciable or amortizable property from constituting UBI.[3345] When Code § 512(b)(5) refers to the sale, exchange, or other disposition of property, it encompasses "gains and losses from involuntary conversions, casualties, etc."[3346]

Special rules apply regarding options.[3347]

Beyond that, let's focus on whether property, held by an exempt organization itself, is inventory or held for the sale to customers, which depend on the organization's activities. An exempt organization's specific business activities ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.[3348] "Where income producing activities are of a kind normally conducted

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[3345] Reg. § 1.1245-6(b) (see part II.G.5.b Code § 1245 Property) may override Code § 512(b)(5):

> *Nonrecognition sections overridden*. The nonrecognition provisions of subtitle A of the Code, which section 1245 overrides include, but are not limited to, sections 267(d), 311(a), 336, 337, 501(a), 512(b)(5) and 1039. See section 1245(b) for the extent to which section 1245(a)(1) overrides sections 332, 351, 361, 371(a), 374(a), 721, 731, 1031, 1033, 1071, and 1081 (b)(1) and (d)(1)(A). For limitation on amount of adjustments reflected in adjusted basis of property disposed of by an organization exempt from income taxes (within the meaning of section 501(a)), see paragraph (a)(8) of § 1.1245-2.

[3346] Reg. § 1.512(b)-1(d)(1).

[3347] Reg. § 1.512(b)-1(d)(2) provides:

> There shall be excluded from the computation of unrelated business taxable income any gain from the lapse or termination after December 31, 1975, of options to buy or sell securities (as that term is defined in section 1236(c)). An option is considered terminated when the organization's obligation under the option ceases by any means other than by reason of the exercise or lapse of such option. If the exclusion is otherwise available it will apply whether or not the organization owns the securities upon which the option is written, that is, whether or not the option is "covered." However, income from the lapse or termination of an option is excludable only if the option is written in connection with the organization's investment activities. Thus, for example, if the securities upon which the options are written are held by the organization as inventory or for sale to customers in the ordinary course of a trade or business, the income from the lapse or termination will not be excludable under the provisions of this paragraph. Similarly, if an organization is engaged in the trade or business of writing options (whether or not such options are covered) the exclusion will not be available.

[3348] Reg. § 1.513-1(c)(1) provides:

> *General principles*. In determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. This requirement must be applied in light of the purpose of the unrelated business income tax

by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the regular carrying on of trade or business." [3349] Assets that normally generate business income that the charity sells in an orderly disposition without undertaking further activity do not constitute UBI.[3350]

> to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.

[3349] Reg. § 1.513-1(c)(2)(i), which continues:

> For example, the operation of a sandwich stand by a hospital auxiliary for only 2 weeks at a state fair would not be the regular conduct of trade or business. However, the conduct of year-round business activities for one day each week would constitute the regular carrying on of trade or business. Thus, the operation of a commercial parking lot on Saturday of each week would be the regular conduct of trade or business. Where income producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business. For example, the operation of a track for horse racing for several weeks of a year would be considered the regular conduct of trade or business because it is usual to carry on such trade or business only during a particular season.

Reg. § 1.513-1(c)(2)(ii) provides:

> *Intermittent activities; in general*. In determining whether or not intermittently conducted activities are regularly carried on, the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by non-exempt organizations. In general, exempt organization business activities which are engaged in only discontinuously or periodically will not be considered regularly carried on if they are conducted without the competitive and promotional efforts typical of commercial endeavors. For example, the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business. Similarly, where an organization sells certain types of goods or services to a particular class of persons in pursuance of its exempt functions or "primarily for the convenience" of such persons within the meaning of section 513(a)(2) (as, for example, the sale of books by a college bookstore to students or the sale of pharmaceutical supplies by a hospital pharmacy to patients of the hospital), casual sales in the course of such activity which do not qualify as related to the exempt function involved or as described in section 513(a)(2) will not be treated as regular. On the other hand, where the nonqualifying sales are not merely casual, but are systematically and consistently promoted and carried on by the organization, they meet the section 512 requirement of regularity.

Reg. § 1.513-1(c)(2)(iii) provides:

> *Intermittent activities; special rule in certain cases of infrequent conduct*. Certain intermittent income producing activities occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as trade or business regularly carried on. For example, income producing or fund raising activities lasting only a short period of time will not ordinarily be treated as regularly carried on if they recur only occasionally or sporadically. Furthermore, such activities will not be regarded as regularly carried on merely because they are conducted on an annually recurrent basis. Accordingly, income derived from the conduct of an annual dance or similar fund raising event for charity would not be income from trade or business regularly carried on.

[3350] Letter Ruling 9413020 provided:

A is a sole proprietor engaged in the business of cattle ranching and farming. In these operations, he raises cattle to be sold for beef ("slaughter cattle") and crops. The crops and the slaughter cattle are sold to customers in the ordinary course of his business. As a first step in a plan to wind up and retire from his ranching and farming operation, A will fund the unitrust with separate irrevocable transfers of slaughter cattle and crops with a total value of approximately X. These two transfers will take place within a period of several weeks, and both transfers will occur in 1993.

The trust agreement will permit A to make additional contributions to the unitrust at any time. A anticipates that he will transfer additional farming and ranching assets to the proposed unitrust in another series of transfers that will probably take place in about two years. That second series of transfers will occur as part of A's completion of his plan to wind up and retire from his ranching and farming operation. The items to be transferred at that time will include more slaughter cattle and crops, and also breeding cattle and farm machinery that A has used in his ranching and farming operations. (A is not in the business of selling either breeding cattle or farm machinery.) Although not all of these transfers will occur at one time, it is represented that they will all take place within a period of several months.

A is a cash-basis taxpayer who has deducted all costs incurred in raising the slaughter cattle and crops for the years in which such costs were incurred. A will claim no income tax charitable contribution deduction for any transfer of slaughter cattle, crops, breeding stock or farm machinery (collectively "farm items") to the unitrust.

C will have complete discretion as to whether and when to sell any farm items transferred to the proposed unitrust. It is likely that any quantity of farm items that is received by the unitrust in a particular transfer will be sold by the trustee in a single transaction, or at most two transactions, shortly after such farm items are transferred to the trust. However, at the time of a transfer to the unitrust, neither A nor C will be under any legally binding obligations to sell the transferred farm items.

The proposed unitrust will not take over any operations of A's farm whose farm land and buildings will continue to be owned by the donor, who may retire and discontinue farming in a few years. If C decides to sell any slaughter cattle or crops that A has transferred to the unitrust, it will hire an agent that will try to find a buyer for the items in question at an attractive price. This is a method often used by farmers in selling the agricultural products they raise. It is also one of the fastest and most economical ways of liquidating such items. C will arrange for the slaughter cattle to be fed and cared for on a strictly maintenance basis (*i.e.*, it will not be engaging in efforts to "fatten them for market") from the time it receives them until a sale occurs. If C decides to sell breeding stock, it will sell them at a single auction after arranging for them to be fed and cared for from the time it receives them until the auction. It will use a similar procedure for disposing of any farm machinery it decides to sell. Thus, it is represented that the unitrust will not engage in regularly carried on sales of the farm items as a dealer and that the farm items to be sold are not held by the unitrust for sale to customers in the ordinary course of any unitrust business. It is also represented that the sales of donated farm items will not involve property that is debt-financed under section 514 of the Code….

Section 1.513-1(c)(2)(iii) of the regulations indicates that business is not "regularly carried on" in the case of intermittent income-producing activities that occur so infrequently that neither their recurrence nor the manner of their conduct will cause them to be regarded as a business regularly carried on. See also the discussion of a similar principle in *Robert L. Adam and Judith W. Adam v. Commissioner*, 60 T.C. 996 (September 27, 1973), *Acq.* 1974-1 C.B. 1….

In this case, in regard to sections 511, 512, and 513 of the Code, occasional sales by the unitrust to dispose of the farm items described will not be "regularly carried on" within the meaning of section 512(a)(1) because such sales will be infrequent and intermittent. In addition, the farm items are the types of properties whose income from sales is excludible from unrelated business taxable income pursuant to section 512(b)(5), described above.

For case law in a related area discussing when property is inventory from a regularly carried on business and when sales might be viewed as not from the conduct of a business, see part II.L.2.a.iii Whether Gain from Sale of Property is Subject to SE Tax.[3351] Real estate might or might not constitute inventory.[3352]

A partnership holding debt-financed assets can generate UBI not only on annual income but also on the sale of the partnership interest. Debt of a lower-tier partnership is attributed to an upper-tier partnership and then to the owner,[3353] so creating a patchwork of partnerships will not help.

> Also, as to section 514, these transactions will not involve debt-financed property. Therefore, the unitrust's receipts of the proceeds from any sales of the farm items will not result in any unrelated business taxable income to the unitrust under sections 511 through 514.
>
> Accordingly, under sections 511, 512, 512(b)(5), 513, and 514 of the Code, the unitrust will not have any unrelated business taxable income on its sales, under the circumstances described, of the farm items which the donor may transfer to it.

[3351] Especially fn. 2389.

[3352] See part II.G.12 Future Development of Real Estate, especially fn. 1042. Referring to *Malat* cited in that fn., Letter Ruling 201630009 held:

> Foundation intends to hold the real estate properties as part of a diversified investment portfolio that will also contain cash and publicly traded securities and intends to continue to hold the properties, at least in the near term. Foundation anticipates that any sales of the real estate properties will be sporadic and occasional. The decision to retain or sell any of the real estate properties will be made by Foundation's Board of Directors based on the relevant facts and circumstances and in accordance with their fiduciary duty to prudently manage Foundation's investments. Any such decision will be made on a property-by-property basis, taking into consideration the overall investment portfolio, investment strategy, and capital appreciation. Foundation may decide to make capital improvements to the real estate properties as needed, but the real estate properties will not be held for the primary purpose of improving the properties for immediate resale. The real estate properties will be held as income producing properties and not as inventory used in a trade or business.

[3353] Reg. 1.514(c)-1(a)(2), Example (4), which was cited in TAM 9651001 (which is reproduced in part in fns. 3354-3355 and analyzed in fns. 3357-3365), provides:

> In 1972 X, an exempt organization, forms a partnership with A and B. The partnership agreement provides that all three partners shall share equally in the profits of the partnership, shall each invest $3 million, and that X shall be a limited partner. X invests $1 million of its own funds in the partnership and $2 million of borrowed funds. The partnership purchases as its sole asset an office building which is leased to the general public for purposes other than those described in section 514(b)(1)(A), (B), (C), or (D). The office building cost the partnership $24 million of which $15 million is borrowed from Y bank. This loan is secured by a mortgage on the entire office building. By agreement with Y bank, X s held not to be personally liable for payment of such mortgage. By reason of section 702(b) the character of any item realized by the partnership and included in the partner's distributive share shall be determined as if the partner realized such item directly from the source from which it was realized by the partnership and in the same manner. Therefore, a portion of X's income from the building is debt-financed income. Under these circumstances, since both the $2 million indebtedness incurred by X in acquiring its partnership interest and $5 million, the allocable portion of the partnership's indebtedness incurred with respect to acquiring the office building which is attributable to X in computing the debt/basis percentage (one-third of $15 million), were incurred in acquiring income-producing property, X has acquisition indebtedness of

TAM 9651001 asserted that gain from the sale of a partnership generated UBI with respect to the partnership's debt that was allocated to the seller,[3354] except to the extent

$7 million ($2 million plus $5 million). Similarly, the allocable portion of the partnership's adjusted basis in the office building which is attributable to X in computing the debt-basis percentage is $8 million (one-third of $24 million). Assuming no payment with respect to either indebtedness and no adjustments to basis in 1972, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for such year. Therefore, X's debt/basis percentage with respect to its share of the partnership income for 1972 is 87.5 percent ($7 million/$8 million).

[3354] The TAM reasoned:

There is no disagreement concerning the fact that both Partnership and Z held debt-financed property. Sections 702(b) and 512(c)(1) of the Code make it clear that the income of a partnership retains its character in the hands of the partners. Thus, when Partnership and Z received income attributable to debt-financed property, X reported its share of this income as unrelated business income (UBI). The central area of disagreement is the treatment of income received from the sale of a partnership interest by an exempt organization when the interest of the exempt organization was not purchased with borrowed funds, but the property owned within the partnership was purchased by the partnership itself with (or partially with) borrowed funds.

The facts indicate that X reported for each taxable year its distributive share of rental income from Partnership as unrelated debt-financed income. X did not report as unrelated debt-financed income X's gain on the sale of its interests in Partnership and Z, which held debt-financed real estate. Had Partnership and Z instead sold the debt-financed real estate, X's distributive share of gain from the sale would have been reportable as unrelated debt-financed income. X maintains that because X did not borrow directly to purchase its interests in Partnership and Z, gain from the sale of the partnership interests, rather than from the sale of the debt-financed real estate itself held by the partnerships, was not reportable as unrelated debt-financed income. However, whether X sells its interests in the partnerships or the partnerships sell the real estate, X is accomplishing economically the same result of realizing its share of any appreciation in the debt-financed real estate.

A partnership can be viewed in two ways under subchapter K: as a separate entity or as an aggregate of its partners. See *Casel v. Commissioner*, 79 T.C. 424, 432-33 (1982). The entity view of partnerships treats each partner as owning no direct interest in partnership assets or operations, but only an interest in the partnership entity itself. The aggregate view treats each partner as the owner of a direct and undivided interest in partnership assets and operations. Subchapter K is an attempt to balance the entity view with the aggregate view to avoid the use of a partnership as a means of obtaining improper tax advantages. The many situations not clearly covered by subchapter K can be resolved by both looking to whether the subchapter applies an entity or aggregate approach in analogous situations and considering the purpose of the particular provision of the Code to be applied.

The House Conference Committee report addressing the enactment of Subchapter K states that, even though Subchapter K takes an entity approach in transactions between a partner and a partnership, no inference is intended, however, that a partnership is to be considered as a separate entity for purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions. H.R. Rep. No. 2453, 83d Cong., 2d Sess. 59 (1954).

Example (4) of section 1.514(c)-1(a)(2) of the regulations shows that BOTH debt incurred to acquire a partnership interest AND debt incurred by the partnership to acquire property are included in calculating that portion of a partnership's interest that is subject to acquisition indebtedness. The debt/basis percentage thus calculated for the partnership that the partnership's non-recourse debt was effectively defeased by the establishment of the independently trusteed, fully funded escrow account which is contractually committed to paying interest and principal on the debt.[3355] The latter is consistent with

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> interest is the same whether the partnership sells the property or the partner sells its partnership interest.
>
> An interest in a partnership that holds debt-financed property is effectively an interest in the underlying assets and liabilities of the partnership. An anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result another. The aggregate view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*, section 751(a) and section 512(b)).
>
> For purposes of the debt-financed property rule of section 514 of the Code, the aggregate approach should be applied with respect to sales of partnership interests consistently with the aggregate approach contemplated in section 512(b)(4) with respect to items of income from debt-financed property that flow through to the partners. Analogously, when a partner sells a partnership interest, section 751(a) requires a look through of its partnership interest to determine the character of assets sold and the classification of gain. It would make no economic or policy sense that X should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than have the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided. Consequently, X's sales of its interests in Partnership and Z at a gain result in unrelated business income under section 514.
>
> The debt on Partnership's revolving line of credit apparently existed, at least in part, when X acquired its interest in Partnership. Accordingly, X's share, if any, of this liability under section 752 and regulations thereunder constitutes acquisition indebtedness of X, because the indebtedness was effectively incurred by X in acquiring the partnership interest. See section 514(c)(1)(A) of the Code. In addition, X's share under the section 752 regulations of any increases in debt on the revolving line of credit after X acquires its interest in Partnership constitutes acquisition indebtedness to the extent the increases were incurred to acquire or improve property within the meaning of section 514(c)(1)(A), (B), or (C).
>
> Because the debt with respect to X's interest in Z was incurred before July 18, 1984, the effective date for application of this exception to organizations such as X, the exception provided in section 514(c)(9)(A) of the Code is not applicable. See P.L. 98-369. In addition, X has not shown that it meets the specific requirements of section 514(c)(9)(B).

Reg. 1.514(c)-1(a)(2), Example (4), which was referred to in the quote above, is reproduced in fn. 3353.

[3355] The TAM reasoned:

> Even though the properties of Z are collateral on the prior loan of Y's, the payment of the loan is not an obligation of Z, nor was it an obligation of Venture or a previous obligation of any of the other ventures. Y personally makes the payments and neither the loan nor the payments on it are considered in calculating partnership income. However, even though this is not a debt of Z, X could be at risk of loss of its share of the value of the property if the property should be foreclosed upon. Thus, X, in that case, though not contractually obligated, would in effect be paying on the loan. This risk is eliminated by the creation of the independently trusteed, fully funded, escrow account solely for the purpose of paying the loan should Y default. Therefore, the loan, although collateralized by Z property, is not an obligation or liability of Z or X, and the escrow account, which must at all times be maintained a level sufficient to pay off the loan, ensures that even if Y should default neither Z nor X would be at risk of any loss or be required to make any

Letter Rulings that held that loans from a partner to a partnership did not trigger debt-financed income.[3356]

The TAM was not clear how the UBI was computed. To me, the better view of the TAM's analysis is that one looks through the partnership to see the extent to which the debt constituted acquisition indebtedness with respect to the partnership's assets,[3357] which may extend to treatment as UBI of a portion of other assets held by the partnership as well,[3358] but would also mean that debt incurred merely to fund operations

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> payments. Because neither Z nor X are obligated on the loan, and are not at risk to suffer any loss because of the loan, it is not a debt of either and can be excluded in calculating acquisition indebtedness.

[3356] Letter Ruling 8415105 included the following facts:

> In those instances in which the Partnership invests indirectly in a Project through a Joint Venture, the Partnership's investment may, in some transactions, consist of both a capital contribution and a loan to the particular Joint Venture. The monies invested by the Partnership in the Joint Venture will consist solely of the capital contributions received by the Partnership from Y {the corporate general partner] and the Limited Partners, including your capital contribution. Neither Y nor the Limited Partners will borrow any portion of their respective capital contributions. The Partnership's capital contribution and loan to the Joint Venture, together with the capital contribution, if any, of the developer, will be used by the Joint Venture to acquire the Project. Any funds used by the Joint Venture to acquire a Project will be obtained solely from the Partnership or the developer/co-venturer, and no part of the acquisition price will be financed by a third-party lender or the seller of a particular Project. The terms of the joint venture agreement to be entered into by the Partnership and a developer will provide that any such loan by the Partnership will be entitled to certain priorities established by the agreement or the laws of the jurisdiction under which the particular Joint Venture is formed, including for example, the repayment of the loan from any available liquidation proceeds prior to the return of either joint venturer's capital contribution.

Letter Ruling 8415105 concluded:

> The loans from the Partnership to any Joint Venture in which it is a co-venturer will be funded by each Limited Partner from each partner's capital, rather than by borrowing from third party sources. Accordingly, the properties acquired would not be considered to be debt-financed property within the meaning of section 514 of the Code. It follows that section 512(b)(4) would not apply in these situations.

Letter Ruling 8414066 appeared identical to Letter Ruling 8415105 in this respect.

[3357] Andersen Tax LLC, ¶ 20.02[2][c] Sources of UBTI and Exceptions From UBTI Characterization, *Tax Economics of Charitable Giving*, said in a footnote:

> To reach its conclusion, the IRS applied an aggregate (*i.e.*, not an entity) approach, so it looked through the partnership to determine if there was debt financing, and treated the situation the same as if the partnership itself sold the assets that had been debt financed.

591 T.M. *Real Estate Transactions by Tax-Exempt Entities*, part II.G.3.f., Sale of Partnership Interests, states:

> Applying an aggregate view of partnerships, the National Office advised that an interest in a partnership that holds debt-financed property is effectively an interest in the partnership's underlying assets and liabilities. Thus, the National Office deemed the charity to have received unrelated debt-financed income from the sale of its interest in the first partnership.

[3358] 723 T.M. *Publicly Traded Partnerships*, part III.D.2.c. Sale of a Partnership Interest, states:

> Based on the rationale expressed in TAM 9651001,[849] the IRS may attempt to include in a tax-exempt organization's UBTI any gains recharacterized as ordinary income under § 751(a) to the extent those gains are attributable to excluded property. In TAM 9651001, the IRS relied in part on § 751(a) to justify its application of the aggregate

view of partnerships.[850] The IRS also stated that the aggregate view of partnerships is consistent with the treatment of partnerships under § 512(b). This position also would be consistent with the IRS's apparent belief that the same result should occur regardless of whether the tax-exempt organization sold its interest in the partnership or the partnership sold its assets.[851]

[849] *Cf.* Rev. Rul. 89-108, 1989-2 C.B. 100 (gain from sale of partnership interest that is attributable to inventory is not eligible to be reported under installment sale rules because installment method would not be available if selling partner had sold its share of underlying inventory); CCA 200722027 (applying rationale of Rev. Rul. 89-108 to gain attributable to unrealized receivables). See also Rev. Rul. 91-32 (gain on sale of foreign partner's interest in partnership was ECI to extent attributable to U.S. trade or business property of partnership). [Gorin note: The Tax Court has repudiated Rev. Rul. 91-32. See fn. 3365.]

[850] It is not clear from the memorandum whether the IRS asserted that § 751(a) treats the transferor as selling an undivided interest in partnership assets rather than a partnership interest. Section 751(a) is merely an income recharacterization rule and should not constitute a basis for deeming a selling partner to have sold an interest in the underlying property of the partnership. The legislative history to the rules regarding transfers of partnership interests is consistent with this approach. *See, e.g.*, H.R. Rep. No. 83-1337, at 4096-7 (1954) (stating that § 751(a) was adopted to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests, but that [t]he general rule that the sale of an interest in a partnership is to be treated as the sale of a capital asset is retained).

[851] *See* TAM 9651001 ([a]n anomalous result would occur if ownership of debt-financed property through a partnership would result in one tax treatment when direct ownership would result another). For example, if a partnership conducting an unrelated trade or business recognized income from the sale of inventory, § 512(b)(5) would not exclude from a tax-exempt organization's UBTI its distributive share of that income. § 512(b)(5)(A). If, instead, the tax-exempt organization sold its partnership interest, § 751(a) would recharacterize any gain or loss recognized by the organization from the sale that is attributable to the inventory as ordinary income, which then would be included in the tax-exempt organization's UBTI.

Carman, "'Contract Units' As A Work-Around For UBTI," *Journal of Real Estate Taxation* (4th Quarter 2011), stated:

> If an exempt organization is a partner in a partnership that borrows money to make an investment, the unrelated debt-financed income rules are applied to the exempt organization as if the organization borrowed the money and owned the property directly.[9]
>
> [9] Rev. Rul. 74-197, 1974-1 CB 143, TAM 9651001.

In Rev. Rul. 74-197, an exempt organization invested in a general partnership, which borrowed money to acquire investment property. The ruling held that the partnership's borrowing constituted acquisition indebtedness and, accordingly, the exempt trust's investment activity may result in UBTI.

Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.06[4] Disposition of Partnership Interests, also approaches the issue on an aggregate basis [footnotes citing to TAM omitted]:

> Importantly, the Service has also ruled that a partner of a partnership is treated as having unrelated debt-financed income on the disposition of a partnership interest that was not acquired with funds borrowed by the tax-exempt organization directly if the partnership itself had acquisition indebtedness with respect to partnership assets. The Service reasoned that a partnership is an aggregate of its partners and not a separate entity for this purpose and that a partnership interest is a direct and undivided interest in partnership assets and liabilities. The Service reasoned that [t]he 'aggregate' view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*,

after the CRT acquires the partnership interest would not generate debt-financed income.[3359] One article suggests that the TAM may be wrong[3360] but would apply the

> section 751(a) and section 512(b)). The Service also made the tax policy argument that [i]t would make no economic or policy sense that [the exempt partner] should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than having the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided. The Service also ruled that this reasoning applied only to the extent that the partnership liabilities constituted acquisition indebtedness within the meaning of Section 514.

[3359] Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[10] Indebtedness Incurred by Pass-Through Entities, commented on the TAM:

> In this technical advice memorandum, the Service also made an important distinction with regard to unsecured debt incurred by the partnership pursuant to a revolving line of credit: namely, that the partnership's unsecured debt under the revolving line of credit that was outstanding at the time the exempt organization became a partner was acquisition indebtedness of the partner with respect to its partnership interest, on the theory that a portion of the partnership's unsecured debt at the time of the exempt organization's admission became, in effect, a debt of the exempt partner. However, the Service also ruled that increases in debt on the revolving line of credit after the exempt organization acquires its partnership interest would constitute acquisition indebtedness only to the extent that the increases were incurred to acquire or improve property within the meaning of Section 514(c)(1)(A), Section 514(c)(1)(B) or Section 514(c)(1)(C). In other words, if the partnership drew down on its line of credit to fund operating expenses, rather than to fund acquisitions of property, increases in the debt incurred on the revolving line of credit after the exempt organization acquires its interest in the partnership would not constitute acquisition indebtedness.

[3360] Woodhull, Selling A Partnership Interest Means Complexity For Tax-Exempt Partners, *Taxation of Exempts* (WG&L) (Mar./Apr. 2012), stated that a number of practitioners have questioned whether the IRS position would be upheld if this issue were to be litigated and later argued:

> The IRS also noted that Example 4 of Reg. 1.514(c)-1(a)(2) provides further support for debt-financed UBTI characterization…. According to the IRS, the debt/basis percentage thus calculated for the partnership interest is the same whether the partnership sells the property or the partner sell its partnership interest.
>
> Notwithstanding the Service's statement in the TAM, Example 4 does not actually state that the debt/basis percentage is the same whether the partnership sells the property or the partner sells the partnership interest. Example 4 in fact provides that in 1972, X's average acquisition indebtedness is $7 million and X's average adjusted basis is $8 million for such year. Therefore, X's debt/basis percentage *with respect to its share of partnership income* [emphasis added] for 1972 is 87.5 percent. The conclusion that should be drawn from this example is that portfolio income (interest, rental income, and capital gains) that is reported to a tax-exempt partner on the partner's Schedule K-1 is debt-financed income to the extent of its entire debt/basis percentage. This conclusion in Example 4 is also consistent with Sections 512(c)(1) and 702(b). Both sections, as noted above, attribute the character of the income earned by the partnership to the partners. Furthermore, if the partnership sells its own debt-financed assets, it is clear under Sections 702(b), 512(c)(1), and 512(b)(4) that a portion of the realized gain will be characterized as debt-financed gain to the extent of the debt/basis percentage and that the debt portion of this percentage includes debt incurred to acquire the partnership interest as well as debt incurred by the partnership.
>
> Again, in this situation, the debt-financed gain is reported on the Schedule K-1 issued to the tax-exempt partner. The distinction that appears to be missing from the IRS interpretation of Example 4 in TAM 9651001 is that the above Code sections all relate to

TAM by referring to the partnership interest rather than looking at the underlying assets,[3361] the latter seeming to be supported by a statement made by a treatise that in other places looks to the aggregate theory.[3362] It's difficult to reconcile the TAM's looking

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> income that is earned by the partnership and then allocated and reported on a Schedule K-1 as part of the partner's distributive share. The gain on the sale of a partnership interest is not earned by the partnership and is neither allocated nor reported on the partner's Schedule K-1. Thus, if one looks strictly at the Code and regulations, there is an argument that the gain from the sale of the partnership interest that was not acquired with debt should be excluded from characterization as debt-financed UBTI in that the partnership interest is not property subject to acquisition indebtedness. The fact that debt is used by the partnership to acquire underlying assets, and that this debt is used to determine the debt/basis percentage of the tax-exempt partner's distributive share of portfolio income allocated by the partnership, does not mean that the proceeds of the partner's sale of its ownership interest are subject to the debt-financed UBTI rules.
>
> The Service's conclusion in TAM 9651001 is that whether X sells its interests in the partnerships or the partnerships sell the real estate, X is accomplishing economically the same result of realizing its share of any appreciation in the debt-financed property. This may be true economically, but, as discussed above, the Code and regulations do not necessarily support that conclusion. Even when the IRS appears to acknowledge that the aggregate view is not clearly supported by Section 514, it still maintains that this approach is suggested by Example 4 and Sections 751 and 512(b), and notes that Congress could not have intended that Section 512(b)(4) could be so easily subverted.

[3361] Woodhull, Selling A Partnership Interest Means Complexity For Tax-Exempt Partners, *Taxation of Exempts* (WG&L) (Mar./Apr. 2012), stated:

> Assuming that [the TAM] is a correct interpretation, calculating debt-financed UBTI with respect to the tax-exempt partner's capital gain or loss on the sale of its interest in the partnership will require the partner to:
>
> (1.) Calculate the highest amount of the partnership's indebtedness during the 12-month period ending on the date of the sale, including the partnership's allocable share of any indebtedness in lower-tier partnerships.
>
> (2.) Calculate the tax-exempt partner's allocable share of that indebtedness. Assuming that the debt is nonrecourse debt secured only by the partnership assets, this may be determined by reference to the partner's overall interest in the partnership unless the partnership agreement provides otherwise. If the debt is recourse with respect to one or more partners, it would affect this determination.
>
> (3.) Divide the tax-exempt partner's share of the partnership's indebtedness by the partner's average adjusted basis in the partnership. The partner's average adjusted basis in the partnership is the average of the partner's adjusted basis as of the first day during the tax year of the partner during which it held the interest in the partnership and its adjusted basis as of the date of the sale.
>
> (4.) Multiply the tax-exempt partner's share of the partner's capital gain or loss on the sale of its interest in the partnership by the percentage calculated above. The resulting amount will be debt-financed UBTI to that partner.

It later concluded:

> To determine the portion of the partner's capital gain or loss that is debt-financed UBTI, the tax-exempt partner should multiply its capital gain realized from the sale of the partnership interest as calculated above by the debt/basis percentage, the numerator of which is the partner's share of the highest amount of the partnership's debt during the 12-month period preceding the sale, and the denominator of which is the partner's average adjusted basis in the partnership during the tax year in which the sale took place.

[3362] Compare from fn. 3359 & Mancino, *Taxation of Exempt Organizations*, ¶ 26.03[10] Indebtedness Incurred by Pass-Through Entities, stating that:

at the aggregate approach and then seeming to turn around and apply an entity approach.[3363] This uncertainty is not the only way in which the TAM's position creates serious tax issues for exempt organizations that acquire partnership interests for investment purposes.[3364]

On the other hand, the burden now appears to be on the IRS to point to a specific provision overriding the general rule that a partnership interest is taxed as a single asset, viewing the partnership as a single entity, rather than viewing the partnership interest as an aggregate of the underlying interests.[3365] In other words, even though Code § 702 preserves the character of income flowing through a partnership's K-1 and runs those items through a Code § 512 analysis, Code § 512(b)(5) does not look through the partnership interest in applying its exclusion from UBI to gain on sale of the interest (subject of course to the debt-financed override provided by Code § 512(b)(4)[3366]). Thus, although Code § 751 may recharacterize gain on sale of a partnership interest,[3367] Code § 751 does not purport to override Code § 512(b)(5),[3368] so that ordinary income

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> the Service [took the position] that the partnership's unsecured debt under the revolving line of credit that was outstanding at the time the exempt organization became a partner was acquisition indebtedness of the partner with respect to its partnership interest, on the theory that a portion of the partnership's unsecured debt at the time of the exempt organization's admission became, in effect, a debt of the exempt partner.

with fn. 3358, Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 26.06[4] Disposition of Partnership Interests:

> The Service reasoned that a partnership is an aggregate of its partners and not a separate entity for this purpose and that a partnership interest is a direct and undivided interest in partnership assets and liabilities. The Service reasoned that [t]he 'aggregate' view of the partnership interest, while not clearly delineated in section 514 of the Code, is suggested by Example (4) of section 1.514(c)-1(a)(2) of the regulations and is consistent with treatment of partnership interests elsewhere in the Internal Revenue Code (*e.g.*, section 751(a) and section 512(b)). The Service also made the tax policy argument that [i]t would make no economic or policy sense that [the exempt partner] should defeat the existing aggregate approach to section 512(b)(4) simply by selling an intermediary rather than having the intermediary sell the debt-financed property. We believe that Congress could not have intended that section 512(b)(4) could be so easily avoided. The Service also ruled that this reasoning applied only to the extent that the partnership liabilities constituted acquisition indebtedness within the meaning of Section 514.

[3363] The IRS might have been uncomfortable applying only an entity approach, in light of GCM 39486 (1986), described in detail in fn. 3324, in which debt from a wraparound mortgage was not deemed assumed by the tax-exempt partner.

[3364] Hill & Mancino, *Taxation of Exempt Organizations*, ¶ 29.05. Taxation of Pass-Through Income, made that observation, commenting:

> First, the sale of a partnership interest is not a sale of the underlying asset of the partnership, so the result is not necessarily economically the same. Second, the exempt organization may have no control over the timing of the incurrence or repayment of debt by the partnership. This position is problematic because Section 514 uses a twelve-month lookback rule.

[3365] *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017) (repudiating Rev. Rul. 91-32), discussed more fully in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fns. 4124-4126.

[3366] See fn. 3344.

[3367] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

[3368] Code § 751(a) and Reg. § 1.751-1(a)(1) provide that part of the gain "shall be considered as an amount realized from the sale or exchange of property other than a capital asset." Other than would not constitute UBI.[3369] Furthermore, merely holding a partnership interest that was donated and then selling it does not mean that the owner was engaged in a trade or business even though the partnership itself was, so selling the partnership interest does not constitute engaging in a business and therefore would not be captured by Code § 511, the latter being the underpinning of all UBI taxation. A similar argument would apply for tax-exempt investors that hold partnership interests as part of their investment strategy, so long as they are not dealers and the partnership interests themselves (without looking inside the partnerships) qualify under Code § 512(b)(5).

All of the above assumes that any business activity is unrelated to the exempt organization's exempt function. Gross income is UBI only if the trade or business producing the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.[3370] Thus, one must examine the relationship between the business activities which generate the particular income in question—the activities, that is, of producing or distributing the goods or performing the services involved—and the accomplishment of the organization's exempt purposes.[3371] The collection of accounts receivable as part of the continuing day to day operation of exempt activities is not UBI.[3372]

II.Q.6.d.ii. UBTI Related to an S Corporation

Any K-1 income or gain from the sale of the S corporation stock constitutes unrelated business income if the shareholder is an IRA holding bank stock before October 22, 2004 or is a qualified retirement plan (other than an ESOP) or a Code § 501(c)(3) charity.[3373]

A charitable remainder trust may not hold stock in an S corporation.[3374] Even if it could, the imposition of unrelated business income tax would be disastrous.[3375]

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expressly not protecting certain noncapital assets such as inventory and property held for sale to customers, Code § 512(b)(5) does not require that property be a capital asset to qualify for its exclusion from UBI.

[3369] However, Woodhull, Selling A Partnership Interest Means Complexity For Tax-Exempt Partners, *Taxation of Exempts* (WG&L) (Mar./Apr. 2012), expressed a view that is inconsistent with my conclusion (footnotes omitted):

> In general, the portion of a partner's gain or loss on the sale of a partnership interest that is attributable to Section 751 assets is treated as ordinary income or loss, and is subject to tax as UBTI to tax-exempt partners.

I called the author, and he said that he had not considered the point I raised above. In an informal conversation on November 10, 2017, he said that he agrees with my conclusion.

[3370] Reg. 1.513-1(d)(1).

[3371] Reg. 1.513-1(d)(1).

[3372] Letter Ruling 9005068.

[3373] Code § 512(e), which was added by P.L. 104-188, effective for taxable years beginning after December 31, 1997.

[3374] For what types of trusts can own stock in an S corporation, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. An electing small business trust (ESBT) is the only type of trust described there into which a charitable remainder trust (CRT) might fit, but Code § 1361(e)(1)(B)(iii) prohibits a CRT from qualifying as an ESBT. However, an S corporation may donate property to a charitable remainder trust; see part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

Suppose a trust's remainder passes to charity, and the trust holds S corporation stock. Every day the trust holds the stock after the primary beneficiary's death generates more and more UBTI. Consider converting the S corporation into an LLC taxed as an S corporation in a tax-free Code § 368(a)(1)(F) reorganization[3376] as early as one can (if converting is not more expensive than selling to an unrelated third party),[3377] then when the primary beneficiary dies the LLC has 75 days to convert to partnership or disregarded entity status retroactive to the date of death.[3378]

II.Q.6.d.iii. Charitable Deduction Against UBTI

If the charity is a trust, it may deduct up to 50% of UBTI for gifts made to another charity.[3379]

If the charity is a corporation, it may deduct up to 10% of UBTI for gifts made to another charity.[3380]

[3375] See part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust especially fns. 3321-3322.

[3376] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[3377] If the S corporation holds assets that are depreciable or amortizable in the hands of the buyer, conversion might trigger ordinary income on the entire gain from sale of those assets, whereas sale to a third party might generate ordinary income only to the extent of recapture of amortization or accelerated depreciation deductions. Compare part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill) to part II.G.5.b Code § 1245 Property.

[3378] See parts II.P.3 Conversions (timing of election to convert) and II.P.3.b From Corporations to Partnerships and Sole Proprietorships (effect of election to convert).

[3379] See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction, especially fn.3549.

[3380] Code § 512(b)(1) provides:

> In the case of any organization described in section 511(a), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 10 percent of the unrelated business taxable income computed without the benefit of this paragraph.

Reg. § 1.512(b)-1(g)(3) provides:

> The contribution, whether made by a trust or other exempt organization, must be paid to another organization to be allowable. For example, a university described in section 501(c)(3) which is exempt from tax and which operates an unrelated business, shall be allowed a deduction… for gifts or contributions to another university described in section 501(c)(3) for educational work but shall not be allowed any deduction for amounts expended in administering its own educational program.

Code § 511(a) provides:

> (1) *Imposition of tax*. There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".
>
> (2) *Organizations subject to tax*.
>
> (A) Organizations described in sections 401(a) and 501(c). The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust

A charity that spends donations it receives on programs (as opposed to using donations for grants to other charities) should consider not receiving directly a gift that would generate UBTI, because the charity will be taxed on all of the UBTI:

- Instead, the gift should be made to a trust that is a Type I supporting organization or donor advised fund, so that the UBTI can be reduced by the trust's up to 50% deduction for distributions to the ultimate charity.

- The trust should consider forming a single member LLC that is disregarded for income tax purposes, to accept the donation; the LLC should have significant other assets. Contributions to the LLC will be deductible as if made directly to the trust.[3381] Forming the LLC may avoid a trap that applies when the flow-through entity does not distribute to the trust before yearend at least as much cash as the amount of the trust's expected charitable contribution deduction.[3382] The LLC would use cash from its other assets to distribute to the trust cash at least equal in amount to the gross income flowing through the LLC to the trust. That way, the trust's receipts from the LLC will equal or exceed the gross income passing through the LLC, allowing the trust to meet the rules requiring its contribution to charity to be from gross income that the trust actually received. However, that concern applies to charitable distributions not made from unrelated business income (UBI) and therefore deductible under Code § 642(c)[3383] and presumably does not apply to charitable distributions made from UBI and therefore deductible under Code § 681 applying the Code § 170 rules.[3384]

II.Q.6.e. Assignment of Income on Property Being Sold

Although the IRS does not attack the donation of marketable securities that a charity sells immediately after the contribution,[3385] it has attempted to treat, as a sale by the

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described in subsection (b) or an organization described in section 501(c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

(B) *State colleges and universities*. The tax imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such tax shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

Code § 11 imposes tax on corporations.

[3381] See fn. 276, found in part II.B Limited Liability Company (LLC).

[3382] See part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income, describing the issue and a similar strategy in fns. 3540-3542.

[3383] See fn. 3382.

[3384] See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction.

[3385] Rev. Rul. 74-53 (no assignment of income where no express or implied obligation imposed upon the trustee to sell or exchange). For the origin of the assignment of income rule, see *Lucas v. Earl*, cited in fn. 1268, found in part II.G.23 Taxing Entity or Individual Performing Services.

donor, the contribution of closely-held stock to a charity, followed by a redemption. After losing,[3386] the IRS ruled:[3387]

> In *Palmer*, the taxpayer had voting control of both a corporation and a tax-exempt private foundation. Pursuant to a single plan, the taxpayer donated shares of the corporation's stock to the foundation and then caused the corporation to redeem the stock from the foundation….The Service will treat the proceeds of a redemption of stock under facts similar to those in *Palmer* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.

Taxpayers who fall within the no-binding-agreement safe harbor of Rev. Rul. 78-197 are protected from the IRS, even if the sale appears certain to occur.[3388] Given that the probability of sale affects valuation, a taxpayer might maximize the charitable deduction by waiting to make the donation until the dale before the sale closes.

An enforceable cause of action under the promissory estoppel theory counted as a legally binding commitment to sell stock.[3389] So did the tender of shares sufficient to bind the shareholders of a corporation being acquired by a taxable merger, even though the acquiring corporation had not legally bound itself to acquire the shares.[3390]

[3386] *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd* on another issue, 523 F.2d 1308 (8th Cir. 1975).

[3387] Rev. Rul. 78-197, followed Letter Rulings 8623007, 9413020, 9452020, 9452026, 9611047, and 200230004.

[3388] *Rauenhorst v. Commissioner*, 119 T.C. 157 (1993), which focused exclusively on legally binding commitments. In that case, the court faulted the IRS' nonspecific allegations of an informal agreement or understanding between the donees and other parties, accepting on their face affidavits the taxpayer produced. The court also rejected the IRS' contentions that certain facts caused the assignment of income doctrine to apply:

> In support of respondent's position that the right to sale proceeds had ripened to a practical certainty at the time of the contributions, he cites: (1) The September 28, 1993, letter of intent from WCP expressing its intention to purchase all the issued and outstanding stock of NMG; (2) the October 22, 1993, resolution by WCP's board of directors, which authorized its officers to negotiate and enter into the agreement for the purchase of all the issued and outstanding capital stock of NMG; and (3) a valuation report prepared by Houlihan, Lokey, Howard, & Zukin (Houlihan Lokey), which was attached to petitioners' 1993 return and which opined that, as of November 12, 1993, there was little chance the transaction involving WCP would not close on or before December 31, 1993. Those items might be particularly relevant for determining whether the stock warrant purchase ripened to a practical certainty; however, none of those items alone, or in combination, show that the donees were legally bound, or could be compelled, to sell their stock warrants.

[3389] *Blake v. Commissioner*, T.C. Memo 1981-579, *aff'd* 697 F.2d 473 (2nd Cir. 1982).

[3390] *Ferguson v. Commissioner*, 108 T.C. 244 (1997), *aff'd* 174 F.3d 997 (9th Cir. 1999), *followed Gail Vento, LLC v. U.S.*, 111 A.F.T.R.2d 2013-1505 (D.C. V.I. 2013). *Ferguson* included some contingencies that the court disregarded. In *Ferguson*, the gift was made September 9, 1988. Here is the timeline for the tender:

> On July 28, 1988, AHC, CDI Holdings, Inc. (CDI), and DC Acquisition entered into the merger agreement. According to the merger agreement, DC Acquisition would be merged into AHC, and AHC would thereupon become a wholly owned subsidiary of CDI as soon as practicable after DC Acquisition had purchased the stock of AHC pursuant to

II.Q.6.f. Incomplete Gift and Charitable Partial Interest Prohibitions

II.Q.6.f.i. Completed Gift Requirement

A Code § 170 deduction is allowed "only if the transfer at issue satisfies the six essential elements of a bona fide inter vivos gift:"[3391]

(1) a donor competent to make the gift;

(2) a donee capable of taking the gift;

(3) a clear and unmistakable intention on the part of the donor to absolutely and irrevocably divest himself of the title, dominion, and control of the subject matter of the gift, in praesenti;

> the tender offer. The merger agreement provided that each outstanding share of AHC stock, following the purchase of AHC stock pursuant to the tender offer, would be converted into the right to receive $22.50 a share in cash. On August 3, 1988, DC Acquisition made a tender offer for the stock of AHC at $22.50 a share. By the close of business on August 31, 1988, more than 50 percent of the outstanding shares of AHC stock had been tendered or guaranteed. At that time, despite the various contingencies to be discussed infra, we believe the reality and substance of the merger agreement and the tender offer indicate that the stock of AHC was converted from an interest in a viable corporation to a fixed right to receive cash.
>
> The tender or guarantee of more than 50 percent of the outstanding shares of AHC stock was the functional equivalent to a vote by the shareholders of AHC approving the merger. The terms of the tender offer provided that DC Acquisition, with the acquisition of a majority of AHC stock, could assure that the requisite number of affirmative votes in favor of the merger would be received even if no other shareholder voted in favor of the merger. Therefore, with the exception of the hypothetical possibility that a sufficient number of tendered or guaranteed shares of AHC stock could be withdrawn, DC Acquisition was positioned to proceed unilaterally with consummation of the merger by the close of business on August 31, 1988.

So the conditions to effectuate the merger had been satisfied before the gift, with the chance of the conditions being undone being viewed as remote.

[3391] *Fakiris v. Commissioner*, T.C. Memo. 2017-126, fn. 12, citing:

> *Goldstein v. Commissioner*, 89 T.C. 535, 541-542 (1987) (quoting *Weil v. Commissioner*, 31 B.T.A. 899, 906 (1934), *aff'd*, 82 F.2d 561 (5th Cir. 1936)); *Guest v. Commissioner*, 77 T.C. 9, 15-17 (1981); *Stjernholm v. Commissioner*, T.C. Memo. 1989-563.

Before that quote, the footnote stated:

> It is well settled that the term "charitable contribution" as it is used generally in sec. 170 and the regulations thereunder is synonymous with the term "gift". See *Collman v. Commissioner*, 511 F.2d 1263, 1267 (9th Cir. 1975), *aff'g in part, rev'g in part, and remanding* T.C. Memo. 1973-93; *Seed v. Commissioner*, 57 T.C. 265, 275 (1971); *Sutton v. Commissioner*, 57 T.C. 239, 242 (1971); *Wolfe v. Commissioner*, 54 T.C. 1707, 1713 (1970); *Murphy v. Commissioner*, 54 T.C. 249, 252 (1970); *McLaughlin v. Commissioner*, 51 T.C. 233, 234 (1968), *aff'd*, 23 A.F.T.R.2d (RIA) 69-1763 (1st Cir. 1969); *Perlmutter v. Commissioner*, 45 T.C. 311, 316-317 (1965); *DeJong v. Commissioner*, 36 T.C. 896, 899 (1961), *aff'd*, 309 F.2d 373, 376-379 (9th Cir. 1962); *Stjernholm v. Commissioner*, T.C. Memo. 1989-563, *aff'd*, 933 F.2d 1019 (10th Cir. 1991).

(4) the irrevocable transfer of the present legal title and of the dominion and control of the entire gift to the donee, so that the donor can exercise no further act of dominion or control over it;

(5) a delivery by the donor to the donee of the subject of the gift or the most effectual means of commanding the dominion of it; and

(6) acceptance of the gift by the donee.

A retained right to require the donee to transfer ownership to another nonprofit made the gift conditional and therefore nondeductible.[3392]

If a transfer for charitable purposes depends on the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible.[3393]

II.Q.6.f.ii. Forced Sale to Related Party for Note

CCA 201507018 disallowed a deduction of a partnership interest (referred to as Units) that the charitable Organization immediately sold for a note to a related party for a note:

> In the present case, Partner has claimed a deduction under § 170 for a donation of Units to Organization. However, after Transaction, and within a day of Partner's assignment of Units to Organization, Organization does not hold any rights to Units. Organization holds Note. Further, Partner, through Partner's power to approve of Partnership distributions to Corp, controls when in fact interest payments will be made on Note. Had Partner or Corp contributed Note directly to Organization, a deduction under § 170 would not be allowed because payment of the donation would not have been made within the year and, under Rev. Rul. 68-174, Note would have been treated as a promise to make a donation, but not an actual donation….
>
> Under the terms of the Partnership Agreement, Organization is required to surrender its right as an assignee of Units to Partner on Partner's terms. Further,

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[3392] *Fakiris v. Commissioner*, T.C. Memo. 2017-126, mentioning Reg § 1.170A-1(e) (see fn. 3393) but also noting *Graev v. Commissioner*, 140 T.C. 377, 390 (2013), and *Briggs v. Commissioner*, 72 T.C. at 656-659.

[3393] Reg § 1.170A-1(e), which provides:

> *Transfers subject to a condition or power*. If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest in property passes to, or is vested in, charity on the date of the gift and the interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appears on the date of the gift to be so remote as to be negligible, the deduction is allowable. For example, A transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible. A is entitled to a deduction under section 170 for his charitable contribution.

under the Partnership Agreement, Organization had to obtain the approval of Partner to transfer its interest in Units. Partner, in Partner's sole discretion, could approve or disapprove any transfer. Partner, in exercising this discretion, had no fiduciary duty at the time of Transaction to Organization. If Organization attempted to transfer its interest in Units to a third party, Partner had the power to nullify the transfer. Further, the Special Call Price would become active and the call price provision limits the call price to Organization's contributions which are zero. Accordingly, Partner had the power to nullify the donation to Organization if Organization attempted to transfer its interest in Units without Partner's approval. Further, Organization could not retain its interest in Units without violating its representations to the Service that it would not hold an interest in a Partnership with nonexempt taxpayers. Partnership could call Organization's interest in Units at any time. Based on the above elements of Transaction, Organization was essentially compelled to engage in Transaction.

II.Q.6.f.iii. Charitable Partial Interest Prohibition

Generally, if a taxpayer contributes less than the taxpayer's entire interest in such property, for individual income tax purposes[3394] a charitable income[3395] tax deduction is allowed only to the extent that the value of the interest contributed would be allowable as a deduction if that interest had been transferred in trust:

- This rule does not apply if the donation is of "the taxpayer's entire interest in the property, such as an income interest or a remainder interest."[3396]

- However, if "the property in which such partial interest exists was divided in order to create such interest and thus avoid" the partial interest prohibition, the deduction is not allowed.[3397]

[3394] This provision applies for purposes of Code § 170, which is contributions deducted on a personal income tax return (including contributions through an S corporation or a partnership). It does not apply for the fiduciary income tax deduction under Code § 642(c); see part II.J.4.c Charitable Distributions. However, if and to the extent that the trust has unrelated business taxable income, Code § 170 would apply to calculate the percentage limitations of the deduction; I have not formed an opinion on whether the UBTI rules makes the charitable partial interest prohibition not apply for income tax purposes. See part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction, fns. 3545-3551. See also part II.Q.6.d Unrelated Business Income.

[3395] Code § 170(f)(3)(A). However, Code § 170(f)(3)(B) excludes from this rule a contribution of a remainder interest in a personal residence or farm, a contribution of an undivided portion of the taxpayer's entire interest in property, and a qualified conservation contribution.

[3396] Reg. § 1.170A-7(a)(2)(i), which further provides:

> Thus, if securities are given to A for life, with the remainder over to B, and B makes a charitable contribution of his remainder interest to an organization described in section 170(c), a deduction is allowed under section 170 for the present value of B's remainder interest in the securities.

[3397] Reg. § 1.170A-7(a)(2)(i), which further provides:

> Thus, for example, assume that a taxpayer desires to contribute to a charitable organization an income interest in property held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer transfers the remainder interest in such property to his son and immediately thereafter contributes the income interest to a

- On the other hand, the partial interest prohibition does not apply to a contribution of a partial interest in property if the contribution constitutes part of a charitable contribution not in trust in which all interests of the taxpayer in the property are given to a charitable organization.[3398]

- Nor does it apply "merely because the interest which passes to, or is vested in, the charity may be defeated by the performance of some act or the happening or some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible."[3399]

- Also, the prohibition does not apply to an undivided portion of a donor's entire interest in property, which "must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted."[3400]

Although the preceding bullet points describe income tax rules, similar rules apply for gift tax[3401] and estate tax[3402] purposes, except that, where the initial division results in an interest being transferred to a noncharitable person, any later contribution of the donor's entire remaining interest in the property "will not be considered the donor's entire interest in the property" for estate and gift tax purposes.[3403] Donating 20% of the taxpayer's

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> charitable organization, no deduction shall be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the retained income interest. In further illustration, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer grants a life estate in such property to his son and immediately thereafter contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest.

[3398] Reg. § 1.170A-7(a)(2)(ii), which continues:

> Thus, if on March 1, 1971, an income interest in property is given not in trust to a church and the remainder interest in the property is given not in trust to an educational organization described in section 170(b)(1)(A), a deduction is allowed for the value of such property.

[3399] Reg. § 1.170A-7(a)(3), referring to Reg § 1.170A-1(e), which is reproduced in fn. 3393, found in part II.Q.6.f.i Completed Gift Requirement.

[3400] Reg. § 1.170A-7(b)(1)(i).

[3401] Code § 2522(c)(2), incorporating by reference the Code § 170(f)(3)(B) exclusion in fn. 3395; see Reg. § 25.2522(c)-3(c).

[3402] Code § 2055(e)(2), incorporating by reference the Code § 170(f)(3)(B) exclusion in fn. 3395; see Reg. § 20.2055-2(e)(2). Code § 2055(e)(3) may allow a post-mortem reformation.

[3403] Reg. §§ 25.2522(c)-3(c)(2)(i) and 20.2055-2(e)(2)(i). The former illustrates this rule:

> For example, if the donor gave a life estate in an office building to his wife for her life and retained a reversionary interest in the office building, the gift by the donor of one-half of that reversionary interest to charity while his wife is still alive will not be considered the transfer of a deductible interest; because an interest in the same property has already passed from the donor for private purposes, the reversionary interest will not be considered the donor's entire interest in the property. If, on the other hand, the donor had been given a life estate in Blackacre for the life of his wife and the donor had no other interest in Blackacre on or before the time of gift, the gift by the donor of one-half of that life estate to charity would be considered the transfer of a deductible interest;

unitrust interest in a charitable remainder trust six years after the trust's formation did not trigger the partial interest prohibition.[3404] Donating all of one's annuity interest in a charitable remainder annuity trust did not violate the prohibition.[3405]

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because the life estate would be considered the donor's entire interest in the property, the gift would be of an undivided portion of such entire interest.

[3404] Letter Ruling 9550026 involved a joint-and-survivor net-income charitable remainder unitrust. The transaction involved the following steps:

(a) Taxpayer A will execute a disclaimer that is substantially similar to the one submitted with your ruling request. This disclaimer provides that Taxpayer A disclaims his contingent right to receive Taxpayer B's unitrust interest after Taxpayer B's death. Taxpayer B will execute a disclaimer that is substantially similar to the one submitted with your ruling request. This disclaimer provides that Taxpayer B disclaims her contingent right to receive Taxpayer A's unitrust interest after Taxpayer A's death.

(b) Taxpayers will make a gift of a twenty percent undivided interest in the Unitrust Payment to University, by execution and delivery of an irrevocable assignment valid under State A law.

(c) The income interest in Trust which University receives in this gift will merge with its remainder interest in Trust, leaving University with a twenty percent undivided interest in the entire trust and an eighty percent undivided interest in the remainder of the trust.

(d) Taxpayers and University will consent to the partial termination of Trust in their respective capacities as grantors and beneficiaries so that all of the grantors and beneficiaries will have consented to termination of twenty percent of the trust.

(e) The trustee of Trust will distribute to University twenty percent of the trust assets. The distributed assets will be fairly representative of the relative bases of the various assets in the trust. The trustee will continue to hold the balance of the Trust assets in accordance with the terms of the trust.

The ruling concluded:

(1) Taxpayers will be entitled to an income tax deduction under section 170 of the Code for the value of the undivided interest in the Unitrust Payment transferred to University.

(2) Taxpayers will be entitled to a gift tax deduction under section 2522 of the Code for the value of the undivided interest in the Unitrust Payment transferred to University.

(3) The value of Taxpayers' gift under sections 170 and 2522 of the Code will be the present value of the right to receive annual payments equal to nine percent of the value of twenty percent of the Trust assets determined annually for a term starting on the date of the transfer of the gift to University and ending on the date of death of the survivor of Taxpayers.

(4) The gift of the undivided part interest in Trust will not cause the trust to cease to be a trust described in 664(d)(2) of the Code.

(5) To the extent that in prior years, Trust had capital gain income, and that income was not realized or included in the income of Taxpayers, such capital gain shall not be included in the income of, or realized by, Taxpayers solely because of the transfer of the undivided interest in the Unitrust Payment to University.

[3405] Rev. Rul. 86-60 involved the following facts:

Situation 1. In 1980, A created a charitable remainder annuity trust (hereinafter, CRAT) described in section 664(d)(1) of the Code. A retained the annuity interest in the trust for life. The remainder beneficiary was X, a charitable organization described in sections 170(c) and 2522(a). In 1984 A transferred the annuity interest in the trust to X.

Situation 2. In 1980, A created a CRAT described in section 664(d)(1) of the Code. The trust instrument provides that the trustee shall pay the annuity amount annually to A for life and upon A's death to B, the successive life interest beneficiary, for such time as

Rev. Rul. 76-143 held that the partial interest prohibition denied charitable deductions when the taxpayer donated the cash surrender value and retained the right to the death benefit, even if all of the rights were fixed (including making the beneficiary designation irrevocable). The denial applied whether the cash value was fully paid[3406] or was for cash value build-up due to the current year's premium.[3407] Now, Code § 170(f)(10) also prohibits various split-dollar and similar arrangements from qualifying for the charitable deduction.

If a donor transfers voting stock but retains the voting rights, Rev. Rul. 81-282 asserted that retaining the voting rights violated the partial interest prohibition.[3408] However, when

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> B survives. Upon the death of the survivor of A and B, the corpus is to be distributed to X, a charitable organization that meets the requirements of sections 170(c) and 2522(a). In 1984, A and B assigned their interests in the trust to the charitable remainder beneficiary.
>
> No property interests were created for the purpose of avoiding the rules of section 170(f)(2) and (f)(3)(A).

The ruling held:

> In *Situation 1*, the gift by A, the grantor, to the remainder beneficiary of A's retained life annuity interest in a charitable remainder annuity trust qualifies for an income tax charitable deduction under section 170 of the Code and a gift tax charitable deduction under section 2522.
>
> In *Situation 2*, where A has created a charitable remainder annuity trust with life annuity interest to A and survivor life annuity interest to B, the gifts by A and B of their life annuity interests in the trust to the charitable remainder beneficiary qualify for an income tax charitable deduction and a gift tax charitable deduction. A's gift of the life annuity, however, qualified for the gift tax charitable deduction only because the interest that was transferred was in one of the forms set out in section 25.2522(c)-3(c)(2) of the regulations.

[3406] The ruling reasoned:

> In *Situation 1*, the gift made by the taxpayer of the right to the cash surrender value of the policy was a gift of less than an entire interest in the property. Furthermore, a gift of this kind is not a gift of a fraction or percentage of each and every substantial interest owned by the donor in such property since the taxpayer retained the right to designate the beneficiary. Even if the taxpayer irrevocably designated the beneficiary prior to making the gift in order to create a remainder interest that would then constitute the taxpayer's entire interest in the property, such division would be regarded as having been made to avoid section 170(f)(3)(A) of the Code and the deduction would not be allowed.

[3407] The ruling reasoned:

> In *Situation 2*, the gift made by the taxpayer of the right to the cash surrender value of a nonpaid-up life insurance policy was also a gift of less than the taxpayer's entire interest in the property. Since the taxpayer retains the right to designate the beneficiary, and the right to surrender the policy and defeat the college's interest, the gift is not a gift of a fraction or percentage of each and every substantial interest in the property.

[3408] The ruling reasoned:

> The right to vote stock is inherent in the ownership of common stock and, as such, is a property right. This right gives the holder a voice in the management of the corporation and is crucial in protecting the stockholder's financial interest. Therefore, the right to vote the stock of X is a substantial right in that stock. See *Brown v. McLanahan*, 148 F.2d 703 (4th Cir. 1945); and *DuVall v. Moore*, 276 F.Supp. 674 (N.D. Iowa 1967).
>
> While A's retention of the right to vote the stock will not defeat Y's right to dividends or the right to dispose of the stock, and, while the right retained by the donor will not defeat the donee's interest in the transferred property, nevertheless, A has not transferred all

a donor kept voting and donated nonvoting restricted[3409] stock, the donation did not constitute a partial interest;[3410] this reasoning also applied to an estate.[3411] Furthermore, when the donated voting stock was subject to a voting agreement created eight years previously for business purposes, the lack of voting rights did not make the gift a nondeductible partial interest.[3412] However, when the terms of the bequest required the

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> substantial rights in the stock to Y. Therefore, A has transferred a partial interest in property to Y within the meaning of section 170(f)(3) of the Code. See Rev. Rul. 76-143.

[3409] Comparing Class A voting to Class B nonvoting:

> The rights of the Class A shares are freely transferable. In contrast, the Class B shares are not transferable except: (1) to the Corporation; (2) in connection with an acquisition of the Corporation; (3) in the case of natural persons, upon death or pursuant to a valid and binding court order mandating transfer; or (4) with the consent of the Corporation's Board of Directors.

[3410] Letter Ruling 201129033, holding:

> In the present case, Donor and Donor's Spouse propose to transfer Class B common stock to Charity. The Class B common stock is a separate property interest apart from the other class of stock in Corporation. Under the facts as presented, the shares of one class of stock do not constitute an interest in the shares of any other class of stock. Therefore, we conclude that for gift tax purposes the plan described above will not result in interests in the same property passing for both charitable and noncharitable purposes within the meaning of § 2522(c)(2).

[3411] Letter Ruling 9022010 reasoned:

> In the present case, [four separate charities] will receive, in effect, under the terms of the will and the Trust, the residue of A's estate, which may include a portion of the Class A nonvoting shares of V. The outright distribution of the Class A nonvoting shares to [the charities] while the Class B voting shares are held in trust for the benefit of individuals will not be a distribution of property for both charitable and noncharitable purposes under section 2055(e)(2) of the Code.
>
> Each class of stock represents a separate property interest. Further, considering that the dividend rights and liquidation preferences of the respective classes are identical and considering the currently issued and outstanding shares in the various classes, each distributee of the respective classes of stock will receive all the property rights and economic benefits inherent in the equity interests represented by those shares. Under the facts as presented, the shares of one class of stock do not constitute an interest in the shares of any other class of stock. Therefore, we conclude that the estate plan described above will not result in interests in the same property passing for both charitable and noncharitable purposes, within the meaning of section 2055(e)(2) of the Code.

[3412] Letter Rulings 200108012, 200108013 and 200108014 included the following facts and holding:

> In 1992, Taxpayer and other Company shareholders entered into a voting agreement. The purpose of the voting agreement was to facilitate any future negotiations to sell Company. Pursuant to the voting agreement, Taxpayer transferred to Individual her voting rights with respect to corporate events affecting change of ownership or control of Company. The voting agreement required Taxpayer to agree to vote as directed by Individual. Recently, the voting agreement was amended to provide that the votes would be directed by a person who is not Individual and is not related to Taxpayer….
>
> When Taxpayer contributes her shares in Company stock to Foundation, she will not contribute all interests in the shares. Certain voting rights have already been transferred to a third party. The voting rights are substantial rights. See Rev. Rul. 81-282. However, because those rights had been transferred eight years ago for a business purpose, the interests were not divided in order to avoid section 170(f)(3)(A). Thus,

executor to retain the stock and pay the dividends to an individual during the period of administration and to distribute the stock to the charity after administration is completed, Rev. Rul. 83-45 asserts that the dividend payment violates the partial interest rule. On the other hand, when a charity separated a debt obligation it issued into principal and income receipts that were legally separate rights, the partial interest prohibition did not apply when holders donated those rights.[3413]

Rev. Rul. 75-373 allowed a charitable contribution deduction in the manner and to the extent provided by Code § 170 for the value of the restricted easement granted in the following situation:

> An individual conveyed an easement in a tract of 50 acres of vacant, beachfront property to the county in which the property was located to be used solely as a public bathing beach and recreational area operated and maintained by the county. The land is located in a rapidly expanding urban area. The county is a political subdivision of state X.
>
> The deed from the taxpayer to the county granted the easement in gross in perpetuity but reserved to the taxpayer certain rights, including the right of access to and from the open water by boat from the remainder of the land owned by the grantor or his heirs, the right to have an open and usable channel connecting the open sea with the lands retained by the grantor, and the retention of all mineral rights in the land underlying the easement. Any prospective drilling and/or mining is to be done by slant from adjacent property so that the surface of the land will not be disturbed. The donor is responsible for all taxes, levies, and assessments of any kind to which the conveyed property is or shall be subject, but the assessment will be reduced to reflect the value of the easement conveyed....
>
> Under the law of state X, an easement in gross in perpetuity is a valuable property right or interest in favor of the party for whose benefit the easement is created and is enforceable by that party.
>
> In the instant case, the easement in gross in perpetuity is an open space easement within the meaning of section 1.170A-7(b)(1)(ii) of the regulations.

Rev. Rul. 76-253 disallowed a deduction for the contribution of land when the taxpayer retained timber-cutting rights.

> section 1.170A-7(a)(2)(i) of the Regulations does not cause disallowance of the charitable contribution deduction in this case.

[3413] Letter Ruling 8939014 described the approved rights as follows:

> Each debenture receipt represents, in form, the right to receive specific future interest or principal payments on the debenture. Accordingly, the debenture receipts will be denominated as coupon receipts and principal receipts. Each coupon receipt will represent the right to receive a single payment at the date of a specific interest payment on the debenture. Each principal receipt will represent the right to receive a specific payment of principal on the debenture. No payments, however, will be made on any debenture receipt prior to the date on which the specific payment of interest or principal, respectively, is made on the debenture.

Rev. Rul. 76-331 applied the partial interest rule to disallow the following contributions:

> *Situation 1*. A corporation transferred a tract of land to an organization described in section 170(c)(2) of the Code. However, it retained all mineral rights with respect to the property, including the sole right to exploit and sell any minerals obtained from the property.
>
> *Situation 2*. An individual, aged 50 and in good health, owned timberland that the individual leased to a corporation in 1975 for a term of 60 years. In 1976, the individual transferred this land to an organization described in section 170(c)(2) of the Code, subject to the individual's receiving, during the individual's lifetime, all the payments due under the lease. Upon the individual's death, all rights under the lease will pass to the charitable organization.

However, if the retained mineral interest cannot ever interfere with the charity's interest, the retained interest might be too insubstantial to invoke the partial interest disallowance.[3414] Donating land to the U.S. did not trigger the prohibition when the donor reserved the right to train a hunting dog and maintain paths for that purpose.[3415] Also, a donation of undivided interests in real estate subject to leases was not subject to the partial interest disallowance when it conveyed all of the donor's rights and duties and substantial interests with respect to the leases and the undivided interests in the property.[3416] (Additional rulings regarding easements need to be reviewed.) But taxpayers who granted a fire department the right to conduct training exercises on their property and destroy a building thereon during the exercises were held not to donate any ownership interest in property to the fire department, and the partial interest rule prohibit deducting the value of the use of the property.[3417]

[3414] *Stark v. Commissioner*, 86 T.C. 243 (1986).

[3415] Rev. Rul. 75-66 involved the following facts and holding:

> An individual donated his entire interest in 800 acres of land to the United States and retained the right during his lifetime to train his personal hunting dog, and any other hunting dog he may subsequently own, on trails extending over the entire tract, including the right to maintain paths and lanes relating to the reserved use. The individual was informed by the United States Department of the Interior that the reservation would not interfere with the Government's use and enjoyment of the donated property. The trails for training the dog are used in accordance with the Department of the Interior's regulations on such use.
>
> the instant case, the retained right during the taxpayer's lifetime to train his personal hunting dog on the entire tract, in accordance with the regulations of the Department of the Interior on such use, is not substantial enough to affect the deductibility of the property contributed.

[3416] Letter Ruling 8639019.

[3417] *Patel v. Commissioner*, 138 T.C. 395 (2012), the official syllabus mentioning the following:

> At the end of May 2006, Ps purchased property in Vienna, Virginia (Vienna property), with the intention to demolish the house situated thereon (house) and construct a new one on the site. Their realtor told them about the Fairfax County Fire and Rescue Department (FCFRD) Acquired Structures Program, where a property owner allows FCFRD to conduct live fire training exercises on his or her property. As part of the exercises, FCFRD destroys, by burning, the designated building on the owner's property. Within a few weeks of purchasing the Vienna property, Ps contacted FCFRD and obtained information about the requirements for participating in the program. After Ps

If the owner of the working interest under an oil and gas lease[3418] gives an overriding royalty interest[3419] or a net profits interest[3420] to a charitable organization, Rev. Rul. 88-37 asserts that the partial interest rule bars the deduction. The ruling viewed the right to control or to participate in control, which a working interest has but which neither an overriding royalty interest nor a net profits interest has, as a substantial right, the retention of which prevents the donated interest from being considered an undivided interest in the donor's property rights.[3421]

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obtained a demolition permit and completed all of the other requirements, they executed documents granting FCFRD the right to conduct training exercises on the Vienna property and to destroy the house by burning during the exercises. During October 2006, FCFRD, along with six other fire departments, used the Vienna property to conduct live fire training exercises, during which the house was destroyed.

[3418] The ruling describes a working interest:

> A working interest is the operating interest under an oil and gas lease. It is typically created by a transaction in which the owner of a tract of land, or the owner of the mineral rights to a tract of land, grants the right to exploit the oil and gas under the land, while at the same time retaining a royalty interest in production. Alternatively, the owner of a tract of land, or the owner of mineral rights to a tract of land, may, as in the instant case, retain the working interest and grant a royalty interest to another person. The owner of the working interest has the exclusive right to exploit the oil and gas resources. For federal tax purposes, a working interest is defined as an interest in oil and gas in place that is burdened with the cost of development and operation of the property. *Brooks v. Commissioner*, 424 F.2d 116 (5th Cir. 1970).

After defining an overriding royalty interest (see fn. 3419) and a net profits interest (see fn. 3420), the ruling comments:

> The right to exploit the oil and gas resources under the land is a right inherent in the ownership of a working interest. Even an owner of only a percentage of the working interest has the right to participate in decisions on the exploitation of the oil and gas resources. The owner of an overriding royalty interest or a net profits interest does not have this right.

[3419] The ruling describes an overriding royalty interest:

> An overriding royalty interest is an economic interest in oil and gas in place, created from the working interest. An overriding royalty entitles its owner to a specified fraction of gross production, free of operating and developing costs. The term of an overriding royalty interest is coextensive with the term of the working interest from which it was created. The transfer of an overriding royalty is an assignment of a property interest and is not an anticipatory assignment of income. See Rev. Rul. 67-118, 1967-1 C.B. 163.

[3420] The ruling describes a net profits interest:

> A net profits interest is, for federal tax purposes, an interest in oil and gas in place that is defined as a share of gross production measured by net profits from operation of the property. It is created out of the working interest and has the same duration. Unlike the income accruing to an overriding royalty, the income accruing to the net profits interest is reduced by specified operating and development costs, but the interest bears these expenses only to the extent of its share of the income. Unlike the working interest, the net profits interest is not required to pay out, advance, or become liable for such costs. *Burns v. Commissioner*, 78 T.C. 185, 209 (1982). Like a transfer of an overriding royalty, the transfer of such a net profits interest conveys, for federal tax purposes, a depletable property interest in oil and gas in place. See *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946), 1946-1 C.B. 69; *Burton-Sutton Oil Co., Inc. v. Commissioner*, 328 U.S. 25 (1946), 1946-1 C.B. 237.

[3421] The IRS reasoned:

On the other hand, separate bequests of preferred stock and common stock did not trigger the partial interest prohibition.[3422]

Rev. Rul. 2003-28 asserted that the partial interest prohibition applies to patents:

(1) A taxpayer's contribution to a qualified charity of a license to use a patent is not deductible under § 170(a) if the taxpayer retains any substantial right in the patent.[3423]

(2) A taxpayer's contribution to a qualified charity of a patent subject to a conditional reversion is not deductible under § 170(a), unless the likelihood of the reversion is so remote as to be negligible.

(3) A taxpayer's contribution to a qualified charity of a patent subject to a license or transfer restriction is deductible under § 170(a), assuming all other

… the donor did not contribute the donor's entire interest in the property but carved out and contributed only a portion of that interest. Further, the portion contributed was not an undivided portion of the donor's interest because it did not convey a fraction of each and every substantial interest or right owned by the donor in the property. By transferring an overriding royalty interest or a net profits interest, the donor has retained the right inherent in the ownership of a working interest to control, or, in the case of ownership of a part of the working interest, to participate in the control of, the development and operation of the lease. This right to control or to participate in control, similar to the retained voting rights in Rev. Rul. 81-282, is a substantial right, the retention of which prevents the donated interest from being considered an undivided portion.

After the transfer, … the contributed interest is a separate property interest for federal tax purposes. However, if the charitable interest is created by dividing a greater interest held by the donor, the application of section 170(f)(3) to deny the charitable contribution deduction is not precluded merely because the contributed interest is a separate property in the hands of the donee and the incidence of taxation on income from the contributed interest is shifted from the donor to the donee. Rev. Rul. 70-477, 1970-2 C.B. 62, for example, holds that for years after the effective date of section 170(f)(3), a contribution of rent-free use of property, even if recognized as a conveyance of property under local law, does not give rise to a deduction under section 170.

In both Situation 1 and Situation 2, therefore, the contributed interest is less than the taxpayer's entire interest within the meaning of section 170(f)(3) of the Code, and is not an undivided portion of the taxpayer's entire interest. In each case, the partial interest was not transferred in trust and was not in a form that would have resulted in an allowable deduction under section 170(f)(2) had it been transferred in trust.

[3422] Letter Ruling 8950071.

[3423] The ruling reasoned:

In *Situation 1*, X contributes a license to use a patent, but retains a substantial right, i.e., the right to license the patent to others. The license granted to University is similar to the rent-free lease described in § 1.170A-7(a)(1) and the partial interest in motion picture films described in § 1.170A-7(b)(1)(i), in that it constitutes neither X's entire interest in the patent, nor a fraction or percentage of each and every substantial interest or right that X owns in the patent. As a result, the contribution in Situation 1 constitutes a transfer of a partial interest, and no deduction under § 170(a) is allowable. The result would be the same if X had retained any other substantial right in the patent. For example, no deduction would be allowable if X had contributed the patent (or license to use the patent) solely for use in a particular geographic area while retaining the right to use the patent (or license) in other geographic areas.

> applicable requirements of § 170 are satisfied, and subject to the percentage limitations of § 170, but the restriction reduces what would otherwise be the fair market value of the patent at the time of the contribution, and therefore reduces the amount of the charitable contribution for § 170 purposes.[3424]

Generally, all the rights to a partnership are considered a single property interest.[3425] It would not appear to be susceptible to being split up as separate assets the way that corporate stock would be. Thus, a donor should transfer a vertical slice of all of the donor's interest in the partnership. For example, one might target one's donation, divide it by 49%, and put that among into an LLC in which a majority vote can direct the manager to sell the LLC's assets. For example, one owns a 20% partnership interest and wants to give away 5%. Transfer a 10.2% partnership interest (5% divided by 49%) into the LLC and then donate a 49% interest in the LLC to the charity. To encourage the charity – especially a donor-advised fund or supporting organization – to use any distributions from the LLC,[3426] one might also consider obligating the non-charitable member of the LLC to pay any expenses (such as from a seller's representations and warranties) either through its share of sale proceeds or by paying the expenses directly.

Donating an assignee interest and retaining the voting rights might be comparable to Rev. Rul. 81-282[3427] and violate the split-interest prohibition. However, when taxpayers donated all of their interest, which was an interest as a limited partner, but the donees received only an interest as an assignee, the Tax Court[3428] and Fifth Circuit in *McCord* allowed a charitable gift tax deduction for an interest as an assignee.[3429] On the other hand, Judge Swift's concurring opinion in the Tax Court argued that the partial interest prohibition applied to assignee interests. Judge Swift pointed out that the donor transferred the economic rights but not the voting and other noneconomic rights[3430] to

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[3424] The ruling reasoned:

> In *Situation 3*, Z transfers to University all of Z's interests in the patent with the restriction that University cannot transfer or license the patent for a period of 3 years after the transfer. Unlike the conditional reversion in Situation 2, the restriction on transfer or license is not a condition that can defeat the transfer. Thus, Z's contribution is deductible under § 170(a), assuming all other applicable requirements of § 170 are satisfied, and subject to the percentage limitations of § 170. See Publication 526, Charitable Contributions (describing other requirements for, and limitations on, the deductibility of charitable contributions). Under § 1.170A-1(c), however, the restriction reduces what would otherwise be the fair market value of the patent, and therefore reduces the amount of Z's charitable contribution. If Z had received a benefit in exchange for the contribution, the value of the benefit would further reduce the amount of Z's charitable contribution. See § 1.170A-1(h); Rev. Rul. 67-246, 1967-2 C.B. 104. See also *Singer Co. v. United States*, 449 F.2d 413, 423-424 (Ct. Cl. 1971).

[3425] See part II.Q.8.e.ii.(a) Unitary Basis, citing Rev. Rul. 84-53.

[3426] See part II.Q.6.d.iii Charitable Deduction Against UBTI, pointing out that a donor-advised fund or supporting organization may generate a deduction against unrelated business income (UBI) by making distributions to a charity in the same calendar year that the entity receives the UBI.

[3427] See fn. 3408.

[3428] *McCord v. Commissioner*, 120 T.C. 358 (2003) (reviewed opinion).

[3429] *Succession of McCord, Jr. v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), allowing the deduction without even mentioning the partial interest rule.

[3430] The majority described certain rights:

> Limited partners generally do not participate in the management of the partnership's affairs. However, limited partners do have veto power with respect to certain major

charity. The majority and Fifth Circuit did not address the issue, being content with the donor having transferred all of the donor's rights.[3431] Both arguments are correct, but neither pointed out what happened to the donor's voting rights. When a partner transfers all of the partner's interest in a partnership and the transferee is not admitted as a partner, the transferor's voting rights lapse. This lapse then gives others who have the right to vote on those matters a higher proportionate vote. Judge Swift, although pointing out that that the charity did not receive noneconomic rights, did not articulate that the donor's voting rights essentially shifted to the other limited partners. Neither the majority nor the Fifth Circuit addressed this shift; their written opinions did not indicate whether they understood that the shift occurred. Thus, one can point to *McCord* as support for the proposition that one does not need to transfer one's noneconomic rights to a charity to avoid the partial interest prohibition, if one does not retain any noneconomic rights, but the strength of this support is unclear, given the lack of analysis of what happened to the voting rights. To avoid any doubt, one might suggest transferring voting rights as well.

II.Q.7. Exiting From or Dividing a Corporation

Double taxation applies to C corporations: taxation when the corporation earns profits and taxation when it distributes the profits. To encourage corporations to distribute profits (triggering the second level of taxation), penalties are imposed for accumulating excessive profits. Before discussing these concepts, consider strategies to avoid future double taxation.

Although dividends are taxed at the same rates as capital gains, taxation of dividends might be less favorable, in that the recipient of a dividend generally cannot use his or her basis to reduce the gain on sale and would not be able to defer tax (with respect to the amount treated as a dividend) if a note is used in the redemption.[3432] A majority shareholder who waives a dividend that is paid to other shareholders does not recognize income if done for a bona fide business reason but does recognize income if the waiver is primarily to benefit family members.[3433] The IRS will consider a ruling request

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> decisions, most notably relating to voluntary bankruptcy filings. In addition, if any two of the children are not serving as managing partners, class B limited partners have voting rights with respect to certain large dollar managerial decisions. Limited partners also have access to certain partnership financial information.

[3431] See fn. 3400, providing that transferring an undivided interest in all of the donor's rights is an exception to the partial interest rules. In *McCord*, the assigned interests also carried with them the right to sell their interests at fair market value for cash, which sale took place shortly after the transfer. Perhaps this quick liquidation made the court more sympathetic to allowing the charitable deduction?

[3432] Code § 301(c)(1) states that the amount distributed as a dividend is ordinary income. Code § 316 generally provides that distributions are taxable as dividends to the extent of the corporation's current and accumulated earnings and profits. However, if and to the extent that a distribution is not a dividend, it is treated more favorably than a sale, in that such distributions first reduce the stock's basis, without any portion of the distribution considered to be a profit, until basis is exhausted. Code § 301(c)(2).

[3433] Rev. Rul. 56-431, holding:

> On the basis of facts in the instant case it is deemed that the benefits to be afforded the taxpayer's relatives by the waiver of his right to share in the dividend payments was the primary purpose for signing the waiver. The alleged business purpose to be served, namely, the payment of a larger dividend to minority stockholders who are key

approving a waiver when the amounts benefitting family members are relatively incidental.[3434] When a subordinated note's value became an issue relating to a merger with an unrelated third party, the IRS waived dividend treatment when the note was disposed of in a disproportionate manner.[3435]

Once commonly used strategy is to distribute the profits to owners through wages to owners (subject to immediate income and FICA taxation at individual rates) or through contributions to qualified retirement plans (subject to income taxation upon distribution from the plans).[3436] However, note that a corporation may not deduct unreasonably high

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employees to maintain their good will, is merely incidental. No opinion is expressed whether such a purpose might be appropriate in other circumstances. Since the amounts distributed to the minority stockholders do not impair the capital by any greater amount than if distributed pro rata to all stockholders, the waiver is not considered necessary to protect the working capital of the corporation. Thus, the taxpayer's disposition of his power to receive his pro rata share of any dividends declared by the corporation, through effecting payment of such pro rata share to his relatives (including his minor children) as well as to his employees by the signing of a waiver must be considered the realization of income by him to the extent of dividend payments waived.

For example, if the corporation in the instant case declared dividends of $1000 on January 31, 1955, and, in accordance with the waiver previously executed by the majority stockholder, it paid the total of such dividends, pro rata, to the minority stockholders, the taxpayer, or majority stockholder, will be considered to have realized income to the extent of 65 percent of the total dividends paid, or $650, since he owned 65 percent of the capital stock of the corporation. The minority stockholders will be considered to have received, as dividends, only $350.

The above conclusion is not in conflict with Revenue Ruling 45, C. B. 1953-1, 178, which holds that the declaration of a dividend upon minority shares did not result in the receipt of income by the majority stockholder who had waived his right to share in the dividend. That ruling was based upon a factual situation in which no family or direct business relationship existed between the majority and minority stockholders and the arrangement was entered into only for bona fide business reasons, situations which do not exist in the instant case.

[3434] Section 3 of Rev. Proc. 67-14 provides that the IRS will consider a ruling request if all of the following conditions exist:

.01. A bona fide business reason must exist for the proposed waiver of dividends.

.02. The relatives of the stockholder proposing to waive his right to future dividends must not be in a position to receive more than 20 percent of the total dividends distributed to the nonwaiving shareholders. For this purpose the relatives of a waiving stockholder include his brother and sister (whether by the whole or half blood), spouse, ancestors, and lineal descendants, the spouses of his brothers and sisters (whether by the whole or half blood) and the spouses of his lineal descendants.

.03. A ruling issued on a proposed waiver of dividends transaction will clearly indicate that the ruling will no longer be applicable if any change in the stock ownership during the waiver period enables nonwaiving relatives to receive more than 20 percent of a dividend, unless the change occurs because of death.

.04. A ruling issued on a proposed waiver of dividends transaction will not be effective for a period longer than three years from the date of the ruling.

.05. A request for a ruling on a proposed waiver of dividends transaction must be submitted to the National Office in accordance with Revenue Procedure 67-1, page 544, this Bulletin.

[3435] Letter Ruling 201636037.

[3436] See part II.A.1.b C Corporation Tactic of Using Shareholder Compensation to Avoid Dividend Treatment.

compensation. This issue applies primarily when profits come from the sale of goods (rather than services) or from the efforts of non-owners. Generally, a professional should be able to justify compensation based on profits derived directly from the professional's work.

When a shareholder takes money out of a corporation without declaring compensation, the transfer constitutes a distribution unless the shareholder can prove that it was a bona fide loan to the shareholder[3437] or perhaps a repayment of a loan the shareholder made to the corporation.[3438]

Any assets that could appreciate may be held by the owners directly and rented to the corporation. The owners should hold these assets in one or more LLCs.

II.Q.7.a. Corporate Redemption

II.Q.7.a.i. Redemption Compared to Cross-Purchase

The remaining parts of this part II.Q.7.a and part II.Q.7.b Redemptions or Distributions Involving S Corporations describe various issues involved in corporate redemptions.

How might one compare a redemption to a purchase by a new or existing shareholder (a cross-purchase)? One should consider the reliability (or lack thereof) of the corporation as a purchaser compared with a shareholder as a purchaser. A cross-purchase generally avoids the tax issues that involve redemptions. If C corporation stock is involved, one might consider preserving for the buyer the possibility that up to $10 million[3439] of future gain might be excluded from income;[3440] that benefit applies only to stock issued by the corporation, and a redemption that occurs to close to a stock issuance can disqualify the stock issuance.[3441] The special rule for ordinary loss

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[3437] *Zang v. Commissioner*, T.C. Memo. 2017-55, which held that the payments constituted income, without specifying the type of income. The court set forth the law:

> Objective factors are considered to determine the parties' intent and whether a bona fide loan occurred, and no single factor is dispositive. See *Welch v. Commissioner*, 204 F.3d 1228, 1230 (9th Cir. 2000), *aff'g* T.C. Memo. 1998-121; *Frierdich v. Commissioner*, 925 F.2d 180, 182 (7th Cir. 1991), *aff'g* T.C. Memo. 1989-393. We examine the following factors to determine whether the additional checks and cash withdrawals that petitioners received were loans:
> (1) the ability of the borrower to repay;
> (2) the existence or nonexistence of a debt instrument;
> (3) security, interest, a fixed repayment debt, and a repayment schedule;
> (4) how the parties' records and conduct reflect the transaction;
> (5) whether the borrower has made repayments;
> (6) whether the lender had demanded repayment;
> (7) the likelihood that the loans were disguised compensation for services; and
> (8) the testimony of the purported borrower and lender.
> *Welch v. Commissioner*, 204 F.3d at 1230; see also *Kaider v. Commissioner*, T.C. Memo. 2011-174.

[3438] See part II.G.19 Debt vs. Equity.

[3439] Or ten times the stock's basis, if greater. Code § 1202(b)(1)(B).

[3440] See part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[3441] See text accompanying fns. 3756 -3759.

treatment of up to $50,000 on the sale of stock also applies only to stock issued to the holder.[3442]

II.Q.7.a.ii. Hybrid Between Redemption and Cross-Purchase When Selling to New Shareholder or Other Shareholders

Instead of a shareholder selling all of his or her C corporation stock to a buyer, consider selling some of the stock and having the corporation redeem the rest. That way, instead of the buyer having to pay tax on dividends used to buy the stock, the buyer pays tax only on dividends the buyer uses to buy the seller's stock, and corporation completes the rest of the purchase, reducing the corporation's earnings and profits.[3443] This imposes double taxation (the corporation paying tax on its earnings used to buy the seller's stock, and the seller paying capital gain tax) instead of triple taxation (the corporation paying tax on its earnings used to pay a dividend to the buyer, then the buyer paying dividend tax, and the seller paying capital gain tax).[3444]

The redemption reduces the corporation's earnings and profits,[3445] thereby reducing potential dividend treatment and facilitating an S election.[3446] If the corporation does not make an S election, consider whether the buyer should first buy the stock directly from the corporation, which may make the stock eligible for a certain capital gain

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[3442] See part II.Q.7.k Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244.

[3443] In *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954):

> Prospective buyer did not want to assume the tax liabilities which it was believed were inherent in the accumulated earnings and profits of the corporation. To avoid said profits and earnings as a source of future taxable dividends, buyer purchased part of taxpayer's stock for cash. Three weeks later, after corporate reorganization and corporate action, the corporation redeemed the balance of taxpayer's stock, purchasing the same as treasury stock which absorbed substantially all of the accumulated earnings and surplus of the corporation.

The IRS and lower court did not like this tax-motivated structure. The Sixth Circuit said that taxpayers can use the structure that is most favorable, holding:

> Since the intent of the taxpayer was to bring about a complete liquidation of her holdings and to become separated from all interest in the corporation, the conclusion is inevitable that the distribution of the earnings and profits by the corporation in payment for said stock was not made at such time and in such manner as to make the distribution and cancellation or redemption thereof essentially equivalent to the distribution of a taxable dividend.

The IRS agreed to follow *Zenz* in Rev. Ruls. 54-458 (1939 Code) and 55-745 (1954 Code), which was followed (although in a different context) by Rev. Ruls. 75-447, 77-226, 79-273, 81-186, and 84-114.

[3444] For triple taxation, see parts II.Q.1.a.i.(b) C Corporation and II.Q.1.a.ii.(b) C Corporation Redemption (California).

[3445] See fn. 3526, found in part II.Q.7.b.iv.(b) S Corporation Redemptions Using Life Insurance Proceeds.

[3446] The main issue is avoiding possible termination of an S election described in part II.P.3.c.iii Excess Passive Investment Income, which is not difficult to avoid if one is attuned to the issue. See also parts II.P.3.c.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds and II.Q.7.b.iv.(a) S Corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

exclusion,[3447] followed by the seller being redeemed after a waiting period that is generally at least two years.[3448]

This method, however, does not provide the buyer with basis except to the extent that the buyer, rather than the corporation, buys the seller's stock.

II.Q.7.a.iii. Redemption Taxed Either As Sale of Stock or Distribution; Which Is Better When

In a redemption by an entity taxed as a corporation, the seller generally is taxed on the extent to which the redemption proceeds exceed the seller's tax basis.[3449] However, if the seller retains an interest in the corporation, or other family members also retain an interest, the redemption might be considered a distribution rather than a sale of the stock.[3450] In other words, what for state law purposes is a redemption is not necessarily treated as a redemption for income tax purposes.[3451]

A redemption for a promissory note that is recast as a dividend[3452] is immediately taxed; installment sale deferral does not apply – not even to the capital gain portion.[3453]

On the other hand, taxing as a distribution the redemption of S corporation stock might be more favorable than taxing it as the sale of the stock, because generally the former allows basis to apply first to all of the proceeds[3454] and the latter would use only the basis attributable to the block redeemed.

[3447] See part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[3448] See the text accompanying fns. 3756–3766 in part II.Q.7.j.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.
[3449] Code §§ 302(a), 1001.
[3450] Code §§ 302(b)(2)(C) and 302(c) provide that family attribution can cause redemptions to be treated as distributions that might be taxed as dividends rather than as sales.
[3451] However, since Code § 302(a) looks to the Code § 317(b) definition of redemption, generally a transaction must be a redemption for state law purposes before it might be considered a redemption for tax purposes.
[3452] See fn. 3432 in part II.Q.7 Exiting From or Dividing a Corporation.
[3453] Reg. §§ 1.301-1(b), 1.301-1(*l*); *Cox v. Commissioner*, 78 T.C. 1021 (1982); *Brams v. Commissioner*, 734 F.2d 290 (6th Cir. 1984), *aff'g* T.C. Memo. 1983-25. *Cox* held at 1028-1029:

> Section 453(b) requires a sale. Section 301(c)(3)(A) is intended to tax distributions which impair a corporation's capital as capital gains (*Cloutier v. Commissioner*, 24 T.C. 1006, 1013 (1955)). We can see no reason why a taxpayer should be allowed to account for section 301(c)(3)(A) gain differently from income under section 301(c)(1), especially since the applicability of section 301(c)(3)(A) depends, to a large extent, upon the combination of a fortuitous lack of corporate earnings and profits and a small stock basis. We find no intent in section 301(c)(3)(A) to afford shareholders access to a more desirable method of accounting. Section 301(c)(3)(A) merely characterizes the gain as gain from a sale or exchange, it does not provide the sale needed for section 453(b).

[3454] See part II.Q.7.b.i Redemptions or Distributions Involving S Corporations - Generally, especially the text accompanying fns. 3507-3508.

II.Q.7.a.iv. Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303

The amount of cash (or fair market value of property)[3455] that a C corporation distributes to its shareholders:[3456]

(1) Is included in income to the extent that it is a dividend.

(2) Is applied against the adjusted basis of their stock, to the extent it is not a dividend and basis is available.

(3) Constitutes "gain from the sale or exchange of property" to the extent (1) and (2) do not apply.

"Dividend" means any distribution of property[3457] made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), the latter without regard to the amount of the earnings and profits at the time the distribution was made.[3458]

Although qualified dividends are taxed at the same rate as capital gains,[3459] redemptions have an advantage in that the shareholders may deduct tax basis against redemption proceeds. For stock passing from a decedent, the basis adjustment at death might eliminate any tax on redemption. Also, tax deferral using the installment method is not available if the state law redemption is treated for tax purposes as a dividend.[3460] Furthermore, to the extent that a redemption recharacterized as a distribution is treated as a return of capital (because it exceeds earnings and profits and the excess is not treated as a dividend), presumably the distribution would be a return of basis pro rata, which could create unexpected capital gain if some shares have high basis and others have low basis.[3461]

[3455] Code § 301(b)(1). Fair market value is determined as of the date of the distribution. Code § 301(b)(3).

[3456] Code § 301(c).

[3457] Reg. § 1.316-1(a)(1) refers to "any distribution of property as defined in section 317 in the ordinary course of business, even though extraordinary in amount." Code § 317(a) provides:

> For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

However, cases tax as a constructive dividend either the value or the out-of-pocket costs of goods or services a corporation provides to a shareholder in that person's capacity as such. See 764(3d) T.M. IV.F. (detailed discussion); *Federal Tax Coordinator* ¶J-2701 Distribution made for shareholder's benefit in his capacity as a shareholder; Bittker & Eustice, ¶8.06. Constructive Distributions, *Federal Income Taxation of Corporations & Shareholders* (WG&L).

[3458] Code § 316(a).

[3459] Code § 1(h)(11).

[3460] See Regs. §§ 1.301-1(d)(1)(ii), 1.301-1(h)(2)(i) and 1.301-1(l) and Code § 312(a)(2).

[3461] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property, especially the text accompanying fn. 3686.

Code §§ 302 and 303 set forth two methods by which a stock redemption can be qualified to avoid dividend treatment.

Code § 303 provides a way for the estate of a deceased shareholder to obtain cash from a closely held corporation to pay estate taxes and expenses while obtaining the favored tax treatment of an exchange. To qualify for Code § 303, the estate's total stock holdings in the closely held corporation must exceed 35% of the total adjusted gross value of the estate, and the distribution must occur within 90 days after the expiration of the three-year limitations period for the assessment of estate tax set forth in Code § 6501(a) (subject to extension in Tax Court proceedings or if a Code § 6166 election is in place). The amount eligible for Code § 303 redemption cannot exceed the total administration expenses allowable under Code § 2053, including estate taxes and interest.

For amounts exceeding estate taxes and expenses, one of the following four exceptions must apply to qualify as an exchange under § 302:

(a) The redemption is not essentially equivalent to a dividend. This applies on a case-by-case basis, based on whether the redemption results in a "meaningful" reduction in ownership.[3462]

(b) The redemption is substantially disproportionate. A substantially disproportionate redemption is one that decreases the shareholder's voting stock interest below 80% and the shareholder's ownership of outstanding stock below 50% immediately following the redemption. Attribution make this exception difficult to satisfy.[3463]

(c) The redemption is a complete termination of the shareholder's interest. If the shareholder completely terminates his or her interest in the corporation, the redemption may qualify under Code § 302.[3464] A gift of stock to a family member, followed by a redemption of the donor's remaining stock, qualified as a complete termination.[3465]

(d) The redemption is a partial liquidation distribution. A distribution is a partial liquidation[3466] if:[3467]

    (1) it is not essentially equivalent to a dividend (determined at the corporate level rather than the shareholder level);

[3462] *U.S. v. Davis*, 397 U.S. 301 (1970); Rev. Ruls. 75–502, 75–512, and 78–401. The transaction should also have a business purpose. See footnote 31 of *H.J. Heinz Company & Subs. v. U.S.*, 99 AFTR 2d 2007-2940, 76 Fed. Cl. 570 (2007).

[3463] Code §§ 302(c)(1), 318. See Harris & Kessler, Constructive Ownership under Section 318, *Business Entities* (WG&L), Mar/Apr 2016.

[3464] Reg. §§ 1.302-4, 1.302-4T. When a beneficiary grantor trust owns stock in a corporation, the beneficiary is the owner whose complete termination must be tested. Rev. Rul. 72-471, cited with approval in Rev. Rul. 85-13.

[3465] Letter Ruling 200939011.

[3466] Code § 302(b)(4) provides that redemption treatment applies if the distribution is:

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

[3467] Code § 302(e).

(2) the distribution is pursuant to a plan and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year;

(3) the distribution is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business which the corporation has actively conducted for the five years immediately prior to the distribution; and

(4) the distributing corporation is actively engaged in the conduct of a qualified trade or business.

However, a buy-sell agreement might convert what appears to be a redemption above into a deemed dividend followed by a deemed cross-purchase. The IRS takes this position if a shareholder has the primary, unconditional obligation to enter into a cross-purchase and the corporation redeems the stock instead.[3468] However, the IRS does not take this position if a shareholder has a mere option to cross-purchase, if a shareholder's purchase obligation is contingent on the corporation not redeeming the stock, if a shareholder has the right to assign the purchase obligation to the corporation, or if the agreement is amended before a shareholder's purchase obligation became unconditional.[3469]

Also certain Code § 302(d) redemptions and other transactions might be recharacterized if any of the company's stock "is structured so that dividends (as defined in section 316) paid by the corporation with respect to the stock are economically (in whole or in part) a return of the holder's investment (as opposed to only a return on the holder's investment)."[3470]

II.Q.7.a.v. Redemptions and Alternative Minimum Tax

Life insurance proceeds received by a C corporation may be taxed under the corporate alternative minimum tax (AMT) because insurance proceeds increase a corporation's book earnings, but are not included in the taxable income of the corporation.[3471] As the cash value of corporate owned life insurance policy grows over the amount of premiums paid each year, annual exposure to AMT will grow as well.

However, AMT does not apply to corporations whose average annual gross receipts do not exceed a threshold. Generally, the corporation's average annual gross receipts for all 3-taxable-year periods beginning after December 31, 1993 and ending before such taxable year cannot have exceeded $7,500,000.[3472] However, for the first 3-taxable-year

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[3468] Rev. Rul. 69-608, Situations 1, 2 and 3.
[3469] Rev. Rul. 69-608, Situations 4, 5, 6 and 7, respectively.
[3470] Reg. § 1.7701(l)-3(b)(2)(i), explaining stock to which Reg. § 1.7701(l)-3 might apply. See Reg. § 1.7701(l)-3(e), Example (3) for a Code § 302(d) redemption that would be recharacterized. Most planning for dividends and earnings & profits (E&P) under Code §§ 312 and 316 is beyond the scope of my materials.
[3471] Code § 56(g).
[3472] Code § 55(e)(1)(A). Only taxable years beginning after December 31, 1993, are taken into account in calculating these averages.

period (or portion thereof) of the corporation which is taken into account under this test, average annual gross receipts cannot have exceeded $5,000,000.[3473]

This tax does not apply to S corporations.[3474]

II.Q.7.a.vi. Redemptions and Accumulated Earnings Tax

Generally, a C corporation that accumulates funds could also be subject to the 20% accumulated earnings tax.[3475] The tax applies to every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed,"[3476] except:[3477]

(1) a personal holding company (as defined in section 542),

(2) a corporation exempt from tax under subchapter F (section 501 and following), or

(3) a passive foreign investment company (as defined in section 1297).

Thus, it complements the personal holding company tax, which is also designed to force C corporations to declare dividends. See part II.A.1.e Personal Holding Company Tax.

The tax is on "accumulated taxable income."[3478] "Accumulated taxable income" means the adjusted taxable income,[3479] minus the sum of the dividends paid deduction[3480] and the accumulated earnings credit.[3481]

The accumulated earnings credit works as follows:

- "If the corporation is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year."[3482]

- Otherwise, the accumulated earnings credit is equal to such part of the earnings and profits for the taxable year as are retained for the business' reasonable needs, minus a certain deduction relating to U.S.-source capital gains.[3483] The dividends paid

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[3473] Code § 55(e)(1)(B).
[3474] Code § 56(g)(6).
[3475] Code § 531.
[3476] Code § § 532(a).
[3477] Code § § 532(b).
[3478] Code § 531.
[3479] Code § 535(b) adjusts taxable income, including to deduct federal income and certain other taxes, deduct charitable contributions with modifications, diallow the dividends-received deducitons, allow capital losses subject to modifications, and deduct U.S.-source capital gains.
[3480] Code § 561.
[3481] Code § 535(b).
[3482] Code § 535(c)(3).
[3483] Code § 535(c)(1).

deduction[3484] reduces retained earnings and profits.[3485] The accumulated earnings credit for such a corporation is no less than the amount by which $250,000 exceeds the corporation's accumulated earnings and profits at the close of the preceding taxable year.[3486] The $250,000 amount is reduced to $150,000 for a corporation the principal function of which is the performance of services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.[3487]

Let's examine how the $250,000 credit would work for a mere holding or investment company. Suppose the accumulated earnings and profits at the close of the preceding taxable year were $250,000 or more. The credit would be zero, because $250,000 did not exceed the accumulated earnings and profits at the close of the preceding taxable year. Suppose the accumulated earnings and profits at the close of the preceding taxable year were $200,000. The credit would be $50,000, leaving $200,000 subject to the tax. the sweet spot would seem to be $125,000 accumulated earnings and profits at the close of the preceding taxable year, where a credit of $125,000 ($250,000 minus $125,000) would offset the $125,000 accumulated earnings and profits at the close of the preceding taxable year. Of course, that assumes that the corporation is not a personal holding company, which is exempt from the accumulated earnings tax.[3488]

Earnings and profits of a corporation accumulating beyond the business' reasonable needs is determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence proves otherwise.[3489] A corporation being a mere holding or investment company is prima facie evidence of the purpose to avoid income tax with respect to shareholders.[3490] If the corporation does not the liquidity to pay a cash distribution, it should consider declaring a Code § 565 consent dividend,[3491] being extra careful about the consent dividend if a trust that makes charitable contributions is a shareholder.[3492]

However, reasonable business needs include the business' reasonably anticipated needs, funding a redemption to pay estate tax or expenses of estate administration, or is being used to fund certain redemptions of charitable shareholders.[3493] Consider documenting the business purposes for accumulating earnings in annual meeting minutes. If the earnings get too high and cannot be reduced through high but

[3484] Code § 561.
[3485] Code § 535(c)(1).
[3486] Code § 535(c)(2)(A).
[3487] Code § 535(c)(2)(B).
[3488] See fn 3477 and part II.A.1.e Personal Holding Company Tax.
[3489] Code § 533(a).
[3490] Code § 533(a).
[3491] CCA 201653017 asserted accumulated earnings tax on a holding company and would not accept lack of liquidity as an excuse, pointing to the consent dividend procedure and relying on the discussion of that procedure's purpose in TAM 9124001.
[3492] See part II.Q.7.c.i.(b) Business Income Limiting Trust Income Tax Deduction, including the paragraph accompanying fn. 3536.
[3493] Code § 537(a)(1), (2).

reasonable compensation (especially qualified retirement plans) or rent, consider making an S election.[3494]

II.Q.7.a.vii. Corporate Liquidation

When a corporation liquidates completely:

- Generally, the liquidating corporation recognizes gain or loss on the distribution of property in complete liquidation as if such property were sold to the distributee at its fair market value.[3495] Code § 337 (liquidation of an 80%-owned corporate subsidiary) and other provisions of Code § 336 provide exceptions. The entire gain (not just depreciation recapture) from the deemed sale of any depreciable or amortizable property may be taxed as ordinary income (which, in addition to having consequences to S corporation owners, can be an issue to C corporations that have capital losses that could otherwise be offset).[3496]

- The shareholder's proceeds are considered to be proceeds from selling the shareholder's stock.[3497] Such proceeds are reduced by any liabilities the shareholders assume.[3498] Subject to a particular exception, dividend taxation does not apply to the deemed sale proceeds.[3499]

Rather than applying installment sale rules to the gain on sale, basis is applied to each receipt until basis runs out, and then gain is recognized for proceeds in excess of basis.[3500]

"As a general rule, losses resulting from a complete liquidation will be recognized only after the corporation has made its final distribution."[3501] However, if at least 99% of the proceeds have been paid to the shareholders, they can recognize loss on the liquidation at that time.[3502] Furthermore, "certain exceptions to the general rule have been recognized by the courts where the stock is shown to have been worthless prior to complete liquidation, such as, for example, where the corporation's liabilities exceeded

3494 Although S corporations cannot have excessive income from investments, that prohibition is easy to avoid using a modest amount of oil and gas investments. See part II.P.3.c.iii Excess Passive Investment Income, especially fn. 2867.

3495 Code § 336(a).

3496 See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

3497 Code § 331.

3498 Rev. Rul. 59-228.

3499 Code § 331(b).

3500 Rev. Rul. 85-48, amplifying Rev. Rul. 68-348. The proceeds are applied separately to each allocable block of stock. For allocating proceeds to more than one class of stock, see Rev. Rul. 79-10.

3501 *Schmidt v. Commissioner*, 55 T.C. 335, 340 (1970), citing *Dresser v. United States*, 55 F.2d 499, 511-512 (Ct. Cl. 1932), *certiorari denied* 287 U.S. 635 (1932); *Turner Construction Co. v. United States*, 364 F.2d 525 (2nd Cir. 1966); and Rev. Rul. 68-348.

3502 Rev. Rul. 69-334.

its assets,"[3503] or "where the losses are so reasonably certain in fact and ascertainable in amount as to justify their deductions before they were absolutely realized."[3504]

Suppose, a corporation transfers assets to a trust for the benefit of the shareholders to take of post-liquidation winding-up issues, such as contingent liabilities. In such a case, the shareholders are considered the "owners" of the trust under the grantor trust rules.[3505] If in a subsequent year, the shareholders or the trust discharge a contingent liability of the corporation, such discharge will give rise to a capital loss in the year of discharge.[3506]

One might decide that the above constitutes substantial authority for taking the following position:

1. When shareholders liquidate a corporate at a loss and some of the liquidating proceeds are escrowed to cover contingent liabilities, the loss is recognized at the time the proceeds are escrowed based on the amount of the escrow.

2. Any payments from the escrow for contingent liabilities are recognized as capital losses when paid. Any amounts escrowed for known liabilities would constitute liabilities assumed, reducing the net sale proceeds and causing or increasing the loss.

It has been suggested to me that the IRS might take a rigid position that losses are not allowed until all contingencies are finally resolved and that the above position is stronger when a liquidating trust is used rather than an escrow account. However, the language quoted in the analysis persuades me enough to take the deduction as described above.

[3503] *Schmidt v. Commissioner*, 55 T.C. 335, 340-341 (1970), citing *Dresser v. United States,* 55 F.2d 499, 512 (Ct. Cl. 1932), *certiorari denied* 287 U.S. 635 (1932)*; Industrial Rayon Corp. v. Commissioner*, 94 F.2d 383 (6th Cir. 1938); *Gowen v. Commissioner,* 65 F.2d 923 (6th Cir. 1933), *affirming* 24 B.T.A. 1028, *certiorari denied* 290 U.S. 687 (1933); *Weintraub v. United States,* 26 A.F.T.R. 1183 (E.D. Pa. 1939).

[3504] *Schmidt v. Commissioner*, 55 T.C. 335, 341 (1970), citing *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *Commissioner v. Winthrop*, 98 F.2d 74 (2nd Cir. 1938), *affirming* 36 B.T.A. 314 (1937), *acq.* 1940-1 C.B. 5. Further discussing *Winthrop*, *Schmidt* stated:

> The *Winthrop* case was held to be controlling in *Palmer v. United States*, an unreported case (D. Conn. 1958, 1 A.F.T.R. 2d 863, 58-1 U.S.T.C. par. 9288). In that case, a corporation contracted to sell all of its assets, except cash, to another corporation and adopted a resolution to liquidate and dissolve. The purchase price was paid, 70 percent in cash and 30 percent in notes secured by a first mortgage on the property sold. The District Court held that the taxpayer sustained a loss in 1952, the year of the sale, since there was no uncertainty as to the amount of cash and the notes, secured by the mortgage, could reasonably be valued at par.

[3505] Rev. Rul. 72-137. Rev. Proc. 82-58 which specifies the conditions that must be present before the IRS will consider issuing advance rulings whether a liquidating trust is treated as such or as a business entity under Reg. § 301.7701-4, and Rev. Proc. 91-15 provides a checklist that must accompany all such requests. For rules governing liquidating trusts generally, see part II.D.4.b Liquidating Trusts. For grantor trusts generally, see part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[3506] Rev. Rul. 72-137.

II.Q.7.b. Redemptions or Distributions Involving S Corporations

II.Q.7.b.i. Redemptions or Distributions Involving S Corporations - Generally

If the corporation has an S election in place, then taxation as a distribution generally is favorable, in that distributions generally reduce basis,[3507] without any part of the distribution being treated as profit on the sale of stock.[3508] Redemptions might very well be taxed as distributions,[3509] so long as they are not partial liquidations.[3510]

If the corporation has no accumulated C corporation earnings and profits (E&P), distribution treatment produces the same result as redemption treatment after basis is used up. As described below, if the corporation has no accumulated C corporation earnings and profits and the distributions exceed the corporation's accumulated adjustments account (AAA), dividend treatment can result in a qualified dividend that might receive capital gain tax rates (if such rates apply to dividends that year). In corporations with accumulated C corporation earnings and profits, consider to elect treating the distribution first as a dividend coming from C corporation earnings and profits.[3511]

See also part II.Q.7.a.vii Corporate Liquidation. Any activity for the year that affects basis is applied in determining the basis of the liquidated stock.[3512]

For the termination of the S election wiping out AAA, see part II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation.

For the effect of a transfer on the allocation of income reported on the involved shareholders' K-1s, see part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation, within part III.B.2.j Tax Allocations upon Change of Interest.

[3507] If the corporation has always been an S corporation, then earnings increase basis under Code § 1367(a)(1)(A) and distributions reduce basis under Code §§ 1367(a)(2)(A) and 1368(b)(1) (without the need to maintain an accumulated adjustments account). If the corporation has prior C corporation earnings, then taxable earnings give rise to an accumulated adjustments account (AAA) under Code § 1368(e) and distributions reduce basis under Code §§ 1367(a)(2)(A) and AAA under Code § 1368(c)(1).
Note, however, that distributions from a Qualified Subchapter S Subsidiary to its parent are ignored. See Reg. § 1.1361-4(a)(1)(ii), the principles of which were adopted in Reg. § 1.1361-5(a)(4), Example (4).

[3508] Code § 1368; Rev. Rul. 95-14. However, life insurance and other nontaxable income will increase stock basis but will not increase the accumulated adjustments account (AAA). Code § 1368(e)(1). Similarly, premiums paid on life insurance owned by the S corporation do not reduce AAA. Rev. Rul. 2008-42. If the S corporation has prior C corporation earnings and profits, then a distribution in excess of AAA will constitute a taxable dividend rather than merely being applied against the basis acquired by that life insurance or other nontaxable income. Code §§ 1368(c)(2), 301(c).

[3509] See part II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303.

[3510] See fns. 3466-3467 and accompanying text.

[3511] Code § 1368(e)(3). See part II.P.3.c Conversion from C Corporation to S corporation, for special considerations involving S corporations that used to be C corporations.

[3512] Letter Ruling 200106009.

II.Q.7.b.ii. Redemptions or Distributions Involving S Corporations Compared with Partnerships

Presumably any payment for stock treated as a distribution instead of a redemption would be applied pro rata to the owner's shares, which might cause premature taxation if some shares have much lower basis than other shares.[3513] However, if all shares have the same adjusted basis, this would not be a concern.

The owner of a partnership interest, however, treats all of the owner's interest in the partnership as a single holding,[3514] allowing the entirety of the owner's basis to be applied against any distribution before triggering gain.[3515] For more about partnership redemptions compared with installment sales of stock, see parts II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale and II.Q.8.b.ii.(e) Effect of Code § 736 Payments, Installment Sale Payments, or Deferred Compensation on Balance Sheet; be cautious, however, about property distributions,[3516] especially those within seven years of any contribution to a partnership in exchange for a partnership interest.[3517]

Partial liquidations would not receive this favorable distribution treatment for an S corporation,[3518] but classifying a pro rata distribution as a partial liquidation would not change its treatment under Code § 736 as described above, so partnership treatment allows more rapid use of basis.

Also, suppose the corporation redeemed stock in exchange for a promissory note, and the redemption was treated as a distribution. Installment treatment is not permitted in a corporate setting for notes that are treated as distributions,[3519] thereby accelerating income, whereas a naked promise to pay a partner in redemption of a partnership interest does not count until cash is paid.[3520]

II.Q.7.b.iii. S Corporation Receipt of Life Insurance Proceeds

In Letter Ruling 200409010, upon the death of the key person, the S corporation (presumably using the accrual method of accounting) would immediately redeem the stock held by the key person at the time of death by issuing a promissory note to the key person's estate. After the redemption, the remaining shareholders would elect to cut off

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3513 See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property, especially fn. 3686.
3514 See part II.Q.8.e.ii.(a) Unitary Basis.
3515 See part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions.
3516 See part II.Q.8.b.i Distribution of Property by a Partnership.
3517 See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, including a warning that a partner contributing cash in exchange for a partnership interest also causes these issues to arise, as described in the text accompanying fn. 3932.
3518 See fns. 3466-3467 and accompanying text.
3519 See fn. 3453.
3520 See part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

the taxable year.[3521] By terminating the taxable year after the redemption but before submitting a claim on the life insurance policy, the remaining shareholders sought to have all of the insurance proceeds allocated to their stock for purposes of increasing their tax basis. The IRS ruled that the life insurance death benefit will be required to be recognized as of the date of death. Notwithstanding needing to go through the claims submission and evaluation process, death would establish the corporation's rights to the proceeds as a beneficiary of the insurance policy.

Thus, the basis increase due to the receipt of the life insurance death benefit would not be allocated solely to the surviving shareholders. By using a redemption, they would have received a smaller basis increase than if they had received the life insurance proceeds directly and bought the decedent's stock.

II.Q.7.b.iv. S Corporation Distributions of, or Redemptions Using, Life Insurance Proceeds

II.Q.7.b.iv.(a). S Corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations

Below is a variation of the theme of part II.P.3.c.iv Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds.

In Rev. Rul. 2008-42,[3522] an S corporation purchased an employer-owned life insurance contract on the life of one of its employees in order to cover expenses the company would incur as a result of the death of the employee (also known as a key-man policy). The employee was a highly compensated employee of the corporation. The corporation paid all of the premiums for the policy and was the beneficiary of the policy. At the end of the taxable year, the corporation had earnings and profits ("E&P"). The IRS reminded us that Code 101(j) imposes notice and reporting requirements regarding employer-owned life insurance to preserve the Code § 101 exclusion of life insurance proceeds from income taxation.[3523]

The IRS ruled that premiums paid did not reduce the S corporation's AAA. It also ruled that the death benefit received does not increase the S corporation's AAA. What the IRS does not point out is the general ordering rules of Code § 1368, which are that distributions from an S corporation are treated as the following with respect to each shareholder:

1. A tax-free distribution to the extent of the lesser of stock basis or a pro rata share of AAA, then

2. A taxable dividend to the extent of a pro rata share of E&P, then

3. Return of principal to the extent of remaining basis, and finally

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[3521] Code § 1377(a)(2); for more details, see part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

[3522] See New Ruling Provides Guidance on AAA of S corporations, *Business Entities* (WG&L) (Jan./Feb. 2009).

[3523] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

4. Capital gain.

Suppose, for example, that the shareholders contributed $10,000 to the corporation at its inception, and no stock has been transferred since inception. It operated as a C corporation and earned $1,000,000 of E&P. Then it elects S status and has $250,000 of AAA. A key employee dies, and the corporation receives $1,500,000 of life insurance proceeds from a term policy and then distributes $700,000 to the shareholders. The consequences are:

- Immediately before the employee died, the shareholders had tax basis in their stock of $260,000, which is the sum of the initial $10,000 contribution and the $250,000 of AAA. Immediately after the death, this tax basis is increase to $1,760,000 due to the receipt of death benefits.

- Of the $700,000 the shareholders receive, $250,000 is a tax-free return of AAA that they could have pulled out tax-free before the employee died; their stocks' tax basis is reduced to $1,510,000 by reason of the $250,000 tax-free distribution. The remaining $450,000 is a taxable dividend out of the $1,000,000 E&P, even though it can be traced to the tax-free life insurance proceeds and even though the shareholders have ample basis to receive distributions if the corporation had never been a C corporation. E&P is reduced to $550,000, since $450,000 out of the $1,000,000 E&P has been distributed.

Turning tax-free life insurance proceeds into taxable dividends – not a good deal!

Suppose instead that the shareholders had owned the policy, had been the beneficiaries, and had received distributions from the corporation to pay premiums:

- Each year, AAA would have been reduced to the extent of the distributions that were used to pay premiums.

- The shareholders receive the life insurance proceeds tax-free, assuming they complied with Code § 101(j) as in the Revenue Ruling.

- When the shareholders invest into the company the $800,000 that, under the above example was retained in the corporation, their stock basis increases by that $800,000 to $1,060,000 from the pre-death $260,000 used in the example.

- Thus, the shareholders have lower basis than in the first example, which is the price they pay for not having dividend income.

- If future distributions exceed AAA, they could have dividend income up to the full $1,000,000 of E&P.

Thus, this alternative defers dividend taxation but does not avoid it if future distributions significantly exceed AAA. However, if future distributions in excess of AAA are in the form of redemptions that are taxed as such, then this alternative might very well avoid dividend taxation.

A more tax-efficient way to structure this alternative would be for the shareholders to contribute their $800,000 investment of the life insurance proceeds to a new limited liability company taxed as a partnership. Then either:

- The new LLC loans the proceeds to the S corporation as needed, documenting the loan with interest at the applicable federal rate.

- The S corporation then contributes all of its business assets to the LLC. Later, when the LLC does not need part or all of the $800,000 anymore, it can distribute that excess money to the shareholders as a tax-free return of their capital contribution. This might or might not be a practical alternative, depending on the non-tax issues caused by transferring the S corporation's assets, as well as the annual expense of filing two business income tax returns instead of one. This is more cumbersome than the loan alternative, but it might have the positive effect of shifting a significant portion of the business operations to a partnership income tax model, which is more tax-efficient when changing the composition of the business' equity ownership, as discussed at the beginning of part II.M Buying into a Business, as well at part II.M.4 Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules, of these materials.

Finally, to protect the life insurance from various business exigencies inherent in the shareholders owning life insurance under the alternative, the shareholders should consider forming a limited liability company to hold the life insurance.

These issues could be avoided if the corporation had an S election in place from inception or to the extent it had distributed all of its E&P in the past. Owners of S corporations with E&P might consider cleansing the corporation's E&P while dividend rates are low. Code § 1368(e)(3) allows taxpayers to elect to reverse the normal distribution rules and have distributions come first from E&P and then from AAA to implement this strategy.[3524]

Finally, owners of limited liability companies or other entities taxed as partnerships would not need to even consider this issue.

II.Q.7.b.iv.(b). S Corporation Redemptions Using Life Insurance Proceeds

When an S corporation redeems stock under Code § 302(a) or 303(a):

- AAA is reduced by an amount equal to the AAA multiplied by the number of shares redeemed and divided by the number of shares of stock in the corporation immediately before the redemption.[3525]

- E&P is reduced by a ratable share of post-2/28/1913 E&P.[3526]

[3524] See part II.P.3.c, for issues relating to S corporations that have E&P.
[3525] Code § 1368(e)(1)(B); Reg. § 1.1368-2(d)(1)(i).
[3526] Code § 312(n)(7), superseding the limitations of Reg. § 1.312-5. Rev. Rul. 79-376, which had governed, was obsoleted by Rev. Rul. 95-71, presumably in response to this change; see T.M. 767 Redemptions IV.A.2.c. The Senate Report to P.L. 98-369 that enacted the current statutory language provides:

- These reductions in AAA and E&P are independent of each other.[3527]

If an S corporation is a former C corporation with significant E&P, then a disadvantage of a redemption relative to a cross-purchase is that AAA is reduced in a redemption, whereas in a cross-purchase AAA is not affected. (It could be an advantage if the goal is to cleanse the corporation of E&P to avoid worrying about the passive investment income rules, but those rules are easy to work around by investing in oil and gas partnerships; see part II.P.3.c.iii Excess Passive Investment Income.)

II.Q.7.b.v. Donation of Stock to Charity Followed by S Corporation Redemption

See part II.Q.6.d.ii UBTI Related to an S Corporation.

If the donee is not an eligible shareholder (for example, a government),[3528] consider donating to a donor advised fund and then having the proceeds go to the charity.

II.Q.7.c. S Corporations Owned by a Trust Benefitting Charity

S corporation stock is a challenging asset for a charity to hold.

Note that a charitable remainder trust can own a partnership but not an S corporation;[3529] however, an S corporation may donate property to a charitable remainder trust.[3530]

Also see parts II.G.3.d.ii Basis Limitations on Deducting Charitable Contributions Made by an S Corporation or a Partnership and II.Q.6 Contributing a Business Interest to Charity. For a discussion of S corporation contributions to charity, see C. Hoyt, "Charitable Gifts By Subchapter S Corporations and by Shareholders of S Corporation Stock," *ALI-ABA Estate Planning Course Materials Journal* (April 2006).[3531]

The S corporation's business activities are not attributable to the charity in determining the nature of the charity's activities, which means that a lot of S corporation business income does not destroy the charity's otherwise exempt status.[3532]

> In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption.

[3527] Reg. § 1.1368-2(d)(1)(iii).

[3528] See part II.A.2.g Shareholders Eligible to Hold S Corporation Stock, especially fn. 131.

[3529] For what types of trusts can own stock in an S corporation, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation. An electing small business trust (ESBT) is the only type of trust described there into which a charitable remainder trust (CRT) might fit, but Code § 1361(e)(1)(B)(iii) prohibits a CRT from qualifying as an ESBT.

[3530] See part II.Q.7.c.iv Using a Charitable Remainder Trust to Avoid Built-in Gain Tax.

[3531] http://files.ali-cle.org/thumbs/datastorage/lacidoirep/articles/EPCMJ_EPCMJ0604-HOYT_thumb.pdf.

[3532] Letter Ruling 201441018.

II.Q.7.c.i. Income Tax Trap - Reduction in Trust's Charitable Deduction

II.Q.7.c.i.(a). Contribution Must Be Made from Gross Income

Although trusts can deduct amounts of gross income[3533] paid to charity, the trust must actually receive the income and must be authorized to make the payment to charity.[3534] Gain recognized on the in-kind satisfaction of a pecuniary distribution to charity meets this test.[3535] Income included on an estate's K-1 from an S corporation does not support

[3533] The amount must be payable out of gross income and not out of corpus. Rev. Rul. 2003-123 pointed out the requirement to trace gross income:

> Under section 642(c), a trust is generally allowed an unlimited charitable deduction for amounts that are paid from gross income for charitable purposes pursuant to the terms of the governing instrument. Because section 642(c) specifically requires that a charitable deduction is available only if the source of the contribution is gross income, tracing of the contribution is required in determining its source. *Van Buren v. Commissioner*, 89 T.C. 1101, 1109 (1987); *Riggs National Bank v. United States*, 352 F.2d 812 (Ct. Cl. 1965); *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 1108 (1973); see also *Crestar Bank v. Internal Revenue Service*, 47 F. Supp.2d 670 (E.D. Va. 1999).

However, various conventions apply to this tracing rule. Satisfaction of a formula pecuniary bequest that is not allocated income does not qualify for this charitable deduction. Rev. Rul. 68-667. On the other hand, if the trust instrument is silent, a charitable deduction is allowed when applicable state law provides that, where the trust instrument is silent, payments are required to be made first from income of the trust and, if the income is not sufficient, then from its principal. Rev. Rul. 71-285. Thus, the IRS is not looking to trace dollars mechanically but rather looks to whether the income was first earned and then allocated to the contribution.

[3534] Rev. Rul. 2004-5 stated:

> For a trust to claim a charitable deduction under § 642(c) for amounts of gross income that it contributes for charitable purposes, the governing instrument of the trust must give the trustee the authority to make charitable contributions. This requirement is an essential element to qualify the trust to claim a deduction for a charitable contribution made directly by the trust. In the case of a trust's investment in a partnership, the partnership may make a charitable contribution from the partnership's gross income, and that income is never available to the trust. For federal tax purposes, however, the trust must take into account its distributive share of the partnership's income, gain, loss, deductions (including charitable contributions), and credits. Under these circumstances, a trust's deduction for its distributive share of a charitable contribution made by a partnership will not be disallowed under § 642(c) merely because the trust's governing instrument does not authorize the trustee to make charitable contributions.

FSA 200140080 reached the same conclusion, pointing out that the UBTI concerns described below must also be addressed. CCA 200928029 (which appears to have been a quick email) asserted:

> Rev. Rul. 2004-5 does permit trusts to claim charitable contributions made by a partnership of which the trust is a partner, even if the trust instrument does not provide for charitable contributions. However, the Rev. Rul. does not eliminate a second requirement that this charitable contribution be made out of the trust's gross income. Therefore, the contribution of the easement does cannot be claimed as a charitable contribution.

Gross income distributed to charity under an inter vivos power of appointment to distribute to charity satisfies the requirement that the charitable distribution be authorized under the trust agreement. Letter Ruling 200906008.

[3535] Rev. Rul. 83-75, holding that the distribution by a trust of corpus consisting of appreciated securities in satisfaction of its obligation to pay a fixed annuity to a qualified charitable a Code § 642(c) deduction unless the S corporation distributes that income to the estate; this issue can also arise with consent dividends[3536] and partnership income.[3537] The latter problem does not apply if an electing small business trust election is made;[3538] so, instead of electing to be taxed as an estate,[3539] a qualified revocable trust might want to make an ESBT election. This policy is so strong that an estate was not permitted a charitable set-aside deduction with respect to undistributed S corporation income even though the estate was the sole owner of the S corporation and the charity would ultimately receive all of the estate's residue, including the S corporation stock.[3540] An S corporation was able to satisfy this requirement by distributing accounts receivable, which would first be used to satisfy remaining estate liabilities and then either be distributed to or set aside for the estate's sole beneficiary, a private foundation.[3541] If there is a disconnect between cash flow and K-1 items, consider creating an LLC that holds plenty of cash and also holds the partnership or S corporation. That way, the K-1 from the partnership or S corporation can be accompanied by cash. In other words, if the K-1 is $100,000, the LLC distributes $100,000 to the trust. If the pass-through entity is an S corporation, the estate must be the LLC's sole owner so that the LLC can be disregarded for income tax purposes; an LLC taxed as a partnership would not be an eligible S corporation shareholder.[3542]

The extent to which gross income the trust received during the year must be traced to a distribution from the trust to charity is unclear; the IRS appears to believe that, the

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organization is a sale or exchange of the securities that results in taxable gain to the trust, but the trust is entitled to a charitable deduction equal to the amount of gain recognized upon the distribution of appreciated securities (after making adjustment for any deduction of capital gain provided under the tax law at that time). Letter Ruling 9044047 provided a similar result.

[3536] A consent dividend is a deemed (not actually distributed) dividend from a corporation to avoid accumulated earnings tax; see fn. 3491, found in part II.Q.7.a.vi Redemptions and Accumulated Earnings Tax. *Estate of Esposito v. Commissioner*, 40 T.C. 459 (1963), denied a charitable set-aside deduction for consent dividends, even though the entire residue was set aside for charity.

[3537] In *Estate of Freund v. Commissioner*, 35 T.C. 629, *aff'd* 303 F.2d 30 (2nd Cor. 1962), the estate received a K-1 for all of the partnership's earnings, some of which decedent withdrew before death and some of which the estate withdrew after death. The charitable deduction was allowed only with respect to the amount the partnership to the estate distributed after death.

[3538] Under 2017 tax reform, Code § 642(c) does not apply to an ESBT; see fn 4529 in part III.A.3.e.ii.(b) ESBT Income Taxation - Overview and also note that fn 4528 allows an ESBT to deduct charitable contributions against its S corporation income only to the extent they are on the K-1 from the S corporation.

[3539] See part II.J.7 Election to Treat a Revocable Trust as an Estate.

[3540] *Sid W. Richardson Foundation v. U.S.*, 430 F.2d 710 (5th Cir. 1970), *reh. den.* 430 F.2d 710 [the decision and the denial of rehearing were published together], *cert. den.* 4/5/1971, *reh. den.*, 403 US 912 (1971). The tax years in question were 1960 and 1961 – before Code § 681 moved UBTI items from Code § 642(c) into Code § 170. Generally, Code § 512(e) treats as unrelated business income S corporation K-1 items and gain from the sale of S corporation stock, even if the S corporation never engaged in any business or debt-financed activities.

[3541] Letter Ruling 201246003.

[3542] See part II.A.2.f.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity, especially fns. 134-138, the latter which makes me very confident that a disregarded entity treated as owned by one qualified individual can hold stock in an S corporation so long as the entity continues to be disregarded in that manner.

distribution to charity can be deducted to the extent that the distributed property itself constituted gross income in the current or in any prior year.[3543]

II.Q.7.c.i.(b). Business Income Limiting Trust Income Tax Deduction

Although normally trusts may deduct all of their gross income that they pay to charity,[3544] this deduction is eliminated to the extent that the trust has unrelated business taxable income (UBTI).[3545] However, in computing the UBTI causing this disallowance, a charitable contribution deduction is allowed, using the percentages that apply to contributions by an individual.[3546] Thus, a partial charitable contribution is allowed to be made out of unrelated business income.[3547] The contribution must be made during the taxable year; the one-year delay permitted by Code § 642(c)(1) does not apply to this

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[3543] CCA 201042023 (trust's charitable contribution deduction should be limited to the adjusted basis of the properties purchased from accumulated gross income). Contradicting the CCA and holding in the taxpayer's favor is *Green v. United States*, 2015 BL 363697, W.D. Okla., No. 5:13-cv-01237, 11/4/15 (trust's charitable contribution deduction are *not* limited to the adjusted basis of the properties purchased from accumulated gross income). *U.S. v. Benedict*, 338 U.S. 692 (1950) (capital gains which expressly is not to be taken into account in computing taxable net income as also excluded from statutory gross income) denied a deduction under for a contribution of certain capital gains because those gains were excludable from gross income under another provision. The CCA cited that case and *W.K. Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (3d Cir. 1944), both of which the *Green* judge rejected as controlling.
See also fn. 3533 (tracing requirement applies but uses accounting conventions rather than actual tracing); Fox, ¶12.04 Requirement That Source of Contribution Be From Gross Income, *Charitable Giving: Taxation, Planning, and Strategies* (WG&L); WTAS LLC, ¶31.09 Source of Payment: Gross Income Only, *Tax Economics of Charitable Giving* (WG&L), citing *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937) (charitable contributions by a trust need not be shown to have been paid out of income received in the year in which they were made if, by the terms of the trust, no limitation was prescribed on the source of payment), and its progeny.
Jonathan Blattmachr's 2015 Heckerling materials stated:

> It seems that if the partnership's gross income is used to acquire another asset, the contribution to charity of the asset, so acquired with the trust's gross income, should be treated as a contribution of gross income for purposes of Section 642(c).[23]
>
> [23] See, e.g*., Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), dealing with the predecessor to current Section 642(c) and in which the Court deferred to the fiduciary's accounting treatment to answer the question whether a certain payment was made from gross income or principal. See, also, Chief Counsel Advice (CCA) 201042023 (the Service ruled that a property bought with accumulated income of a trust was deductible under Section 642(c) when distributed to charity because it was out of gross income. However, the charitable deduction was limited to the trust's adjusted basis in the property. (Not precedent.) Cf. *Crestar Bank v. Internal Revenue Service*, 47 F.Supp.2d 670 (E.D. Va. 1999); *Freund's Estate v. Commissioner*, 303 F.2d 30 (2nd Cir. 1962); *Sid W. Richardson Foundation v. U.S.,* 430 F.2d 710 (5th Cir. 1970); *Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (1944); *Estate of Joseph Esposito v. Commissioner*, 40 TC 459 (1963).

[3544] Code § 642(c).
[3545] Code §§ 642(c)(4) and 681. See part II.Q.6.d Unrelated Business Income.
[3546] Code § 512(b)(11); Reg. § 1.512(b)-1(g).
[3547] Reg. § 1.681(a)-2(b).

deduction.[3548] Furthermore, consider whether the trust also becomes subject to an individual's restrictions[3549] regarding substantiation[3550] and identity of donee.[3551]

Any K-1 income or gain from the sale of the S corporation stock constitutes unrelated business income if the shareholder is an IRA holding bank stock before October 22, 2004 or is a qualified retirement plan (other than an ESOP) or a Code § 501(c)(3) charity;[3552] as mentioned in fn. 3549 above, Code § 681(a) takes away the Code § 642(c) deduction from trusts (and instead applies the individual percentage limitations) to the extent that they have unrelated business income, determined as if the trust were a Code § 501(c)(3) charity. This is yet another disadvantage of S corporations compared to partnerships, the income from which is unrelated business income only to the extent it fits within the usual unrelated business income (UBI) categories; see part II.Q.6.d Unrelated Business Income. If a trust that owns S corporation stock that is includible in the income beneficiary's estate and has a charitable remainderman, the S corporation might liquidate immediately after the beneficiary's death, to minimize UBTI; one easy way might be to convert the S corporation to an LLC taxed as an S corporation during the planning stage,[3553] then

[3548] Reg. § 1.681(a)-2(a).

[3549] Reg. § 1.681(a)-2(a) provides:

> While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to unrelated business income, a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11), as illustrated in paragraphs (b) and (c) of this section.

Code § 512(b)(11) provides:

> In the case of any trust described in section 511(b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

Tying in the final piece of statutory authority, Code § 511(b) provides:

> (1) *Imposition of tax*. There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a tax computed as provided in section 1(e). In making such computation for purposes of this section, the term taxable income as used in section 1 shall be read as unrelated business taxable income as defined in section 512.
>
> (2) *Charitable, etc., trusts subject to tax*. The tax imposed by paragraph (1) shall apply in the case of any trust which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

[3550] See part II.J.4.c Charitable Distributions, fn. 1774.

[3551] See part II.J.4.c Charitable Distributions, fn. 1776.

[3552] Code § 512(e), some of which was added by P.L. 104-188, effective for taxable years beginning after December 31, 1997.

[3553] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. Instead of doing a merger or former conversion, the S corporation might transfer all of its assets to the LLC and then liquidate, trying to use the statute of limitations for claims against liquidated companies to avoid claims by creditors from when the revoke the election to be taxed as a corporation as of the beneficiary's death. On the other hand, an ESBT might be in a better position to deduct charitable contributions flowing from an S corporation's K-1 than any other fiduciary entity holding an interest in a pass-through entity.[3554]

This partial deduction means that the trustee should not distribute all of the UBI to charity, because the trust will need to pay income tax on the UBI that cannot be fully offset by the charitable deduction.[3555] If the trust mandates that all of the income be paid to charity, the trustee may still allocate the taxes as an expenditure charged against income so that the trustee can pay the taxes.[3556]

Fortunately, these rules do not apply to estates.[3557] If a qualified revocable trust elects to be taxed as an estate, then it should escape this limitation.[3558] These rules also would not apply to QSSTs, because the beneficiary is treated as the owner of the S corporation stock for income tax purposes;[3559] of course, the beneficiary would have the overall charitable deduction contribution limitations, which limitations do not apply to trusts that do not have unrelated business income. An ESBT cannot deduct contributions it makes but can, subject to the rules of this part II.Q.7.c.i, deduct its distributive share of contributions the S corporation makes.[3560]

Once all of this analysis regarding unrelated business income is done at the trust level, presumably it will not be repeated at the charity's level, because the trust does not give the charity a K-1.[3561] When deciding whether to have a business run by a charity itself or by a trust that benefits charity, consider the following:

S corporation operated a business or otherwise subjected itself to tort liabilities; see part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale.

[3554] See part II.Q.7.c.i.(a) Contribution Must Be Made from Gross Income, especially fn 3538 and the text preceding it.

[3555] For example, in Reg. § 1.681(a)-2(c), Ex. 3, the trust paid the charity all $31K of its UBI, but it still had $24K of taxable income (based on a 20% charitable deduction limitation). It reserved no cash to pay that tax, a fact not pointed out by the Example.

[3556] Section 506(a)(2) of the Uniform Principal and Income Act.

[3557] Code § 681 and the regulations thereunder apply to trusts; they does not mention estates. Letter Ruling 201246003 authorized a full Code § 642(c) deduction for income from an S corporation set aside for the estate's sole beneficiary, which was a private foundation.

[3558] See part II.J.7 Election to Treat a Revocable Trust as an Estate.

[3559] See fn. 4478.

[3560] See part III.A.3.e.ii.(b) ESBT Income Taxation - Overview, especially fns. 4528.

[3561] Consistent with Code § 663(a)(2), Reg. § 1.663(a)-2 provides:

> Any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in section 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under section 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under section 662. Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in section 642(c). For purposes of this section, the deduction provided in section 642(c) is computed without regard to the provisions of section 508(d), section 681, or section 4948(c)(4) (concerning unrelated business income private foundations).

Notice 2004-35 provides:

- If the activity definitely would generate UBTI, run it through the trust. Instead of all of the UBTI being taxed, the trust will be taxed on only the excess UBTI over the charitable deduction.

- If there is substantial authority for the activity not generating UBTI, for example because it is related to the charity's exempt purpose, then perhaps the charity should undertake the activity and report it as not being subject to UBTI.

II.Q.7.c.ii. Private Foundations, Etc.

A private foundation may hold only limited amounts of an S corporation[3562] (or similar amounts for other entities, including C corporations and partnerships),[3563] and any excess amounts may be held for only five or so years.[3564] However, if the business entity does not operate a business and instead merely generates investment income, it will not be subject to this rule.[3565]

II.Q.7.c.iii. Cleansing Earnings and Profits from a Prior C Corporation

As discussed above, dividend treatment applies to the extent that a distribution exceeds AAA and is made out of C corporation earnings and profits. This treatment would not apply on liquidation of the corporation.[3566] What happens when a trust that owns an interest in an S corporation has a charity as its beneficiary?

The charitable income tax deduction should offset dividend income received by the trusts from the corporation.[3567] Making an ESBT election should not affect the charitable

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> The Treasury Department and the Internal Revenue Service intend to propose regulations modifying Treas. Reg. § 53.4940-1(d)(2) to provide that a private foundation's net investment income for purposes of section 4940 does not include distributions from trusts and estates. Until further guidance is promulgated, income distributions from trusts and estates will not retain their character in the hands of a distributee private foundation for purposes of determining the foundation's net investment income under section 4940(c).

[3562] See Potter, "Using S Corporation Stock to Fund an Individual Shareholder's Private Foundation," *Estates, Gifts & Trusts Journal* (BNA) 5/11/2017, saved as Thompson Coburn LLP document number 6561372.

[3563] Reg. § 53.4943-3(c) applies these rules to partnerships, sole proprietorships, trusts, etc. See Wilson, Better Late than Never: Incorporating LLCs into Section 4943 (3/31/2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2587781 or Thompson Coburn LLP document number 6174131; I am not expressing an opinion on the article's recommendations.

[3564] Code § 4943. The founder might be able to give all of his or her C corporation voting stock to one or more trusts and all of his or her nonvoting stock to charitable remainder trusts. See Letter Ruling 201303021.

[3565] Letter Ruling 201447043, citing Code § 4943(d)(3).

[3566] See Letter Ruling 200402003 regarding an S corporation that merges into a nonprofit corporation.

[3567] Code § 642(c). Code § 512(e)(1) characterizes S corporation items as unrelated business income; however, those items are just items on the K-1 issued by the S corporation, together with any gain or loss on the disposition of the stock in the S corporation. Congress appeared to recognize that distributions of C corporation earnings and profits would escape this tax when it provided for basis reductions with respect to some of that dividend income, as described in the text accompanying fn. 3569; this basis reduction provision was enacted at the same time as the income tax deduction, because the dividend is not considered part of the S portion.[3568] If the trust's basis in the S corporation stock was determined by reason of purchase, the dividend income reduces the basis of the S stock in determining the gain or loss on the sale that constitutes unrelated business taxable income.[3569]

If distributions exceed AAA and earnings & profits, that excess would be treated as a return of capital,[3570] reducing basis.[3571] Any amount that exceeds basis would be treated as a gain from the sale of stock,[3572] which would be treated as part of the S portion and, if an ESBT election is in effect, would not be offset by the charitable income tax deduction.

If an amount is intended to be accumulated in the trust, then using AAA is the easiest way.

If an amount is intended to be distributed to charity and it's possible that future distributions will need to be accumulated, then a Code § 1368(e)(3) election should be made to treat the distribution as a dividend from earnings and profits so that AAA is used only for future accumulated distributions.

II.Q.7.c.iv. Using a Charitable Remainder Trust to Avoid Built-in Gain Tax

If an S corporation contributes built-in gain property to a term-of-years (typically 20 years) charitable remainder trust ("CRT") for the benefit of the corporation[3573] and that property is sold for a capital gain, then the sale will not trigger immediate tax. Instead, the CRT's distributions will come first from ordinary income and not from any built-in gain, and during the recognition period distributions will be subject to built-in gain tax only to the extent that capital gain constituting built-in gain is distributed to the S corporation.[3574] The contributed assets must not constitute substantially all of the corporation's assets, since a corporation recognizes gain if it conveys substantially all of

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tax K-1 items and gain on the sale of stock. See Conference Report 104-737, reproduced in *RIA Checkpoint* at COMREP ¶13,611.001 S corporations permitted to have 75 shareholders. (Small Business Job Protection Act of 1996, PL 104-188, 8/20/96), P.L. 104-188, Sec. 1316(c), and P.L. 105-34, Sec. 1523(a).

[3568] Reg. §§ 1.641(c)-1(g)(2), 1.641(c)-1(l), Example (1)(iii).

[3569] Code § 512(e)(2). This rule would not apply if the trust acquired its stock by reason of death, since that provision (by way of Code § 1361(e)(1)(C)) refers to Code § 1012, not Code § 1014.

[3570] Code § 1368(c)(3).

[3571] Code § 1368(b)(1).

[3572] Code § 1368(b)(2).

[3573] The term interest must benefit the corporation; if it benefits the shareholders, then the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders for tax purposes and the partners or the shareholders will be treated as the grantors of the trust. Letter Ruling 200203034, citing Reg. § 1.671-2(e)(4), and also holding that the trust would not qualify as a charitable remainder trust.

[3574] Letter Ruling 200644013 focused on whether a contribution of property that had built-in gain accumulated from prior C corporation years would trigger Code § 1374 built-in gain tax. In that ruling, the corporation contributed real estate to a 20-year CRT. Later, but before the end of the Code § 1374 recognition period, the CRT would sell the property and use the sale proceeds to invest in stocks, bonds, and other securities that pay interest and dividends. The IRS declined to rule on whether the corporation would have recognized built-in gain under Code § 1374 on unitrust amounts received by it after the recognition period.

its assets to a tax-exempt entity.[3575] See also part II.D.2 Business Entity as Grantor of Trust.

Also, if and to the extent that sale (or holding) of the asset constitutes unrelated business taxable income (UBTI), this strategy will not work. Any UBTI a CRT earns is subject to a 100% excise tax, in addition to being taxable when distributed to the beneficiary, resulting in an ultimate tax well in excess of 100%.[3576] For example, a so-called "negative basis asset"[3577] generally has significant debt-financed income, and debt-financed income/gain and ordinary business income are UBTI.[3578]

II.Q.7.d. Special Rules for Certain Sales of Stock in an S Corporation

The sale of stock in an S corporation can be treated as a sale of the corporation's assets, followed by the corporation's liquidation. See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

II.Q.7.e. Bequest to a Corporation

A bequest to a corporation is treated as a bequest to the remaining shareholders, followed by a contribution of capital to the corporation.[3579] Thus, the remaining shareholders receive an increased basis in their stock in the corporation.

If the bequest is of stock in the corporation, a bequest to the remaining shareholders directly would be cleaner from an income tax perspective, in that the remaining shareholders may specifically identify lots of stock when they sell or otherwise transfer their stock. However, a bequest to the corporation might be simpler, in that ownership might vary over time, and a "transfer on death" designation to the corporation will accomplish the objective in a simple manner.

Naming a corporation as the beneficiary of a life insurance policy might generate some challenging disclosures on the estate tax return.[3580]

[3575] Reg. § 1.337(d)-4(a)(1).

[3576] See part II.Q.6.c Possible Adverse Consequences When Contributing Partnership Interest to Charitable Remainder Trust, especially fns. 3321-3322.

[3577] See fn. 4973.

[3578] Code §§ 512, 513, and 514. Consider whether Code § 514(c)(2)(B) might address that concern.

[3579] Rev. Rul. 74-329.

[3580] Reg. § 20.2031-2(f) provides:

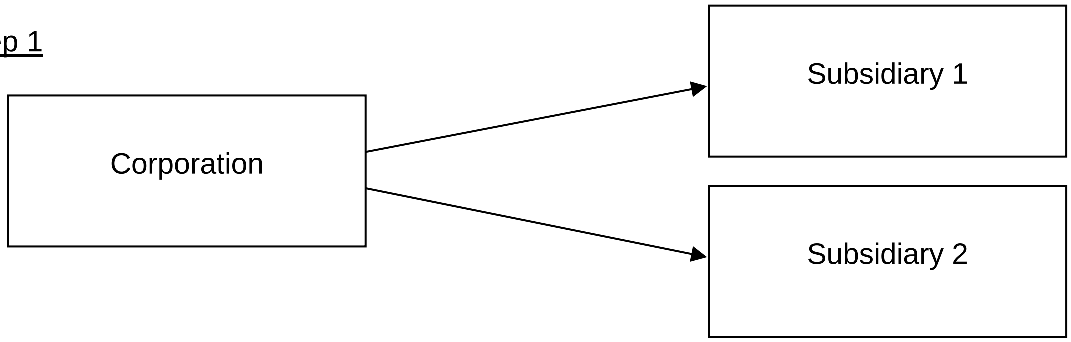
> In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.

If the decedent gratuitously named the corporation as the beneficiary of a life insurance policy, arguably the death benefits' inclusion under Code § 2042 should be the only inclusion under the principle that it is really a bequest to the other shareholder and not to the corporation. Consideration of the death benefit should not equate to required inclusion in value in a situation such as that. However, the result is not nearly as clean as when the corporation itself owns the

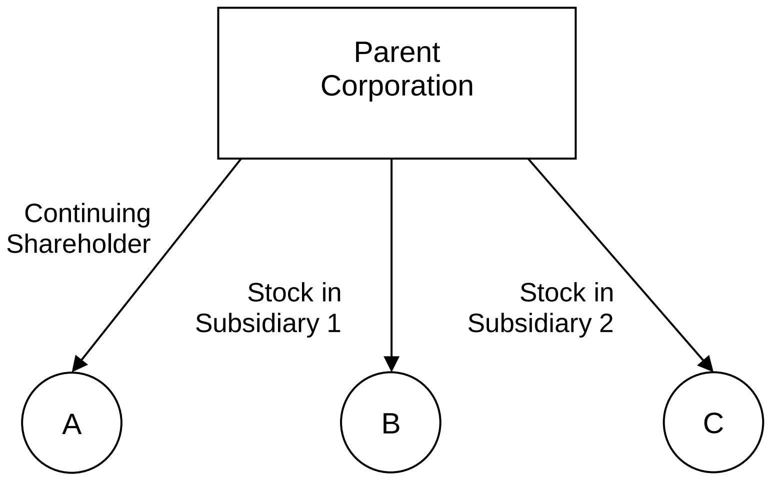
II.Q.7.f. Corporate Division Into More Than One Corporation

II.Q.7.f.i. Overview

<u>Step 1</u>



<u>Step 2</u>



If a corporation owns another corporation, the parent corporation has no earnings and profits, and the subsidiary's value equals the parent's basis in its stock, then distributing the subsidiary might not have much tax effect. However, that is often not the case, and one wants to look for a way to do a tax-free corporate division, as described below.

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policy, which Reg. § 20.2042-1(c)(6) provides generally does not result in incidents of ownership even if the decedent controls the corporation. So a business owner who wants the business entity to hold insurance on the owner's life should consider instead having the entity own the policy. Consider Code § 2035 if transferring an existing policy. A tax-efficient way to move the policy might involve part II.Q.4.i Life Insurance LLC. When an entity owns a life insurance policy, consider part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

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In a spin-off, split up, etc., a corporation transfers one or more active businesses into one of more subsidiaries:

- "Active business" includes active real estate rental.
- It also includes an interest in an LLC that conducts an active business – 20% if the corporation performs management functions and 33-1/3% if not.

The active business needs to be at least 5 years old.

The transaction needs a business purpose that could not be accomplished in another nontaxable transaction.

- Estate planning is not a valid reason to split up a business.
- Differences in management objectives generally constitute a valid reason.
- Personal dislike is not enough; resolving disputes over business strategy generally is.

Letter Ruling 200842003 was a creative estate planning technique:[3581]

- Parent split corporation into 5 different entities.
- Parent sold an interest in each entity to a different irrevocable grantor trust for a different child.
- Although Code § 355 required the parent to continue to hold on to the new corporations, the parent was deemed not to have sold the corporations because the sale to the irrevocable grantor trust was disregarded for income tax purposes.

Also, a transaction in which (1) a parent corporation transfers all of the interests in its limited liability company that is taxable as a corporation to the first subsidiary in exchange for additional stock, (2) the first subsidiary transfers all of the interests in the limited liability company to the second subsidiary in exchange for additional stock, (3) the second subsidiary transfers all of the interests in the limited liability company to the third subsidiary in exchange for additional stock, and (4) the limited liability company elects to be disregarded as an entity separate from its owner for federal income tax purposes effective after it is owned by the third subsidiary, is properly treated for federal income tax purposes as two transfers of stock in Code § 351 exchanges followed by a Code § 368(a)(1)(D) reorganization.[3582]

If the corporation has a complex corporate structure implicating Code § 2701, one can prevent gift tax problems by making sure that the shareholders' rights in each corporation are identical to those they held in the parent corporation.[3583]

[3581] See part II.Q.7.f.iii.(g) Combining Split Up With Sale to Irrevocable Grantor Trust.
[3582] Rev. Rul. 2015-10.
[3583] See Letter Ruling 9843010, discussed in fn. 5540.

II.Q.7.f.ii. Code § 355 Requirements

Code § 355 provides seven requirements that must be met for a tax-free corporate division. The main corporation to be divided may be referred to as the distributing corporation. A corporation, stock in which is being distributed, may be referred to as the controlled corporation.

If a corporation cannot satisfy these rules, consider part II.Q.7.h.ix Value Freeze as Alternative to Code § 355 Division.

The IRS will not issue private letter rulings merely to provide comfort. Instead, it will rule on only an issue of law the resolution of which is not essentially free from doubt and that is germane to determining the tax consequences of the transaction.[3584]

Furthermore, the IRS ordinarily will not issue letter rulings:[3585]

- If property owned by any distributing corporation or any controlled corporation becomes the property of a regulated investment company (RIC), within the meaning of Code § 851, or a real estate investment trust (REIT), within the meaning of Code § 856, in a certain type of transaction.[3586]

- If, immediately after any such distribution, the fair market value of the gross assets of the trade(s) or business(es) on which the distributing corporation or the controlled corporation relies to satisfy the active trade or business requirement of Code § 355(b) is less than 5% of the total fair market value of the gross assets of such corporation.[3587]

II.Q.7.f.ii.(a). Distribution to a Shareholder with Respect to the Shareholder's Stock

The first requirement Code § 355 sets out for a tax-free corporate division is that a distribution is made to a shareholder with respect to the shareholder's stock***.***[3588]

The distribution can be made in the following ways:

[3584] Rev. Proc. 2013-32.

[3585] Rev. Proc. 2015-43. Notice 2015-59 announced these changes because, depending on the situation:

> The Treasury Department and the Service believe that these transactions may present evidence of device for the distribution of earnings and profits, may lack an adequate business purpose or a Qualifying Business, or may violate other § 355 requirements. In addition, these transactions may circumvent the purposes of Code provisions intended to repeal the Supreme Court's decision in *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935) (General Utilities repeal). See, *e.g.*, §§ 311(b), 337(d), 367(a)(5), and 367(e); H.R. Rep. No. 100-391, at 1080-1084 (1987).

Section 3 of Notice 2015-59 was obsoleted by REG-134016-15 (7/15/2016).

[3586] Adding paragraph (57) to section 4.01 of Rev. Proc. 2015-3.

[3587] Adding paragraph (58) to section 4.01 of Rev. Proc. 2015-3.

[3588] Code § 355(a)(1)(A)(i). A distribution with respect to other securities is beyond the scope of these materials.

- First, the distribution could be a disproportionate distribution, where some of the shareholders receive a distribution and some do not. This type of division, a "split-off," is most often used when all of a company's stock is owned by the second generation of a family. One group of shareholders will receive a distribution of stock in the controlled corporation in exchange for their stock in the distributing corporation. The distribution could also be a pro-rata distribution.[3589] However, in family business succession planning, the pro-rata distribution scheme can be hard to use, since tax-free treatment might not be allowed if the distribution's stated purpose was to end shareholder dispute.

- Another option for distributions under Code § 355 would be a partially disproportionate distribution that involves a shareholder or group of shareholders leaving the distributing corporation completely, as in the disproportionate distribution, but one shareholder keeps his stock in the distribution corporation and receives some stock in the controlled corporation. This is another "split-off" scenario and is usually used when the corporate separation occurs before the death of the business founder or family patriarch and that person holds the ownership interest in both corporations.

II.Q.7.f.ii.(b). Distribute Stock of a "Controlled Corporation" Which Distributing Corporation Controls Immediately Before the Distribution

The second requirement for a tax-free division under Code § 355 is that the distributing corporation must distribute stock of a "controlled corporation" which it controls immediately before the distribution.[3590]

Additionally, the distributing corporation must distribute all of the stock of the controlled corporation that it owns or at least must distribute enough of the stock to meet the Code § 368 control requirements.[3591] Under Code § 368, a corporation controls another if it owns at least 80% of the total combined voting power of the controlled corporation and at least 80% of the total number of shares of all other classes of stock of the controlled corporation. If the distributing corporation retains any of the controlled corporation's stock, it must establish that the retention was not in pursuance of a plan to avoid taxes.[3592]

Determining whether an acquisition of control has substance for federal tax purposes can be difficult and fact-intensive.[3593] The government became concerned that, in some

[3589] Code § 355(a)(2)(A).
[3590] Code § 355(a)(1)(A).
[3591] Code § 355(a)(1)(D); Reg. § 1.355-2(e)(1).
[3592] Reg. § 1.355-2(e)(2).
[3593] Rev. Proc. 2016-40, Section 2.10. In describing the background for this concern, various parts of Section 2 pointed to Rev. Rul. 56-117, Rev. Ruls. 63-260, 69-407, and 98-27 (limiting the application of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945), the limitation being based, in part, on § 1012(c) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 916-17, which added Code § 355(e)). Rev. Proc. 2016-40, Section 2.09 explained:

> Although the § 355(e) legislative history states, and Rev. Rul. 98-27 provides, that post-distribution events are not to be taken into account in determining whether a distributing corporation has control of the distributed corporation, this interpretation of § 355 applies

cases, taxpayers may not be able to determine whether such an acquisition has substance with sufficient certainty to proceed with transactions that otherwise satisfy the requirements of Code § 355.[3594] Rev. Proc. 2016-40 provides a safe harbor[3595] for the following transactions that meet certain requirements:[3596]

(1) D owns C stock not constituting control of C;

(2) C issues shares of one or more classes of stock to D and/or to other shareholders of C (the issuance), as a result of which D owns C stock possessing at least 80 percent of the total combined voting power of all classes of C stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of C;

(3) D distributes its C stock in a transaction that otherwise qualifies under § 355 (the distribution); and

(4) C subsequently engages in a transaction that, actually or in effect, substantially restores

(a) C's shareholders to the relative interests, direct or indirect, they would have held in C (or a successor to C) had the issuance not occurred; and/or

(b) the relative voting rights and value of the C classes of stock that were present prior to the issuance (an unwind).

The IRS will not assert that such a transaction lacks substance, and that therefore D lacked control of C immediately before the distribution, within the meaning of Code § 355(a)(1)(A), if the transaction is also described in one of the following safe harbors:[3597]

.01 No Action Taken Within 24 Months. No action is taken (including the adoption of any plan or policy), at any time prior to 24 months after the distribution, by C's board of directors, C's management, or any of C's controlling shareholders (as defined in § 1.355-7(h)(3)) that would (if implemented) actually or effectively result in an unwind.

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only after it has been determined that, at the time of the distribution, the distributing corporation otherwise had control of the distributed corporation in substance. Thus, the § 355(e) legislative history and Rev. Rul. 98-27 do not prevent the step transaction doctrine from applying to determine if, taking into account all facts and circumstances (including post-distribution events), a pre-distribution acquisition of control has substance such that a distributing corporation has control of a corporation within the meaning of § 355(a)(1)(A) immediately prior to a distribution of the stock of that corporation.

[3594] Rev. Proc. 2016-40, Section 2.10.

[3595] Rev. Proc. 2016-40, Section 5 describes scope and effect of being within or not being within the safe harbors.

[3596] Rev. Proc. 2016-40, Section 3.

[3597] Rev. Proc. 2016-40, Section 4.

.02 Unanticipated Third Party Transaction. C engages in a transaction with one or more persons (for example, a merger of C with another corporation) that results in an unwind, regardless of whether the transaction takes place more or less than 24 months after the distribution, provided that--

(1) There is no agreement, understanding, arrangement, or substantial negotiations (within the meaning of § 1.355-7(h)(1)) or discussions (within the meaning of § 1.355-7(h)(6)) concerning the transaction or a similar transaction (applying the principles of § 1.355-7(h)(12) and (13), relating to similar acquisitions), at any time during the 24-month period ending on the date of the distribution; and

(2) No more than 20 percent of the interest in the other party, in vote or value, is owned by the same persons that own more than 20 percent of the stock of C. For purposes of this section, ownership is determined by application of the constructive ownership rules of § 318(a) as modified by § 304(c)(3), except that for purposes of applying § 318(a)(3)(A) and (B), the principles of § 304(c)(3)(B)(ii) (without regard to § 304(c)(3)(B)(ii)(I)) apply.

II.Q.7.f.ii.(c). Cannot Be Used Principally As a Device to Distribute the Earnings and Profits of either the Distributing or Controlled Corporations or Both

The third requirement is that the corporate division cannot be used principally as a device to distribute the earnings and profits of either the distributing or controlled corporations or both.[3598]

This rule prevents a corporation from helping its shareholders avoid dividend treatment by abusing Code § 355 and enabling shareholders to avoid immediate tax consequences, and to get capital gains treatment when one of the divided corporations is eventually sold. Although changes in the tax law since 2003 diminished the incentive to transform dividends into capital gains by lowering the tax rate on dividend income, sale treatment remains more beneficial than dividend treatment, because sale treatment allows the seller to use the seller's basis to offset gain and to defer tax using the installment method.[3599]

The determination that a division is being used as a device to avoid taxes is a facts and circumstances based test, but a number of "device factors" are strong evidence of tax avoidance. For example, when a distribution is pro-rata and no stock is surrendered back to the corporation, the IRS will take a close look at the transaction and make sure the distribution is not in fact a dividend.[3600] Another factor that may indicate abuse is when stockholders "cash-out" shortly after the division.[3601] The purpose of the Code § 355 tax-free provisions is to allow a corporation to continue its business is the

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[3598] Code § 355(a)(1)(B).
[3599] See part II.Q.7.a.iii Redemption Taxed Either As Sale of Stock or Distribution; Which Is Better When.
[3600] Reg. § 1.355-2(d)(2)(ii).
[3601] Reg. § 1.355-2(d)(2)(iii).

form of two corporations instead of one, not to allow stockholders a quick tax-free way out of the company. The IRS will take into consideration significant changes in economic conditions that may have caused a stockholder to cash-out shortly after a distribution,[3602] but it is a situation the IRS will examine closely. The IRS will also examine the "nature, kind, amount, and use of the assets" of both the distributing and controlled corporations immediately after the transaction.[3603] This examination prevents a company from attempting to distribute assets unrelated to the corporation's business under a guise of splitting the corporation's active business. Another questionable situation arises when the controlled corporation and the distributing corporation have an exclusionary post-division relationship where one corporation is the secondary corporation that essentially serves the other.[3604] When such a relationship exists and the secondary corporation could be sold without adversely affecting the other corporation's business, the IRS considers this to be evidence of a tax-avoidance device.[3605] Proposed regulations would modify the nature and use of assets device factor.[3606]

In addition to listing numerous "device factors" in the Regulations, the IRS also provides a number of "nondevice factors" that are evidence of no tax avoidance purpose. Again, this determination is based on facts and circumstances, but the presence of one of these factors can help a corporation defend its division. These "nondevice factors" include having a strong business purpose of the transaction, having a distributing corporation that is publicly traded and widely held, and having a distribution to shareholders that are domestic corporations eligible for the dividends-received deduction.[3607] Proposed regulations would modify the corporate business purpose nondevice factor.[3608]

Proposed regulations would add a per se device test to the device determination.[3609]

The IRS has removed this test from its list of areas on which it will not issue a private letter ruling.[3610]

[3602] PLR 9030037 (approving later trades when publicly traded stock was to be sold, but not by insiders), PLR 8932038 (approving post-division gift of 10% of corporation), PLR 9041078 (approving later trades when publicly traded stock was to be sold, but not by insiders).
[3603] Reg. § 1.355-2(d)(2)(iv)(A).
[3604] Reg. § 1.355-2(d)(2)(iv)(C).
[3605] Reg. § 1.355-2(d)(2)(iv)(C).
[3606] REG-134016-15 (7/15/2016).
[3607] Reg. § 1.355-2(d)(3).
[3608] REG-134016-15 (7/15/2016).
[3609] REG-134016-15 (7/15/2016), providing:

> Under proposed § 1.355-2(d)(5), if designated percentages of Distributing's and/or Controlled's Total Assets are Nonbusiness Assets, the transaction would be considered a device, notwithstanding the presence of any other nondevice factors, for example, a corporate business purpose or stock being publicly traded and widely held. By their nature, these transactions present such clear evidence of device that the Treasury Department and the IRS have determined that the nondevice factors can never overcome the device potential. The only exceptions to this per se device rule would apply if the distribution is also described in § 1.355-2(d)(3)(iv) (distributions in which the corporate distributee would be entitled to a dividends received deduction under section 243(a) or 245(b)) or in redesignated § 1.355-2(d)(6) (§ 1.355-2(d)(5) of the current regulations, relating to transactions ordinarily not considered as a device).

[3610] Rev. Proc. 2016-45.

II.Q.7.f.ii.(d). Active Business

The fourth requirement of Code § 355 is the "active business" test. For what is an "active business," see part II.Q.7.f.iii Active Business Requirement for Code § 355.

Both the distributing corporation and the controlled corporation must be engaged in an active trade or business for five years before the distribution. Thus, it may not always be easy for a business owner to separate the business into two distinct corporations, and sometimes it may be more costly for the business owner to do so than it would be for him to maintain the business as a whole and use less tax-advantageous business separation techniques when such separation becomes necessary. For example, two divisions could be separated into two wholly owned limited liability companies.

Code § 355(b)(1) requires that either (A) immediately after the division the distributing and controlled corporations are engaged in the active conduct of a trade or business, or (B) immediately before the distribution, the distributing corporation has no assets other than stock or securities of the controlled corporation and the controlled corporation is engaged in an active business immediately after the distribution. Four specific requirements must be met in order for a corporation to be treated as engaged in an active business. First, the corporation must be engaged in the active conduct of a trade or business, or, immediately after the distribution, substantially all of its assets are stock and securities of a corporation controlled by it which is engaged is such a trade or business.[3611] "Active trade or business" for purposes of Code § 355 is defined as a specific group of activities of the corporation being carried on for purposes of earning income or profit and the activities included in such group include all operations that form any part of, or step in, the process of earning income or profit.[3612] Next, such trade or business is required to have been actively conducted throughout the five-year period ending on the date of the distribution.[3613] The trade or business also must not have been acquired within that five-year period in a transaction in which gain or loss was recognized either in whole or in part.[3614] Finally, the control of a corporation conducting an active trade or business must not have been acquired in a taxable transaction in the same five year period.[3615] Additional details are further below.

[3611] Code § 355(b)(2)(A).

[3612] Reg. § 1.355-3(b)(2)(ii). Specifically excluded from the definition of an active trade or business are activities such as holding of stock, securities, land or other property for investment purposes. Reg. § 1.355-3(b)(2)(iv). Additionally, owning or operating real or personal property used in a trade or business is not considered an active trade or business unless the owner also performs significant services with respect to the operation and management of the property. Reg. § 1.355-3(b)(2)(iv). Rev. Rul. 2007-42 approved a real estate rental activity that included certain services. The corporate parent of the LLC that engaged in those activities was deemed engaged in an active trade or business when the corporation owned 1/3 (but not 20%) of the LLC. Note also that proposed regulations have been issued that the author has not undertaken to study; see Cummings, The New Section 355(b) Active Trade or Business Proposed Regulations, *Journal of Taxation*, August 2007, page 74.

[3613] Code § 355(b)(2)(B). See Rev. Ruls. 2002-49 and 2007-42 regarding business conducted through an LLC.

[3614] Code § 355(b)(2)(C).

[3615] Code § 355(b)(2)(D). Letter Ruling 201551005 approved the target shareholders' receipt of cash boot and consequential recognition of gain when all of the target corporation's assets had a carryover basis. Letter Ruling 201551009 approved the recognition of income under

II.Q.7.f.ii.(e). Transaction Must Have At Least One Corporate Business Purpose

The fifth requirement is that the transaction must have at least one corporate business purpose.[3616]

This requirement ensures that nonrecognition treatment is given only to distributions that are part of readjustments of corporate structures caused by business exigencies and to readjustments of continuing interests in property under modified corporate form.[3617] The purpose must be a "real and substantial non Federal tax purpose."[3618] The distribution to shareholders does not satisfy a corporate business purpose if the corporate business purpose can be achieved through a nontaxable transaction that does not involve the distribution of stock of a controlled corporation and is neither impractical nor unduly expensive.[3619]

The Regulations also note that a "shareholder purpose… is not a corporate business purpose."[3620] However, sometimes a shareholder's purpose is so coextensive with the corporate business purpose that no real distinction exists between the two, and in such cases, the transaction will be considered to have a corporate business purpose.[3621] Clearly, not all shareholder disputes will rise to the level of a corporate business purpose. For example, a dispute between shareholders who are not part of management would have little effect on the business itself, thus, such a dispute would not be co-extensive with a business purpose. The Regulations provide an example of a shareholder dispute that would be coextensive with a corporate business purpose.[3622] The example involves a corporation, owned by two shareholders, engaged in two businesses – manufacturing and selling furniture and selling jewelry. Shareholder A wants to continue the furniture business, and Shareholder B wants to continue the jewelry business. If A and B decide to split up the business and cut ties with one another, the transaction will be considered to have a corporate business purpose – the business will likely benefit from having the interested shareholder running the business – even though the separation was also driven by a shareholder purpose.

Code §§ 481 (change of accounting method) and 751 (relating to differing interests in hot assets – see part II.Q.8.b.i.(f) Code § 751 – Hot Assets).

[3616] Reg. § 1.355-2(b).

[3617] Reg. § 1.355-2(b).

[3618] Reg. § 1.355-2(b).

[3619] Reg. § 1.355-2(b)(3). Reg. § 1.355-2(b)(5), Example (3) provides:

> Corporation X is engaged in the manufacture and sale of toys and the manufacture and sale of candy. The shareholders of X wish to protect the candy business from the risks and vicissitudes of the toy business. Accordingly, X transfers the toy business to new corporation Y and distributes the stock of Y to X's shareholders. Under applicable law, the purpose of protecting the candy business from the risks and vicissitudes of the toy business is achieved as soon as X transfers the toy business to Y. Therefore, the distribution is not carried out for a corporate business purpose. See paragraph (b)(3) of this section.

[3620] Reg. § 1.355-2(b)(2).

[3621] Reg. § 1.355-2(b).

[3622] Reg. § 1.355-2(b)(5), Example (2).

Real world businesses may not have such neatly separable businesses within one corporation, as in the example from the Regulations. But even in "single function" businesses, a shareholder purpose (shareholder dispute) can still rise to the level of a corporate business purpose. The IRS has approved a Code § 355 tax-free corporate division where the division was driven by friction that had developed between shareholders "regarding fundamental management policy and the expansion of the business" and the shareholders had been "unable to agree to a current fair market value of the stock."[3623]

Thus, for a shareholder dispute to rise to the level of a corporate business purpose, the dispute must be one that will negatively affect the corporation's business if it is not carried out. Disputes between purely passive shareholders will not reach that threshold. But disputes between active shareholders on whether to grow the company or other differences in business philosophies would likely reach the necessary corporate business purpose threshold. Essentially, as long as the dispute is between active shareholders, as is usually the case in the standard family business model, it should be relatively easy to establish that the dispute would affect the corporation's operations, thus establishing that the shareholder purpose is co-extensive with a corporate business purpose.

The IRS has removed this test from its list of areas on which it will not issue a private letter ruling.[3624]

II.Q.7.f.ii.(f). Continuity of Interest

The sixth requirement is "continuity of interest."[3625]

The division really must be a division and not essentially a sale. One or more direct or indirect owners of the distributing corporation before the distribution must own, in the

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[3623] Letter Ruling 8943038. See also Letter Ruling 201411012, which, consistent with IRS ruling policy, declined to rule on business purpose:

> Sibling 1 is President of Distributing, operating and managing the businesses with active input from Sibling 2 and both siblings' adult children. In recent years, however, the Shareholders have disagreed significantly about the direction in which to take each of the businesses. Therefore, they propose the following transaction:
>
> (i) Distributing will form Controlled and transfer to it approximately c percent of Distributing's active trade or business assets, including some of the separable tracts of land, in exchange for all of Controlled's outstanding stock (the Contribution).
>
> (ii) Distributing will distribute to Sibling 2 all of the Controlled shares in exchange for all of Sibling 2's stock in Distributing (the Split-Off).
>
> After the Split-Off, Sibling 1 will hold all of the outstanding stock of Distributing, which will remain actively engaged in its historic businesses using the remaining d percent of its historic business assets. Sibling 2 will hold all of the outstanding stock of Controlled, which will be actively engaged in Business E using the c percent of Distributing's historic business assets received in the Contribution.

Presumably the taxpayers request the ruling to approve Code § 355's other requirements (although the IRS also declined to rule on the device test or whether the split-off was part of a plan proscribed by Reg. § 1.355-7).

[3624] Rev. Proc. 2016-45.

[3625] Reg. § 1.355-2(c).

aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation. Continuing ownership of 50% or more should be enough to establish a continuity of interest.[3626] In most family business divisions, meeting this test will not be a problem, since both the distributing and controlled corporations will be owned by original shareholders.

II.Q.7.f.ii.(g). The Active Trade or Business That Existed Five Years Before the Separation Must Exist After The Separation

The final requirement is that the active trade or business that existed five years before the separation must exist after the separation.[3627]

This requirement will normally be easy to fulfill, as long as all other requirements are met, since corporations that meet the "active business" requirements will likely meet this requirement as well.

II.Q.7.f.iii. Active Business Requirement for Code § 355

The IRS and Treasury have provided significant guidance for what qualifies as an active business. Below is a history of some of the most important guidance.

II.Q.7.f.iii.(a). Farming

In Rev. Rul. 73-234, a corporation engaged in a farm operation as follows:

- The planting, raising, and harvesting of crops and the breeding and raising of livestock in the corporation's farm operation are done by tenant farmers, acting as independent contractors. The tenant farmers are compensated by a share of the proceeds from the sale of all crops and livestock resulting from the farm operation. The corporation employs a general handy-man to maintain the farm property and equipment.

- The corporation employs its sole shareholder and president to participate in the farm operation. He prefers to contract with tenant farmers who have experience with farm machinery and livestock. He supplies all equipment and arranges for all financing necessary for the corporation's operation. With regard to the farm equipment, he engages a local mechanic for the maintenance and repair thereof that is not performed by the general handy-man or the tenant farmers.

- The president devotes significant time and effort to the corporation's farm business. He studies Federal price support and acreage reserve programs, plans all rotation, planting, and harvesting of crops, and purchases and plans the breeding of livestock. He hires seasonal workers and purchases farming equipment, is responsible for handling sales of all crops and livestock, and is responsible for accounting to the tenant farmers for their shares of the proceeds of the sales.

[3626] See Reg. § 1.355-2(c)(2), Example (2) and Rev. Proc. 96-30, § 4.07.
[3627] Code § 355(b), Reg. § 1.355-2(h) and 1.355-3(b)(3). See also the last sentence of fn 3612 regarding proposed regulations under Reg. § 1.355-3.

The IRS ruled that the corporation's farm activities included its direct performance of substantial management and operational functions, apart from those activities performed by the tenant farmers acting as independent contractors. Therefore, the corporation satisfied the active business requirements.

Rev. Rul. 86-126 explains that not all tenant farming qualifies as an active business. In that case:

- The sole officers and shareholders are both farmers who are engaged in the business of farming their own individual tracts of farmland not owned by the corporation, which holds title to large tracts of farmland elsewhere in the same state. Each tract of land held by the corporation is leased for one year at a time to a tenant farmer who has agreed with the corporation to share one-half of all income and expenses of the farm. Each party to the lease is responsible for securing the financing necessary to pay that party's share of expenses. In the case of each tract leased, the planting, raising, and harvesting of corn and soybeans (the only crops grown on these farms) are done by the tenant farmer. The tenant farmer also supplies the farm equipment used in these activities. The tenant farmer repairs and maintains the equipment, and also maintains the irrigation system, fences, and other fixtures located on the property. After consulting with the corporation's officers, the tenant farmer purchases all herbicides, insecticides, and fertilizers used on the property. Also after consulting with them, the tenant farmer contracts to sell the crops at a future date, or sells them when harvested. Each tenant farmer is responsible for accounting to the corporation's officers for the corporation's share of the proceeds.

- The officers each devote to substantial part of their time to the operation of their own respective farms which are unconnected with the farmland owned by the corporation. After completing work on their own properties, the officers occasionally inspect the crops and improvements located on each leased tract. If any corrective steps must be taken, an officer points out the problem to the tenant farmer, who makes the necessary corrections in the way the tenant farmer sees fit. The officers also decide each year what portion of each tract will be leased, in the light of soil conservation needs, market conditions, and federal price support and acreage reserve programs. They review each tenant farmer's accounting of operations and sales.

The IRS contrasted this situation with Rev. Rul. 73-234. In that case, the corporation was engaged in hiring seasonal workers, purchasing and supplying equipment, maintaining equipment, arranging financing, planning all rotation and planting and harvesting of crops, purchasing livestock, planning livestock breeding, selling all crops and livestock, and accounting to the tenant farmers for their shares of the proceeds. That corporate activity, carried on through its own employees and constituting active and substantial managerial and operational activity, contrasts with the activity carried on by the employees of P in the present situation. Here, the IRS said, the corporation either did not engage in the above activities at all, or engaged in them only on a limited basis. At best, it said, the corporation could be considered to engage in some managerial and operational activity but not enough to "qualitatively distinguish its operations from mere investments."

Because of the absence of active and substantial operational and managerial activities, the corporation did not satisfy the active business requirement.

II.Q.7.f.iii.(b). Rev. Rul. 79-394 – Commercial Real Estate

In this ruling, the stock of corporation P is owned by four unrelated individuals. For over five years, P has owned all the stock of corporations X and Y. During that period, P has acted solely as a holding company, X has been engaged in the general contracting business, and Y has been engaged in renting its commercial and residential real estate to unrelated third parties. X's employees have performed all operational activities in connection with Y's rental business. X has paid its employees for these services and has been reimbursed by Y. Y's three officers, who are also officers of P and X, supervise, control and direct the employees of X performing work for Y. Y's officers receive no compensation from Y for the amount of their time devoted to the management and supervision of Y's affairs. These officers are paid only by P and X, and P and X have been reimbursed by Y for the services rendered by the officers to Y.

Y holds title to several commercial and residential rental buildings and associated realty. Y, through its officers and X's employees, continuously seeks additional property of a similar nature for expansion of its rental business. When property is located, Y negotiates its purchase and required financing. Y is primarily obligated on the mortgages relating to its property and pays the principal and interest due thereon. Newly acquired buildings are renovated or altered to reflect the design by Y of custom floor plans that make the property suitable for rental. Y periodically repaints and refurbishes its existing property.

Y endeavors to keep its property rented at all times. When new property is available or when existing property is vacated, Y immediately advertises to attract new tenants. Y verifies the information contained in a prospective tenant's application and negotiates the lease provisions.

Pursuant to the terms of its leases, Y provides and pays for gas, water, electricity, sewage, and insurance for the property and pays the taxes assessed thereon. Moreover, the lease agreements require Y to provide day-to-day maintenance and repair services. These services include insect control, janitorial service, trash collection, ground maintenance, and heating, air conditioning and plumbing maintenance. Y routinely inspects its properties.

Y maintains separate records and accounts to reflect income and expenses relating to each of Y's rental properties as well as Y's general expenses.

Y's above described activity in acquiring, renovating, refurbishing, maintaining, servicing and leasing its rental property is accomplished under the supervision and control of Y's officers using the employees of X.

For valid business reasons, P proposes to distribute all of the Y stock to one of its shareholders solely in exchange for all of that shareholder's P stock in a transaction intended to be tax-free under Code § 355(a). The fair market value of the Y stock to be distributed and the P stock to be surrendered in the exchange are equal.

After the proposed distribution, Y will continue its rental activities as discussed above, and will directly employ, on a full time basis, most of those employees who have worked on its behalf before the distribution.

The IRS held that Y was engaged in the active conduct of a trade or business under Code § 355(b) for the five year period preceding distribution of its stock, notwithstanding the fact that during that period it had no employees other than its officers. Moreover, Y will be engaged immediately after the distribution in the active conduct of a trade or business.

The IRS viewed the only factor tending to prove the lack of a pre-distribution active trade or business conducted by Y to be the absence of salaried employees of Y. The IRS reasoned that, given the nature of Y 's conduct of its pre-distribution rental operations and the existence of substantial objective factors that otherwise adequately demonstrate the active conduct of a trade or business, Y's failure to have salaried employees should not, without more, result in failure to meet the Code § 355(b) active trade or business requirement. However, the IRS further stated that the presence or absence of formal employment of employees other than officers, in the distributing corporation or the controlled corporation, will be one factor for consideration in making this determination under Code § 355(b).

II.Q.7.f.iii.(c). Rev. Rul. 80-181 – Reimbursement for Services

The IRS amplified Rev. Rul. 79-394, ruling that the Code § 355(b) active trade or business requirement is satisfied even if Y does not reimburse P and X for the use of their employees and officers in the conduct of Y's real estate activities.

The IRS pointed out, however, that, if Y did not reimburse X and P for the services that X's employees and X's and P's officers rendered to Y, then the IRS would apply Code § 482 to allocate income to X and P in an amount equal to an arm's length charge for the services rendered by the employees of X and the officers of X and P to Y. Y would then deduct the amounts deemed paid by Y to X and P for the services rendered.

II.Q.7.f.iii.(d). Rev. Rul. 92-17 – Participation by Partners in Rental LP

For more than 5 years, limited partnership LP has owned several commercial office buildings that are leased to unrelated third parties. Corporation D has owned a 20% interest in LP for more than 5 years, and throughout that period of time D has been a general partner of LP. The partnership agreement requires that D, as a general partner, provide the managerial services to LP necessary to operate LP's rental business. For more than 5 years, D has owned all the stock of C, a corporation which has been actively engaged for more than 5 years in the conduct of a trade or business that is unrelated to D's activities.

LP continuously seeks additional properties to expand its rental business. When a property is located, LP negotiates its purchase and financing and determines whether renovations or alterations are necessary to make the building suitable for rental. LP periodically repaints and refurbishes its existing properties.

LP's leases require LP to provide day-to-day upkeep and maintenance services for its office buildings. These services include trash collection, ground maintenance, electrical and plumbing repair, and insect control. Additionally, LP advertises for new tenants, verifies information contained in lease applications, negotiates leases, handles tenant complaints, prepares eviction notices and warnings for delinquent tenants, collects rent, and pays all expenses, including gas, water, sewage, electricity and insurance for the office buildings. LP also maintains financial and accounting records to reflect income and expenses relating to each of its rental properties as well as LP's general expenses.

LP has conducted these activities for more than five years. Officers of D form active and substantial management functions with respect to LP's activities, including making significant business decisions of the partnership (e.g., decisions with respect to significant renovations of partnership properties, the purchase and sale of properties, and significant financings and refinancings). In addition, D's officers regularly participate in the overall supervision, direction and control of LP's employees in their performance of LP's operational functions.

For a valid business purpose, D proposes to distribute all its C stock pro rata to D's shareholders in a transaction intended to satisfy Code § 355. After the distribution, officers of D will continue to provide LP with the services described above.

Except for the issue of whether the activities performed by D in connection with the operation of LP's rental business constitute an active trade or business, the transaction will otherwise meet all the requirements of Code § 355.

The IRS held that, if officers of a corporation that is a general partner in a limited partnership perform active and substantial management functions for the partnership, including making significant business decisions of the partnership and regular participation in the overall supervision, direction and control of the employees of the partnership in operating the partnership's rental business, the corporation is engaged in the active conduct of a trade or business under Code § 355(b) and the distribution of the stock of C by D to D's shareholders is tax-free to the D shareholders under section 355.

The IRS reasoned that the fact that a partnership engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation does not mean that each partner in the partnership is considered to engage in the active conduct of a trade or business for purposes of Code § 355(b). It stated that whether a partner is considered to engage in the active conduct of a trade or business must be made with reference to the activities of the partner as well as the partnership.

It further reasoned that, D, like Y in Rev. Rul. 79-394, performs through its officers and the employees of LP significant services with respect to the operation and management of LP's rental business. The only factor tending to prove that D has not been engaged in the active conduct of a trade or business is D's lack of employees to perform the operational services necessary to operate LP's office buildings. However, this factor, standing alone, will not cause D to fail the Code § 355(b) active trade or business test.

II.Q.7.f.iii.(e). Rev. Rul. 2007-42 – Level of Participation in Rental LLC

The IRS contrasted two situations in which a corporation (D) owns a membership interest in an LLC taxed as a partnership, holding that in one case D was deemed engaged in the active conduct of a trade or business and the other case D was not deemed to be so engaged.

In Situation 1, D was deemed to be deemed engaged in the active conduct of a trade or business. For more than five years, LLC owned several commercial office buildings that are leased to unrelated third parties. LLC has one class of membership interests outstanding. For more than five years, D has owned a 33.3% membership interest in LLC and has owned all the stock of a subsidiary (C), a corporation that has been engaged for more than five years in the active conduct of a trade or business that is unrelated to D's activities.

LLC continuously seeks additional properties to expand its rental business. When a property is located, LLC negotiates its purchase and financing and determines whether renovations or alterations are necessary to make the building suitable for rental. LLC periodically repaints and refurbishes its existing properties.

Pursuant to the terms of its leases, LLC provides day-to-day upkeep and maintenance services for its office buildings. These services include trash collection, ground maintenance, electrical and plumbing repair, and insect control. Additionally, LLC advertises for new tenants, verifies information contained in lease applications, negotiates leases, handles tenant complaints, prepares eviction notices and warnings for delinquent tenants, collects rent, and pays all expenses, including gas, water, sewage, electricity and insurance for the office buildings. LLC also maintains financial and accounting records to reflect income and expenses relating to each of its rental properties as well as LLC's general expenses.

The above described activities of LLC have been conducted for more than five years. The employees of LLC perform all management and operational functions with respect to LLC's rental business. Neither D nor any other member of LLC performs services with respect to LLC's business.

The IRS ruled that D is engaged in the active conduct of LLC's rental business for purposes of Code§ 355(b) because D owns a significant interest in LLC and LLC performs the required activities that constitute an active trade or business under the regulations.

In Situation 2, the facts are the same as Situation 1 except that D owns a 20% membership interest in LLC. The IRS ruled that D was not engaged in the active conduct of LLC's rental business for purposes of Code§ 355(b) because a 20% interest was not sufficiently significant.

The IRS reasoned that the fact that a partnership engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation does not necessarily mean that each partner in the partnership is considered to be engaged in the active conduct of a trade or business for purposes of Code § 355(b). In such a case, the determination of whether a partner is considered to be engaged in the active conduct of a trade or business must be based on the requirements of Code § 355 and the regulations thereunder taking into account the activities of the partner (if any), the partner's interest in the partnership, and the activities of the partnership.

Although Rev. Rul. 92-17 viewed a 20% interest in a partnership to be sufficient, in that case the corporate partner performed management functions. The IRS pointed out that D's officers performed active and substantial management functions with respect to LP, including the significant business decision-making of the partnership, and regularly participated in the overall supervision, direction, and control of LP's employees in operating LP's rental business. Rev. Rul. 2002-49 reached a similar conclusion where

D and another corporation (X) each own a 20% interest in a member-managed LLC and D and X jointly managed the LLC's business.

The IRS looked to Reg. § 1.368-1(d)(4)(iii)(B) to validate its position that a one-third interest was sufficient to impute activity to a partner that does not perform active and substantial management functions for the business of the partnership. That regulation, regarding the continuity of business enterprise requirement applicable to corporate reorganizations, provides that the issuing corporation will be treated as conducting a business of a partnership if members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business.

II.Q.7.f.iii.(f). Proposed Regulations on Active Conduct of Business

Recent proposed regulations would provide that, for purposes of the active conduct of a business rule, a partner in a partnership will be attributed the trade or business assets and activities of that partnership during the period that such partner satisfies the requirements; however: the stock of a corporation owned by the partnership is not attributed to a partner; for purposes of determining the activities that are conducted by the partnership that may be attributed to the partner, the activities of independent contractors, and partners that are not affiliates of the partner, are not taken into account; and, generally, the activities of partners that are affiliates of the partner are only taken into account during the period that such partners are affiliates of the partner.[3628] The trade or business assets and activities of a partnership will be attributed to a partner if the partner owns a ***significant*** interest in the partnership.[3629] Generally, the trade or business assets and activities of a partnership will be attributed to a partner if the partner performs active and substantial management functions for the partnership with respect to the trade or business assets and activities (for example, makes decisions regarding significant business issues of the partnership and regularly participates in the overall supervision, direction, and control of the employees performing the operational functions for the partnership), and the partner owns a ***meaningful*** interest in the partnership.[3630]

Examples illustrate these concepts:[3631]

Example (8). Jointly owned partnership. For more than five years, D has owned all of the stock of C, and D and C each have owned a 17-percent interest in Partnership. Throughout this period, D and Partnership have engaged in the active conduct of ATB1 and ATB2, respectively. In year 6, D transfers its 17-percent interest in Partnership to C and distributes all of the C stock to the D shareholders. Because D owns Code § 1504(a)(2) stock of C, D and C are treated as one corporation for purposes of determining whether D and C are engaged in the active conduct of a trade or business.[3632] Accordingly, throughout the pre-distribution period, D and C are each treated as owning a 34-percent interest in Partnership, and both D and C are treated as engaged in the active conduct of both ATB1 and ATB2 throughout the pre-distribution period.[3633] The transfer of the Partnership interest is disregarded.[3634] After the

[3628] Prop. Reg. § 1.355-3(b)(2)(v)(A).
[3629] Prop. Reg. § 1.355-3(b)(2)(v)(B).
[3630] Prop. Reg. § 1.355-3(b)(2)(v)(C).
[3631] Prop. Reg. § 1.355-3(d)(2).
[3632] Prop. Reg. § 1.355-3(b)(1)(ii).
[3633] Prop. Reg. § 1.355-3(b)(2)(v)(A), (B).

distribution, C owns 34% of Partnership and is therefore engaged in the active conduct of ATB2.[3635] Therefore, both D and C satisfy Code § 355(b).

Example (22). Partnership—meaningful but not significant. For more than five years, unrelated X and Y have owned a 20% and one-third interests, respectively, in Partnership. The remaining interests in Partnership are owned by unrelated parties. For more than five years, Partnership has manufactured power equipment. But for the performance of all its management functions by employees of X, Partnership would satisfy all the requirements of Prop. Reg. § 1.355-3(b)(2)(i). X and/or Y will be attributed the trade or business assets and activities of Partnership only if the corporation satisfies the requirements of Prop. Reg. § 1.355-3(b)(2)(v)(B) or (C).[3636] While X does not satisfy the requirements of Prop. Reg. § 1.355-3(b)(2)(v)(B) because X's interest in Partnership is not significant, under Prop. Reg. § 1.355-3(b)(2)(v)(C), X owns a meaningful interest in Partnership and performs active and substantial management functions for the trade or business assets and activities of Partnership. Therefore, X is attributed the trade or business assets and activities of Partnership. Accordingly, X is engaged in the active conduct of the business of manufacturing power equipment.[3637] In determining whether Y is engaged in the business of manufacturing power equipment, the management functions performed by X for Partnership are not taken into account.[3638] Therefore, although Y is attributed Partnership's trade or business assets and activities under Prop. Reg. § 1.355-3(b)(2)(v)(B) because Y owns a significant interest in Partnership, Y is not engaged in the business of manufacturing power equipment because neither Y nor Partnership perform any management functions for the business.[3639]

Example (23). Partnership—significant but not meaningful. The facts are the same as Example 22 except that all the management functions related to the business of Partnership are performed by employees of Partnership. Because employees of Partnership perform all of the management functions related to the trade or business assets and activities of manufacturing power equipment, Partnership itself satisfies all the requirements of Prop. Reg. § 1.355-3(b)(2)(i). X neither owns a significant interest in Partnership nor performs active and substantial management functions with respect to the trade or business assets and activities of Partnership. Accordingly, X does not satisfy the requirements Prop. Reg. § 1.355-3(b)(2)(v)(B) or (C), X is not attributed the trade or business assets and activities of Partnership's business of manufacturing power equipment, and X is not engaged in the active conduct of the business of manufacturing power equipment. On the other hand, because Y owns a significant interest in Partnership, Y satisfies the requirements of Prop. Reg. § 1.355-3(b)(2)(v)(B). Therefore, Y is attributed the trade or business assets and activities of Partnership's business. Accordingly, Y satisfies the requirements of Prop. Reg. § 1.355-3(b)(2)(i) and is engaged in the active conduct of the business of manufacturing power equipment.

Example (24). Partnership—significant by many. The facts are the same as Example 23 except that X, Y, and Z each own a one-third interest in Partnership.

3634 Prop. Reg. § 1.355-3(b)(1)(ii).
3635 Prop. Reg. § 1.355-3(b)(2)(v)(A), (B).
3636 Prop. Reg. § 1.355-3(b)(2)(v)(A).
3637 Prop. Reg. § 1.355-3(b)(2).
3638 Prop. Reg. § 1.355-3(b)(2)(v)(A).
3639 Prop. Reg. § 1.355-3(b)(2)(iii).

Because X, Y, and Z each own a significant interest in Partnership, each of X, Y, and Z satisfies the requirements of Reg. § 1.355-3(b)(2)(v)(B). Accordingly, each of X, Y, and Z is attributed the trade or business assets and activities of Partnership, satisfies the requirements of Reg. § 1.355-3(b)(2)(i), and is engaged in the active conduct of the business of manufacturing power equipment.

II.Q.7.f.iii.(g). Combining Split Up With Sale to Irrevocable Grantor Trust

While we waited for those proposed regulations to be finalized, Letter Ruling 200842003 was issued, providing an excellent example of how a family business can be divided and then sold using a sale to a separate irrevocable grantor trust for each adult child. First, the parent split the corporation into five different entities. Then, the parent sold an interest in each entity to a different irrevocable grantor trust for a different child. Although Code § 355 required the parent to continue to hold on to the new corporations, the parent was deemed not to have sold the corporations because the sale to the irrevocable grantor trust was disregarded for income tax purposes. Below are details excerpted from the ruling.

Distributing is a C corporation. Less than 10 years ago, Distributing elected taxation as an S corporation. Distributing has two classes of common stock that differ only by the number of votes per share. All of the Distributing stock is owned by one family. Shareholder 5 is the parent of each of Shareholders 1 through 4. The parent and the children own the Series A stock. The children own the Series B stock. The parent is the majority shareholder of Distributing.

Distributing has directly had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

For what are represented to be valid business reasons, Distributing has proposed the following transactions (the "Proposed Transactions"):

(i) Distributing will create Controlled 1, Controlled 2, Controlled 3, and Controlled 4 (collectively, the "Controlled corporations").

(ii) Distributing will transfer all of its assets to the Controlled corporations in exchange for all of the stock of each of the Controlled corporations and the assumption by each of the Controlled corporations of the liabilities associated with the assets transferred (collectively, the "Contributions").

(iii) Distributing will distribute pro rata all of its stock in each of the Controlled corporations to Shareholders 1 through 5 in exchange for all of the stock of Distributing held by Shareholders 1 through 5 (collectively, the "Distributions"). Each of the Controlled corporations will make an S election on the first available date after the Distributions.

(iv) Distributing will liquidate.

Shareholder 5 will establish four irrevocable grantor trusts: Trust 1, Trust 2, Trust 3, and Trust 4 (collectively, the "Trusts"). Distributing represents that Shareholder 5 will be the grantor of each of the Trusts and will be treated as the owner of each Trust's assets under Code § 671. Shareholder 1 will be the sole beneficiary of Trust 1, Shareholder 2 will be the sole beneficiary of Trust 2, Shareholder 3 will be the sole beneficiary of Trust 3, and Shareholder 4 will be the sole beneficiary of Trust 4.

Shareholder 5 will transfer e% of her stock in Controlled 1 to Trust 1, e% of her stock in Controlled 2 to Trust 2, e% of her stock in Controlled 3 to Trust 3, and e% of her stock in Controlled 4 to Trust 4 (the "Gift Transactions"). Shareholder 5 will sell f% of her stock in Controlled 1 to Trust 1, f % of her stock in Controlled 2 to Trust 2, f% of her stock in Controlled 3 to Trust 3, and f% of her stock in Controlled 4 to Trust 4 in exchange for promissory notes from each Trust (the "Sale Transactions"). Distributing has represented that the Gift Transactions and the Sale Transactions are disregarded for federal income tax purposes.

Shareholder 5's estate plan provides that her ownership interests in each of the Controlled corporations will be separated, so that Shareholder 1 will only inherit the stock of Controlled 1, Shareholder 2 will only inherit the stock of Controlled 2, Shareholder 3 will only inherit the stock of Controlled 3, and Shareholder 4 will only inherit the stock of Controlled 4.

The taxpayer made the following representations regarding the Proposed Transactions:

(a) Neither the business nor control of any entity conducting this business was acquired during the five-year period ending on the date of the Distributions in a transaction in which gain or loss was recognized (or treated as recognized) in whole or in part.

(b) The fair market value of the stock of each of the Controlled corporations to be received by each shareholder of Distributing will be approximately equal to the fair market value of the Distributing stock surrendered by each shareholder in exchange therefor.

(c) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.

(d) Following the Proposed Transactions, the Controlled corporations will each continue, independently and with its separate employees, the active conduct of its share of all the integrated activities of Business D conducted by Distributing prior to consummation of the Proposed Transactions.

(e) The distribution of the stock of each of the Controlled corporations is carried out for the following corporate business purposes: (1) to implement business succession planning; and (2) to avoid shareholder deadlock after implementation of the plan by allowing each shareholder in the post-transition structure to independently manage his or her portion of Distributing's business.

(f) The Proposed Transactions are not used principally as a device for the distribution of the earnings and profits of Distributing or the Controlled corporations.

(g) For purposes of Code § 355(d), immediately after the Distributions, no person (determined after applying Code § 355(d)(7)) will hold stock possessing 50% or more of the total combined voting power of all classes of Distributing stock entitled to vote or 50% or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in Code § 355(d)(5) and (8)) during the five-year period (determined after applying Code § 355(d)(6)) ending on the date of the Distributions.

(h) For purposes of Code § 355(d), immediately after the Distributions, no person (determined after applying Code § 355(d)(7)) will hold stock possessing 50% or more of the total combined voting power of all classes of any Controlled stock entitled to vote or 50% or more of the total value of the shares of all classes of any Controlled stock, that was either (i) acquired by purchase (as defined in Code § 355(d)(5) and (8)) during the five-year period (determined after applying Code § 355(d)(6)) ending on the date of the Distribution, or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in Code § 355(d)(5) and (8)) during the five-year period (determined after applying Code § 355(d)(6)) ending on the date of the Distributions.

(i) Any liabilities assumed (within the meaning of Code § 357(d)) by the Controlled corporations in the Proposed Transactions were incurred in the ordinary course of business and are associated with the assets being transferred.

(j) With respect to each Contribution to a Controlled corporation, the total adjusted bases and the total fair market value of the assets transferred to the Controlled corporation by Distributing in the Proposed Transactions will exceed the sum of the amount of any liabilities assumed (within the meaning of Code § 357(d)) by the Controlled corporation in the exchange.

(k) No intercorporate debt will exist between Distributing and any of the Controlled corporations at the time of, or subsequent to, the Distributions.

(l) Payments made in connection with all continuing transactions, if any, between any of the Controlled corporations will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(m) No parties to the Proposed Transactions are investment companies as defined in Code § 368(a)(2)(F)(iii) and (iv).

(n) The Distributions are not part of a plan or series of related transactions (within the meaning of Treas. Reg. § 1.355-7) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50% or greater interest (within the meaning of Code § 355(d)(4)) in either Distributing or any of the Controlled corporations (including any predecessor or successor of Distributing or any of the Controlled corporations).

(o) Immediately after the Distributions, either (i) no person will hold a 50% or greater interest (within the meaning of Code § 355(g)) in the stock of Distributing or any of the Controlled corporations who did not hold such an interest immediately before the distribution, or (ii) neither Distributing nor any of the Controlled corporations will be a disqualified investment corporation (within the meaning of Code § 355(g)(2)).

The IRS ruled as follows:

(1) Each Contribution, together with its respective Distribution, will be a reorganization within the meaning of Code § 368(a)(1)(D). With respect to each such reorganization, Distributing and the respective Controlled corporation will be “a party to a reorganization” within the meaning of Code § 368(b).

(2) No gain or loss will be recognized by Distributing on the Contributions (Code § 357(a) and 361(a)).

(3) No gain or loss will be recognized by any of the Controlled corporations on the Contributions (Code § 1032(a)).

(4) The basis of each asset received by each of the Controlled corporations in the Contributions will equal the basis of that asset in the hands of Distributing immediately before the Contributions (Code § 362(b)).

(5) The holding period of each asset received by each of the Controlled corporations in the Contributions will include the period during which Distributing held the asset (Code § 1223(2)).

(6) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder 1, Shareholder 2, Shareholder 3, Shareholder 4, or Shareholder 5 on their receipt solely of the stock of the Controlled corporations in the Distributions (Code § 355(a)).

(7) No gain or loss will be recognized by Distributing in connection with the Distributions (Code § 361(c)(1)).

(8) With respect to each of Shareholders 1 through 5, the aggregate basis of the stock of the Controlled corporations in their hands after the Distributions will equal the aggregate basis of the Distributing stock surrendered in exchange therefor, and this aggregate basis will be allocated between the stock of the Controlled corporations in proportion to the fair market value of each immediately following the Distributions in accordance with Treas. Reg. § 1.358-2(a) (Code § 358(a) and (b)(2)).

(9) The holding period of the stock in each of the Controlled corporations received by each of Shareholders 1 through 5 in the Distributions will include the holding period of the Distributing stock surrendered in exchange therefor, provided the Distributing stock was held as a capital asset on the date of the Distributions (Code § 1223(1)).

(10) The earnings and profits of Distributing (if any) will be allocated to each of the Controlled corporations in accordance with Code § 312(h) and Treas. Reg. section 1.312-10(a).

(11) Each of the Controlled corporations will be subject to Code § 1374 with respect to any asset transferred from Distributing to the Controlled corporations to the same extent Distributing was subject to Code § 1374 with respect to such asset. For purposes of Code § 1374, the recognition period of each of the Controlled

corporations will be reduced by the portion of Distributing's recognition period that expires prior to Distributing's transfer of the assets (Code § 1374(d)(8) and IRS Ann. 86-128).

The IRS specifically expressed no opinion regarding:

(i) Whether the Distributions satisfy the business purpose requirement of Treas. Reg. § 1.355-2(b);

(ii) Whether the Distributions are used principally as a device for the distribution of the earnings and profits of Distributing or the Controlled corporations;

(iii) Whether the Proposed Transactions are part of a plan (or series of related transactions) under Code § 355(e)(2)(A)(ii);

(iv) Whether Distributing's election to be taxed as a subchapter S corporation is valid; whether the Controlled corporations are otherwise eligible to be taxed as subchapter S corporations; and whether the Controlled corporations' elections to be taxed as subchapter S corporations will be valid under Code § 1362(a);

(v) The gift and estate tax treatment of the proposed transactions, including whether the Gift Transactions and the Sale Transactions constitute separate transactions for gift tax purposes and the extent to which the Gift Transactions and the Sale Transactions constitute transfers for adequate consideration in money or money's worth; and

(vi) Whether the Trusts are trusts grantor trusts.

II.Q.7.f.iii.(h). Other Estate Planning Applications of Split Ups

Other letter rulings involving Code§ 355 transactions in estate planning situations include:

- Letter Ruling 200850018 (Code § 303 redemption)
- Letter Ruling 200809017 (two families)
- Letter Ruling 200645010 (two locations)
- Letter Ruling 200645010 (three subsidiaries)

II.Q.7.f.iv. Tax Effects When Code § 355 Provisions Are Not Met

If a corporation might not be able to satisfy Code § 355, consider part II.Q.7.h.ix Value Freeze as Alternative to Code § 355 Division to avoid the consequences described in this part II.Q.7.f.iv.

II.Q.7.f.iv.(a). Distributing Corporation

In a number of situations, a distributing corporation may have to recognize gain on a distribution that would otherwise qualify as tax-free, Code § 355 distribution.[3640] The first of these exceptions to the non-recognition rule is the "disguised sale" rule of Code § 355(c)(2), as modified by Code § 355(d). Code § 355(c)(2) requires the distributing corporation to recognize gain when it distributes property, other than stock of the controlled corporation, if the fair market value of the property exceeds it adjusted basis.[3641] Code § 355(d) applies to certain distributions of the controlled corporation's stock, and requires that the distributing corporation recognize gain if any one person holds a 50% or greater interest in disqualified stock in either the distributing or controlled corporation after the distribution.[3642] In family business situations, often the majority shareholder (usually the founder) has owned the business for more than five years. Additionally, even if the founder has transferred equity in the business within the past five years through gifts or through a transfer at death, the disguised sale rule still will not apply, since they only apply to purchase transfers.[3643]

Code § 355(e) is similar to Code § 355(d), but applies when distributions are part of a plan in which one or more persons will acquire 50% or greater interest in either the distributing or controlled corporation.[3644] No five year requirement similar to Code § 355(d) applies, but if one or more persons acquires the 50% or greater interest in either corporation within two years before or after the distribution, then the transaction is considered to be "pursuant to a plan."[3645] Additionally, Code § 355(e) makes no distinction between transfers made for consideration and those made for no consideration. However, to prevent Code § 355(e) from making tax-free corporation division impossible, a number of exceptions limit what is considered an "acquisition" for Code § 355(e) purposes. For example, Code § 355(e)(3)(A)(i) states that the acquisition of stock in a controlled corporation by a distributing corporation will not be taken into account for Code § 355(e) purposes. Temporary and proposed regulations flesh out these rules some and describe the gain resulting from applying these rules.[3646] Additionally, in most family businesses, Code § 355(e) will not be an issue because of a related party provision similar to the one present in Code § 355(d), causing all stock owned by family members to be treated as owned by one person.[3647] The only time that Code § 355(e) is likely to come into play in family business succession planning would be in cases where the founder plans to shift ownership to second generation family

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[3640] Code § 355(c)(2).

[3641] Code § 355(c)(2)(A)(ii). The distributing corporation is taxed as if it had sold the property to the distributee at fair market value. Code § 355(c)(2)(A) (flush language).

[3642] Code § 355(d)(2). Under Code § 355(d)(4), the 50% or greater interest means stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock. Disqualified stock is defined in Code § 355(d)(3) as any stock of the distributing corporation acquired by purchase during the five year period leading up to the distribution and as any stock in the controlled corporation that was acquired by purchase in the five years leading up to the distribution or by distribution on disqualified stock in the distributing corporation.

[3643] Reg. § 1.355-6(d)(1)(i)(A).

[3644] Code § 355(e)(2)(A); see Reg. § 1.355-7.

[3645] Code § 355(e)(2)(B).

[3646] Reg. § 1.355-8T; Prop. Reg. § 1.355-8.

[3647] Code § 355(e)(4)(C)(i).

members who are not lineal descendants of the founder. In such cases, additional planning needs to be done to ensure the transfers and tax-free division will not be considered "pursuant to a plan."

All of the above assumes that the distribution satisfies the requirements of Code § 355 but for the conditions described above. If a transaction does not fit above, consider whether other tax-free provisions apply; otherwise, consider whether the distributing corporation might be taxed on the distribution, as provided in part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

II.Q.7.f.iv.(b). Controlled Corporation

Regardless of whether Code § 355 is met, the controlled corporation will not recognize gain or loss on a corporate division.[3648] Thus, the controlled corporation's basis in the property distributed to it by the distributing corporation before the distribution of the controlled corporation's stock will be equal to the property's basis in the hands of the distributing corporation, increased by any gain recognized by the distributing corporation on the transfer.[3649] When such property distributions are made to the controlled corporation, the distributing corporation must allocate part of its earnings and profits to the controlled corporation.[3650] This allocation will generally be made in proportion to the fair market value of the business and property interests retained by the distributing corporation and the business and property interests of the controlled corporation immediately after the distributions.[3651]

II.Q.7.f.iv.(c). Shareholders

Generally speaking, shareholders of the distributing and controlled corporations will not recognize any gain or loss on the receipt of the controlled corporation's stock in a Code § 355 division. However, if the shareholders of the controlled corporation receive "boot" in addition to stock, then they will have to recognize some gain. This situation will arise when a controlled corporation's shareholder receives other property or money, in addition to the controlled corporation's stock, so that the amount received is equal to the fair market value of the stock the shareholder gave up in the distributing corporation. When this occurs, the shareholder must recognize gain, but not more than the sum of the fair market value of other property and money received.[3652] This type of distribution could also lead to gift tax consequences if one of the shareholders receives more stock than he would have been entitled to, based on his original ownership in the distributing corporation. If the proper donative intent exists, the shareholder may be deemed to have received a gift from the other shareholders. Thus, it is important to make sure that when a shareholder receives more than he was entitled to (based on his ownership), the transfer is properly documented so that it is clear whether there was any intent to gift and the transfer can be properly taxed.

[3648] Code § 118(a).

[3649] Code § 362(b). However, Reg. § 1.362-3 reduces the basis of property acquired in loss importation transaction.

[3650] Reg. § 1.312-10(a). However, a distributing corporation's unused NOL carryover will not be allocated to the controlled corporation. Rev. Rul. 77-133.

[3651] Reg. § 1.312-10(a).

[3652] Code § 356(a)(1).

The total basis of all shareholders' stock in the distributing and controlled corporation after the division will be the same as the total basis of all shareholders' stock in the distributing corporation before the division, increased by gain or other income each shareholder recognized and reduced by returns of capital each shareholder received or loss recognized.[3653] However, each individual shareholder's basis may be different before and after the division and must be recalculated after the division. The shareholder's basis is allocated among stock held after the distribution in based on each share's fair market value relative to the fair market value of all shares.[3654]

II.Q.7.g. Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill)

Generally, a sale or exchange of property, directly or indirectly,[3655] between related persons, will treat as ordinary income any gain recognized to the transferor if such property is depreciable or amortizable property in the hands of the transferee.[3656] Also beware similar issues relating to patents.[3657]

In this context, "related persons" means:[3658]

- a person and all entities which are controlled entities with respect to such person,
- a taxpayer and any trust in which such taxpayer (or his spouse) is a beneficiary, unless such beneficiary's interest in the trust is a remote contingent interest,[3659] and
- except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

As used above, "controlled entity" means, with respect to any person:[3660]

- a corporation more than 50% of the value of the outstanding stock of which is owned (directly or indirectly) by or for such person,[3661]
- a partnership more than 50% of the capital interest or profits interest in which is owned (directly or indirectly) by or for such person, and

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[3653] Code § 358(a)(1).
[3654] Reg. § 1.358-2(a)(2).
[3655] Boot received in a Code § 351 transaction triggered Code § 1239 in *Fish v. Commissioner*, T.C. Memo. 2013-270 (QSSS status terminated when the subsidiary gained another shareholder, causing the parent to be deemed to have transferred the former QSSS' assets to the subsidiary in a Code § 351 transaction).
[3656] Code § 1239(a).
[3657] See part II.G.17.c Patents, especially fn. 1129.
[3658] Code § 1239(b).
[3659] Within the meaning of Code § 318(a)(3)(B)(i).
[3660] Code § 1239(c)(1).
[3661] A requirement to elect an independent director does not cause the shareholder's voting power to drop below this threshold. *Fish v. Commissioner*, T.C. Memo. 2013-270.

- any entity which is a related person to such person under certain attribution rules.[3662]

Certain constructive ownership rules apply in determining ownership.[3663] These rules do not attribute ownership from beneficiaries to a trust.[3664] Thus, the sole owner of an S corporation can avoid application of Code § 1239 after his/her death if he/she bequeaths the stock so than no trust owns more than 50% of the value of the outstanding stock. Note that any ESBT would be considered unrelated to another ESBT; however, a QSST generally is deemed owned by its beneficiary, so presumably the beneficiary's deemed ownership would cause family attribution to apply.[3665]

Code § 1239 applies not only to depreciable property but also to "an amortizable section 197 intangible."[3666] A "section 197 intangible" includes goodwill,[3667] going concern value,[3668] workforce in place,[3669] any information base,[3670] know-how,[3671]

[3662] Code § 267(b)(3), (10), (11), or (12).

[3663] Code § 1239(c)(2), applying Code § 267(c) (other than Code § 267(c)(3)) for purposes of Code § 1239.

[3664] Code § 267(c) provides the following constructive ownership rules:

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

Although paragraph (3) is reproduced above, note that Code § 1239(c)(2) precludes its application to Code § 1239.

[3665] See part III.A.3.e QSSTs and ESBTs. Query if the S corporation is liquidated or substantially all of its assets are sold, in which case the gain would be taxed to the trust. For QSST taxation, see fns. 4478-4482.

[3666] Code § 197(f)(7); Reg. § 1.197-2(g)(8) (which is also consistent with the Joint Committee of Taxation report).

[3667] In this context, the value of a trade or business attributable to the expectancy of continued customer patronage, which expectancy may be due to the name or reputation of a trade or business or any other factor.

[3668] In this context, the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity, including the value attributable to the ability of a business to continue functioning or generating income without interruption notwithstanding a change in ownership, as well as the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

[3669] This includes the existence of a highly-skilled workforce, any existing employment contracts, or a relationship with employees or consultants.

customer-based intangibles,[3672] supplier-based intangibles,[3673] any license, permit, or other right granted by a governmental unit (even if the right is granted for an indefinite period or is reasonably expected to be renewed for an indefinite period), any covenant not to compete, any franchise, trademark, or trade name, and any right under a license, contract, or other arrangement providing for the use of property described above.[3674]

Does Code § 1239 apply to the sale of goodwill? This rule applies only if these assets are "amortizable." However, amortizable section 197 intangibles do not include any intangible created by the taxpayer (a self-created intangible).[3675] On the other hand, the exception for self-created intangibles does not apply to any intangible created in connection with the purchase of a business.[3676] Does the sale of a business transform self-created intangibles into amortizable section 197 intangibles at the time of the sale, so that Code § 1239 applies?[3677] The Tax Court has held that Code § 1239 applies to gain if the property is an amortizable section 197 intangible in the transferee's hands.[3678] (Also note that goodwill that is not being amortized and is held by a partnership would be eligible for a basis step if a Code § 754 election is in place.[3679])

However, Code § 1239 does not apply to depletable property.[3680]

[3670] This includes the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems, customer lists, subscription lists, insurance expirations, patient or client files, or lists of advertisers.

[3671] This includes any patent, copyright, formula, process, design, pattern, know-how, format, package design, internally developed or modified computer software, or interest in a film, sound recording, video tape, book, or other similar property.

[3672] This includes the existence of a customer base, a circulation base, an undeveloped market or market growth, insurance in force, the existence of a qualification to supply goods or services to a particular customer, a mortgage servicing contract, an investment management contract, or other relationship with customers involving the future provision of goods or services.

[3673] This includes the existence of a favorable relationship with persons providing distribution services (such as favorable shelf or display space at a retail outlet), the existence of a favorable credit rating, or the existence of favorable supply contracts.

[3674] Reg. § 1.197-2(b).

[3675] Reg. § 1.197-2(d)(2)(i). See also fn. 3030 regarding amortization of purchased goodwill.

[3676] Reg. § 1.197-2(d)(2)(iii)(B).

[3677] One reading is that Reg. § 1.197-2(g)(8) would have omitted amortizable if this result had been intended. A contrary argument is that Code § 1239 looks to the property in the hands of the transferee, and the self-created goodwill becomes purchased goodwill in the transferee's hands and is therefore amortizable. The contrary argument is more consistent with the purpose of Code § 1239, but Congress might have had other thoughts when it later enacted Code § 197.

[3678] *Fish v. Commissioner*, T.C. Memo. 2013-270.

[3679] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 4155. For an example of the effect of a Code § 754 election on goodwill that is being amortized, see fn. 4310 in part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.

[3680] Letter Ruling 8139052, reasoning:

> Depletion is based upon the concept of the exhaustion of a natural resource, whereas depreciation is based upon the concept of exhaustion, wear and tear, and also obsolescence of property, not otherwise a natural resource, used in a trade or business or held for the production of income. Depletion and depreciation are made applicable to different types of assets and the method by which a depletion allowance is spread over

Furthermore, when a husband and wife who own all of a partnership sell the partnership to a corporation they control, Rev. Rul. 72-172 asserted that Code § 1239 applies to the distribution of the partnership's depreciable property.[3681]

Although sales of partnership interests holding depreciable property trigger ordinary income taxation, that provision does so only to the extent of accumulated depreciation,[3682] whereas Code § 1239 applies with respect to the entire gain. Thus, placing depreciable property into a limited partnership,[3683] before liquidating the corporation or otherwise distributing the partnership interest, may avoid the full brunt of Code § 1239, subject to cautions about doing so too close to the liquidation.[3684]

The partnership provision most closely resembling Code § 1239 is part II.Q.8.c Related Party Sales of Non-Capital Assets By or To Partnerships.

the taxable years is different from that applied in the case of depreciation. 4 J. Mertens, *Law of Federal Income Taxation* 24.02 (1980 rev.).

[3681] The ruling stated:

In the instant circumstances, the transaction had the effect of transferring to the corporation, the partnership assets attributable to the partners' interests in the partnership. See *United States v. R. T. and Gertrude Woolsey et al.*, 326 F.2d 287 (1963); *Edwin E. McCauslen v. Commissioner*, 45 T.C. 588 (1966); and Rev. Rul. 67-65, C.B. 1967-1, 168. Compare *Kimbell-Diamond Milling Company*, 14 T.C. 74 (1950), *affirmed per curiam* 187 F.2d 718 (1951) *certiorari denied*, 342 U.S. 827 (1951).

[3682] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

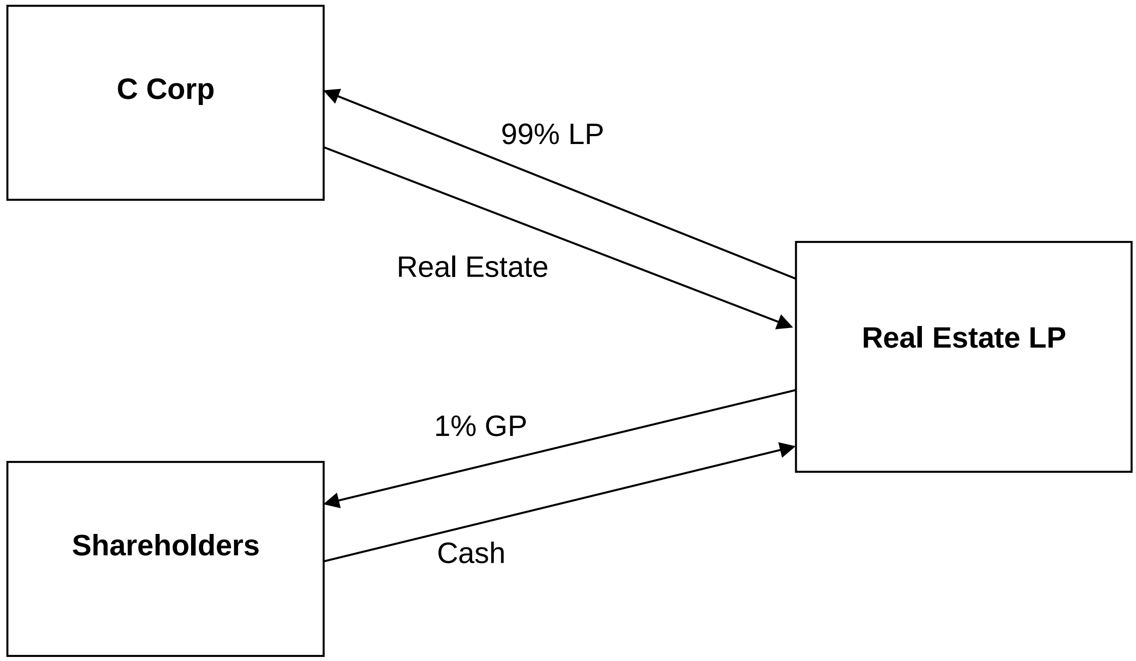
[3683] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership.

[3684] See part II.Q.7.h.iii.(a) Taxable Gain to Corporation When It Distributes Property to Shareholders, especially fn. 3694.

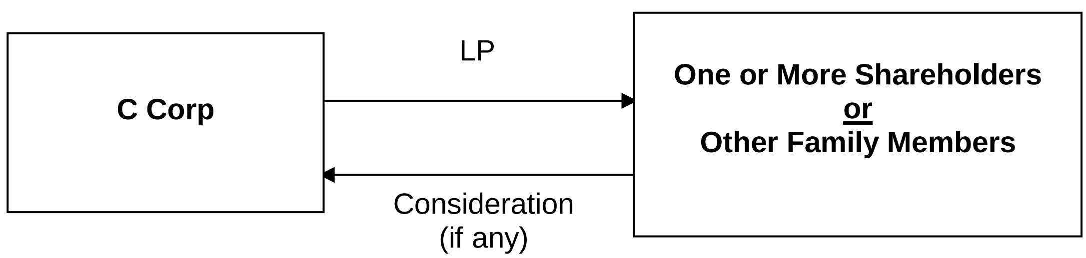
II.Q.7.h. Distributing Assets; Drop-Down into Partnership

II.Q.7.h.i. Structure

<u>Step 1</u>



<u>Step 2</u>



Step 1

General rule under Code § 721 is no gain or loss to contributing partner or receiving partnership when a partnership interest is issued in exchange for cash or other property.

Although real estate is illustrated here, this transaction could involve a line of business or marketable securities. However, if it involves marketable securities and the other partners contribute more than a de minimis amount, then one needs to consider additional issues to avoid gain recognition. Code § 721(b).

Step 2

The corporation recognizes gain as if it had sold the property that was distributed. Code § 311. Given that what is transferred is an interest as a limited partner, valuation discounts would reduce the transfer's value and therefore the gain that it triggers.

Shareholders recognize dividend income to the extent of the corporation's earnings and profits (E&P) if it is a distribution (or a state law redemption that does not qualify as an income tax redemption under Code § 302). The balance of the distribution simply reduces the stock's basis and is capital gain after that.

Step 2 could also be done as a taxable sale.

Step 2 might be done in stages to minimize step transaction attacks, including those mentioned in footnote 3694.

II.Q.7.h.ii. Taxation of Shareholders When Corporation Distributes Cash or Other Property

For taxation of distributions by S corporations, see part II.Q.7.b.iv.(a) S Corporation Distributions of Life Insurance Proceeds - Warning for Former C Corporations.

Distributions to shareholders of a C corporation are taxed as dividends to the extent of earnings and profits (E&P), then as return of basis, and then as gain on the sale of stock.[3685] The distributions are applied to each block of share proportionately; if a block of stock has basis lower than other blocks of stock and runs out of basis, then distributions attributable to that block trigger gain, even if the shareholder has plenty of basis available in other blocks of stock that would otherwise have been available to absorb the distribution tax-free.[3686]

Redemptions reduce E&P.[3687]

II.Q.7.h.iii. Taxation of Corporation When It Distributes Property to Shareholders

The rules below apply to S corporations as well as C corporations.[3688]

II.Q.7.h.iii.(a). Taxable Gain to Corporation When It Distributes Property to Shareholders Other Than in Liquidation of the Corporation

Code § 311(b)(1) taxes a corporation when it distributes appreciated assets to its shareholders in a distribution described in Code §§ 301-307 (note that corporate liquidations are described in Code §§ 331-346).[3689] The corporation is deemed to have

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[3685] Code § 301(c).
[3686] *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971), *rev'g* 303 F.Supp. 1 (E.D. Va. 1969).
[3687] Code § 312(n)(7), superseding the limitations of Reg. § 1.312-5. Rev. Rul. 79-376, which had governed, was obsoleted by Rev. Rul. 95-71, presumably in response to this change; see T.M. 767 Redemptions IV.A.2.c. The Senate Report to P.L. 98-369 that enacted the current statutory language provides:

> In the case of a distribution by a corporation in redemption of its own stock, earnings and profits are to be reduced in proportion to the amount of the corporation's outstanding stock that is redeemed. However, the Senate does not intend that earnings and profits be reduced by more than the amount of the redemption.

[3688] Code § 1371(a).
[3689] For the latter, see part II.Q.7.a.vii Corporate Liquidation.

sold the assets to the distributee.[3690] If the corporation is a C corporation, then the deemed sale is taxed at ordinary income rates, just like any other corporation gain or loss would be. If the corporation is an S corporation, then it is taxed to the shareholders on their K-1s,[3691] subject of course to any applicable built-in gain tax under Code § 1374.[3692] The entire gain (not just depreciation recapture) from the deemed sale of any depreciable or amortizable property may be taxed as ordinary income (which, in addition to having consequences to S corporation owners, can be an issue to C corporations that have capital losses that could otherwise be offset).[3693]

If the distribution is of all of the corporation's interest in the property, the IRS will attempt to disregard any valuation discounts that would not have applied if the corporation had distributed all of the corporation's interest in the property to one shareholder.[3694] Furthermore, if the IRS determines that a corporation's receipt of a partnership interest does not constitute adequate and full consideration for the property it transferred to the partnership, the IRS will argue that a dividend was made to the other partners and that the corporation recognized gain on the property deemed distributed to the other partners.[3695] However, in what might be the same case, the IRS lost that argument, when the taxpayer convinced the court of the taxpayer's business purpose, in *Cox Enterprises, Inc. & Subsidiaries v. Commissioner*.[3696]

II.Q.7.h.iii.(b). Nondeductible Loss to Corporation When It Distributes Property to Shareholders

Under Code § 311(a), a corporation cannot deduct a loss when distributing property, the value of which is less than its basis.

CCA 201421015 concluded:[3697]

[3690] Although a bargain sale of property to a shareholder is a deemed sale for full fair market value with the bargain element constituting a divided, a corporation is not required to make a profit when it provides services to a shareholder – reimbursing the corporation for the costs it incurred is sufficient to avoid any sale or dividend treatment. *Welle v. Commissioner*, 140 T.C. 420 (2013) (services were incidental; business generally was conducted to make a profit in serving the general public).

[3691] Code § 1366.

[3692] See part II.P.3.c.ii Built-in Gain Tax.

[3693] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).

[3694] TAM 200443032; *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), *aff'd* 162 F.3d 1236 (9th Cir. 1999). See also *Robert E. Smith, III v. Commissioner*, T.C. Memo. 2017-218, in which an S corporation was formed and liquidated in the same year and claimed a loss on the deemed sale of the limited partnership interest it received when it also formed the partnership in the same year; the economic substance doctrine disallowed the loss and imposed penalties (see part II.G.16 Economic Substance Penalty and Doctrines, but the tax year was before Code § 7701(o) was enacted, so penalties applied even without that statute).

[3695] TAM 200239001 (property deemed distributed is based on the value of the property contributed to the partnership rather than the value of the partnership interests received by the partner).

[3696] T.C. Memo. 2009-134.

[3697] This disallowed loss nevertheless reduces the S stock's basis. See fn. 819.

Disallowed § 311(a) losses will be treated as non-deductible, non-capital expenses pursuant to § 1367(a)(2)(D). Thus, a § 311(a) loss will reduce shareholders' bases in S corporation stock, and the S corporation must reduce its accumulated adjustments account.

II.Q.7.h.iv. Taxpayer Win in *Cox Enterprises* When IRS Asserted That Contributing Property to Partnership Constituted Distribution to Shareholders (2009)

The *Cox* court held that a corporation's contribution of a television station to a partnership did not constitute a dividend even though the partnership interest it received was originally worth $60.5 million less than the assets it contributed. The partners in the partnership were the remaindermen of certain trusts. These trusts, indirectly and collectively, owned 98% of the corporation's stock.

The corporation contributed assets worth $300 million, became the managing general partner, and received a majority partnership interest, which entitled it to 55% of partnership distributable profits and liquidation proceeds up to specified base amounts and 75% of distributable profits and liquidation proceeds in excess of those base amounts. The other partners contributed assets worth $62 million and received the balance of the rights to distributions. Thus, the corporation contributed nearly 83% ($300 million divided by $362 million) of the assets and received the right to profits of 55%-75%.

The IRS argued that the transfer to the partnership should be deemed an indirect distribution to the remaindermen of the trusts and therefore a distribution to the trusts. Judge Halpern rejected the IRS' contention. First, he held that the corporation's transfer to the partnership "was not intended to provide a gratuitous economic benefit to the other partners…." Second, he held that, even if the corporation had made such a gratuitous transfer, the transfer did not benefit the shareholder trusts.

In *Cox*, several factors demonstrated that the corporation's directors did not intend a gratuitous transfer:

1. The partnership's formation had nontax business reasons. As recommended by independent consultants, the corporation tried to sell these operating assets but was unable to do so. The partnership's formation allowed the corporation to retain, for use in other areas, the working capital it had previously needed for the television station.

2. The corporation's board's executive committee adopted a resolution that the other partners be required to make cash contributions to the partnership "in an amount corresponding to the fair market value of the partnership interests acquired by" those other partners. Furthermore, the other partners' acquisition of partnership interests was to "be on terms and conditions no less favorable to" the corporation "than the terms and conditions that would apply in a similar transaction with persons who are not affiliated with" the corporation.

3. The corporation retained an outside accounting firm "to render an opinion of appropriate marketability and minority interest discounts applicable to a minority interest" in the partnership as of the date of formation. The partners made

contributions based on the appraised amount. Three years later, the corporation's management discovered errors in computing the other partners' interests in the partnership and obtained a new appraisal. The other partners made additional contributions to bring their contributions up to the appraised value.

4. The court relied on *United States v. Byrum* [3698] to find that the controlling shareholders were subject to fiduciary duties to the minority shareholders. In the *Cox* case, two percent of the stock was owned by people who were not members of the controlling family; these minority shareholders were principally employees of the corporation. Judge Halpern pointed out that the minority shareholders did not own interests in the other partners and "would not be made financially whole for the likely shortfall in income and liquidation (or sale) proceeds" if the corporation's contribution to the partnership constituted a transfer to the other partners.

The court also found that any gratuitous transfer to the other partners would not have benefitted the shareholder trusts. The remaindermen of the trusts held significant interests in the partners, so a transfer to the other partners would have accelerated the remaindermen's interests in violation of the trust agreements. Because the trusts were the controlling shareholders (and the court assumed for the sake of argument that the trustees also controlled the actions of the other board members), the trustees would have violated their fiduciary duties by accelerating the interests of the remaindermen. Thus, a gratuitous transfer to the other partners would have been detrimental to the shareholder trusts as entities and would have violated the trustees' fiduciary duties.

The court concluded that any gratuitous transfer of an interest from the corporation to the other partners did not constitute a distribution to the shareholder trusts subject to Code § 311.[3699]

Other issues relating to these parties were still before the court when Judge Halpern wrote this opinion, some of which involved the trusts themselves. Subject to any light shed by those cases, one may draw some planning tips from this case:

1. As usual, documenting a transaction very well is always advisable, particularly documentation demonstrating an intent to deal at arms-length.

2. Although the Tax Court seems to place little weight on the *Byrum* case in family limited partnership cases under Code § 2036, having nonfamily member employees hold 2% of the stock might do the trick.

3. Practitioners often wonder whether parties must contribute assets with fair market value to obtain capital accounts proportionate to their interests in profits when all partners are making their initial contributions on formation of the partnership. In this case, the majority partner (the corporation) contributed assets with value significantly in excess of the value of its partnership interest. However, the minority partners contributed assets equal to the value of their interests in the partnership. Thus, the majority partners received capital accounts that were higher relative to their interests

[3698] 408 U.S. 135, 137-138 (1972).

[3699] For information on Code § 311, see part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

> in profits compared with the minority partners' capital accounts relative to their respective interests in profits. Judge Halpern did not seem to recognize this issue; if he did, he did not mention it in analyzing the dividend issue.[3700] It will be interesting to see whether the companion cases consider this issue to be of consequence.

II.Q.7.h.v. Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014)

In *Bross Trucking, Inc. v. Commissioner*,[3701] the IRS asserted that the existing corporation (Bross Trucking) distributed appreciated intangible assets to its sole shareholder, who then made a gift of the intangibles to his three sons, who organized their own[3702] corporation (LWK Trucking). The alleged value of the intangible assets would have required both filing a gift tax return and paying gift tax.

The court held:

> there are two regimes of goodwill: (1) personal goodwill developed and owned by shareholders; and (2) corporate goodwill developed and owned by the company. Bross Trucking's goodwill was primarily owned by Mr. Bross personally, and the company could not transfer any corporate goodwill to Mr. Bross in tax year 2004.

[3700] If this case is the same as TAM 200239001, then the IRS must have pressed this issue, because the TAM specifically addressed it. The judge did point out that the IRS argued, in the alternative, that the dividend was of the TV station or of a partnership interest. However, he still did not seem to notice the disproportionality on which the TAM focused.

[3701] T.C. Memo. 2014-107.

[3702] The sons were not actually the owners – it was their Roth IRAs, as the court explained:

> LWK Trucking was organized on October 1, 2003. Its stock was divided into two classes when it was organized: class A voting stock and class B nonvoting stock. Class A stock represented a 98.2% interest in LWK Trucking and class B stock represented the remaining 1.8%. In December of 2003 each of the three Bross sons established a self-directed Roth IRA. Later that month, each of the Bross sons directed his respective Roth IRA to acquire 2,000 shares of class A shares in LWK Trucking. Together, the 6,000 shares acquired by the three Roth IRAs represented all of the class A shares in LWK Trucking, giving the three sons a combined 98.2% interest in LWK Trucking.[8] The remaining class B shares were acquired by an unrelated third party.

Footnote 8 commented:

> As stated infra note 19, a discussion on the merits of this structure is not relevant to the issues in these cases and the Court does not address the validity of this transaction.

Footnote 19 stated:

> Thus, Mr. Bross could not transfer Bross Trucking assets to his three sons, and it follows that the three Bross sons could not transfer Bross Trucking assets to each of their respective Roth IRAs. Accordingly, IRS Notice 2004-8, 2004-1, C.B. 333, is outside the scope of these cases because Bross Trucking and LWK Trucking never shared any assets. Further, a discussion on the structure of the Bross sons' ownership of LWK Trucking is outside the scope of this opinion.

My understanding is that the IRS initiated this audit to explore Roth IRA issues, then focused its attack on the corporate issues, trying to get more money from the taxpayers. For more on Roth IRAs owning businesses, see part II.G.21 IRA as Business Owner.

Although a lack of non-compete agreements generally facilitates the lack of corporate goodwill,[3703] in this case regulatory action jeopardized Bross Trucking's business and

[3703] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees? Focusing on the authority cited in fn. 3048, the *Bross Trucking* court held that any goodwill associated with Bross Trucking was personally owned by its shareholder:

> The remaining attributes assigned to Bross Trucking's goodwill all stem from Mr. Bross's personal relationships. Bross Trucking's established revenue stream, its developed customer base, and the transparency of the continuing operations were all spawned from Mr. Bross's work in the road construction industry.
>
> Any established revenue stream, developed customer base, or transparency of continuing operations was a direct result of Mr. Bross's personal efforts and relationships. Like the shareholder in Martin Ice Cream Co., Mr. Bross developed the crucial relationships with the businesses' customers. Bross Trucking's customers chose to patronize the company solely because of the relationships that Mr. Bross personally forged. Mr. Bross had close, personal relationships with the owners of Bross Trucking's primary customers. For example, Mark Twain Redi-Mix, a substantial Bross Trucking customer, was owned by Mr. Bross's wife and two sons. As with the taxpayer in *Norwalk v. Commissioner*, T.C. Memo. 1998-279, it is safe to assume that Bross Trucking's customers sought Mr. Bross' personal ability and reputation when hiring Bross Trucking because he was a successful construction businessman who has been in the road construction industry since the 1960s.
>
> Bross Trucking may have had a developed revenue stream, but only as a result of Mr. Bross' having personal relationships with the customers. It follows that Bross Trucking's developed customer base was also a product of Mr. Bross' relationships. Mr. Bross was the primary impetus behind the Bross Family construction businesses, and the transparency of the continuing operations among the entities was certainly his personal handiwork. [footnote omitted] His experience and relationships with other businesses were valuable assets, but assets that he owned personally.
>
> A company does not have any corporate goodwill when all of the goodwill is attributable solely to the personal ability of an employee. See *MacDonald v. Commissioner*, 3 T.C. 720, 727 (1944); *Norwalk v. Commissioner*, T.C. Memo. 1998-279. Unlike the taxpayer's products in *Solomon v. Commissioner*, T.C. Memo. 2008-102, Bross Trucking's products did not contribute to developing the goodwill. This is demonstrated in part by the services performed by Bross Trucking. Bross Trucking's business model involved hiring independent contractors to haul equipment and supplies around the State. There were very few obstacles to obtaining authority and directly hiring the independent contractors who performed the actual work for Bross Trucking. The State of Missouri's deregulation of the trucking industry allows new entrants to easily begin trucking operations. In other words, it was not Bross Trucking's product which enticed customers to use its services because the services were not unique. *Cf. Schilbach v. Commissioner*, T.C. Memo. 1991-556 (holding that a single-shareholder-owned professional corporation possessed all of the goodwill because the corporation's services were unique and was not based on the ability of the shareholder). The expectation of continuing patronage must have been a result of the unique relationships between Mr. Bross and the customers.
>
> ….
>
> Mr. Bross did not transfer any goodwill to Bross Trucking through an employment contract or a noncompete agreement. A key employee [footnote omitted] who develops relationships for his or her employer may transfer goodwill to the employer through employment contracts or noncompete agreements. See *Martin Ice Cream Co. v. Commissioner*, 110 T.C. at 207. The transfer is evidenced by the employee's covenant to not use his or her goodwill to compete against the employer. *O'Rear v. Commissioner*, 28 B.T.A. 698, 700 (1933) ([I]t is at least doubtful whether a professional man can sell or

necessitated forming a new company.[3704] Therefore, the court held that "the sole attribute of goodwill displayed by Bross Trucking was a workforce in place, and it is

dispose of any good will which may attach to his practice except perhaps by contracting to refrain from practicing.), *aff'd*, 80 F.2d 473 (6th Cir. 1935). In other words, an employee transfers the benefit of his or her relationships to an employer when the employee cannot benefit from the relationships without the employer.

An employer has not received personal goodwill from an employee where an employer does not have a right, by contract or otherwise, to the future services of the employee. See *MacDonald v. Commissioner*, 3 T.C. at 727-728. Mr. Bross did not have an employment contract with Bross Trucking and was under no obligation to continue working for Bross Trucking. A contractual duty to continue to use his or her assets for the benefit of the company may show that an employee transferred personal goodwill to an employer for the length of the obligation. Mr. Bross, however, was under no such obligation: he was free to leave the company and take his personal assets with him. Similarly, the lack of an employment contract shows that there was not an initial obligation for Mr. Bross to transfer any of his personal assets to Bross Trucking. Bross Trucking did not take an ownership interest in Mr. Bross' goodwill from the beginning because Mr. Bross never agreed to transfer those rights. Thus, the lack of an employment contract between Mr. Bross and Bross Trucking shows that Bross Trucking did not expect to--and did not--receive personal goodwill from Mr. Bross. Accordingly, Mr. Bross' personal goodwill remained a personal asset separate from Bross Trucking's assets.

An employee may transfer personal goodwill to an employer through a covenant not to compete. See *Martin Ice Cream Co. v. Commissioner*, 110 T.C. at 207-208; *H & M Inc. v. Commissioner*, T.C. Memo. 2012-290. In those cases the Court held an employee did not transfer personal goodwill to the employer because he or she did not sign a noncompete agreement. Similar to those taxpayers, Mr. Bross never transferred any personal goodwill to Bross Trucking by signing a noncompete agreement. Much in the same way that Bross Trucking did not have any contractual expectation of continued services from Mr. Bross while he was an employee, Bross Trucking could also not expect to benefit from Mr. Bross's personal goodwill after he left the business. Mr. Bross' freedom to use his personal goodwill in direct competition with Bross Trucking if he stopped working for the company shows that he did not transfer it to Bross Trucking.

[3704] The *Bross Trucking* court stated:

Bross Trucking might have had elements of corporate goodwill at some point but had lost most of it by the time of the alleged transfer. Specifically, through various regulatory infractions Bross Trucking lost any corporate goodwill because of an impending suspension and the negative attention brought by the Bross Trucking name. During the late 1990s and early 2000s Bross Trucking was investigated extensively by the DOT and the MCRS. As a result of the investigations, Bross Trucking faced a possible suspension of operations and several fines because the authorities gave Bross Trucking unsatisfactory safety ratings. Further, the various regulatory authorities were hounding Bross Trucking to the point that LWK Trucking wanted to immediately remove the Bross name from leased trucks to avoid their being spotted and stopped.

The impending suspension would cause customers to reevaluate whether to trust Bross Trucking and continue to do business with it. Indeed, Mr. Bross expressed his concern to his attorney that Bross Trucking might not be able to perform necessary functions as a result of the suspension. Mr. Bross's solution was to find or create another business to take over the trucking needs for the Bross family businesses. This is the antithesis of goodwill: Bross Trucking could not expect continued patronage because its customers did not trust it and did not want to continue doing business with it.

Further, the lack of corporate goodwill is demonstrated by the necessity to separate LWK Trucking from Bross Trucking by hiding the Bross name on leased trucks. Trade names therefore the only attribute that the corporation could have distributed to Mr. Bross." The court rejected the IRS' assertion that Bross Trucking's intangible workforce assets were transferred to LWK Trucking[3705] or that any other transfers occurred.[3706]

> and trademarks are the embodiment of goodwill. *Canterbury v. Commissioner*, 99 T.C. 223, 252 (1992). LWK Trucking specifically chose to quickly remove the Bross Trucking name from any leased equipment to avoid confusion between the two companies. This shows that any transferred corporate goodwill was not valuable and may have actually been detrimental to LWK Trucking. In other words, LWK Trucking was trying to hide any relationship with Bross Trucking because association with the targeted company was seen in a negative light. A new company trying to use the transferred goodwill of another company would likely try to associate with the recognized company, not hide the company logo.
>
> Mr. Bross credibly testified that Bross Trucking had relationships with several national suppliers for fuel and parts, but no evidence was submitted showing that LWK Trucking benefited from any transferred supplier relationships. Further, it is unclear whether Mr. Bross or Bross Trucking cultivated the supplier relationships.
>
> ….
>
> Bross Trucking's customers had a choice of trucking options and chose to switch from Bross Trucking to LWK Trucking. Respondent's contention that Bross Trucking transferred a developed customer base and an established revenue stream is misleading because it suggests that the transfer was organized between Bross Trucking and LWK Trucking. It appears, however, that Bross Trucking's customers were interested in changing trucking providers because of the impending suspension, showing that the act was not a transfer of intangibles at the service provider level but a business choice made at the customer level. For example, forming LWK Trucking gave Mark Twain Redi-Mix, which shared ownership with LWK Trucking and one of Bross Trucking's primary customers, the option to use a trucking company with an untarnished reputation and clean service record. Thus, the facts support a finding that Bross Trucking did not transfer its customers but that the customers chose to use a new company because of Bross Trucking's troubled past.

[3705] The *Bross Trucking* court stated:

> As discussed above, the only aspect of corporate goodwill that Bross Trucking displayed was a workforce in place, but Bross Trucking did not transfer an established workforce in place to Mr. Bross. Respondent repeatedly contends that most of the Bross Trucking employees became LWK Trucking employees. The evidence, however, shows that only about 50% of LWK Trucking's employees formerly worked at Bross Trucking. The Court is unconvinced that most of a workforce in place was transferred when only 50% of the current employees were previously employees by the alleged transferor. Instead it appears that LWK Trucking assembled a workforce independent of Bross Trucking. This is demonstrated by the new key employees and services offered by LWK Trucking. Mr. Bross's sons managed LWK Trucking and also engaged in services different from those performed at Bross Trucking. For instance, in 2004 LWK Trucking started One Star Midwest, which sold GPS services, and LWK Trucking later started performing truck maintenance for third parties. Bross Trucking did not perform these services and could not have provided employees to start the separate service lines . LWK Trucking may have hired former Bross Trucking employees, but there is no evidence that these employees were transferred to LWK Trucking rather than hired away on their own merit. It is also unclear whether any of the alleged transferred employees that moved to LWK Trucking were independent contract drivers. These drivers were not obligated to work solely for Bross Trucking and in fact were almost certainly expected to have contracts with companies outside of Bross Trucking. Independent contractors' choosing to accept work from a different business is not a transfer of workers.

II.Q.7.h.vi. IRS' Conservative Roadmap: Letter Ruling 200934013

This ruling approved a corporation's contribution of marketable securities to a partnership in exchange for a partnership interest.[3707] Unlike *Cox Enterprises*, no value was shifted, although future appreciation would be effectively shifted out. This ruling followed the IRS' position that one cannot create discounts by placing assets in a partnership and then distributing all of the corporation's partnership interests to the shareholders. A family-owned S corporation ("Corp") owned 100% of the membership interests in LLC, which was disregarded as an entity separate from Corp for federal tax purposes. LLC's operations consist solely of investing in a diversified portfolio of passive investment assets, including hedge funds, mutual funds, and private equity funds. LLC has no outstanding liabilities. Shareholder A and Corp reached an agreement pursuant to which Shareholder A was admitted as a new member of LLC. Specifically, Shareholder A contributed cash to LLC in exchange for a newly issued, non-voting, preferred interest in LLC. The terms and pricing of the preferred interest were based on an independent appraiser's determination of market rate terms for similar equity investments.

For what have been represented to be valid business purposes, the following steps were proposed: (i) Corp will distribute some of its membership interests in LLC pro-rata to its stockholders (the "Distributed LLC Interests") and (ii) LLC's operating agreement will be amended to provide Corp with a share of LLC's profits disproportionate to capital in exchange for Corp providing future management services to LLC with respect to LLC's ongoing activities. Corp made the following representations with respect to this ruling request:

(a) The principal purpose of the Shareholder A contribution to LLC in exchange for a preferred membership interest was to allow Shareholder A to invest his excess cash directly in a diversified portfolio of investment assets managed by a team of

---

[3706] The *Bross Trucking* court stated:

> In addition, Bross Trucking did not distribute any cash assets and retained all the necessary licenses and insurance to continue business. Further, Mr. Bross remained associated with Bross Trucking and was not involved in operating or owning LWK Trucking. He was free to compete against LWK Trucking and use every cultivated relationship in order to do so. In other words, the fact that Bross Trucking could have resumed its hauling business supports the view that it retained any corporate intangibles. Accordingly, there was no transfer of intangible assets because Bross Trucking's customers chose to use a different company and Bross Trucking remained a going concern.
>
> LWK Trucking did not benefit from any of Bross Trucking's assets or relationships. LWK Trucking was independently licensed and developed a wholly new trucking company. LWK Trucking did not take a transferred basis in any assets such as property or purchased authority. There is no indication that LWK Trucking used any relationship that Mr. Bross personally forged. The Bross sons were in a similarly close capacity to Bross Trucking's customers to develop relationships apart from Mr. Bross. Cultivating and profiting from independently created relationships are not, however, the same as receiving transferred goodwill. It is true that LWK Trucking's and Bross Trucking's customers were similar, but it does not mean that Bross Trucking transferred goodwill; instead the record shows that LWK Trucking's employees created their own goodwill.

[3707] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

experienced professionals, in a manner that allows Shareholder A to enjoy a high rate of preferred return and a priority on distributions. The principal purposes of the Proposed Transaction are to: (1) increase flexibility with respect to the allocation of profits, losses, and cash distributions associated with the LLC asset pool through issuance of various classes of interests in LLC, (2) provide increased liability protection to the LLC asset pool from the ongoing business operations of Corp, (3) facilitate estate planning and charitable objectives of Corp shareholders with respect to their investment in LLC, and (4) facilitate continued co-investment amongst family members outside of Corp.

b) Shareholder A cannot independently cause Corp to distribute its interest in LLC. Additionally, Shareholder A's contribution to LLC was not dependent upon the consummation of the Proposed Transaction and the Corp stockholders had not ratified the Proposed Transaction as of the date of the ruling request.

(c) Following the Proposed Transaction, it is intended that LLC will continue to carry on the operations that were carried on by LLC before the Proposed Transaction.

(d) At the time of the Proposed Transaction, there will be no amounts payable or receivable between LLC and Corp or LLC and Shareholder A.

(e) For purposes of measuring the Code § 311(b) gain to Corp on the Proposed Transaction, if any, the Distributed LLC interests will be valued as a percentage of the value of the assets held by LLC.[3708]

(f) To the best of Corp's knowledge and belief, there is no plan or intention for any transferor to transfer assets to LLC other than cash and/or a diversified portfolio of stocks and securities.[3709]

(g) The assets of LLC immediately prior to the admission of Shareholder A consisted of a diversified portfolio of stocks and securities.[3710]

(h) There is no intention following the Proposed Transaction to dispose of any material assets of LLC (other than dispositions in the ordinary course of business).

(i) To the best of Corp's knowledge and belief, the Corp stockholders have no plan or intention to dispose of any portion of the distributed LLC interests except for the potential transfer to irrevocable trusts which will be taxed as grantor trusts to the respective grantor.

(j) LLC has not, and will not, elect to be classified as a corporation.

[3708] Citing *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), aff'd 162 F.3d 1236 (9th Cir. 1999). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[3709] For this representation, a portfolio of stocks and securities is diversified under Reg. § 1.351-1(c)(6)(i) if it satisfies the 25% and 50% tests of Code § 368(a)(2)(F)(ii), applying the relevant provisions of Code § 368(a)(2)(F)(ii), except that in applying Code § 368(a)(2)(F)(iv), government securities are included in determining total assets unless government securities are acquired to satisfy the requirements of Code § 368(a)(2)(F)(ii).

[3710] As defined under Reg. § 1.351-1(c)(6)(i).

(k) No property, other than cash, has ever been contributed by Corp to LLC, and LLC has never made a distribution of property to Corp.

The IRS ruled:[3711]

- The admission of Shareholder A to LLC caused LLC to convert to a partnership for U.S. federal income tax purposes. Corp, as the sole owner of LLC prior to the admission of Shareholder A, is deemed to contribute the existing assets of LLC to the newly-formed LLC partnership in exchange for a membership interest in LLC.[3712] This deemed transaction is treated as a nontaxable contribution of property to LLC by Corp.[3713] Additionally, because the assets of LLC are represented to be a diversified portfolio of assets, Code § 721(b) does not cause taxation with respect to Shareholder A's contribution of cash and to Corp's deemed contribution of property to LLC.

- Corp's adjusted basis in the Distributed LLC Interests is equal to the product of (A) the amount of Corp's adjusted tax basis in its entire membership interest in LLC and (B) a fraction, the numerator of which is the fair market value of the Distributed LLC Interests on the date of the distribution, and the denominator of which is the fair market value of Corp's entire membership interest in LLC as of that date.

- Corp will recognize gain, if any, on the pro-rata distribution of the Distributed LLC Interests to its stockholders to the extent the fair market value of the Distributed LLC Interests exceeds their adjusted tax basis in the hands of Corp on the date of the distribution.[3714]

II.Q.7.h.vii. What We Learned

The *Cox* case represented a significant shift in value from the corporation to the shareholders' family members. The corporation's contribution was based on a full pro-rata share of its interest in the partnership, but the family members' contribution was based on the discounted value of its interest in the partnership. The IRS argued that the value shift was a disguised dividend to the shareholders, who wanted to benefit their family members, but the taxpayer convinced the court of the transaction's strong business purpose. The IRS would probably attack similar transactions, so tax advisors should go to extra lengths to document a strong business purpose and warn clients of the risks.

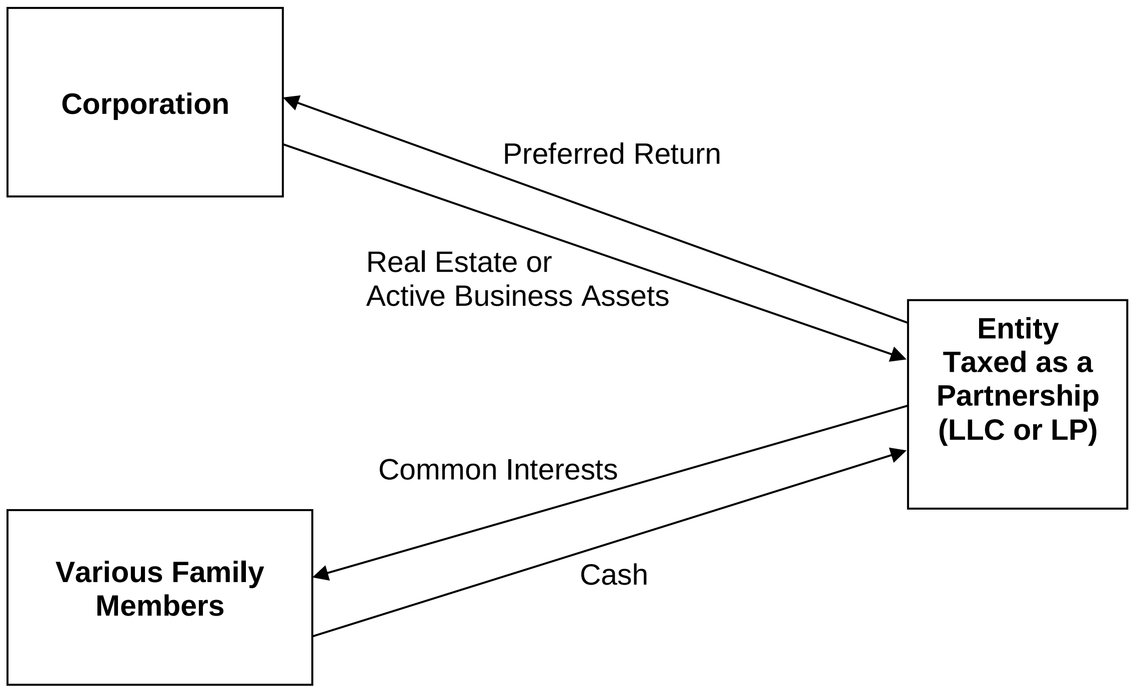
The Letter Ruling shows what the IRS is willing to approve. The IRS continues to want to treat a distribution of a recently formed partnership to its shareholders as if the corporation owned and was distributing the partnership's underlying property. Corporations might want to consider waiting for a while after forming the partnership, then they might consider selling the partnership interests to shareholders at various

[3711] The IRS also ruled regarding Code § 2701 – that a preferred payment right, the rate at which changes over time, was not a qualified payment right except to the extent that a qualified payment right election is made. Reg. § 25.2701-2(b)(6).
[3712] Rev. Rul. 99-5.
[3713] Code § 721(a).
[3714] Code § 311(b). See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

times in separate minority blocks of the partnership, but again they should be prepared for an IRS attack.

II.Q.7.h.viii. Value Freeze as Conservative Alternative

Consider the following structure:



The corporation contributes the real estate or other business assets to a partnership,[3715] taking in return a large preferred partnership interest, with the other partners receiving a common interest in the partnership (an interest in whatever is left whenever the preferred payment obligations have been satisfied). Thus, any total return (appreciation plus cash flow) that exceeds the preferred interest will be outside of the corporation. Moving to this structure is diagrammed in part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure, culminating in the above structure, which is shown at part II.E.7.c.ii Moving New LLC into Preferred Structure.

The preferred return is to be satisfied out of the partnership's net cash flow and payable at the AFR or another appropriate fixed rate. The preferred return should be cumulative and payable on a periodic basis (at least annually) to constitute a qualified payment

[3715] If the owners perceive difficulty in transferring all of its assets, the owners can form an identical corporation, contribute all of the stock in the old corporation to the new corporation, then merge or convert the old corporation into an LLC owned solely by the new corporation. This first step should constitute a nontaxable F reorganization; see part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. The LLC can be the main organization in which the owners are separately admitted as members, but in most cases the corporation would just contribute its interest as the LLC's sole member to a limited partnership. See part II.E Recommended Structure for Entities.

under Code § 2701.[3716] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion. Also, be sure that the preferred partner has more economic risk than that undertaken by a lender.[3717]

If the corporation is receiving a return whose present value is equal to the value of the contributed goodwill (if any), it should not be treated as having distributed such goodwill to its shareholders. Using a preferred partnership adds safety, in that a corporation can easily escape the disguised sale rules. If the preferred profits distribution is payable at no more than 150% of the AFR and is limited to the extent of operating cash flow, each of two regulations[3718] separately creates a presumption that a sale has not occurred.[3719]

[3716] Reg. § 25.2701-2(b)(6)(i)(B).

[3717] *Chemtech Royalty Associates, L.P. v. U.S.*, 114 A.F.T.R.2d 2014-5940 (5th Cir 2014) (1% partnership interest by provider of capital was not sufficient to make provider a partner where partner's preferred return was virtually certain to be paid and 99% partner indemnified provider for any losses; partnership lacked economic substance). Dow provided the partnership with a stable revenue stream and indemnified the banks that provided the capital against any liabilities the partnership incurred:

> First, the transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment regardless of the success of the [Chemtech] venture, just as in the transaction in *Castle Harbour II*….
>
> Second, Dow agreed to bear all of the non-insignificant risks arising out of the Chemtech transactions, which further shows that the parties did not intend to share any possible losses….
>
> Third, just as in *Castle Harbour II*, the foreign banks did not meaningfully share in any potential upside.

The court pointed out:

> As a practical matter, payment of less than the full priority return was highly unlikely because (i) the minimum royalty payments from Dow sufficiently funded the priority return, and (ii) Chemtech could not incur more than $1 million in annual expenses without the banks' approval.

Also, regarding penalties, the court held that:

> the district court erred in foreclosing the applicability of both the substantial-valuation and gross-valuation misstatement penalties. We remand for the court to determine whether to impose either or both of those penalties. We express no opinion on whether the court erred in imposing the negligence and substantial-understatement penalties. On remand, the court should consider the extent to which imposing those penalties remains consistent with this opinion.

Although the court held that the partnership lacked economic substance, no consideration appears to have been given to the penalty described in part II.G.16 Economic Substance.

Also note that the *Castle Harbour* trial court refused to uphold negligence penalties on the taxpayer's actions, *TIFD III-E, Inc. v. U.S.*, 113 A.F.T.R.2d 2014-1557 (D.C. Conn.), which is analyzed by Lipton, *Castle Harbour* V—The Government Loses (Again) in the District Court, *Journal of Taxation* (Oct. 2014).

[3718] Reg. §§ 1.707-4(a)(2) and 1.707-4(b), discussed further in part II.M.3.e Exception: Disguised Sale.

[3719] As discussed in part II.M.3.e Exception: Disguised Sale, it is unlikely that the partnership anti-abuse rules would come into play. The transaction is consistent with the intent of the partnership income tax rules:

- The partnership must be bona fide, and each transaction must have a substantial business purpose. The proposed transaction splits income for generally around 5 years, and it provides the old owner with a way to take control over the business more quickly if the

Although technically not necessary, giving the corporation a small but significant profits interest in the partnership would help show that the corporation really is a partner.

Although one might be inclined to use an LLC, a limited partnership is better if the partnership engages in a trade or business, to help avoid self-employment tax.[3720] When using a limited partnership, consider using an entity taxed as an S corporation for the general partner and conducting business through various single-member LLCs that the limited partnership owns.[3721] For more description showing how to move in such a structure, see part II.E.7 Migrating into Partnership Structure, especially part II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure.

Be careful about possible changes in accounting method. For example, if a cash method C corporation contributes its business to a partnership, the partnership might not be able to continue using the cash method;[3722] for example, if the corporation were a personal service corporation[3723] before the transaction and all of its personal service activities were moved to the partnership, the corporation might no longer qualify and therefore the partnership might not qualify as well. The corporation can avoid this limitation by making an S election[3724] but needs to plan around the built-in gain tax.[3725]

If the corporation has subsidiaries, the subsidiaries could convert to single-member disregarded LLCs, then do a tax-free liquidation;[3726] if the parent and subsidiaries file a consolidated return, be sure that the subsidiaries do not have any excess loss accounts[3727] or deferred intercompany transactions.[3728] Before the liquidation, the parent might consider contributing to the subsidiary any obligations of the subsidiary that the

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transaction does not work out than in a traditional sale. The new owner benefits by minimizing his risk, in that he is not personally liable. These are substantial, practical business issues.

- <u>The form of each transaction must be respected under substance over form principles.</u> No games are being played here: the parties have every incentive to ensure that the new entity's cash flow is distributed as promised in the transaction.
- <u>Clear reflection of income.</u> All distributions the old owner receives are being taxed. The new owner is not being taxed on income the new owner does not receive.

For more information on possible attacks, see fn. 2515.

[3720] See part II.L Self-Employment Tax (FICA).

[3721] See part II.E Recommended Structure for Entities.

[3722] Code § 448(a)(2).

[3723] See part II.G.9 Personal Service Corporations.

[3724] See generally part II.P.3.c Conversion from C Corporation to S corporation.

[3725] See part II.P.3.c.ii Built-in Gain Tax.

[3726] Code §§ 332, 337. See 784 T.M. *Corporation Liquidations*; Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (WG&L), Chapter 10: Complete Liquidations and Other Taxable Dispositions of Corporate Stock and Assets in Bulk, part B. Subsidiary Liquidations.

[3727] Reg. § 1.1502-19. See Hennessey, Yates, Banks & Pellervo, The Consolidated Tax Return (WG&L), ¶13.04. Excess-Loss Accounts.

[3728] Reg. § 1.1502-13 (intercompany transactions). I am not an expert in Code § 332 and consolidated returns; one of my partners told me to watch for excess loss accounts or deferred intercompany transactions. The concept is that certain transactions not recognized in a consolidated environment are recognized when a corporation leaves the consolidated group – in this case, by liquidating a subsidiary.

parent holds or cancelling them outright,[3729] particularly as needed to cause them to have a positive net worth on liquidation.[3730] If the corporation has affiliated corporations, they might combine in a tax-free reorganization[3731] before forming the new entity, so that only one corporation remains as the general partner; each corporation that does not survive the merger as a corporation could survive as an LLC (disregarded for tax purposes) wholly owned by the surviving corporation and then contributed to the limited partnership intact as an LLC that is then wholly owned by the partnership. Generally, among other requirements, reorganizations require a continuity of business to be tax-free; this continuity can be satisfied when the acquired business is continued through the new partnership.[3732] Consider the effect of mergers on accounting methods, in that affiliated corporations using different accounting methods might need to change in some manner when combined into a single taxpayer.

If any owners are members of the same family or if any owner might split up his ownership in the corporate general partner from his interest as a limited partner when making transfers to family members, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Transferring the common interest in a preferred partnership is less tax-efficient than selling (to an irrevocable grantor trust)[3733] an interest in a partnership that just has one class of owners, because (appraisers tell us that) the return required on an equity interest in a partnership generally is significantly higher than the AFR. However, a traditional sale to an irrevocable grantor trust is not practical here, as the corporation would have to form the irrevocable grantor trust for its benefit,[3734] which would undermine the whole concept of getting the property out of corporate solution.

II.Q.7.h.ix. Value Freeze as Alternative to Code § 355 Division

Consider separately applying part II.Q.7.h.viii Value Freeze as Conservative Alternative to different lines of business or groups of assets to split up future growth in each line or group.

[3729] See Reg. § 1.332-7 if the parent does not do this. In a consolidated return environment, the parent can take a bad debt deduction based on the partial or complete worthlessness of the debt. Reg. § 1.1502-13(g)(7), Example 3(iii). For more details, see 784 T.M. *Corporate Liquidations*, part IV Tax Treatment of Intercorporate Debt in a Liquidation of a Subsidiary.

[3730] See 784 T.M. Corporate Liquidations, III. Subsidiary Liquidations Not Qualifying Under §332, C. Insolvent Subsidiary. Reg. § 1.332-2(b) provides:

> Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities.

[3731] Code § 368.

[3732] Reg. § 1.368-1(d)(4)(iii)(A).

[3733] As described in part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[3734] If a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the corporation but is for the personal purposes of one or more of the shareholders, the gratuitous transfer will be treated as a constructive distribution to such shareholders under federal tax principles and the shareholders will be treated as the grantors of the trust. Reg. § 1.671-2(e)(4). See part II.D.2 Business Entity as Grantor of Trust.

The common (non-preferred) interests might be owned by those who have the most interest in particular lines or groups.

Alternatively, each subsidiary depicted at the bottom of part II.E.6 Recommended Partnership Structure – Flowchart can remain wholly owned but might have a separate incentive plan, such as the partnership equivalent of a stock appreciation right.[3735]

None of these alternatives provides the clean break, disentangling shareholders from each other, provided by part II.Q.7.f Corporate Division Into More Than One Corporation.

II.Q.7.i. Distribution or Sale to Shareholder to Defer Gain on the Sale of Corporate Assets and Perhaps Avoid Double Taxation on Part

Consider forming a partnership, using one of the techniques described in part II.Q.7.h Distributing Assets; Drop-Down into Partnership, more than two years before selling property.

The corporation then might sell the partnership interest using an installment note to defer tax.[3736] If the corporation is an S corporation, be sure not to convert capital gain into ordinary income by using depreciable or amortizable assets.[3737]

The partnership's tax return for the year of the sale of the partnership interest (or before) would elect to step-up the basis of its underlying assets.[3738]

If and to the extent that the corporation is a C corporation that can sell the partnership interest at a discount relative to the partnership's underlying assets, that discount reduces income subject to C corporation income tax.

Be careful if the corporation is an S corporation that was a C corporation within the past 10 years.[3739]

II.Q.7.j. Exclusion of Gain on the Sale of Certain Stock in a C Corporation

II.Q.7.j.i. Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation

This part II.Q.7.j applies to stock issued on or after August 11, 1993. The amount of gain that is subject to partial or complete exclusion from income cannot exceed the greater of:[3740]

[3735] See part II.M.4.g Options to Acquire Equity, especially the text accompanying fn. 2688. See also part III.B.7.c Code § 2701 Interaction with Income Tax Planning.
[3736] See parts II.Q.3 Deferring Tax on Lump Sum Payout Expected More than Two Years in the Future and II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner.
[3737] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).
[3738] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
[3739] See part II.P.3.c.ii Built-in Gain Tax.
[3740] Code § 1202(b)(1).

(A) $10 million ($5 million for married filing separately)[3741] reduced by the aggregate amount of eligible gain taken into account under this rule for prior taxable years and attributable to dispositions of stock issued by such corporation, or

(B) 10 times the aggregate adjusted bases[3742] of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.

A taxpayer who wishes to try to exceed these limitations might transfer stock to family members or others by gift before the stock appreciates, and presumably each donee would separately apply the limitation.[3743]

For "qualified small business stock" issued after September 27, 2010 and held for more than five years, Code § 1202 excludes from income all of the gain from its sale or exchange.

For "qualified small business stock" issued before September 28, 2010 and held for more than five years, Code § 1202 excludes from income a portion of the gain from its sale or exchange:

- If the above and other requirements are satisfied, then the portion excluded from income is 50% for stock (60% for gain attributable to an empowerment zone business) acquired before February 18, 2009 and 75% for stock acquired on or after or on or before September 27, 2010.[3744]

- Any gain that is not excluded is subject to 28% tax instead of the usual, lower capital gain rates.[3745]

- Note also that taxable gain from the sale of C corporation stock is subject to the 3.8% tax on net investment income,[3746] whereas gain on the sale of a partnership or S corporation stock engaged in a trade or business is largely excluded from that tax.[3747]

Alternative minimum taxable income includes 7% of the amount excluded from regular taxable income.[3748]

Code § 1045 allows a taxpayer to rollover the gain into new qualified small business stock. Levun describes the Code § 1045 rollover:[3749]

3741 Code § 1202(b)(3).
3742 Only the basis on the date of issuance counts for purposes of this test. See the flush language at the end of Code § 1202(b)(1).
3743 See Code § 1202(h), discussed at fns. 3792-3793.
3744 Code § 1202(a).
3745 Compare Code § 1(h)(4) (tax on Code § 1202 gain) to Code § 1(h)(1) (tax on capital gains generally).
3746 See part II.I 3.8% Tax on Excess Net Investment Income (NII).
3747 See part II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation.
3748 Code § 57(a)(7).

1. The QSBC stock being sold must have been held for more than six months (i.e., the five-year QSBC stock holding period requirement only applies to obtain the QSBC gain exclusion).

2. There is a 60-day period to roll over into qualifying replacement QSBC stock. Note that the taxpayer can hold the proceeds of sale during this period—there is no qualified escrow or qualified intermediary requirements, as there are with respect to like-kind exchanges under Code Sec. 1031.

3. Gain is recognized to the extent of the lesser of gain realized or "boot" received (the same as under the Code Sec. 1031 rules—there is no basis offset against boot).

4. The tax basis of the replacement stock is its purchase price less excluded gain.

5. The holding period of the replacement QSBC stock includes the holding period of the QSBC stock that was sold.

6. The active business requirement of Code Sec. 1202(c) only needs to be met for a period of more than the first six months after the rollover stock is acquired.

"Qualified small business stock" means any stock in a C corporation which the taxpayer acquires on original issue by a qualified small business either in exchange for money or other property (not including stock) or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).[3750]

If any stock in a corporation is acquired solely through the conversion of other stock in such corporation which is qualified small business stock in the hands of the taxpayer, the stock so acquired is treated as qualified small business stock in the hands of the taxpayer and is treated as having been held during the period during which the converted stock was held.[3751]

Special rules apply to C corporation stock owned by certain pass-through entities.[3752] If any amount included in gross income by reason of holding an interest in a pass- through entity meets the requirements of the following sentence, the amount shall be treated as Code § 1202(a) gain and, for purposes of applying Code § 1202(b), such amount shall be treated as gain from a disposition of stock in the corporation issuing the stock disposed of by the pass-thru entity and the taxpayer's proportionate share of the adjusted basis of the pass-through entity in such stock shall be taken into account.[3753]

[3749] See fn. 3823. Also, Rev. Proc. 98-48 explains how to elect Code § 1045 deferral, the deadline for which may be extended using Reg. § 301.9100-3 relief (see, *e.g.*, Letter Ruling 201650010). Reg. § 1.045-1 provides rules for partnerships and supersedes Rev. Proc. 98-48 to that extent (see T.D. 9353 8/14/2007).
[3750] Code § 1202(c)(1).
[3751] Code § 1202(f).
[3752] Code § 1202(g). Code § 1202(g)(4) defines such a pass-through entity as any partnership, any S corporation, any regulated investment company, or any common trust fund.
[3753] Code § 1202(g)(1).

The amount must be attributable to gain on the sale or exchange by the pass-through entity of stock which is qualified small business stock in the hands of such entity (determined by treating such entity as an individual) and which was held by such entity for more than 5 years, and such amount must be includible in the gross income of the taxpayer by reason of the holding of an interest in such entity which was held by the taxpayer on the date on which such pass-through entity acquired such stock and at all times thereafter before the disposition of such stock by such pass-through entity.[3754] This gain exclusion does not apply to any amount to the extent such amount exceeds the amount to this rule would have applied if the amount were determined by reference to the interest the taxpayer held in the pass-through entity on the date the qualified small business stock was acquired.[3755]

The original issuance requirement means that stock bought from another shareholder would not qualify. May one avoid this prohibition by redeeming the seller and issuing stock to the buyer? Code § 1202(c)(3) imposes a waiting period related to redemption activity. Stock is disqualified if, at any time within 2 years before or after the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from the taxpayer or from a person related[3756] to the taxpayer.[3757] In applying the preceding sentence, one can ignore stock acquired from the taxpayer or a related person if the aggregate amount paid for the stock does not exceed $10,000 and no more than 2% of the stock held by the taxpayer and related persons is acquired.[3758] Also, stock is disqualified if, within the year before or after the issuance of such stock, the corporation made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as of the beginning of that 2-year period.[3759] The preceding sentence has a similar de minimis rule.[3760] Although generally a shareholder who transfers stock to an employee or independent contractor (or to a beneficiary of an employee or independent contractor) is treated has transferring the stock to the corporation and the corporation then transferring the stock to the employee or independent contractor,[3761] any such deemed

[3754] Code § 1202(g)(2).

[3755] Code § 1202(g)(3).

[3756] Within the meaning of Code § 267(b) or 707(b).

[3757] Code § 1202(c)(3)(A).

[3758] Reg. § 1.1202-2(a)(2), which further provides:

> The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock held (directly or indirectly) by the taxpayer and related persons immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

[3759] Code § 1202(c)(3)(B).

[3760] Reg. § 1.1202-2(b)(2) provides that, for purposes of this exception:

> … stock exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of all outstanding stock is purchased. The following rules apply for purposes of determining whether the 2-percent limit is exceeded. The percentage of the stock acquired in any single purchase is determined by dividing the stock's value (as of the time of purchase) by the value (as of the time of purchase) of all stock outstanding immediately before the purchase. The percentage of stock acquired in multiple purchases is the sum of the percentages determined for each separate purchase.

[3761] Reg. § 1.83-6(d)(1).

transfer to the corporation is not treated as such for purposes of the anti-redemption rules.[3762] The anti-redemption rules also are not triggered by any of the following:

- The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services.[3763]

- Before a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and the stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and the stock is purchased within 3 years and 9 months from the date of the decedent's death.[3764]

- The stock is purchased incident to the disability or mental incompetency of the selling shareholder.[3765]

- The stock is purchased incident to the divorce (within the meaning of Code § 1041(c)) of the selling shareholder.[3766]

During substantially all of the taxpayer's holding period for such stock, the corporation must be a C corporation and use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses.[3767] See part II.Q.7.j.ii Limitation on Assets a Qualified Small Business May Hold.

The corporation's aggregate gross assets cannot have a basis (including cash) exceeding $50 million (at or before issuance – see footnote for details).[3768]

[3762] Reg § 1.1202-2(c).

[3763] Reg. § 1.1202-2(d)(1)(i).

[3764] Reg. § 1.1202-2(d)(2).

[3765] Reg. § 1.1202-2(d)(3).

[3766] Reg. § 1.1202-2(d)(4).

[3767] Code § 1202(c)(2)(A), (e). The taxpayer must affirmatively prove what the business assets are and that they met this 80% test. *Holmes v. Commissioner*, T.C. Memo. 2012-251, held:

> The record is again devoid of documentary evidence showing the amount of corporate assets owned during the years in which he held the stock and the amount of those assets used in its business of providing on demand physician practice management software. In fact, the only evidence in the record concerning LeonardoMD's business is a stipulated paragraph describing its business as providing on demand physician practice management software delivered over the Web, and petitioner's above-cited testimony. We cannot, on the basis of uncorroborated testimony and a stipulation that does not rule out inactive business assets and income, reasonably conclude that petitioner met his burden of proving that, during substantially all of his holding period for LeonardoMD stock, the corporation used at least 80% of its assets in the active conduct of one or more qualified trades or businesses.

[3768] Code § 1202(d). This applies to gross assets at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance, as well as immediately after the issuance (determined by taking into account amounts received in the issuance).

The following businesses are not eligible for this treatment:[3769]

- any trade or business involving the performance of services in the fields of health, [3770] law, engineering, architecture, accounting, actuarial science,

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[3769] Code § 1202(e)(3).

[3770] Letter Ruling 201436001 held that the health service and related exclusion did not apply to the taxpayer:

> Section 1202(e)(3) excludes various service industries and specified non-service industries from the term qualified trade or business. Thus, a qualified trade or business cannot be primarily within service industries, such as restaurants or hotels or the providing of legal or medical services. In addition, § 1202(e)(3) excludes businesses where the principal asset of the business is the reputation or skill of one or more of its employees. This works to exclude, for example, consulting firms, law firms, and financial asset management firms. Thus, the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners).
>
> Company is not in the business of offering service in the form of individual expertise. Instead, Company's activities involve the deployment of specific manufacturing assets and intellectual property assets to create value for customers. Essentially, Company is a pharmaceutical industry analogue of a parts manufacturer in the automobile industry. Thus, although Company works primarily in the pharmaceutical industry, which is certainly a component of the health industry, Company does not perform services in the health industry within the meaning of § 1202(e)(3). Neither are Company's business activities within any of the prohibited categories set forth in § 1202(e)(3).

Letter Ruling 201717010 held that the health service and related exclusion did not apply to a lab:

> Company provides laboratory reports to health care professionals. However, Company's laboratory reports do not discuss diagnosis or treatment. Company neither discusses with, nor is informed by, healthcare providers about the diagnosis or treatment of a healthcare provider's patients. Company's sole function is to provide healthcare providers with a copy of its laboratory report.
>
> Company neither takes orders from nor explains laboratory tests to patients. Company's direct contact with patients is billing patients whose insurer does not pay all of the costs of a laboratory test.
>
> In addition, you represent that the skills employees bring to Company are not useful in performing X tests and that skills they develop at Company are not useful to other employers.
>
> Further, none of Company's revenue is earned in connection with patients' medical care. Other than the laboratory director [who federal law required to have certain qualifications], Company's laboratory technicians are not subject to state licensing requirements or classified as healthcare professionals by any applicable state or federal law or regulatory authority.
>
> Although Company's laboratory reports provide valuable information to healthcare providers, Company does not provide health care professionals with diagnosis or treatment recommendations for treating a healthcare professional's patients nor is Company aware of the health care provider's diagnosis or treatment of the healthcare provider's patients. In addition, the skills that Company's employees have are unique to the work they perform for Company and are not useful to other employers.
>
> Thus, based on the facts and representations submitted, we conclude that for purposes of § 1202(e)(3), Company is not in a trade or business (i) involving the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.

performing arts,[3771] consulting,[3772] athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees,[3773]

- any banking, insurance, financing, leasing, investing, or similar business,
- any farming business (including the business of raising or harvesting trees),
- any business involving the production or extraction of products, such as oil, gas and mines, eligible for certain depletion deductions, or
- any business of operating a hotel, motel, restaurant, or similar business.

The corporation must be a domestic corporation other than a DISC or former DISC, corporation with respect to which an election under Code § 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, regulated investment company, real estate investment trust, REMIC, or cooperative.[3774]

For additional context, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See fn. 625 in part II.E.1.c.ii Types of Income and Activities Eligible for Deduction.

[3771] For additional context regarding performing arts, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See fn. 626 in part II.E.1.c.ii Types of Income and Activities Eligible for Deduction.

[3772] For additional context regarding consulting, when Congress enacted Code § 199A and referred to Code § 1202(e)(3), it also looked to Code § 448. See fn. 627 in part II.E.1.c.ii Types of Income and Activities Eligible for Deduction.

[3773] However, a commission sales business might not be disqualified under this provision. In *Owen v. Commissioner*, T.C. Memo. 2012-21, a company that sold prepaid legal service policies, including estate planning services, which were like insurance in that purchasers would get a reduced fee in legal cost by joining this prepaid legal membership, was a qualified small business. The court seemed to accept the taxpayer's testimony that, in the industry, independent contractors generally sold the products and services offered by the company. The taxpayer performed services as an executive and as a sales representative and his compensation was reported on Form W-2 (as an executive) and Form 1099-MISC (as an independent consultant who furnished services through his personal corporation that received commissions and in turn paid him using Form 1099-MISC. The court held:

> Although respondent argues that FFAEP is not qualified because one of the principal assets is the skill of Mr. Owen, the Court disagrees. While we have no doubt that the success of the Family First Companies is properly attributable to Mr. Owen and Mr. Michaels, the principal asset of the companies was the training and organizational structure; after all, it was the independent contractors, including Mr. Owen and Mr. Michaels in their commission sales hats, who sold the policies that earned the premiums, not Mr. Owen in his personal capacity.

However, ultimately this holding was moot (which did not stop the court from opining on it), because the taxpayer was trying to do a Code § 1045 rollover of gain on sale from one company to another. Although the new company qualified as described above, the company being sold did not (fn. 3782), resulting in the taxpayer losing the case. So, keep in mind the IRS' lack of incentive to appeal this holding when viewing it as instructive.

[3774] Code § 1202(e)(4).

II.Q.7.j.ii. Limitation on Assets a Qualified Small Business May Hold

The corporation must use at least 80% (by value) of its assets in the active conduct of one or more qualified trades or businesses while the corporation is an eligible corporation.[3775] A specialized small business investment company automatically meets the active business requirement.[3776]

In applying the requirement that the corporation hold active business assets, stock and debt in any subsidiary corporation are disregarded and the parent corporation is deemed to own its ratable share of the subsidiary's assets and to conduct its ratable share of the subsidiary's activities.[3777] The parent owns more than 50% of the combined voting power of all classes of stock entitled to vote, or more than 50% in value of all outstanding stock, of a corporation for the parent to be able to treat the corporation as a subsidiary.[3778] If the holding falls below this threshold, then watch out – the parent fails the active business asset test for any period during which more than 10% of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations which are not subsidiaries of such corporation (other than assets described under the "working capital" exception).[3779]

Under the "working capital" exception, active business assets include assets held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or held for investment and are reasonably expected to be used within two years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business.[3780] However, for periods after the corporation has been in existence for at least two years, no more than 50% of the assets of the corporation may qualify as used in the active conduct of a qualified trade or business by reason of this rule.[3781] Be careful not to start the C corporation just accumulating cash for possible business operations, which will disqualify the corporation.[3782] To avoid this issue and for other reasons as well, consider

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[3775] Code § 1202(e)(1).

[3776] Code § 1202(c)(2)(B), referring to an eligible corporation licensed to operate under section 301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993).

[3777] Code § 1202(e)(5)(A).

[3778] Code § 1202(e)(5)(C).

[3779] Code § 1202(e)(5)(B).

[3780] Code § 1202(e)(6).

[3781] Code § 1202(e)(6).

[3782] *Owen v. Commissioner*, T.C. Memo. 2012-21. The court addressed the qualifications of two companies, one of which did not qualify (this footnote) and one of which did qualify (fn. 3773). In discussing why the company was not a qualified small business under Code § 1202 and therefore not eligible for a capital gain deferral under Code § 1045 (which rollover is not necessary for newer companies), the court imposed a 20% accuracy-related penalty:

> We also find that the Owens did not act with good faith with respect to the section 1045 transaction. Mr. Owen explained that it was his vision to build up J&L Gems as he had the Family First Companies; yet even as late as 2 years after the money had been deposited in the company, J&L Gems had only 16 pieces of jewelry. Mr. Owen should not in good faith have believed that deferring income tax under section 1045, by operating a business, merely involved depositing a large amount of cash in an account. Nor could he reasonably believe that using less than 8 percent of that cash to purchase inventory and selling only a part of what little inventory he did buy to his friends and coworkers was sufficient to defer the tax. Even under Mr. Owen's understanding of

instead starting as an LLC taxable as a partnership then later converting to a corporation.[3783]

A corporation also fails the active business assets test for any period during which more than 10% of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business.[3784] In applying the preceding sentence, the ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business.[3785]

In applying the active business asset test, rights to computer software which produces active business computer software royalties[3786] are treated as an asset used in the active conduct of a trade or business.[3787]

Although Code § 1202 authorizes qualified small business stock to be held by a partnership[3788] and corporate subsidiaries,[3789] it does not discuss the corporation conducting its business through one or more partnerships. Accordingly, from a planning perspective, I would not recommend having a corporation seeking qualified small business status invest its assets in a partnership. However, if one is asked to advice an owner of a corporation that is already invested in a partnership, I would look to the active business rules for corporate split-ups, which describe when an interest in a partnership constitutes an active business asset.[3790]

Special rules apply to certain tax-free transfers.[3791] If a transfer is by gift, at death, or from a partnership,[3792] the transferee shall be treated as having acquired such stock in the same manner as the transferor and having held such stock during any continuous period immediately preceding the transfer during which it was held (or treated as held under these rules) by the transferor:[3793]

- Presumably a taxpayer whose stock's value exceeds the cap of the exclusion of gain[3794] by giving the stock to family members, each of whom could sell the stock separately.

section 1045, that he had to operate the business in good faith and reasonably, he failed to meet that requirement.

[3783] See part II.Q.7.j.iii Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S Corporation or a Partnership? (especially the text accompanying fns. 3815-3821).

[3784] Code § 1202(e)(7).

[3785] Code § 1202(e)(7).

[3786] Within the meaning of Code § 543(d)(1).

[3787] Code § 1202(e)(7).

[3788] See part II.Q.7.j.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fns. 3752-3755.

[3789] See fns. 3777-3779.

[3790] See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[3791] Code § 1202(h).

[3792] Code § 1202(h)(2).

[3793] Code § 1202(h)(1).

[3794] See fn. 3740.

- If the transfer is from a partnership, it must be to a partner of stock with respect to which requirements similar to the pass-through rules described above are met at the time of the transfer (without regard to the 5-year holding period requirement).[3795]

In a Code § 351 formation of a corporation or a Code § 368 reorganization, if qualified small business stock is exchanged for other stock which would not qualify as qualified small business stock but for this rule, such other stock shall be treated as qualified small business stock acquired on the date on which the exchanged stock was acquired.[3796] Unless the stock treated as qualified small business stock by reason of the preceding sentence is issued by a corporation which (as of the time of that transfer) is a qualified small business, Code § 1202 applies to gain from the sale or exchange of stock treated as qualified small business stock by reason of the preceding sentence only to the extent of the gain which would have been recognized at the time of the transfer described in the preceding sentence if Code § 351 or 368 had not applied at such time.[3797]

To the extent provided in regulations, stock in a corporation, the basis of which (in the hands of a taxpayer) is determined in whole or in part by reference to the basis in his hands of stock in such corporation which meets certain requirements or which is received in a reorganization that is a mere change in form[3798] in exchange for stock which meets such requirements, shall be treated as meeting such requirements.[3799]

Generally, built-in gain of property contributed for Code § 1202 stock will not be eligible for the Code § 1202 exclusion.[3800] A similar rule applies to the built-in gain of later contributions to capital with respect to such stock.[3801]

[3795] Code § 1202(h)(2)(C).

[3796] Code § 1202(h)(4)(A). Letter Ruling 9810010 applied Code § 1202(h)(4) to a corporate split-up that was partly tax-free under Code §§ 355(a)(1) and 368(a)(1)(D).

[3797] Code § 1202(h)(4)(B). Code § 1202(h)(4)(C) provides:

> *Successive application*. For purposes of this paragraph, stock treated as qualified small business stock under subparagraph (A) shall be so treated for subsequent transactions or reorganizations, except that the limitation of subparagraph (B) shall be applied as of the time of the first transfer to which such limitation applied (determined after the application of the second sentence of subparagraph (B)).

[3798] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization. Converting a corporation into an LLC taxed as a corporation was such a change. Letter Rulings 201603010-201603014.

[3799] Code § 1202(h)(3), incorporating by reference Code § 1244(d)(2).

[3800] Code § 1202(i)(1) provides that, for purposes of Code § 1202:

> *Stock exchanged for property*. In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation—
>
> (A) such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and
>
> (B) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

[3801] Code § 1202(i)(2) provides that, for purposes of Code § 1202:

> *Treatment of contributions to capital.* If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.

If the taxpayer has an offsetting short position with respect to any qualified small business stock, Code § 1202(a) shall not apply to any gain from the sale or exchange of such stock unless the stock was held by the taxpayer for more than 5 years as of the first day on which there was such a short position, and the taxpayer elects to recognize gain as if such stock were sold on such first day for its fair market value.[3802] For purposes of the preceding sentence, the taxpayer shall be treated as having an offsetting short position with respect to any qualified small business stock if the taxpayer has made a short sale of substantially identical property, the taxpayer has acquired an option to sell substantially identical property at a fixed price, or to the extent provided in regulations, the taxpayer has entered into any other transaction which substantially reduces the risk of loss from holding such qualified small business stock; in applying this rule, any reference to the taxpayer shall be treated as including a reference to any person who is related (within the meaning of Code § 267(b) or 707(b)) to the taxpayer.[3803]

II.Q.7.j.iii. Does the Exclusion for Sale of Certain Stock Make Being a C Corporation More Attractive Than an S Corporation or a Partnership?

Does the exclusion for the sale of certain stock make being a C corporation more attractive than an S corporation or a partnership? First, we will explore when the sale of such stock has advantages, when the sale does not have advantages, and operational income tax issues.

If and to the extent that the gain on the sale of a business relates to the sale of self-created goodwill, the basis of the ownership interest does not reflect that basis, no matter what kind of entity owns the business. To that extent, the sale of such stock is more favorable than the sale of stock in an S corporation[3804] and the sale for cash of a partnership interest.[3805] However, the seller-financed sale of a partnership interest still produces better results than the sale of such stock.[3806]

[3802] Code § 1202(j)(1).

[3803] Code § 1202(j)(2).

[3804] Compare part II.Q.1.a.i.(c) with part II.Q.1.a.i.(d) (moderate tax states) and part II.Q.1.a.ii.(c) with part II.Q.1.a.ii.(d) (California).

[3805] The sale of a partnership interest for cash generally would have similar dynamics regarding goodwill as the sale of S corporation stock. The sale of a partnership interest would have a slight advantage, in that the goodwill could obtain a basis step-up (part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations and fn. 4148, unless the anti-churning rules apply per part II.Q.1.c.iv Goodwill Anti-Churning Rules, especially fn. 3068), but amortization would be over a 15-year period under Code § 197 (fn. 4043). Also, amortizing goodwill turns it into a hot asset, reducing opportunities for deferral on its sale; for more information on the sale of goodwill, including disadvantages of goodwill being amortized, see part II.Q.1.c.i Taxation When a Business Sells Goodwill; Contrast with Nonqualified Deferred Compensation.

[3806] See parts II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill and II.Q.1.a.ii.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill (California).

In some situations, the exclusion for the sale of certain C corporation stock does not provide any particular advantage, if and to the extent that the owner of a pass-through interest would not have gain on sale. If and to the extent that the sale of the business interest arises from reinvested earnings, the basis of a partnership interest[3807] or stock in an S corporation is increased.[3808] Furthermore, if a pass-through entity redeems only part of one's ownership, the reinvested earnings might offset part or all of the gain on the sale – perhaps even that attributable to self-created goodwill.[3809]

Furthermore, the exclusion is available only for qualified stock that is issued, gifted, or bequeathed to the taxpayer,[3810] making it unavailable to subsequent purchasers of the stock.

Many business sales are asset sales, much of which would be capital gain subjected to lower tax rates to the owners of pass-throughs and subjected to higher rates when sold by a C corporation.[3811] This is especially important when an entity sells only a business line,[3812] rather than the entire business. When the entity sells all of its assets, it might as well liquidate to take full advantage of the exclusion on the gain on sale of the stock and let the shareholders move the sale proceeds outside of a potentially risky business environment.[3813]

[3807] Code § 705. However, as described in part II.Q.8.e.ii.(a) Unitary Basis, a partner does not have the flexibility of a shareholder to pick and choose which shares to sell.

[3808] Code § 1367.

[3809] For S corporations, see part II.Q.7.b.i Redemptions or Distributions Involving S Corporations - Generally, especially fns. 3507-3509. Of course, the basis resulting reduction basis reduces the ability to take distributions and increases future gains on the sale of the stock, the latter which might not be of concern if and to the extent the stock receives a new basis on the shareholder's death. See part II.H.9 Basis Step-Up In S Corporations That Had Been C Corporations.
For partnerships, see part II.Q.8.b Partnership Redemption or Other Distribution.

[3810] See various requirements described in part II.Q.7.j.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation.

[3811] See part II.A.1.a C Corporations Generally, especially fns. 5-7.

[3812] One cannot easily divide a business tax-free, sell a business line, and liquidate the corporation owning just that business lines. See part II.Q.7.f.ii Code § 355 Requirements.

[3813] See part II.F.2 Asset Protection Benefits of Dissolving the Business Entity After Asset Sale. Levun's article, cited at fn. 3823, comments:

> Note that the receipt of liquidation proceeds after a corporate asset sale also qualifies for the QSBC exclusion. However, because of the corporate-level tax exacerbated by the lack of a corporate capital gains rate, the scales would still tip in favor of flow-through taxation, notwithstanding no tax due on liquidation. In other words, assume all an entity owns is zero-basis self-created goodwill having a value of $1 million. In the case of an asset sale as an LLC, there would be federal tax due of $200,000 (assuming a 20-percent maximum capital gains rate). In the case of the same asset sale by a QSBC, while there would be no shareholder tax on the liquidation of the corporation, the corporate entity-level federal tax burden would be $340,000 (or tax at a 35-percent rate, to the extent the corporation has taxable income in excess of $10 million).

A stock sale tends to have a lower sale price than an asset sale, due to buyer's concerns about assuming undisclosed or unseen liabilities and perhaps not receiving a basis step-up in the corporation's assets.[3814]

For the effect of structure on operations, see:

- Part **Error! Reference source not found. Error! Reference source not found.** (concluding that they don't)

- Part II.E Recommended Structure for Entities (explaining why a partnership structure is better than a corporate structure).

Furthermore, if one decides that a C corporation structure is ultimately desirable, one might consider instead starting as an LLC taxable as a partnership or sole proprietorship, which enables start-up losses to be deducted more easily anyway;[3815] then, if one determines that a C corporation is the ideal structure, convert[3816] to a qualified small business corporation[3817] the earlier of five years before a sale is anticipated or shortly before the $50 million gross asset limitation is exceeded.[3818] The delay in forming the corporation can help avoid being disqualified for not deploying start-up capital quickly enough.[3819] During this initial operating period, the owners could build basis in the assets that are contributed (or deemed contributed) at the time of conversion, which basis increase might lead to a larger exclusion on the sale of the

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[3814] Regarding the latter, see part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations, noting that the inside basis step-up may apply under part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, the latter which is considered most attractive for S corporation holders but also may be attractive when using the Code § 1202 exclusion.

[3815] See part II.G.3 Limitations on Losses and Deductions; Loans Made or Guaranteed by an Owner, especially part II.G.3.c.iii Comparing C Corporation Loss Limitations to Those for Partnership and S Corporation Losses.

[3816] See part II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations. One might simply file Form 8832 to elect corporate taxation, assign the LLC to a corporation, or convert or merge the LLC into a corporation. As to the former, Letter Ruling 201636003 held:

> While ownership of a corporation is normally tied to stock ownership, and under state law LLC owners hold a member interest and not formal stock, the term "stock" for federal tax purposes is not restricted to cases where formal stock certificates have been issued. Rather, it has been consistent Service position that for federal tax purposes stock ownership is a matter of economic substance, *i.e.*, the right to which the owner has in management, profits, and ultimate assets of a corporation. The presence or absence of pieces of paper called "stock" representing that ownership is immaterial. See Rev. Rul. 69-591, 1969-2 C.B. 172.
>
> Therefore, based on the facts and representations submitted, we rule that the Corporation stock meets the definition of qualified small business stock under §§§ 1202(c), 1202(f) and 1202(h).

[3817] See part II.P.3.d Conversions from Partnerships and Sole Proprietorships to C Corporations or S Corporations.

[3818] See fn. 3768.

[3819] See part II.Q.7.j.ii Limitation on Assets a Qualified Small Business May Hold, especially the text accompanying fns. 3780-3782.

stock.[3820] However, if the entity accumulates debt in excess of basis, forming the corporation might be a taxable event.[3821]

For a case study on converting a partnership to a C corporation to accommodate a venture capital firm's desire for this exclusion, whether converting to a C corporation is a good idea, the Code § 1045 rollover, and issues facing recipients of profits interests on conversion,[3822] see Levun, "Using Partnerships to Leverage "Zero-Tax" Code Sec. 1202 Stock."[3823]

II.Q.7.k. Special Provisions for Loss on the Sale of Stock in a Corporation under Code § 1244

An individual[3824] may deduct the first $50,000 of loss[3825] on the sale of "section 1244 stock" as an ordinary loss, rather than a capital loss.[3826]

"Section 1244 stock" is stock of a domestic corporation if:[3827]

[3820] See part II.Q.7.j.i Rules Governing Exclusion of Gain on the Sale of Certain Stock in a C Corporation, especially fn. 3742.

[3821] See parts II.M.2.b Initial Incorporation: Effect of Assumption of Liabilities and II.M.2.c Contribution of Partnership Interest to Corporation.

[3822] See part II.M.4.f Issuing a Profits Interest to an Employee. Levun, fn. 3823, points out:

> As a final observation, and somewhat of a frolic and detour, let's assume that the LLC being discussed in this column had a service provider that had been previously admitted as a partner (either by reason of (1) having received a fully vested LLC interest, (2) having received a profits interest subject to a substantial risk of forfeiture but for which the requirements of Rev. Proc. 2001-43, 2001-2 CB 191, had been satisfied or (3) having received a capital interest subject to a substantial risk of forfeiture for which a timely Code Sec. 83(b) election had been made. Also assume that, as part of the incorporation transaction contemplated above (to obtain QSBC stock), the service provider was required to agree to a substantial risk of forfeiture with respect to the C corporation stock he was now obtaining in the LLC to C corporation conversion transaction. Rev. Rul. 2007-49, 2007-2 CB 237, would require that a Code Sec. 83(b) election be made in order for the service partner to be treated as a shareholder in the corporation. This revenue ruling provides that the transfer of vested stock in exchange for nonvested stock in a tax-free corporate reorganization requires a Code Sec. 83(b) election in order for the service provider to be considered the tax owner of the shares received in the reorganization. While the revenue ruling addresses a tax-free reorganization under Code Sec. 368(a), there is no reason to believe that the result would be any different in a Code Sec. 351 transaction. Note that making a Code Sec. 83(b) election does not result in any tax to the service provider, as under the principles contained in Rev. Rul. 2007-49, the service provider would be considered to have paid an amount for the QSBC stock equal to its fair market value.

[3823] *Partnership Tax Watch Newsletter* (Current), No. 349, PARTNERSHIP TAX PLANNING and PRACTICE 11/22/2016, saved as Thompson Coburn LLP document no. 6486765.

[3824] Trust, estates, and corporations are not eligible for this treatment. Code § 1244(d)(4); see Part II.J.11.b Code § 1244 Treatment Not Available for Trusts. Individuals may deduct losses flowing through partnerships if the partnerships were the original owners, and corporations may not claim this benefit. Reg. § 1.1244(a)-1(b)(2).

[3825] $100,000 if married filing jointly. Code § 1244(b).

[3826] Code § 1244(a).

[3827] Code § 1244(c).

- at the time such stock is issued, such corporation was a small business corporation,

- such stock was issued by such corporation for money or other property (other than stock and securities), and

- such corporation, during the period of its five most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

The corporation cannot be capitalized with more than $1 million adjusted basis of assets.[3828]

Although it applies to the sale of stock in an S corporation, it might not provide much of a benefit, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the shareholder each year. Similarly, this provision might not provide much of a benefit when choosing whether to be taxed as a corporation instead of a partnership, as often such a loss arises from loss due to operations and therefore was already deducted as a loss on the K-1 issued to the partners each year. Furthermore, S corporation shareholders and partners in a partnership would likely obtain a current deduction for such losses, rather than having to wait until their ownership is disposed of, and they would not be required to jump through any statutory hoops similar to Code § 1244 to obtain the ordinary loss deduction. For more information on the concepts described in this paragraph, see part II.G.3 Limitations on Losses.

II.Q.7.l. Deferring Gain on Sale of Marketable Securities by Investing in a Specialized Small Business Investment Company

Generally, an individual may defer $50,000 or a corporation may defer $250,000 of gain on the sale of any publicly traded securities by reinvesting in a specialized small business investment company (SSBIC).[3829]

An SSBIC is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993.[3830] That provision authorizes the licensing of small business investment companies organized to invest in small business concerns in such a way as to facilitate ownership by persons whose participation in the free enterprise system has been hampered by social or economic disadvantages.[3831]

[3828] Code § 1244(c)(3).
[3829] Code § 1044.
[3830] Code § 1044(c)(3).
[3831] Federal Tax Coord. 2d ¶ I-3794.

II.Q.8. Exiting From or Dividing a Partnership

Below, a few themes emerge:

- Exiting a partnership in exchange for a portion of the partnership's assets can be a nontaxable event, in which the exiting partner's basis is reallocated among the distributed assets.[3832]

- Seller-financed redemptions for cash can save a level of capital gain tax, and the buyer and seller can come out ahead, if structured properly.

- If a partner contributes property with a basis not equal to its fair market value, and that partner or that property leaves the partnership within seven years of the contribution, beware of the tax effects!

Contrasting partnership and corporate tax-free divisions:

- A partnership division does not require a business purpose to be nontaxable, but a corporate division does. Generally, a partnership division is not taxable.[3833]

- Contrast a seven-year waiting period for partnership distributions (other than divisions) described further below with a five-year waiting period for corporate divisions. However, the waiting periods are for different reasons! In partnerships, it is to account for contributed property. In corporations, it is to make sure business activities are conducted continuously for at least five years.

Generally, the parties can designate whether a transaction constitutes a sale between partners or a redemption by the partnership.[3834]

See also part II.P.3.g Conversions from Partnership to Sole Proprietorships and Vice Versa.

II.Q.8.a. Partnership as a Master Entity

II.Q.8.a.i. Partnership Rules Allowing Basis Shifting

Partnerships provide the opportunity to shift basis from one asset to another, which can be helpful when it appears that a low basis asset will be sold; see part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.[3835]

[3832] See Abrams, Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear, *TM Memorandum* (2/16/2009).

[3833] Reg. § 1.708-1(d).

[3834] Letter Ruling 9715008 (respecting the form of a sale between partners). The ruling relied on *Foxman v. Commissioner*, 41 T.C. 535, 551 (1964) (treating a transaction as a sale between partners), aff'd 352 F.2d 466 (3d Cir. 1965) and also cited *Cooney v. Commissioner*, 65 T.C. 101, 109 (1975) (treating a transaction as a redemption).

[3835] Paul S. Lee of Northern Trust has been exploring this idea and has called this the mother ship partnership.

However, the partnership needs to be properly seasoned, which generally means at least 7 years from the time that property is contributed to the partnership until the time property is distributed.[3836] Changes in or issuances of partnership interests when the partnership has property with basis different from fair market value can also bring this 7-year waiting period into play.[3837]

If one has considerable marketable securities that one would like to be in a partnership, one should consider placing them in a partnership that has no business assets.[3838] Although the strategy described in this part II.Q.8.a is not geared toward marketable securities, if the estate is large enough then one might consider dividing the marketable securities into a few partnerships that move in different directions and using a series of rolling, asset-splitting GRATs to shift value to the next generation.[3839] This might be a good strategy for the cash generated from an equity-stripping transaction designed to obtain a basis step-up on real estate with minimal estate tax cost.[3840]

The basis shifting opportunity might work best when few assets are involved. Furthermore, generally it requires a Code § 754 election to be in effect, and such an election requires record-keeping that is often quite complex.[3841] Thus, one might consider dividing the partnership and making the Code § 754 election only with respect to the property involved in the basis shifting strategy.[3842]

Various basis stripping strategies involve plays on differences between outside basis and inside basis.[3843] A transfer of a partnership interest allocates basis according to the

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3836 See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

3837 See text accompanying fn. 3932, which is part of the link from fn. 3836.

3838 Distributions of marketable securities from a partnership might be a taxable transaction. See parts II.Q.8.b.i.(a) Code § 731: General Rule for Distributions (distributions from a partnership generally do not generate income tax) and II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them) (special rules taxing such distributions). See particularly text accompanying fn. 3877 et. seq.

3839 See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust, especially the text accompanying fn. 4901.

3840 See part II.H.10 Extracting Equity to Fund Large Gift. This strategy requires leveraging and maintaining a security interest in loan proceeds, and placing different baskets of marketable securities into separate LLCs (that start as single member LLCs but sooner or later become taxed as partnerships) can facilitate maintaining this security interest. See part II.H.10.d Maintaining the Security Interest in the Loan Proceeds If Using a Donee Guarantee.

3841 See generally part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

3842 See part II.Q.8.d Partnership Division, especially fn. 4056 (division should result in identical percentage interests before and after the division for each partnership).

3843 For an example, see part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue. For a more generic description of inside basis and outside basis, see my blog article, "Tax basis: The key to reducing gain on sale or deducting asset purchases," at http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.

value of the transferred interest, rather than according to the proportion of rights to income, distributions, etc.[3844]

One might consider having any marketable securities be held in their own partnership that qualifies as an "investment partnership." See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

Also, note that certain assets are not conducive to non-pro rata distributions of property. See part II.Q.8.b.i.(f) Code § 751 – Hot Assets. To the extent practicable, one might consider holding such assets in a separate partnership and leasing them to the businesses they serve.[3845] Consider the effect, if any, this isolation of leasing activity might have on the passive loss rules and the 3.8% net investment income tax.[3846]

Similarly, consider whether consolidating assets inside of a partnership affects the passive loss grouping rules,[3847] which impact not only the use of passive losses and credits but also the 3.8% tax on net investment income.[3848]

Check to see whether the applicable jurisdiction imposes fees or taxes on partnerships or LLCs.[3849]

II.Q.8.a.ii. Caution When Using Master Entity If Liquidity Needed to Pay Estate Tax

Estate tax generated by business interests can be deferred. Obtaining a deferral for a year or two does not require any special structuring.[3850] Obtaining longer deferrals

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[3844] See part II.Q.8.e.ii.(a) Unitary Basis.

[3845] Leasing tangible personal property generally constitutes self-employment income, whereas leasing real generally does not. See part II.L.1 FICA: Corporation

For corporations, compensation, including any distributions re-characterized as salaries, is subject to income tax and FICA tax. Income retained by the corporation and not paid as compensation is not subject to FICA tax.

If all of the remuneration to an individual from related corporations is disbursed through the common paymaster, the total amount of FICA imposed on the employer and employee is determined as though the individual has only one employer (the common paymaster). The common paymaster is responsible for filing information and tax returns and issuing Forms W-2 with respect to wages it is considered to have paid under this rule.

For S corporations, shareholders' health insurance is deductible to the S corporation and considered compensation to owners. However, it is subject to FICA only if offered in a plan that discriminates in favor of owners. The owners may deduct health insurance subject to the same rules as partners and sole proprietors.

Income Subject to Self-Employment Tax.

[3846] See parts II.K Passive Loss Rules and II.I 3.8% Tax on Excess Net Investment Income (NII), especially II.K.1.e Rental Activities.

[3847] See part II.K.1.b Grouping Activities.

[3848] See part II.I.8 Application of 3.8% Tax to Business Income, especially part II.I.8.a.ii Passive Activity Grouping Rules.

[3849] For example, New York City imposes a 4% tax on unincorporated business organizations.

[3850] See part III.B.5.d.i Overview of Discretionary Extensions Under Section 6161.

requires the right structure and involves more uncertainty with partnerships than with corporations.[3851]

If one places assets in a master partnership, consider whether those might affect the owner's estate's ability to make a Code § 6166 to defer estate tax if the owner has insufficient liquidity.[3852] If the partnership is merely a holding entity and does not itself engage in business activity, it might be considered a nonbusiness asset ineligible for such an election.[3853]

II.Q.8.a.iii. Examples of Using Partnership to Shift Basis

II.Q.8.a.iii.(a). Applying Outside Basis to Very Low Inside Basis

Each of A, B, and C invests $500 in a partnership that uses its $1,500 capital to buy land: Parcel X for $100 and Parcel Y for $1,400.

Parcel X grows in value to $900, and Parcel Y increases in value to $1,800. Thus, the partnership's assets are worth $2,700 ($900 plus $1,800). Thus, ignoring valuation adjustments, each partner's interest is worth $900 ($2,700 divided by 3).

The partnership distributes Parcel X to C in liquidation of C's partnership interest. C's $500 basis is applied to Parcel X, increasing its basis from $100 to $500.

If a Code § 754 election is not in place, then Parcel Y's basis does not change.

Although as a group the partners have managed to increase the real estate's tax basis, C did not get a great deal. If C sells Parcel X, C recognizes a $400 gain ($900 value minus its new $500 basis). If the partnership had sold Parcel X, the $800 gain ($900 value minus $100 basis before the distribution), then each partner (including C) would recognize a $267 gain ($800 divided by 3). Thus, C would pay tax on $133 more gain ($400 minus $267) than if the partnership had not distributed Parcel X. On the other hand, C is relieved of responsibility for $133 gain inherent in Parcel Y ($1,800 value minus $1,400 basis equals $400 gain; $400 gain divided by 3 partners equals $133).

II.Q.8.a.iii.(b). Basis Stripped from Distributed Property and Applied to Remaining Property

Each of D, E, and F contributes $200 to a partnership, which uses its $600 contributions to buy land: $200 for Parcel M and $400 for Parcel N. Parcel M increases in value to $400, and Parcel N decreases in value to $200. The partnership distributes Parcel N to F in redemption of F's partnership interest. Parcel N's basis is reduced to F's $200 basis, which is a $200 ($400 basis inside the partnership minus $200 in F's hands) basis reduction. If the partnership has a Code § 754 election in place, the $200 basis

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[3851] See part III.B.5.d.ii Code § 6166 Deferral.

[3852] See part III.B.5.d.ii Code § 6166 Deferral, especially part III.B.5.d.ii.(a) What is a Business?

[3853] Code § 6166(b)(9). Although Code § 6166(b)(8) provides special rules making corporate holding companies eligible, it does not apply to partnership holding companies. For more details, see fn. 5373.

that is stripped from Parcel N is added to the basis of Parcel M, which is increased from $200 to $400.

II.Q.8.a.iii.(c). Basis Stripped from New Property and Applied to Existing Property

Each of G, H, and I contributes $100 to a partnership, which buys Parcel T (raw land) for $300. Parcel T's value increases to $900, and the partners take advantage of this value increase by causing the partnership to borrow $600 (which is $200 debt per partner) and distribute that $600 equally to G, H and I ($600 divided by 3 equals $200 distribution each), resulting in each having a capital account of -$100 ($100 initial contribution minus $200 distribution), which also happens to equate to $100 debt in excess of basis ($200 share of debt minus $100 original capital contribution). Note that each partner's share of Parcel T's unrealized appreciation is $200, which is $600 ($900 value minus $300 basis) divided by 3.

The partnership borrows $300 to buy Parcel U (raw land) for $300. Parcel U retains its value. Thus, the partnership's net value continues to be $300, which is the excess of the $1,200 values of Parcels T ($900) and U ($300) over the partnership's debt of $900 ($600 on Parcel T and $300 on Parcel U).

The partnership distributes Parcel U to G to redeem G's partnership interest. G assumes $200 of the debt on Parcel U, and the partnership shifts $100 of the debt on Parcel U to Parcel T. Thus, G receives $100 net value ($300 value of Parcel U minus $200 debt assumed). The basis of G's partnership interest before the distribution was $200, consisting of $100 original contribution plus $300 debt (1/3 of the partnership's $900 debt before distribution) minus $200 prior cash distribution. On the distribution, G assumed $200 of debt and was relieved of $300 of debt, for a net reduction in debt of $100. This $100 net debt reduction is treated as a $100 cash distribution. Thus, the basis of G's partnership interest after the distribution is $100 ($200 basis before distribution minus $100 deemed distribution), and G recognizes no gain or loss on the redemption on G's partnership interest. After the redemption:

- Parcel U's basis is reduced from its original $300 to the $100 basis of G's partnership interest. This $200 basis strip ($300 original basis minus $100 remaining basis) from Parcel U will be applied to increase the partnership's basis in Parcel T from its initial $300 to a new $500 if the partnership has a Code § 754 election in effect.

- G winds up with Parcel U with a $300 value, $100 basis, and a $200 debt. Thus, the net value of G's position is $100 ($300 value minus $200 debt). Before the redemption, G had net debt in excess of basis of $100; after the redemption, G continues to have $100 debt in excess of basis ($200 debt minus $100 basis in Parcel U).

- The partnership has Parcel T with $900 value, $500 basis, and $700 debt ($600 from the original borrowing and $100 from Parcel U). Thus, the partnership has property with $400 value in excess of basis ($900 value minus $500 basis), which is $200 value in excess of basis per partner ($400 divided by 2 partners), the same as before the redemption. Furthermore, the partnership has $200 debt in excess of basis ($700 debt minus $500 basis), which translates to each partner having $100 debt in excess of basis ($200 divided by 2 partners).

Has the partnership made a disguised sale of Parcel U to G? See Reg. § 1.707-6(b)(2).

II.Q.8.a.iii.(d). Basis Shift When Parent Owns Large Majority

Parent owns 98%, Son owns 1%, and Daughter owns 1% of a partnership. The partnership has land that the partnership previously bought that has $100 value and $100 debt, so the partnership has net equity of zero and each partner's interest is worthless. Based on prior distributions that zeroed out everyone's basis, Parent is allocated $98 debt in excess of basis, and each of Son and Daughter is allocated $1 debt in excess of basis ($2 total).

Partnership plans to sell the property, would result in $98 gain to Parent, $1 gain to Son, and $1 gain to Daughter.

Instead, Parent contributes $25 to the partnership, which the partnership uses, together with $100 of additional borrowing to buy Parcel Q (land) for $125.

The partnership then redeems Parent, distributing Parcel Q and its associated $100 debt to Parent. Parent's basis in Parent's partnership interest before the redemption was $123, which comes from $98 original debt plus $98 new debt (98% of the $100 borrowed to buy Parcel Q) plus $25 contributed toward the purchase of Parcel Q minus $98 prior distributions. In the redemption, Parent assumed the $100 debt but was relieved of Parent's $196 ($98 original debt plus $98 new debt) share of liabilities before the redemption, the basis of Parent's partnership interest decreased by $96 ($196 liabilities relieved minus $100 liabilities assumed) to $27 ($123 minus $96). Thus, Parcel Q's basis deceases from its original $125 basis to $27 (the basis of Parent's partnership interest), a $98 reduction in basis. If the partnership has a Code § 754 election in place, this $98 basis strip from Parcel Q translates into a $98 increase in the basis of the original land.

After the redemption, each of Son and Daughter owns one half of the partnership. The partnership has the original land, with a value of $100, basis of $98, and liabilities of $100. When Parent was redeemed, Son and Daughter assumed the partnership's original debt, so their share of liabilities increases by $98 from $2 combined to $100 combined. Their basis increases correspondingly, so that, instead of having $2 debt in excess of basis, they have $98 debt in excess of basis ($100 liabilities allocated minus $2 prior distributions).

Thus, when the partnership sells the original property for $100, the partnership recognizes a $2 gain ($100 proceeds minus $98 basis), the same $2 gain that would have been allocated to Son and Daughter if Parcel Q had never come into the picture.

The difference is in Parent's treatment. Parent would have been allocated $98 gain before Parcel Q came into the picture. Now, Parent does not pay any tax on the sale of the original land. Instead, the basis of Parcel Q has been reduced by $98 because of the redemption. If Parent holds Parcel Q until death, Parcel Q's unrealized gain is wiped out by a basis step-up.

II.Q.8.b. Partnership Redemption or Other Distribution

II.Q.8.b.i. Distribution of Property by a Partnership

Distributions to a partner may be taxable under Code §§ 731, 704(c)(1)(B), and 737.[3854] After the parts describing Code § 731 are the discussions of the other two sections.

II.Q.8.b.i.(a). Code § 731: General Rule for Distributions

Partnership distributions of property are usually tax-free to both the partnership and the partner under Code § 731(a)[3855] and (b), whether current distributions or liquidating distributions.[3856]

[3854] Partnership distributions might also be subject to the anti-abuse rules (regulations issued under Code § 701), which was asserted in CCA 200650014 when a partnership acquired real estate to be distributed to a partner and that partner was allocated all of the economic risks of that real estate purchase.

[3855] A loan from a partnership to a partner who is obligated to repay the amount of the loaned money or property does not constitute a distribution subject to Code § 731 but is a loan governed by Code § 707(a). To the extent that such an obligation is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation. Reg. § 1.731-1(c)(2). The partnership has taxable income or loss in an amount equal to the difference between its basis in the distributed debt and the debt's fair market value at the time of the distribution, just as if the partnership had sold the debt for this amount and distributed the sale proceeds to the distributee-partner-debtor. The distributee-partner generally does not recognize any gain on the distribution unless the amount of the distribution exceeds the basis of his interest and, unless the special liquidating distribution rule in Code § 731(a)(2) applies, does not recognize a loss; however, the distributee-partner might recognize cancellation-of-indebtedness income on the deemed purchase of the debt. McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 19.02[5] Distributions of a Partner's Debt to the Debtor-Partner. Letter Ruling 201314004 confirmed the Code § 731 aspects of such a distribution but did not address any other issues. The IRS treats differently partner indebtedness that the partnership bought from a third party. In that case, if the partnership distributes (in a liquidating or nonliquidating distribution) the indebtedness to the partner so that the debt is extinguished, the distribution of property rules will apply to determine the consequences for the partnership. Under Code § 61(a)(12) (and Reg. § 1.61-12(c)(2)), the partner is treated as having repurchased its indebtedness for an amount equal to the fair market value of the indebtedness and therefore will recognize capital gain or loss to the extent the fair market value of the indebtedness differs from the basis of the indebtedness determined under Code § 732. Rev. Rul. 93-7. CCA 201525010 stated, The regulations under § 752 do not determine if a debt is recourse or nonrecourse to a partnership for purposes of determining whether, upon foreclosure of the property, the partnership has cancellation of debt income under § 61(a)(12) or gains from dealings in property under § 61(a)(3). A panel at the May 2016 meeting of the ABA Section on Taxation seemed to disagree with the assumption of the parties in *Great Plains Gasification Associates v. Commissioner*, T.C. Memo. 2006-276, that certain debt was nonrecourse based on Code § 752. The author of CCA 201525010 indicated that the CCA was not just her view but rather was a consensus approach at the IRS.

A deficit capital account is not by itself sufficient to establish the creation of a loan. Similarly, the fact that on a final accounting the partners will take a deficit capital account into consideration is not sufficient to create an obligation to repay a loan. If there is no unconditional and legally enforceable obligation that requires a partner to repay any of the amounts withdrawn to the partnership on or before a determinable date, then withdrawals by that partner that created a

Exceptions to this rule include:

- Part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value

- Part II.Q.8.b.i.(f) Code § 751 – Hot Assets

- Part II.M.3.e Exception: Disguised Sale.

Also, Code § 731(a)(1) requires a partner to recognize gain on a monetary distribution when the distribution exceeds the partner's adjusted basis in the partnership;[3857] for the taxation of any gain, see part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner. A reduction in a partner's share of liabilities[3858] is considered a cash payment in the amount of the liabilities discharged.[3859] The amount of gain

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deficit in his capital account are not loans governed by Code § 707(a) but are partnership distributions received by him in his capacity as a partner. Rev. Ruls. 73-301, 81-241.

[3856] Reg. § 1.731-1(a)(1)(i).

[3857] Code § 731(a)(2) explains potential loss recognition consequences of a partnership distribution.

[3858] See part II.C.3 Allocating Liabilities (Including Debt).

[3859] Rev. Rul. 74-40, Situations 2 and 3 are most relevant, but let's look at all three for the sake of completeness. Situation 1 involved the following facts and conclusions:

> L is a limited partner in partnership GL to which he contributed $10,000 in cash on its formation. His distributive share of partnership items of income and loss is 10 percent and he is not entitled to receive any guaranteed payments. The adjusted basis of his partnership interest at the end of the current year is $20,000. His proportionate share of partnership liabilities, on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000. The partnership has no other liabilities. L sells his interest in the partnership to M, an unrelated taxpayer, for $10,000 in cash. At the time of the transaction the partnership had no unrealized receivables or inventory items described in section 751 of the Internal Revenue Code of 1954 nor any goodwill and L had been paid his distributive share of partnership income.
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> [Citations to Code §§ 752(c) and 741 and to Reg. §§ 1.752-1(e) and 1.751-1(d) follow.]
>
> Accordingly, in the instant situation, the amount realized by L from the sale of his partnership interest is $25,000, consisting of cash in the amount of $10,000 and release from his share of partnership liabilities in the amount of $15,000. Since the adjusted basis of L's interest in the partnership is $20,000, he realized a gain of $5,000 determined under the provisions of section 741 of the Code.

Situation 2 involved the following facts and conclusions:

> The facts are the same as in situation 1, except that L withdraws from the partnership and the partnership distributes $10,000 to him in cash in complete liquidation of his interest in the partnership.
>
> [Citations to Code §§ 752(b), 731(a), 731(c) and 736 and to Reg. § 1.736-1(b)(1) follow.]
>
> Accordingly, in the instant situation, distributions to L with respect to his partnership interest total $25,000 and consist of cash in the amount of $10,000 and a decrease in his share of the partnership liabilities in the amount of $15,000 that is considered under section 752(b) of the Code as a distribution of money to L by the partnership.
>
> Furthermore, since the money distributed ($25,000) exceeds the adjusted basis of L's interest in the partnership immediately before the distribution ($20,000), he realizes a gain of $5,000 determined under the provisions of section 731(a) of the Code.

recognized is the excess of the distribution over the partner's adjusted basis;[3860] basis in a partnership interest includes any partnership debt allocated to it.[3861] If the partnership distributes cash and property to a partner in the same transaction, the partner applies the cash to basis and then allocates basis to the property distributed.[3862] However, if a liquidating distribution consists of only cash, unrealized receivables, or inventory with an adjusted basis to the recipient partner that is less than the partner's adjusted basis in the partnership, then the partner would recognize loss.[3863]

However, special rules apply to marketable securities, which might be treated as cash for purposes of Code § 731(a)(1) and therefore might trigger gain on distributions.[3864]

II.Q.8.b.i.(b). Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them)

Although marketable securities are not normally be considered cash for income tax purposes, they are treated as "money" for purposes of Code § 731(a)(1) gain calculation.[3865] Thus, distributions of marketable securities can result in gain under Code § 731(a)(1), if the total amount of money and securities distributed is higher than the adjusted basis of the partner's partnership interest. Beware that "marketable

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Situation 3 involved the following facts and conclusions:

> Instead of selling his interest L withdraws from the partnership at a time when the adjusted basis of his interest in the partnership is zero and his proportionate share of partnership liabilities, all of which consist of liabilities on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000.
>
> Accordingly, L is considered to have received a distribution of money from the partnership of $15,000 and realizes a gain of $15,000 determined under the provisions of section 731(a) of the Code.

See also Rev. Rul. 77-402 (similar result when grantor trust status terminates with respect to a partnership interest), discussed in fn. 4974, found in part III.B.2.a Tax Basis Issues When Using Irrevocable Grantor Trusts, and Rev. Rul. 75-194 (deemed bargain sale of partnership interest contributed to charity), discussed in fn. 3313, found in part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity.

[3860] Code § 731(a)(1).

[3861] See part II.C.3 Allocating Liabilities (Including Debt), especially part II.C.3.a Basic Consequences of Changes in Liability Allocations.

[3862] Although Code § 731 and the regulations thereunder do not appear to address this issue, Reg. § 1.732-1(a) and (b) implicitly mandate this result when determining the basis of assets distributed to a partner.

[3863] Code § 731(a)(2).

[3864] See part II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them).

[3865] Code § 731(c)(1). Marketable securities are defined in Code § 731(c)(2)(A) as financial instruments and foreign currencies which are, as of the date of distribution, actively traded. Code § 731(c)(2)(B) includes mutual funds, derivatives and various other financial instruments. Code § 731(c)(2)(C) defines financial instruments to include stocks and other equity interests, evidences of indebtedness, options, forwards, futures, notional principal contracts and derivatives.

securities" means not only financial instruments[3866] and foreign currencies which are, as of the date of the distribution, actively traded,[3867] but also:[3868]

- any interest in a common trust fund or a regulated investment company, the latter which is offering for sale or has outstanding any redeemable security[3869] of which it is the issuer,

- any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities,[3870]

- any financial instrument the value of which is determined substantially by reference to marketable securities,

- except to the extent provided in regulations, any interest in a precious metal which, as of the date of the distribution, is actively traded[3871] unless such metal was produced, used, or held in the active conduct of a trade or business by the partnership,

- except as otherwise provided in regulations, interests in any entity[3872] if substantially all of the assets[3873] of such entity consist (directly or indirectly) of marketable securities, money, or both, and

- to the extent provided in regulations,[3874] any interest in an entity[3875] not described in the preceding bullet point to the extent of the value of such interest which is attributable to marketable securities, money, or both.

3866 Financial instrument includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives. Code § 731(c)(2)(C).

3867 Code § 731(c)(2)(A).

3868 Code § 731(c)(2)(B).

3869 As defined in section 2(a)(32) of the Investment Company Act of 1940. Code § 731(c)(2)(B)(i)(II).

3870 FSA 200219008 asserted that short-term (nine-month) debt instruments issued by a bank should be treated as financial instruments that were readily convertible into money. The IRS probably viewed them as the equivalent of certificates of deposit.

3871 Within the meaning of Code § 1092(d)(1). Code § 731(c)(2)(B)(iv).

3872 According to Letter Ruling 200223036, this includes a partnership division under part II.Q.8.d Partnership Division. More details on the Letter Ruling are at fn. 4086.

3873 Reg. § 1.731-2(c)(3)(i) provides:

> *Substantially all*. For purposes of section 731(c)(2)(B)(v) and this section, substantially all of the assets of an entity consist (directly or indirectly) of marketable securities, money, or both only if 90 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

This rule also applies for purposes of the investment company rules that might trigger gain recognition when a partnership is formed. See part II.M.3.b Exception: Diversification of Investment Risk, fn. 2503.

3874 Reg. § 1.731-2(c)(3)(ii) provides:

> *Less than substantially all*. For purposes of section 731(c)(2)(B)(vi) and this section, an interest in an entity is a marketable security to the extent that the value of the interest is

However, two exceptions to the "marketable securities are money" rule of Code § 731(c) often apply. First, a marketable security is not treated as money if the security was contributed to the partnership by the partner receiving the distribution, except to the extent the security's value is attributable to other marketable securities or money contributed to the entity to which the distributed security relates.[3876] Second, Code § 731(c) does not apply to distributions of marketable securities by investment partnerships to eligible partners.[3877] An investment partnership is defined in Code § 731(c)(3)(C)(i) as a partnership that never has been engaged in any trade or business[3878] and whose assets have always substantially consisted of money, stock, notes and bonds, interest rate or currency contracts, foreign currencies, interests in or derivate financial instruments, and other specifically prescribed assets; and an eligible partner is a partner who has contributed only the aforementioned types of assets to the partnership.[3879] With regard to investment partnership status, remember that, if the partnership owns an interest in an entity that is a disregarded entity or partnership for federal income tax purposes, that entity's activity will be treated as a trade or business activity of the holding partnership. Thus, it could be beneficial to set up two partnerships and have one hold the assets that will prevent investment partnership status and another that would be an investment partnership. Furthermore, certain investment partnerships formed with almost all contributions being in the form of cash might be eligible for

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> attributable (directly or indirectly) to marketable securities, money, or both, if less than 90 percent but 20 percent or more of the assets of the entity (by value) at the time of the distribution of an interest in the entity consist (directly or indirectly) of marketable securities, money, or both.

This rule also applies for purposes of the investment company rules that might trigger gain recognition when a partnership is formed. See part II.M.3.b Exception: Diversification of Investment Risk, fn. 2503.

[3875] Letter Ruling 200223036 provides helpful analysis of the consequences of a situation similar to this arising from a partnership division. See fn. 4086.

[3876] Code § 731(c)(3)(A)(i); Reg. § 1.731-2(d)(1)(i). Letter Rulings 201537002 and 201537003 applied that rule to replacement stock certificates (referring to Reg. § 1.1012-1(c)(2)) for purposes of this rule and Code §§ 704(c)(1)(B) and 737; the rulings appear to be merely comfort rulings, because nothing jumped out at me as in doubt.

[3877] Reg. § 1.731-2(e)(1). An eligible partner includes a remainderman of a trust that was an eligible partner. Letter Rulings 200824005 and 200824009. This includes the remaindermen when the LLC starts as a disregarded entity and becomes a partnership when distributed to the remaindermen. Letter Ruling 201421001 (described more fully in fn. 307). However, it does not include the transferor or transferee in a nonrecognition transaction involving a transfer of any portion of an interest in a partnership with respect to which the transferor was not an eligible partner. Code § 731(c)(3)(C)(iii)(II).

[3878] Reg. § 1.731-2(e)(4) provides:

> *Partnership tiers*. For purposes of section 731(c)(3)(C)(iv) and this section, a partnership (upper-tier partnership) is not treated as engaged in a trade or business engaged in by, or as holding (instead of a partnership interest) a proportionate share of the assets of, a partnership (lower-tier partnership) in which the partnership holds a partnership interest if—
>
> (i) The upper-tier partnership does not actively and substantially participate in the management of the lower-tier partnership; and
>
> (ii) The interest held by the upper-tier partnership is less than 20 percent of the total profits and capital interests in the lower-tier partnership.

[3879] Code § 731(c)(3)(C)(iii). Investment partnerships, as defined in 86 Ill. Admin. Code § 100.9730, are also exempted from the Illinois replacement tax that generally would otherwise apply to an Illinois partnership. 35 ILCS 5/205(b).

avoiding the mandatory inside basis step-down that applies when certain transfers of partnership interests or assets occur when a partnership has significant loss assets.[3880]

Two more exceptions might not apply frequently, but are still important to note. First, if the security was acquired in a nonrecognition transaction and the value of the securities and money exchanged in that nonrecognition transaction is less than 20% of the value of all the assets exchanged in the nonrecognition transaction, the securities will not be considered money.[3881] Additionally, the security is not treated as money if it was not a marketable security on the date the partnership acquired it and the issuing entity did not have any outstanding marketable securities at that time, the partnership held the security for at least six months before it became marketable, and the partnership distributed the security within five years of when it became marketable.[3882]

In addition to these four general exceptions to Code § 731(c), Code § 731(c)(3)(B) limits the amount of marketable securities treated as money, thereby limiting the amount of gain a recipient partner has to recognize. The limitation is calculated by first determining the partner's share of the partnership's built-in gain in all of its marketable securities, before the distribution is made.[3883] From this amount you subtract the partner's distributive share of the built-in gain that is attributable to marketable securities held by the partnership immediately after the transaction.[3884] The end result is the amount of marketable securities that are treated as "property other than money." Thus, to the extent a distribution of marketable securities does not decrease the recipient's share of built-in gain, the recipient will not be taxed under Code § 731(c). In other words:

- Try to make sure that each person retains a proportionate amount of unrealized appreciation.

- If the parties miss the mark a little, then they are taxed on shifted unrealized appreciation only to the extent that they missed the mark.

- Consider that any tax imposed will increase basis. Given that marketable securities tend to turn over anyway, part or all of the tax due to missing the mark a little might very well be saved when the marketable securities are later sold.

II.Q.8.b.i.(c). Disguised Sale from Partnership to Partner

A distribution of property from a partnership to a partner may be recharacterized as sale of that property in exchange for the partner's contribution of cash or property.[3885]

[3880] See text accompanying footnote 4175.
[3881] Reg. § 1.731-2(d)(1)(ii).
[3882] Reg. § 1.731-2(d)(1)(iii).
[3883] Code § 731(c)(3)(B); Reg. § 1.731-2(b)(2).
[3884] *Id*.
[3885] Reg. § 1.707-6(a) provides:

> Rules similar to those provided in § 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.

Generally, one would apply rules similar to those described in part II.M.3.e Exception: Disguised Sale.[3886]

Thus, when a partnership distributes property and within two years after the distribution the recipient contributes cash, the partnership is deemed to have sold the property if the rules described in part II.M.3.e Exception: Disguised Sale would have recharacterized the opposite transaction.[3887]

Disclosure rules similar to those described in part II.M.3.e Exception: Disguised Sale would apply.[3888]

II.Q.8.b.i.(d). Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property

When the distribution is a liquidating distribution, the partner's adjusted basis in the distributed property is equal to the adjusted basis of the partner's interest in the partnership, less any money distributed.[3889] Therefore, if a high basis partnership interest is redeemed in exchange for low basis property, the property receives a new basis equal to the basis of the redeemed partnership interest;[3890] this basis increase has no consequences to the partnership if a Code § 754 election is not in place (and certain

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[3886] See fn. 3885, in which Reg. § 1.707-6(a) refers to Reg. § 1.707-3.

[3887] Reg. § 1.707-6(d), Example (1), "Sale of property by partnership to partner," provides:

(i) A is a member of a partnership. The partnership transfers property X to A. At the time of the transfer, property X has a fair market value of $1,000,000. One year after the transfer, A transfers $1,100,000 to the partnership. Assume that under the rules of section 1274 the imputed principal amount of an obligation to transfer $1,100,000 one year after the transfer of property X is $1,000,000 on the date of the transfer.

(ii) Since the transfer of $1,100,000 to the partnership by A is made within two years of the transfer of property X to A, under rules similar to those provided in § 1.707-3(c), the transfers are presumed to be a sale unless the facts and circumstances clearly establish otherwise. If no facts exist that would rebut this presumption, on the date that the partnership transfers property X to A, the partnership is treated as having sold property X to A in exchange for A's obligation to transfer $1,100,000 to the partnership one year later.

[3888] Reg. § 1.707-6(c) provides:

Disclosure rules. Similar to the rules provided in §§ 1.707-3(c)(2) and 1.707-5(a)(7)(ii), a partnership is to disclose to the Internal Revenue Service, in accordance with § 1.707-8, the facts in the following circumstances:

(1) When a partnership transfers property to a partner and the partner transfers money or other consideration to the partnership within a two-year period (without regard to the order of the transfers) and the partnership treats the transfers as other than a sale for tax purposes; and

(2) When a partner assumes or takes subject to a liability of a partnership in connection with a transfer of property by the partnership to the partner, and the partnership incurred the liability within the two-year period prior to the earlier of the date the partnership agrees in writing to the transfer of property or the date the partnership transfers the property, and the partnership treats the liability as a qualified liability under rules similar to § 1.707-5(a)(6)(i)(B).

[3889] Code § 732(b).

[3890] Code § 732(b).

mandatory basis adjustments are not in effect)[3891] and no consequences to the redeemed partner or other partners so long as none of the exceptions to the nonrecognition apply.[3892] The consequence would be a basis reduction.[3893] However, this basis reduction would apply only to the extent of any unrealized losses in the partnership's assets; it would not reduce the basis of any assets with unrealized gains.[3894]

In non-liquidating distributions, the partner's adjusted basis in the property distributed is simply the partnership's adjusted basis in the property before the distribution.[3895] However, the partner's adjusted basis in the distributed property cannot exceed his adjusted basis in his partnership interest less any money distributed at the same time.[3896]

The substituted basis portion continues the partnership The substituted basis portion continues the contributing partner's depreciation schedule.[3897]

If a transferee partner receives a distribution of property from the partnership within two years after acquiring an interest or part thereof in the partnership by a transfer with respect to which a Code § 754 election was not in effect, the partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have as if a Code § 754 election were in effect; see part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election. This applies whether or not the distribution liquidates the partnership interest.

However, when a partnership distributes unrealized receivables (Code § 751(c)) or substantially appreciated inventory items (Code § 751(d)) in exchange for any part of a partner's interest in other partnership property (including money), or, conversely, partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items, the distribution will be treated as a sale or exchange of property under the provisions of

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[3891] Part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 2159 briefly describes the effect on basis when a Code § 754 election is in place or in connection with certain substantial built-in loss transactions.

[3892] For possible exceptions to nonrecognition, see parts II.Q.8.b.i.(b) Code § 731(c): Distributions of Marketable Securities (Or Partnerships Holding Them), II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, and II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

[3893] See part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

[3894] See fn. 4195, found in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[3895] Code § 732(a)(1).

[3896] Code § 732(a)(2).

[3897] Code § 168(i)(7).

Code § 751(b).[3898] In such case, Code § 732 determines the partner's basis of the property which the partner is treated as having sold to or exchanged with the partnership (as constituted after the distribution); the partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it.[3899] However, Code § 732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by the partner in a sale or exchange under Code § 751(b), so the basis of such property shall be its cost to the partner.[3900]

The rule that assets received in a liquidating distribution get a basis equal to the liquidated partnership interest's basis can result in the liquidated asset receiving a basis step-up:[3901]

> Partner B, with a partnership interest having an adjusted basis to him of $12,000, retires from the partnership and receives cash of $2,000, and real property with an adjusted basis to the partnership of $6,000 and a fair market value of $14,000. The basis of the real property to B is $10,000 (B's basis for his partnership interest, $12,000, reduced by $2,000, the cash distributed).

However, this can turn around to bite the taxpayer, when the basis of the distributed assets exceeds the basis of the recipient's partnership interest (even if not in liquidation):[3902]

> Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed).

Thus, the distributed property's basis decreased by $2,000, the excess of the $8,000 basis before the distribution over the $6,000 basis after the distribution.

However, Code § 734(b)(1), which applies if a Code § 754 election is in effect,[3903] causes the partnership to allocate this basis to other assets.

Special opportunities are available if the partnership has low basis property and a partner has a low basis partnership interest. (The partner might need to receive a large cash distribution to turn a high basis partnership interest into a low basis partnership interest.)[3904] The partnership borrows to buy property. The partnership then distributes

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[3898] Reg. § 1.732-1(e).

[3899] Reg. § 1.732-1(e), referring to Code § 751(b) and Reg. § 1.751-1(b).

[3900] Reg. § 1.732-1(e).

[3901] Reg. § 1.732-1(b).

[3902] Reg. § 1.732-1(a), Example (2).

[3903] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[3904] If the partnership borrows to finance this distribution, consider the interest tracing rules to make sure that the partnership can deduct the interest. Because the debt the partnership incurred generally would give everyone's partnership interest a higher basis, note the suggestions further below in this part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible the new property to the partner with the low basis. If a Code § 754 election is in place or if the distribution falls within the special rules of Code § 732(d), the distribution strips basis from the new property and results in the partnership allocating that stripped basis to the old, low basis property.

This basis stripping technique requires more work than is described above. The debt the partnership incurred generally would give everyone's partnership interest a higher basis.[3905] Increasing the basis of the distributee partner's partnership interest would reduce the basis stripping. Keeping the basis of the distributee partner's partnership interest low requires one of the following to occur:

- Make the distribution terminate the partner's interest in the partnership. Because the distributee will no longer be a partner, he will no longer be allocated any liabilities in the partnership. This reallocation of liabilities will be treated as a cash distribution,[3906] reducing the basis of his partnership interest available to allocate to the distributed property.[3907]

    - If the partner whose interest is being redeemed contributed to the partnership within seven years assets that the partnership retains <u>or</u> was allocated some built-in gain in the property when other partners were later admitted to the partnership, the partner would recognize gain when leaving the partnership,[3908] undercutting part or all of the short-term tax saving from the basis stripping transaction. To plan in advance for the possibility of using this strategy, on might consider forming a partnership many years before the opportunity arises.[3909]

    - If the partner wishes to stay in the partnership, consider dividing the partnership before this series of transactions,[3910] so that only the low basis asset remains in the partnership that eventually would buy this new property. Note, however, that a partnership division that distributes a partnership holding marketable securities might trigger Code § 731(c) gain.[3911]

- Take some special action to make sure that the partners other than the distributee partner are allocated the debt used to buy the new property. These actions relate to

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Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property for keeping the basis of the distributee partner's partnership interest low.

3905 Code §§ 752(a) (a partnership's incurring debt is treated as a cash contribution to the partnership), 722 (contribution of cash increases the basis of the contributor's partnership interest).

3906 Code § 752(b).

3907 Reg. § 1.732-1(b).

3908 See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value.

3909 See part II.Q.8.a Partnership as a Master Entity.

3910 See part II.Q.8.d Partnership Division. The division should keep the partners' percentage ownership the same in each partnership before and after the division to prevent the 7-year anti-mixing bowl rules (see fn. 3908) from applying to either partnership; see fn. 4056.

3911 See fns. 3872 and 4086.

the nature of the debt, loan guarantees, and other documentation shifting risk of loss regarding the debt.[3912]

- If the distributed property is encumbered by debt to reduce the equity distributed to the redeemed partner, make sure that the debt is old and cold.[3913]

Also, be careful not to trip the anti-abuse regulations, which set forth basic ideas generally respecting[3914] or criticizing[3915] partnership transactions, including a facts and

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[3912] See part II.C.3 Allocating Liabilities (Including Debt). Code § 752 analysis can interact with the Code § 465 at-risk rules; see part II.G.3.g At Risk Rules, especially CCA 201606027, including key excerpts in fns. 876-879.

[3913] See Reg. § 1.707-6(b)(2) (dealing with liabilities incurred in connected with disguised sales). Reg § 1.707-6(d) includes the following example:

Example (2). *Assumption of liability by partner*.

(i) B is a member of an existing partnership. The partnership transfers property Y to B. On the date of the transfer, property Y has a fair market value of $1,000,000 and is encumbered by a nonrecourse liability of $600,000. B takes the property subject to the liability. The partnership incurred the nonrecourse liability six months prior to the transfer of property Y to B and used the proceeds to purchase an unrelated asset. Assume that, under the rule of § 1.707-5(a)(2)(ii) (which determines a partner's share of a nonrecourse liability), B's share of the nonrecourse liability immediately before the transfer of property Y was $100,000.

(ii) The liability is not allocable under the rules of § 1.163-8T to capital expenditures with respect to the property transferred to B and was not incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held. Since the partnership incurred the nonrecourse liability within two years of the transfer to B, under rules similar to those provided in § 1.707-5(a)(5), the liability is presumed to be incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary. Assuming no facts exist to rebut this presumption, the liability taken subject to by B is not a qualified liability. The partnership is treated as having received, on the date of the transfer of property Y to B, $500,000 ($600,000 liability assumed by B less B's share of the $100,000 liability immediately prior to the transfer) as consideration for the sale of one-half ($500,000/$1,000,000) of property Y to B. The partnership is also treated as having distributed to B, in B's capacity as a partner, the other one-half of property Y.

[3914] Reg. § 1.701-2(a) provides:

Intent of subchapter K. Subchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax. Implicit in the intent of subchapter K are the following requirements—

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those

circumstances test.[3916] These regulations accept some basis shifting, which is inherent in Code § 732 itself, such as apportioning among tangible assets with equal value[3917] or

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> provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. See, for example, paragraph (d) Example 6 of this section (relating to the value-equals-basis rule in § 1.704-1(b)(2)(iii)(c)), paragraph (d) Example 9 of this section (relating to the election under section 754 to adjust basis in partnership property), and paragraph (d) Examples 10 and 11 of this section (relating to the basis in property distributed by a partnership under section 732). See also, for example, §§ 1.704-3(e)(1) and 1.752-2(e)(4) (providing certain de minimis exceptions).

For regulations under Code § 752 that were changed in October 2016, see part II.C.3 Allocating Liabilities (Including Debt).

[3915] Reg. § 1.701-2(b) provides:

> *Application of subchapter K rules.* The provisions of subchapter K and the regulations thereunder must be applied in a manner that is consistent with the intent of subchapter K as set forth in paragraph (a) of this section (intent of subchapter K). Accordingly, if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K—
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> (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
> (2) One or more of the purported partners of the partnership should not be treated as a partner;
> (3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;
> (4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or
> (5) The claimed tax treatment should otherwise be adjusted or modified.

[3916] Reg. § 1.701-2(c) provides:

> *Facts and circumstances analysis; factors.* Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. These factors are illustrative only, and therefore may not be the only factors taken into account in making the determination under this section. Moreover, the weight given to any factor (whether specified in this paragraph or otherwise) depends on all the facts and circumstances. The

presence or absence of any factor described in this paragraph does not create a presumption that a partnership was (or was not) used in such a manner. Factors include:

(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;

(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

(5) Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. In this regard, particular scrutiny will be paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or

(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

[3917] Reg. § 1.701-2(d) provides:

Example (10). Basis adjustments under section 732; use of partnership consistent with the intent of subchapter K.

(i) A, B, and C are partners in partnership PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of $100x, will be liquidated with the following assets of PRS: a nondepreciable asset with a value of $60x and a basis to PRS of $40x, and related equipment with two years of cost recovery remaining and a value and basis to PRS of $40x. Neither asset is described in section 751 and the transaction is not described in section 732(d). Under section 732(b) and (c), A's $100x basis in A's partnership interest will be allocated between the nondepreciable asset and the equipment received in the liquidating distribution in proportion to PRS's bases in those assets, or $50x to the nondepreciable asset and $50x to the equipment. Thus, A will have a $10x built-in gain in the nondepreciable asset ($60x value less $50x basis) and a $10x built-in loss in the equipment ($50x basis less $40x value), which it expects to recover rapidly through cost recovery deductions. In selecting the assets to be distributed to A, the partners had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference among a group of nonmarketable securities[3918] the basis of a partnership interest that is being liquidated. On the other hand, the regulations view as abusive duplication of

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to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly. This shift provides a federal tax timing advantage to A, with no offsetting detriment to B or C.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) A's basis in the assets distributed to it was determined under section 732(b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a nondepreciable to a depreciable asset. However, the basis rules under section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard (see paragraph (a)(3) of this section), are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision of subchapter K, are clearly contemplated. Thus, the application of section 732 to this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

[3918] Reg. § 1.701-2(d) provides:

Example (9). Absence of section 754 election; use of partnership consistent with the intent of subchapter K.

(i) PRS is a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, A, a partner with a capital account balance and basis in its partnership interest of $100x, wishes to withdraw from PRS. The partnership agreement entitles A to receive the balance of A's capital account in cash or securities owned by PRS at the time of withdrawal, as mutually agreed to by A and the managing general partner, P. P and A agree to distribute to A $100x worth of non-marketable securities (see section 731(c)) in which PRS has an aggregate basis of $20x. Upon distribution, A's aggregate basis in the securities is $100x under section 732(b). P RS does not make an election to adjust the basis in its remaining assets under section 754. Thus, PRS's basis in its remaining assets is unaffected by the distribution. In contrast, if a section 754 election had been in losses a partner contributing property with a built-in loss and later receiving other assets with low value in liquidation of his partnership interest (to get a high basis allocated to the distributed assets), then selling the distributed assets at a loss,[3919] a result largely

effect for the year of the distribution, under these facts section 734(b) would have required PRS to adjust the basis in its remaining assets downward by the amount of the untaxed appreciation in the distributed property, thus reflecting that gain in PRS's retained assets. In selecting the assets to be distributed, A and P had a principal purpose to take advantage of the facts that A's basis in the securities will be determined by reference to A's basis in its partnership interest under section 732(b), and because PRS will not make an election under section 754, the remaining partners of PRS will likely enjoy a federal tax timing advantage (i.e., from the $80x of additional basis in its assets that would have been eliminated if the section 754 election had been made) that is inconsistent with proper reflection of income under paragraph (a)(3) of this section.

(ii) Subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. See paragraph (a) of this section. The decision to organize and conduct business through PRS is consistent with this intent. In addition, on these facts, the requirements of paragraphs (a)(1) and (2) of this section have been satisfied. The validity of the tax treatment of this transaction is therefore dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard under paragraph (a)(3) of this section. A's basis in the distributed securities is properly determined under section 732(b). The benefit to the remaining partners is a result of PRS not having made an election under section 754. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, paragraph (a)(3) of this section provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the requirements of paragraphs (a)(1) and (2) of this section), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

(iii) In general, the adjustments that would be made if an election under section 754 were in effect are necessary to minimize distortions between the partners' bases in their partnership interests and the partnership's basis in its assets following, for example, a distribution to a partner. The electivity of section 754 is intended to provide administrative convenience for bona fide partnerships that are engaged in transactions for a substantial business purpose, by providing those partnerships the option of not adjusting their bases in their remaining assets following a distribution to a partner. Congress clearly recognized that if the section 754 elections were not made, basis distortions may result. Taking into account all the facts and circumstances of the transaction, the electivity of section 754 in the context of the distribution from PRS to A, and the ultimate tax consequences that follow from the failure to make the election with respect to the transaction, are clearly contemplated by section 754. Thus, the tax consequences of this transaction will be treated as satisfying the proper reflection of income standard under paragraph (a)(3) of this section. The Commissioner therefore cannot invoke paragraph (b) of this section to recast the transaction.

[3919] Reg. § 1.701-2(d) provides the following example in which the lack of a Code § 754 was viewed as abusive:

Example (8). Plan to duplicate losses through absence of section 754 election; use of partnership not consistent with the intent of subchapter K.

(i) A owns land with a basis of $100x and a fair market value of $60x. A would like to sell the land to B. A and B devise a plan a principal purpose of which is to permit the duplication, for a substantial period of time, of the tax benefit of A's built-in loss in the land. To effect this plan, A, C (A's brother), and W (C's wife) form partnership PRS, to which A contributes the land, and C and W each contribute $30x. All partnership items are shared in proportion to the partners' respective contributions to PRS. PRS invests the cash in an investment asset (that is not a marketable security within the meaning of section 731(c)). PRS also leases the land to B under a three-year lease pursuant to which B has the option to purchase the land from PRS upon the expiration of the lease for an amount equal to its fair market value at that time. All lease proceeds received are immediately distributed to the partners. In year 3, at a time when the values of the partnership's assets have not materially changed, PRS agrees with A to liquidate A's interest in exchange for the investment asset held by PRS. Under section 732(b), A's basis in the asset distributed equals $100x, A's basis in A's partnership interest immediately before the distribution. Shortly thereafter, A sells the investment asset to X, an unrelated party, recognizing a $40x loss.

(ii) PRS does not make an election under section 754. Accordingly, PRS's basis in the land contributed by A remains $100x. At the end of year 3, pursuant to the lease option, PRS sells the land to B for $60x (its fair market value). Thus, PRS recognizes a $40x loss on the sale, which is allocated equally between C and W. C's and W's bases in their partnership interests are reduced to $10x each pursuant to section 705. Their respective interests are worth $30x each. Thus, upon liquidation of PRS (or their interests therein), each of C and W will recognize $20x of gain. However, PRS's continued existence defers recognition of that gain indefinitely. Thus, if this arrangement is respected, C and W duplicate for their benefit A's built-in loss in the land prior to its contribution to PRS.

(iii) On these facts, any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for federal tax purposes (see paragraph (c) of this section). Accordingly, the transaction lacks a substantial business purpose (see paragraph (a)(1) of this section). In addition, factors (1), (2), and (4) of paragraph (c) of this section indicate that PRS was used with a principal purpose to reduce substantially the partners' tax liability in a manner inconsistent with the intent of subchapter K. On these facts, PRS is not bona fide (see paragraph (a)(1) of this section), and the transaction is not respected under applicable substance over form principles (see paragraph (a)(2) of this section). Further, the tax consequences to the partners do not properly reflect the partners' income; and Congress did not contemplate application of section 754 to partnerships such as PRS, which was formed for a principal purpose of producing a double tax benefit from a single economic loss (see paragraph (a)(3) of this section). Thus, PRS has been formed and availed of with a principal purpose of reducing substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance over form doctrine or the disguised sale rules under section 707 (see paragraph (h) of this section)), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

deterred by changes in the law since then.[3920] They also view as abusive distributing an insubstantial asset, allocating substantial basis to it, and then selling it at a substantial loss.[3921] Depending on the situation, not making a Code § 754 election might be

[3920] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[3921] Reg. § 1.701-2(d) provides:

> *Example (11).* Basis adjustments under section 732; plan or arrangement to distort basis allocations artificially; use of partnership not consistent with the intent of subchapter K.
>
> (i) Partnership PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS, which has a value of $95x and a basis of $5x. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan a principal purpose of which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes $100x to PRS for an interest therein. Subsequently (at a time when the value of the partnership's assets have not materially changed), PRS distributes to X in liquidation of its interest in PRS the land and another asset with a value and basis to PRS of $5x. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under section 732(b) and (c), X's $100x basis in its partnership interest is allocated between the assets distributed to it in proportion to their bases to PRS, or $50x each. Thereafter, X plans to sell the second asset for its value of $5x, recognizing a loss of $45x. In this manner, X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets will be determined under section 732(b) and (c), thus, in effect, shifting a portion of X's basis economically allocable to the land that X intends to retain to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax timing advantage to X, with no offsetting detriment to any of PRS's other partners.
>
> (ii) Although section 732 recognizes that basis distortions can occur in certain situations, which may produce tax results that do not satisfy the proper reflection of income standard of paragraph (a)(3) of this section, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard contained in paragraph (a)(3) of this section is not treated as satisfied, because, taking into account all the facts and circumstances, the application of section 732 to this arrangement, and the ultimate tax consequences that would thereby result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership (if respected), the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly (see paragraph (c)(1) of this section). On these facts, PRS has been formed and availed of with a principal purpose to reduce the taxpayers' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K. Therefore (in addition to possibly challenging the transaction under applicable judicial

considered abusive[3922] or not abusive.[3923] Also, the IRS reserves the right to assert and to rely upon applicable nonstatutory principles and other statutory and regulatory authorities to challenge transactions,[3924] which might subject taxpayers to penalties,[3925] so be careful not to get too cute.

Other partnership transactions might also be helpful.[3926]

Note that partners can shift basis without going through this process, but the transactions also require seasoning. Suppose A has for many years held low basis real estate worth $1 million. Last year, B bought real estate for $1 million, intending to hold it for investment. A and B swap real estate in a tax-free Code § 1031 exchange.[3927] The old property now has a high basis in B's hands, and the new property has a low basis in A's hands. Code § 1031 generally requires A and B to have intended to hold the property for investment when they bought them and to intend to hold the swapped property for investment after the Code § 1031 exchange.

In reviewing anything in this part II.Q.8.b.i.(d), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

II.Q.8.b.i.(e). Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value

The Code § 731(a) rule that there are no tax consequences to a partner when the partner receives a partnership distribution is subject to two exceptions if the distribution is made within seven years after the partner contributed property to the partnership:

- First, earlier it was discussed that Code § 704(c)(1)(B) triggers gain when the partnership distributes contributed property to a partner other than the contributing partner[3928] within seven years after the contribution; it also applies if the partnership agreement is amended within seven years to shift to the other partner the burdens and benefits and the property is distributed to that other partner more than seven years after contribution.[3929]

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principles and statutory authorities, such as the disguised sale rules under section 707, see paragraph (h) of this section), the Commissioner can recast the transaction as appropriate under paragraph (b) of this section.

[3922] Reg. § 1.701-2(d), Example (8).

[3923] Reg. § 1.701-2(d), Example (9).

[3924] Reg. § 1.701-2(i).

[3925] See part II.G.16 Economic Substance Penalty.

[3926] See Abrams, Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear, *TM Memorandum* (2/16/2009).

[3927] See part II.G.15 Like-Kind Exchanges.

[3928] When a partnership distributes to a partner property that the partnership contributed, none of Code § 704(c)(1)(B), 731(c) or 737 applied. See fn. 3876.

[3929] Reg. § 1.704-4(f)(2), Example (1).

- Second, Code § 737 will trigger gain to a distributee partner if the partner contributes property to the partnership and then receives a distribution of some other property[3930] within seven years of the partner's original contribution. When such a distribution is made, the partner must recognize gain equal to the lesser of (1) the excess of the fair market value of the distributed property over the partner's partnership interest's adjusted basis (less any money received in the distribution) or (2) the partner's net pre-contribution gain.[3931] Net pre-contribution gain, as defined in Code § 737(b), is the gain that would have been recognized by the distributee partner under Code § 704(c)(1)(B) if all property the partner had contributed to the partnership within seven years of the distribution that was still held by the partnership immediately before the distribution was distributed by the partnership to some other partner.

These rules relate to Code § 704(c) responsibility – the allocation to a partner of built-in gain or loss when the partnership contributes to a partnership property the basis of which differs from its fair market value – which integrates with part II.P.1.a.i Allocations of Income in Partnerships. Also, if a new partner joins a partnership (or an existing partner makes a non-pro rata contribution) when the partnership holds property the basis of which differs from its fair market value:

- The existing partners' capital accounts obtain Code § 704(c) responsibility;[3932] this is called a "reverse-Code § 704(c))" allocation. Thus, any unrealized gain that occurred between the time the partnership acquired the property and the time a new partner joined (or an existing partner makes a non-pro rata contribution) constitutes Code § 704(c) responsibility that is allocated to all of the existing partners.[3933] This

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[3930] When a partnership distributes to a partner property that the partnership contributed, none of Code § 704(c)(1)(B), 731(c) or 737 applied. See fn. 3876.

[3931] Code § 737(a)(1) and (2).

[3932] See Reg. § 1.704-3(a)(6). See also Reg. § 1.704-1(b)(2)(iv)(s)(2).

[3933] Reg. §§ 1.704-1(b)(5), Example (14)(i), provides:

> MC and RW form a general partnership to which each contributes $10,000. The $20,000 is invested in securities of Ventureco (which are not readily tradable on an established securities market)…. Assume that the Ventureco securities subsequently appreciate in value to $50,000. At that time SK makes a $25,000 cash contribution to the partnership (thereby acquiring a one-third interest in the partnership), and the $25,000 is placed in a bank account. Upon SK's admission to the partnership, the capital accounts of MC and RW (which were $10,000 each prior to SK's admission) are, in accordance with paragraph (b)(2)(iv)(f) of this section, adjusted upward (to $25,000 each) to reflect their shares of the unrealized appreciation in the Ventureco securities that occurred before SK was admitted to the partnership. Immediately after SK's admission to the partnership, the securities are sold for their $50,000 fair market value, resulting in taxable gain of $30,000 ($50,000 less $20,000 adjusted tax basis) and no book gain or loss. An allocation of the $30,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $30,000 taxable gain will, in accordance with section 704(c) principles, be shared $15,000 to MC and $15,000 to RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

Reg. §§ 1.704-1(b)(5), Example (14)(ii), provides:

responsibility can be reflected by either a special allocation of gain in the partnership agreement or by revaluing capital accounts on the books,[3934] but the partnership must take one of these steps for the partnership agreement to be respected.[3935] An

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> Assume the same facts as (i), except that after SK's admission to the partnership, the Ventureco securities appreciate in value to $74,000 and are sold, resulting in taxable gain of $54,000 ($74,000 less $20,000 adjusted tax basis) and book gain of $24,000 ($74,000 less $50,000 book value). Under the partnership agreement the $24,000 book gain (the appreciation in value occurring after SK became a partner) is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $54,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the taxable gain will, in accordance with section 704(c) principles, be shared $23,000 to MC $23,000 to RW, and $8,000 to SK, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

Reg. §§ 1.704-1(b)(5), Example (14)(iii), provides:

> Assume the same facts as (i) except that after SK's admission to the partnership, the Ventureco securities depreciate in value to $44,000 and are sold, resulting in taxable gain of $24,000 ($44,000 less $20,000 adjusted tax basis) and a book loss of $6,000 ($50,000 book value less $44,000). Under the partnership agreement the $6,000 book loss is allocated equally among MC, RW, and SK, and such allocations have substantial economic effect. An allocation of the $24,000 taxable gain cannot have economic effect since it cannot properly be reflected in the partners' book capital accounts. Under paragraph (b)(2)(iv)(f) of this section and the special partners' interests in the partnership rule contained in paragraph (b)(4)(i) of this section, unless the partnership agreement provides that the $24,000 taxable gain will, in accordance with section 704(c) principles, be shared equally between MC and RW, the partners' capital accounts will not be considered maintained in accordance with paragraph (b)(2)(iv) of this section.

[3934] For how to revalue, see Reg. § 1.704-1(b)(2)(iv)(f), which is reproduced in fn. 422 in part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts). See also Reg. § 1.704-1(b)(5), Example (33). Although generally this responsibility is determined separately for each asset, see an alternative approach is in part II.P.1.a.i.(b) Special Rule for Allocations of Income in Securities Partnerships.

[3935] See Reg. § 1.704-1(b)(5), Example (14)(iv), referencing Reg. § 1.704-1(b)(1)(iii), (iv).

Reg. § 1.704-1(b)(1)(iii) provides:

> *Effect of other sections*. The determination of a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph is not conclusive as to the tax treatment of a partner with respect to such distributive share. For example, an allocation of loss or deduction to a partner that is respected under section 704(b) and this paragraph may not be deductible by such partner if the partner lacks the requisite motive for economic gain (see, *e.g.*, *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966)), or may be disallowed for that taxable year (and held in suspense) if the limitations of section 465 or section 704(d) are applicable. Similarly, an allocation that is respected under section 704(b) and this paragraph nevertheless may be reallocated under other provisions, such as section 482, section 704(e)(2), section 706(d) (and related assignment of income principles), and paragraph (b)(2)(ii) of § 1.751-1. If a partnership has a section 754 election in effect, a partner's distributive share of partnership income, gain, loss, or deduction may be affected as provided in § 1.743-1 (see paragraph (b)(2)(iv)(m)(2) of this section). A deduction that appears to be a nonrecourse deduction deemed to be in accordance with the partners' interests in the partnership may not be such because purported nonrecourse liabilities of the partnership in fact constitute equity rather than debt. The

unexpected part of this issue is that one can become saddled with Code § 704(c) responsibility for assets one did not contribute; consider whether this might reset the seven-year period with respect to that newly acquired Code § 704(c) responsibility (I have not researched the latter).

- If the partnership included a nominal partner merely to get the seven-year period running and the previously contributed property is promptly distributed to a partner who is admitted just after the seven-year had run, the nominal partner's existence is ignored in determining the seven-year period, so Code § 704(c)(1)(B) taxes the contributing partner.[3936]

Note that Code § 737 is applied after Code § 731(c), which means that any marketable securities that are treated as money for Code § 731(c) purposes are ignored when applying Code § 737.[3937] This can lead to a favorable result for a distributee partner in two ways. First, since the property piece of the distribution is reduced by treating marketable securities as money, the Code § 737 gain potential is reduced. Second, the total amount of cash and marketable securities treated as money could be less than the basis of the distributee partner's partnership interest, resulting in no gain recognition under Code § 731.

As in the Code § 704(c) analysis, the prevailing view among commentators seems to be that a transferee of a partnership interest will "step into" the transferor's shoes in Code § 737 situations. This view is supported by the fact that regulations supporting Code § 704(c)(1)(B) and Code § 737 were written by the same people, at the same time, in the same project, and are likely to have been designed to work in coordination with one another. A partner should not be able to avoid the rules of Code § 737 by transferring the partnership interest to a third party. Thus, the transferee partner should be treated as the contributing partner under Code § 737.[3938]

> examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address the effect of other sections or limitations on such allocations.

Reg. § 1.704-1(b)(1)(iv) provides:

> *Other possible tax consequences*. Allocations that are respected under section 704(b) and this paragraph may give rise to other tax consequences, such as those resulting from the application of section 61, section 83, section 751, section 2501, paragraph (f) of § 1.46-3, § 1.47-6, paragraph (b)(1) of § 1.721-1 (and related principles), and paragraph (e) of § 1.752-1. The examples in paragraph (b)(5) of this section concern the validity of allocations under section 704(b) and this paragraph and, except as noted, do not address other tax consequences that may result from such allocations.

Implicit in clause (iv) is that failure to maintain proper capital accounts can have gift tax consequences under Code § 2501.

Also see Reg. § 1.704-1(b)(2)(iv)(b), which is reproduced in the text accompanying fn. 418 in part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts).

[3936] Reg. § 1.704-4(f)(2), Example (2).

[3937] Reg. § 1.731-2(g).

[3938] I am very comfortable with the statement in the text, although it is not totally free from doubt. See Robinson, Don't Nothing Last Forever – Unwinding the FLP to the Haunting Melodies of Subchapter K, *ACTEC Journal*, Spring 2003, p. 302; Blum and Harrison, Another View: A Response to Richard Robinson's Don't Nothing Last Forever – Unwinding the FLP to the

When contributed property is distributed to any non-contributing partner within seven years of its contribution, the contributing partner is treated as if the property were sold to the recipient partner at its fair market value and must recognize the proper gain or loss under Code § 704(c)(1)(A); however, an exception applies for certain deemed like-kind exchanges.[3939] This like-kind exception applies not only to Code § 704(c) but also to Code § 737.[3940] Thus, partners in a real estate mixing bowl partnership might completely avoid gain recognition under Code §§ 704(c)(1)(B) and 737 if the partnership is liquidated before the seven year waiting period and the different partners each receive part or complete ownership of various properties owned by the partnership.[3941]

For issues relating to built-in losses, see the American Bar Association Section of Taxation's "Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004," *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).

Haunting Melodies of Subchapter K, *ACTEC Journal*, Spring 2003, p. 313; and Robinson's Comments on Blum and Harrison's Another View, *ACTEC Journal*, Spring 2003, p. 318.

[3939] Code § 704(c)(2). See Borden and Longhofer, The Effect of Like-Kind Property on the Section 704(c) Anti-Mixing Bowl Rules, *TM Real Estate Journal* (3/2/2011). Reg. § 1.704-4(d)(3) provides:

> *Distributions of like-kind property*. If section 704(c) property is distributed to a partner other than the contributing partner and like-kind property (within the meaning of section 1031) is distributed to the contributing partner no later than the earlier of (i) 180 days following the date of the distribution to the non-contributing partner, or (ii) the due date (determined with regard to extensions) of the contributing partner's income tax return for the taxable year of the distribution to the noncontributing partner, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under section 704(c)(1)(B) and this section is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution. The contributing partner's basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner's adjusted tax basis in the partnership interest under section 704(c)(1)(B) and this section. See § 1.707-3 for provisions treating the distribution of the like-kind property to the contributing partner as a disguised sale in certain situations.

Reg. § 1.704-4(d)(4) provides an example.

[3940] In determining the precontribution gain subject to possible taxation under Code § 737, Reg. § 1.737-1(c)(2)(iv) provides:

> *Section 704(c)(1)(B) gain recognized in related distribution*. A distributee partner's net precontribution gain is determined after taking into account any gain or loss recognized by the partner under section 704(c)(1)(B) and § 1.704-4 (or that would have been recognized by the partner except for the like-kind exception in section 704(c)(2) and § 1.704-4(d)(3)) on an actual distribution to another partner of section 704(c) property contributed by the distributee partner that is part of the same distribution as the distribution to the distributee partner.

However, Reg. § 1.737-1(c)(2)(v) requires an actual distribution:

> *Section 704(c)(2) disregarded*. A distributee partner's net precontribution gain is determined without regard to the provisions of section 704(c)(2) and § 1.704-4(d)(3) in situations in which the property contributed by the distributee partner is not actually distributed to another partner in a distribution related to the section 737 distribution.

[3941] Breitstone and Wilensky, Dividing a Real Estate Empire: The Mixing Bowl Alternative, *TM Memorandum* (BNA) (3/9/2015).

II.Q.8.b.i.(f). Code § 751 – Hot Assets

Code § 751(a) and Reg. § 1.751-1(a)(1) provide that part of the gain attributable to hot assets (substantially appreciated inventory or unrealized receivables) "shall be considered as an amount realized from the sale or exchange of property other than a capital asset." Because capital gain treatment does not apply, this gain tends to be viewed as ordinary income.

A partner might be deemed to have entered into a transaction regarding hot assets if:[3942]

- The partner receives hot assets in exchange for all or a part of the partner's interest in other partnership property (including money), or
- The partner receives partnership property (including money) in exchange for all or a part of the partner's interest in hot assets.

This rule does not apply to not apply to a distribution of property that the distributee contributed to the partnership or Code § 736(a) payments to a retiring partner or successor in interest of a deceased partner.[3943]

Proposed regulations "prescribe how a partner should measure its interest in a partnership's unrealized receivables and inventory items.. and … provide guidance regarding the tax consequences of a distribution that causes a reduction in that interest."[3944]

A partnership's inventory items are "substantially appreciated" if their fair market value exceeds 120% of the partnership's adjusted basis in such property, unless a principal

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[3942] Code § 751(b)(1).
[3943] Code § 751(b)(2).
[3944] REG-151416-06, Certain Distributions Treated as Sales or Exchanges [FR Doc. 2014-25487 Filed 10/31/2014 at 8:45 am; Publication Date: 11/03/2014]. The proposed regulations would obsolete Rev. Rul. 84-102. For the effective date:

> The regulations, as proposed, apply to distributions occurring in any taxable period ending on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. The rules contained in § 1.751-1(a)(2) would apply to transfers of partnership interests that occur on or after [11/03/2014]. However, the rules contained in § 1.751-1(a)(2) are a clarification of existing rules, and no inference is intended from the change to § 1.751-1(a)(2) with respect to sales or exchanges of partnership interests prior to the effective date for § 1.751-1(a)(2). The rules contained in § 1.751-1(a)(3) continue to apply to transfers of partnership interests that occur on or after December 15, 1999. A partnership and its partners would be able to rely on § 1.751-1(b)(2) of these proposed regulations for purposes of determining a partner's interest in the partnership's section 751 property on or after [11/03/2014] provided the partnership and its partners apply each of § 1.751-1(a)(2), § 1.751-1(b)(2), and § 1.751-1(b)(4) of these proposed regulations consistently for all partnership distributions and sales or exchanges, including for any distributions and sales or exchanges the partnership makes after a termination of the partnership under section 708(b)(1)(B).

See Longhofer and Rimmke, Proposed Section 751(b) Regulations: An Exchange for the Better? *Journal of Taxation* (Aug. 2015).

purpose for acquiring such property was to avoid these rules regarding inventory items.[3945] "Inventory items" include:[3946]

- the partnership's Code § 1221(a)(1) property,[3947]

- any other partnership property that, if the partnership sold or exchanged them, would be considered property other than a capital asset and other than Code § 1231 property,[3948] and

- any other property the partnership held that, if held by the selling or distributee partner, would be considered property of the type described above.

"Unrealized receivables" include, to the extent not previously includible in income under the partnership's tax accounting method, any rights (contractual or otherwise) to payment for:[3949]

- goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

- services rendered, or to be rendered.

For purposes of Code §§ 731, 732, 741, and 751, but not for purposes of Code § 736,[3950] "unrealized receivables" includes the following as if the partnership had been sold it at its fair market value, to the extent that their sale would trigger certain unfavorable tax treatment:[3951]

- mining property,[3952]

- stock in a DISC,[3953]

- Code § 1245 property (generally, depreciable personal property),[3954]

- stock in certain foreign corporations,[3955]

[3945] Code § 751(b)(3).
[3946] Code § 751(d).
[3947] Real estate might or might not constitute inventory. See part II.G.12 Future Development of Real Estate, especially fn. 1042.
[3948] Code § 1231 is discussed in part II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business. Code § 1245 depreciation recapture overrides Code § 1231; see fn. 965.
[3949] Code § 751(c).
[3950] P.L. 103-66 (8/10/1993), § 13262(b), deleted the reference to Code § 736.
[3951] Code § 751(c).
[3952] As defined in Code § 617(f)(2), to the extent that Code § 617(d)(1) would apply.
[3953] As described in Code § 992(a), to the extent that Code § 995(c) would apply.
[3954] As defined in Code § 1245(a)(3), to the extent that Code § 1245(a) would apply.
[3955] As described in Code § 1248, to the extent that Code § 1248(a) would apply. For purposes of applying Code § 731, 741, and 751, in the case of an individual, the tax attributable to such

- Code § 1250 property (generally, real estate depreciated faster than straight-line depreciation),[3956]

- farm land,[3957]

- franchises, trademarks, or trade names,[3958] or

- an oil, gas, or geothermal property.[3959]

For purposes of Code §§ 731, 732, 741, and 751, but not for purposes of Code § 736, "unrealized receivables" also includes any market discount bond[3960] and any short-term obligation[3961] but only to the extent of the amount which would be treated as ordinary income if the partnership had sold such property.

More drastic consequences may apply when selling to a controlled corporation interests in a partnership holding depreciable property (including depreciable real estate that would not have depreciation recapture under Code § 1250), taxing the entire gain as ordinary income, not just the part that might have constituted depreciation recapture.[3962]

See also part II.Q.8.c Related Party Sales of Non-Capital Assets By or To Partnerships.

II.Q.8.b.i.(g). Characteristics of Distributed Property

Often, asset distributions precede, follow, or are substitutes for the transfer of partnership interests. Therefore, the concepts of distributions and transfers of partnership interests should be considered together. For the latter, see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).

A distributed property's basis depends on whether the distribution liquidated the partner's partnership interest:

- Generally, the basis of property (other than money) distributed by a partnership to a partner, other than in liquidation of the partner's interest, is its adjusted basis to the partnership immediately before such distribution.[3963] However, this basis cannot

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amount shall be limited in the manner provided by Code § 1248(b) (relating to gain from certain sales or exchanges of stock in certain foreign corporation). Code § 751(e).

[3956] As defined in Code § 1250(c), to the extent that Code § 1250(a) would apply. Code § 1250(a)(1)(A)(i) applies Code § 1250(a) to additional depreciation, referring to subsections (b)(1) and (b)(4). Subsection (b)(1) applies to depreciation faster than straight line. Subsection (b)(4) applies to certain rehabilitation expenditures.

[3957] As defined in Code § 1252(a), to the extent that Code § 1252(a) would apply.

[3958] Referred to in Code § 1253(a), to the extent that Code § 1253(a) would apply.

[3959] As defined in Code § 1254, to the extent that Code § 1254(a) would apply.

[3960] As defined in Code § 1278.

[3961] As defined in Code § 1283.

[3962] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), especially the text accompanying fns. 3681-3682.

[3963] Code § 732(a)(1).

exceed the adjusted basis of the partner's interest in the partnership, reduced by any money distributed in the same transaction.[3964]

- The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is the partnership interest's adjusted basis, reduced by any money distributed in the same transaction.[3965]

However, neither of these rules applies to the extent that a distribution is treated as a sale or exchange of property under Code § 751(b) (relating to unrealized receivables and inventory items).[3966]

Also, special rules apply to a partner who acquired all or a part of his interest by a transfer with respect to which a Code § 754 election is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within two years after such transfer.[3967] The partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in Code § 743(b) were in effect.[3968] Depending on the situation, this basis adjustment requires elections or is mandatory.[3969]

A partner's holding period for property received in a distribution from a partnership generally includes the partnership's holding period.[3970]

[3964] Code § 732(a)(2). If that cap causes a loss of basis, the partnership can reallocate that lost basis to the partnership's other assets under Code § 734 if a Code § 754 election is in place. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.
[3965] Code § 732(b).
[3966] Code § 732(e). For details regarding these assets, see part II.Q.8.b.i.(f) Code § 751 – Hot Assets.
[3967] Code § 732(d). For a discussion of these rules, including any opportunity to shift basis from non-depreciable to depreciable assets, see McKee, Nelson & Whitmire, ¶26.01 Transferees' Special Basis Adjustments in Connection With Subsequent Distributions, *Federal Taxation of Partnerships & Par*tners (WG&L).
[3968] Reg. § 1.732-1(d)(1)(iii). The amount of this adjustment is not diminished by any depletion or depreciation of that portion of the basis of partnership property arising from this special basis adjustment, since depletion or depreciation on such portion before distribution is allowed or allowable only if the optional adjustment under Code § 743(b) is in effect. Reg. § 1.732-1(d)(1)(iv). If this property is not the same property which would have had a special basis adjustment, then such special basis adjustment applies to any like property received in the distribution, if the transferee, in exchange for the property distributed, has relinquished the transferee's interest in the property with respect to which the transferee would have had a special basis adjustment. Reg. § 1.732-1(d)(1)(v).
[3969] Reg. § 1.731-1(d)(2), (3), (4).
[3970] Code § 735(b). See Goold & Schneider, Finding the Gold Nuggets in Partnership Holding Periods, *Passthrough Entities* 31 (Nov./Dec. 2002). See also Borden, Navigating State Law and Tax Issues Raised by Partnership and LLC Reorganizations, *Business Entities* (Jul./Aug. 2014), suggesting that the holding period of distributed property might be the longer of the partnership's holding period or the partnership interest's holding period.

When a partner who receives "hot assets" later disposes of them, the partner will recognize ordinary income:

- The disposition of Code § 751(c) unrealized receivables received from a partnership is ordinary gain or loss.[3971]

- The disposition of Code § 751(d) inventory received from a partnership, within 5 years from the date of the distribution,[3972] is ordinary gain or loss.[3973]

If any of these hot assets is disposed of in a nonrecognition transaction or a series of nonrecognition transactions, the above tax treatment shall also apply to any substituted basis property resulting from such transaction(s).[3974]

II.Q.8.b.ii. Partnership Redemption – Complete Withdrawal Using Code § 736

II.Q.8.b.ii.(a). Introduction to Code § 736

When a partnership redeems[3975] a partner's interest in full,[3976] Code § 736(a) provides that payments may be deductible to the partnership and ordinary income to the selling

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[3971] Code § 735(a)(1).

[3972] For purposes of this rule, the partnership's holding period does not tack, and Code § 751(d) (defining inventory item) shall be applied without regard to any holding period in Code § 1231(b). Code § 735(b), (c)(1).

[3973] Code § 735(a)(1).

[3974] Code § 735(c)(2)(A). This rule does not apply to any stock in a C corporation received in a Code § 351 exchange. Code § 735(c)(2)(B).

[3975] Code § 736 applies only to payments made by the partnership and not to transactions between partners. Reg. § 1.736-1(a)(1)(i). If the responsibility for making payments in a transaction between partners is assigned to the partnership, the assignment does not transform the sale into a Code § 736 redemption. *Coven v. Commissioner*, 66 T.C. 295 (1976), *acq.* 1976-2 C.B. 1, reasoning:

> We therefore conclude that petitioner sold his partnership interest to Suttenberg individually. The resulting tax consequences accordingly cannot be determined by section 736, since that section applies "only to payments made by the partnership and not to transactions between the partners." Sec. 1.736-1(a)(1)(i), Income Tax Regs. See also *Karan v. Commissioner*, 319 F.2d 303, 307 (7th Cir. 1963), *affg.* a Memorandum Opinion of this Court; *Smith v. Commissioner*, 313 F.2d 16, 19 (10th Cir. 1962), *affg.* 37 T.C. 1033 (1962); *Charles F. Phillips*, 40 T.C. 157, 161 (1963); 1 Willis, Partnership Taxation, sec. 46.01, p. 606 (2d ed. 1976).[10]
>
> [10] Although the agreement made a specific allocation for goodwill, capital gains treatment under sec. 736(b)(2)(B) would still not be possible, even if that agreement were not later superseded, because sec. 736 is inapplicable to this sale between partners. Furthermore, even if sec. 736 were applicable, the Consultant Contract, which was adopted, does not make any reference to goodwill, and the partnership did not operate under a written agreement: no operative written partnership agreement specifying payments for goodwill thus existed. Sec. 736(b)(2)(B) would therefore still be inapplicable. See *V. Zay Smith*, 37 T.C. 1033, 1037 (1962), *affd.* 313 F.2d 16 (10th Cir. 1962).

[3976] Code § 736 applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. Code § 736 does not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Reg. § 1.736-1(a)(1)(i). A partner retires when that partner;[3977] if and to the extent that these payments are based on partnership income rather than being fixed, they constitute a shifting of a distributive share of partnership income to the retiring partner, rather than a deduction to the partnership and income to the retiring partner.[3978] Or, one may choose to apply Code § 736(b) so that they are nondeductible to the partnership (although possibly depreciated or amortized) and gain to the partner.[3979] (In analyzing the discussion below, note that one must be careful in relying on the regulations, which were last amended before P.L. 103-66 was enacted in 1993.[3980])

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person ceases to be a partner under local law. However, for partnership income tax purposes, a retired partner or a deceased partner's successor will be treated as a partner until such partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii). Thus, if one of the members of a two-person partnership retires or dies and the retiring member or deceased member's estate is to receive Code § 736 payments, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's or deceased member's estate's entire interest is liquidated, since the retiring partner or deceased member's estate continues to hold a partnership interest in the partnership until that time. Reg. § 1.736-1(a)(6).

3977 For whether such payments are subject to self-employment tax, see part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

3978 Reg. § 1.736-1(a)(4). The retiring partner might like (if credits are passed through) or dislike (if nondeductible expenses increase taxable income) this result.

3979 Except to the extent Code § 751(b) applies (see part II.Q.8.b.i.(f) Code § 751 – Hot Assets), the amount of any gain or loss with respect to such payments shall be determined under Code § 731. Reg. § 1.736-1(b)(6). However, where the total of such payments is a fixed sum, the seller may elect (in the seller's tax return for the first taxable year for which the seller receives such payments), to report and to measure the amount of any gain or loss by the difference between the amount treated as a distribution under Code § 736(b) in that year, and the portion of the partner's adjusted basis that bears the same proportion to the partner's total adjusted basis for the partner's partnership interest as the amount distributed under Code § 736(b) in that year bears to the total amount to be distributed under Code § 736(b). *Id*.

3980 The legislative history to 1993 changes to Code § 736 provides:

> *In general*.
>
> The bill generally repeals the special treatment of liquidation payments made for goodwill and unrealized receivables. Thus, such payments would be treated as made in exchange for the partner's interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent. The bill does not change present law with respect to payments made to a general partner in a partnership in which capital is not a material income-producing factor. The determination of whether capital is a material income-producing factor would be made under principles of present and prior law [e.g., sections 401(c)(2) and 911(d) of the Code and old section 1348(b)(1)(A) of the Code]. For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice. In addition, the bill does not affect the deductibility of compensation paid to a retiring partner for past services.

Code § 736 prevails over the rules of Code § 1001 that normally govern sales.[3981] For further discussion, see part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

We will see below that generally a Code § 736(b) payment is taxed under Code § 731(a), so one might wonder how important it might be to be within the scope of Code § 736. Part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale, especially the text accompanying fns. 4009-4012, explains why Code § 736 treatment can be extremely important.

Further below, a brief discussion illustrates why a partner whose interest is being redeemed would generally prefer Code § 736(a) treatment, even though at first glance it would seem that the retiring partner would prefer Code § 736(b) treatment, since capital gains rates are lower than ordinary income rates.

II.Q.8.b.ii.(b). Flexibility in Choosing between Code § 736(a) and (b) Payments

Before explaining this counter-intuitive rule, let's discuss the flexibility allowed. Within certain limits, the redemption agreement can provide that as much or as little of the redemption payments receive treatment under Code § 736(a) or (b).[3982] However,

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> *Unrealized receivables*.
>
> The bill also repeals the special treatment of payments made for unrealized receivables (other than unbilled amounts and accounts receivable) for all partners. Such amounts would be treated as made in exchange for the partner's interest in partnership property. Thus, for example, a payment for depreciation recapture would be treated as made in exchange for an interest in partnership property, and not as a distributive share or guaranteed payment that could give rise to a deduction or its equivalent.

Regarding payments for past services, see part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner, regarding when such payments are not subject to self-employment tax.

[3981] The first sentence of Reg. § 1.1001-1(a) says, **Except as otherwise provided in subtitle A of the Code**, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. (emphasis added)

[3982] Reg. § 1.736-1(b)(5)(iii). For what constitutes an agreement designating payments, see *Commissioner v. Jackson Investment Company*, 346 F.2d 187 (9th Cir. 1965), *rev'g* 41 T.C. 675 (reviewed decision 1964 holding that a withdrawal agreement was not given effect under Code § 736 as it did not constitute a partnership agreement); the Tax Court seems to have abandoned its decision in *Jackson Investment Company* in other Circuits as well – see *Spector v. Commissioner*, T.C. Memo. 1982-433, characterizing *Jackson Investment Company* as involving an ambiguous provision. If an agreement between all the remaining partners and the withdrawing partner or his successor in interest does not designate payments, then, subject to the limits described further below, Reg. § 1.736-1(b)(5)(i), (ii) provide the following:

> If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under section 736(b) bear to the total fixed agreed payments under section 736(a) and (b). The balance, if any, of such amount received in the same taxable year shall be treated as a distributive share or a guaranteed payment under section 736(a)(1) or (2). However, if the total amount received in any one year is less than the amount considered as a distribution under section 736(b) for that year, then any unapplied portion shall be added to the portion of the payments for the following year

Code § 736(b) payments cannot exceed the fair market value of the withdrawing partner's share of the partnership property;[3983] therefore, Code § 736(a) must apply to such excess.

Except as discussed below, Code § 736(b) payments cannot be for (and therefore Code § 736(a) must apply to) the partnership's:

- Unrealized receivables;[3984]
- Goodwill, except to the extent that the partnership agreement provides for a payment with respect to goodwill.

The above limitation on what constitutes Code § 736(b) payments means that such payments must be classified as Code § 736(a) payments. It does not mean that such payments are the only types of payments that can be classified as Code § 736(a) payments instead of Code § 736(b) payments.[3985]

However, starting in 1993, payments for unrealized receivables and goodwill are eligible for Code § 736(a) treatment only if capital is not a material income-producing factor for the partnership and the retiring or deceased partner was a general partner in the partnership.[3986] The regulations have not been updated to take into account this rule. In applying this rule, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual.[3987] The professional practice of a doctor, dentist, lawyer, architect, or accountant is not treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in

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> or years which are to be treated as a distribution under section 736(b). For example, retiring partner W who is entitled to an annual payment of $6,000 for 10 years for his interest in partnership property, receives only $3,500 in 1955. In 1956, he receives $10,000. Of this amount $8,500 ($6,000 plus $2,500 from 1955) is treated as a distribution under section 736(b) for 1956; $1,500, as a payment under section 736(a).
>
> If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments shall first be treated as payments in exchange for his interest in partnership property under section 736(b) to the extent of the value of that interest and, thereafter, as payments under section 736(a).

Whether a Code § 754 election is in effect or is deemed to be in effect might affect whether undesignated payments are 736(a) or 736(b) payments. McBride, Alice's Estate in the Wonderland of Subchapter K, *Tax Notes* 2/23/2009, pages 971-980.

[3983] Reg. § 1.736-1(b)(5)(iii).

[3984] Code § 736(b)(2)(A). Unrealized receivables include the right to payments for (1) goods delivered, or to be delivered, to the extent the proceeds would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered. Code § 751(c), which is further described in part II.Q.8.b.i.(f) Code § 751 – Hot Assets. However, for purposes of Code § 736, they do not include other items that Code § 751 would normally treat as unrealized receivables. See text accompanying fns. 3950-3961.

[3985] Reg. § 1.736-1(b)(3) provides a ceiling on payments for goodwill, not a floor under which they may not be lowered. *Tolmach v. Commissioner*, T.C. Memo. 1991-538.

[3986] Code § 736(b)(3).

[3987] See fn. 3980.

the physical plant constituting the office from which such individual conducts that practice if the capital investment is merely incidental to such professional practice.[3988]

Code § 736(a) payments are available for payments in the form of mutual insurance not determined by reference to any partnership asset,[3989] payments of compensation to a retired partner for past services,[3990] and perhaps a portion[3991] of payments where capital is a material income-producing factor.[3992]

If and to the extent that goodwill would not be eligible for Code § 736(a) treatment, consider how one would measure goodwill. For example, if the retiring partner was undercompensated for prior services before the company reached its full potential or for any other reason, payments could be allocated to past services.

If none of the above works around the inability to apply Code § 736(a) to goodwill, consider doing a partial redemption instead of a complete termination. Code § 736 applies only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership.[3993] Instead, provide a preferred interest in the partnership's profits up to a certain limit. Generally, reallocating profits between partners is not a taxable event.[3994]

II.Q.8.b.ii.(c). Comparing Code § 736(a) with (b) Strategically

See the example in part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis. The "Capital Gains to Seller" scenario corresponds to part II.Q.1.a.i.(d) S Corporation Double Taxation, which corresponds to Code § 736(b) payments, and the "Ordinary Income to Seller" scenario corresponds to part II.Q.1.a.i.(e) Partnership Single Taxation of Goodwill, which corresponds to Code § 736(a) payments. The contrast between these scenarios is illustrated in part II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill.

<u>Main Points</u>

1. Using a capital gain Code § 736(b) scenario, taxes consume much more to the parties as a whole than would the ordinary income Code § 736(a) scenario in meeting the targeted payments of "principal." Thus, the ordinary income scenario provides more money available to buy out the seller and ease the stress of the buy-out.

2. To compensate the seller for a higher ordinary income tax rate, the seller must receive more to generate the same after-tax flow. Thus, the stated sales price would

[3988] See fn. 3980.
[3989] Reg. § 1.736-1(a)(2).
[3990] See fn. 3980.
[3991] If the partners have agreed that the value of the Code § 736(b) payments is not to exceed a certain amount that is below fair market value, the remainder would be Code § 736(a) payments.
[3992] Banoff, More on Section 736(a) Payments After RRA '93 Changes, 83 *Journal of Taxation* 191 (Sept. 1995).
[3993] See fn. 3976.
[3994] See part II.C.6 Shifting Rights to Future Profits.

appear to be higher and more burdensome, although really the buyer is better off because deducting the payments saves more than the additional purchase price cost.

3. In the § 736(a) scenario, increases in ordinary income tax rates harm the seller disproportionately, although it might be possible for the buyer to agree to pay seller more because the buyer saves more tax by making those additional payments. On the other hand, in a capital gain scenario, an increase in capital gain rates without a corresponding increase in ordinary income rates would not help the buyer save as much tax by paying the seller more.

4. Code § 736(a) requires a complete liquidation in the redeemed partner's interest.[3995] However, the complete redemption may be made over time, and Code § 736 does not terminate the partnership, even if only one owner is left (but Code § 736 does not prevent termination if the partnership ceases activity).[3996] If the partnership assumes

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[3995] Reg. § 1.736-1(a)(1)(i).

[3996] Rev. Rul. 75-154 involved the following facts:

> ABC partnership was formed in 1968 to conduct a management consulting business. Under the terms of the partnership agreement, upon retirement, the retiring partner was entitled to receive, in addition to amounts paid for his interest in partnership property, a specified amount payable in monthly installments over a three-year period following his retirement. There was no provision in the partnership agreement with respect to the payment to a retiring partner for goodwill. Partner C retired on January 2, 1972, and received 12 monthly payments from the partnership during 1972. On January 2, 1973, all of the business and financial activities of the partnership ended and A and B withdrew from the business. The former partners, A and B, assumed their share of the remaining liability to C and made the required payments for the years 1973 and 1974.

The ruling analyzed and held:

> Section 1.736-1(a)(6) of the Income Tax Regulations provides, in part, that a retiring partner or a deceased partner's successor in interest receiving payments under section 736 of the Code is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated. Therefore, if one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time.
>
> Section 1.736-1(a)(6) of the regulations prevents the termination of a partnership under section 708 of the Code, only in those situations in which the partnership would otherwise be terminated because of the withdrawal of a retiring or a deceased partner who is entitled to receive payments under section 736(a)(2). However, in the instant case, section 1.736-1(a)(6) of the regulations does not prevent the termination of the partnership under section 708, even though C was receiving liquidating payments under section 736(a)(2). It was the withdrawal of A and B that caused the partnership to terminate, not C's prior retirement.
>
> Accordingly, the partnership did not continue to exist under section 736 of the Code, but terminated under section 708 when partners A and B discontinued the financial operation of the partnership and withdrew from the business.
>
> It has been previously held that payments that would have been deductible by a partnership had it continued in existence were deductible by the former partners after termination of the partnership. See *Flood v. United States*, 133 F.2d 173 (1st Cir. 1943).
>
> Thus, in the instant case, after the partnership terminated, payments made by former partners A and B, in satisfaction of the liability to retired partner C, are deductible by them

the partner's share of liabilities, it cannot deduct the payment of those liabilities under Code § 736 later than the year in which the partner's relationship with the partnership terminated;[3997] the liabilities are treated as relieved (and therefore cash is deemed paid) when the withdrawing partner is no longer a partner (ignoring the Code § 736 deemed continuation).[3998]

5. The above treatment does not apply to the extent that the LLC is repaying the seller's capital account, to the extent that the seller's capital account would be the LLC's earnings that are allocated to the seller but not distributed. The seller would not be taxed on such distributions, because they were taxed when originally earned.

6. Combined with a Code § 754 election, a Code § 736(b) payment would generate a separate basis for each asset whose basis is adjusted, and each year a new set of assets would be created.[3999] Rather than try to recover that tax benefit, a Code § 736(a) is an easier way for the remaining partners to avoid tax on earnings used to buy the redeemed partner.

7. A partnership might be structured with profits interests that shift over time, which might achieve results similar to that of Code § 736 without the partner completely retiring. For example, suppose an older partner brought in a lot of business, but the agreement would be that the younger partners would take over the business after a number of years. The partnership might be structured to give the older partner a larger profits interest in early years and a smaller profits interest in later years. Generally, merely shifting interests in future profits is not a taxable event.[4000] The objective would be to structure it not as a sale, but rather as an allocation of profits related to the business each partner generates and the services each partner performs.

8. A technique similar to Code § 736 ordinary income payments used to be available to corporations in some situations. If the corporation could make a case that the departing shareholder was under-compensated for prior services, the corporation would pay compensation to him or her, with economic results similar to that of Code § 736 ordinary income payments. Code § 409A has made that strategy more difficult to use, imposing a 20% penalty on deferred compensation to the extent substantially vesting occurs after December 31, 2004, unless the statute's strict requirements are satisfied. To use deferred compensation payments based on prior services, the parties would need to prove that it is fair to compensate the selling owner-employee for prior services even though the employer was previously not legally obligated to do so. The sooner one plans for this future compensation, the

as trade or business expenses under section 162(a) of the Code in the year paid, since the payments would have been deductible by the partnership if it had not terminated. Furthermore, the payments to C are includible in C's gross income under section 61(a) in the year received.

[3997] *Whitman & Ransom v. Commissioner*, T.C. Memo. 2005-172.

[3998] See Reg. § 1.736-1(b)(7), Example (1), implementing Reg. § 1.736-1(a)(2) (treating assumption of liabilities treated as a distribution of money under Code § 752 in applying Code § 736).

[3999] See the paragraph of text accompanying fn. 4028 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

[4000] See part II.C.6 Shifting Rights to Future Profits.

easier it will be to prove reasonableness, since the owner-employee will be earning the compensation over time in a manner that is specifically referred to as an incentive for continued efforts. A challenge is that an appropriate level of compensation may be difficult to determine many years in advance of a sale.

Additional Code § 736 Issues

As discussed above, to the extent permitted by law, generally:

- Returns of basis should be structured as Code § 736(b) payments, because the seller is not taxed on them, and

- Profit on the sale of a partnership should be structured as Code § 736(a) payments, and the sale price should be increased at least enough to compensate the seller for paying taxes at ordinary income and self-employment and similar tax rates instead of any applicable capital gain rates.

II.Q.8.b.ii.(d). Comparing Code § 736(b) to an Installment Sale

Suppose one partner is exiting and being bought out over time, and one or more remaining partners will have higher interests in profits and losses. Should it be structured as a sale from one partner to another, or should the partnership redeem the exiting partner? If the latter, should the partnership issue a note to the partner?

In many cases, the partnership should redeem the exiting partner, documented by the partnership agreement without a separate promissory note. Code § 736 redemptions of a retiring partner are often better than an installment sale; and issuing a note might move the transaction into an unclear tax posture, whereas relying solely on the partnership agreement avoids certain questions. Merely shifting the right to future profits would not generate an income tax consequence;[4001] however, shifting a partner's capital account and any gain or loss inherent in that partner's share of the partnership's existing value would have income tax consequences. We have already seen how Code § 736(a) payments tend to work better for the partnership's value relating to goodwill;[4002] the rest of this part II.Q.8.b.ii.(d) discusses all components of value in a general sense.

Code § 736 taxes the retired partner on Code § 736 payments as if the retired partner were still a partner;[4003] complete liquidation of a partner's interest does not occur until no

[4001] See part II.C.6 Shifting Rights to Future Profits.
[4002] See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis, especially parts II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill and II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill.
[4003] Reg. § 1.736-1(a)(6). Although a partner retires when he ceases to be a partner under local law, a retired partner or a deceased partner's successor will be treated as a partner for partnership income tax purposes (subchapter K, chapter 1 of the Code) until the partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii). Does this continuation of treatment as a partner apply for purposes of the income in respect of a decedent rules of Code § 1014(c), which is found in subchapter O of chapter 1 of the Code? See part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411.

more payments may be made to the withdrawn partner.[4004] Code § 736(a) payments are taxed in the year for which they are made, rather than in the year of receipt.[4005] Furthermore, except to the extent Code § 751(b) applies, the amount of any gain or loss with respect to payments under Code § 736(b) for a retiring or deceased partner's interest in property for each year of payment shall be determined under Code § 731.[4006]

Code § 736 redemptions do not appear to contemplate the installment sale rules applying. If Code § 736 applies instead of the installment sale rules applying, then, rather than pro rating basis among the scheduled installment payments the way an installment sale would work, basis is applied fully to the earliest payments until it is used up. Thus, Code § 736 payments defer recognition of gain on sale relative to installment sales, a benefit that is not present in the sale of stock in a C or an S corporation; it also allows distributions to be applied to the partner's entire basis in the partnership,[4007] whereas distributions to shareholders are applied pro rata to their shares and are taxed according to the basis in each block of shares,[4008] perhaps heightening the impact of deferred basis recovery for those sales that are redemptions recharacterized as distributions.

The installment sale of a partnership interest can be particularly disastrous if the partnership has significant "hot assets," which can include not only inventory and accounts receivable but also depreciable property,[4009] because income from those items is taxable immediately – even if it exceeds the amount that the seller received up front.[4010] However, depreciable property and certain other property[4011] are not "hot assets" when applying Code § 736.[4012]

Not all redemptions qualify for Code § 736 treatment – they need to be "in liquidation of the interest of a retiring partner or a deceased partner."[4013] If a Code § 736 payment obligation is evidenced as a promissory note rather than contract right, do the installment

[4004] *Brennan v. Commissioner*, T.C. Memo, 2012-209 (citing Reg. § 1.761-1(d) and imposing a negligence penalty for failure to report the partner's distributive share of income earned before the partner received the final payment) , *aff'd* 116 A.F.T.R.2d 2015-6569 (9th Cir. 2015).
[4005] Reg. § 1.736-1(a)(5).
[4006] Reg. § 1.736-1(b)(6).
[4007] See part II.Q.8.e.ii.(a) Unitary Basis.
[4008] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property, especially fn. 3686.
[4009] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets.
[4010] See part II.Q.8.e.ii.(c) Availability of Installment Sale Deferral for Sales of Partnership Interests, especially fn. 4129.
[4011] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially fns. 3952-3959.
[4012] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially fn. 3950.
[4013] Code § 736(a), (b)(1). Reg. § 1.736-1(a)(1)(i) elaborates:

> Section 736 and this section apply only to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. See section 761(d). Section 736 and this section do not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. Section 736 and this section apply only to payments made by the partnership and not to transactions between the partners. Thus, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of section 736.

sale provisions apply when the partner receives the note?[4014] The amounts paid for his interest in assets are treated in the same manner as a distribution in complete liquidation under Code §§ 731, 732, and, where applicable, 751.[4015]

Neither Code § 731 nor Code § 732 nor the regulations under either statute address the effect of distributing a note in which the partnership is the maker. For purposes of maintaining capital accounts, generally distributions of notes do not count as distributions except to the extent that the partner disposes of or the partnership repays the note, but a distribution of a note will count as a distribution if the note is readily tradable on an established securities market,[4016] is negotiable,[4017] or perhaps if it is

[4014] See Kim and Saunders, Redeeming a Partner with The Partnership's Note, *TM Memorandum* (BNA) (3/21/2016).

[4015] Reg. § 1.736-1(a)(2), which also refers to Reg. § 1.751-1(b)(4)(ii). Reg. § 1.751-1(b)(4)(ii) provides:

> Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736 must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736-1.

However, the scope of unrealized receivables is narrower under Code § 736 than on other transactions involving hot assets; see part II.Q.8.b.i.(f) Code § 751 – Hot Assets, especially the text accompanying fn. 3950.

[4016] In addition to Reg. § 1.704-1(b)(2)(iv)(e)(2) that is reproduced in fn. 4017, consider that Code §§ 731(c)(2)(B)(ii) (any financial instrument which, pursuant to its terms or any other arrangement, is readily … exchangeable for, money or marketable securities) and 731(c)(2)(C) (The term 'financial instrument' includes … evidences of indebtedness ….) treat a distribution of publicly traded debt as a cash distribution.

[4017] Reg. § 1.704-1(b)(2)(iv)(e)(2) provides:

> *Distribution of promissory notes*. Notwithstanding the general rule of paragraph (b)(2)(iv)(b)(5), except as provided in this paragraph (b)(2)(iv)(e)(2), if a promissory note is distributed to a partner by a partnership that is the maker of such note, such partner's capital account will be decreased with respect to such note only when there is a taxable disposition of such note by the partner or when the partnership makes principal payments on the note. The previous sentence shall not apply if a note distributed to a partner by a partnership who is the maker of such note is readily tradable on an established securities market. Furthermore, the capital account of a partner whose interest in a partnership is liquidated will be reduced to the extent of (i) the fair market value, at the time of distribution, of any negotiable promissory note (of which such partnership is the maker) that such partnership distributes to the partner on or after the date such partner's interest is liquidated and within the time specified in paragraph (b)(2)(ii)(b)(2) of this section, and (ii) the fair market value, at the time of

payable upon demand.[4018] However, a leading treatise strongly opposes counting a note in which the partnership is the maker, whether or not negotiable, as a distribution;[4019] the treatise does, suggest, however, reducing the basis available to allocate to other distributed assets by the amount of payments expected to be made.[4020] Issuing a formal

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> liquidation, of the unsatisfied portion of any negotiable promissory note (of which such partnership is the maker) that such partnership previously distributed to the partner. For purposes of the preceding sentence, the fair market value of a note will be no less than the outstanding principal balance of such note, provided that such note bears interest at a rate no less than the applicable federal rate at time of valuation.

[4018] Consider that Code §§ 731(c)(2)(B)(ii) (any financial instrument which, pursuant to its terms … is readily convertible into, or exchangeable for, money) and 731(c)(2)(C) (The term 'financial instrument' includes … evidences of indebtedness ….) treat a distribution of a demand note as a cash distribution.

[4019] McKee, Nelson & Whitmire, ¶19.05. Distributions in Complete Liquidation of a Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L), reasons (footnotes omitted):

> Treating even a secured negotiable promissory note of the partnership as cash or a cash equivalent, the distribution of which triggers gain under § 731(a), would be inconsistent with the statutory scheme of Subchapter K because a § 754 election by the partnership would permit the partnership to increase the basis of its assets as the result of the distribution of zero-basis property. Similarly, treating a partnership's promissory note as property for purposes of applying §§ 731 and 732 also would produce results totally inconsistent with the Subchapter K scheme. Property characterization in connection with a current distribution would give the note a zero basis in the distributee-partner's hands under § 732(a)(1) because it would have a zero basis in the partnership's hands immediately prior to the distribution. Subsequent payments on the note would have to be treated as payments rather than distributions; the expenditure of partnership assets with no corresponding overall impact on the bases of the partners' interests would destroy the symmetry between the partnership's basis in its assets and the partners' bases in their interests, which Subchapter K strives to preserve. Similarly, if a partnership note were treated as property distributed as the sole consideration for the liquidation of a partner's entire interest in the partnership, it would take on a basis equal to the distributee-partner's basis in his interest. If a § 754 election were in effect, the partnership would be required to reduce the basis of its retained assets under § 734(b)(2)(B) by the amount of the distributee-partner's post-distribution basis in the note. By contrast, a cash distribution in the amount of the note would produce an increase in the basis of partnership assets if the cash distributed exceeded the distributee-partner's predistribution basis in his interest. A partnership note should thus not be treated as property under §§ 731 and 732, either. Payments on the note should be treated as distributions of cash, subject to all the rules applicable to such distributions.

[4020] McKee, Nelson & Whitmire, ¶19.05. Distributions in Complete Liquidation of a Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L), reasons in a footnote:

> See Reg. § 1.732-1(b) (Where a partnership distributes property (other than money) in liquidation of a partner's entire interest in the partnership, the basis of such property to the partner shall be an amount equal to the adjusted basis of his interest in the partnership reduced by the amount of any money distributed to him *in the same transaction*. (emphasis added)). The reference to the same transaction should be interpreted to refer to the entire series of liquidating distributions in order to be consistent with the Regulations § 1.761-1(d) definition of liquidation. Further, any other interpretation of Regulations § 1.732-1(b) would make the timing of liquidating distributions a key ingredient in determining the basis of distributed property, and would allow taxpayers to artificially inflate the basis of property distributed in liquidation by agreeing to defer cash distributions. For example, assume a partner, whose basis of his interest is $10,000, is to receive $4,000 cash and a capital asset in liquidation of his

note creates much complexity and uncertainty,[4021] so one might consider keeping the payment right a contract right not reduced to a note. On the other hand, using a note and installment sale treatment would enable a cleaner break between the redeemed partner and the partnership and simplify inside basis step up issues (fn. 4028). The clean break from the partnership allows the retiring partner not to be treated as a partner any more for income tax purposes[4022] but also locks in the installment sale gain as income in respect of a decedent, the latter making the installment obligation ineligible for a basis step-up at death, whereas mere Code § 736(b) installments appear eligible for a basis step-up at death.[4023]

One might also be cautious when admitting a partner and redeeming a partner close in time to each, lest the IRS argue a disguised sale between the retiring partner and the new partner.[4024]

> interest. Under the interpretation suggested in the text, the distributed capital asset will have a basis of $6,000 to the partner regardless of the order in which the distributions are made. If subsequent cash distributions are not taken into account in computing the basis of the distributed capital asset, the capital asset will take a basis of $10,000 if it is distributed first and the $4,000 cash distribution will be taxable when received, a combination that would allow the distributee to accelerate losses (by selling the distributed capital asset) in exchange for a deferred gain on the eventual receipt of the cash.

[4021] See Cuff, Distributions of Promissory Notes In Liquidation of a Partner's Interest, *Journal of Real Estate Taxation* (now simply *Real Estate Taxation*) (WG&L), (1st Qtr. 2006) (capital accounting for promissory note distributions to a partner, allocations with respect to contributed property, allocations after a book-up of partnership assets, the minimum gain chargeback, the qualified income offset, unrecaptured Code § 1250 gain, allocation of partnership liabilities, and collapsible partnerships); Cuff, Promissory Notes In Liquidation of a Partner's Interest Still Hold Questions, *Journal of Real Estate Taxation* (now simply *Real Estate Taxation*) (WG&L), (2nd Qtr. 2006) (considering the interplay of the rules described in the 1st Qtr. Article, and the rules on disguised sales and collapsible partnerships).

[4022] See fns. 4003-4004.

[4023] See fns. 4026 and 4027 and part II.H.2.e IRD Assets Not Eligible for a Basis Step-Up.

[4024] See Kim and Saunders, Redeeming a Partner with The Partnership's Note, *TM Memorandum* (BNA) (3/21/2016). Announcement 2009-4 stated:

> Until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law.

Announcement 2009-4 looks askance at a couple of cases in this area, which cases are discussed in the Kim and Saunders article but which might control, notwithstanding the IRS' view. Announcement 2009-4 stated:

> Section 707(a)(2)(B) provides that, under regulations prescribed by the Secretary, if transfers of property between a partner or partners and a partnership, when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated as either transactions between the partnership and one who is not a partner or between two or more partners acting other than in their capacity as partners. The legislative history of section 707(a)(2)(B) indicates the provision was adopted as a result of Congressional concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by related partnership distributions. See H.R. Rep. No. 861, 98th Cong. 2nd Sess. 861 (1984), 1984-3 (Vol. 2) CB 115. Specifically, Congress was concerned about court decisions that allowed tax-

Letter Ruling 8304059 assumed that using a promissory note to redeem a partner does not necessarily take the transaction out of Code § 736 and ruled that any interest paid constitutes a Code § 707(c) guaranteed payment and that Reg. §§ 1.267(b)-1(b) and 1.707-1(c) prevent Code § 267 from limiting the timing of the interest deduction. Although a Code § 736 payment may bear interest, it need not.[4025] For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services

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free treatment in cases that were economically indistinguishable from sales of property to a partnership or another partner, and believed that these transactions should be treated for tax purposes in a manner consistent with their underlying economic substance. See H.R. Rep. No. 432, 98th Cong. 2nd Sess. 1218 (1984) (H.R. Rep.), and S. Prt. No. 169 (Vol. I), 98th Cong. 2nd Sess. 225 (1984) (S. Prt.) (discussing *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980), and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983), both of which involved disguised sales of a partnership interest).

[4025] Garlock, ¶1308 Debt Contributed To And Distributed From Partnerships, *Federal Income Taxation of Debt Instruments* (CCH), asserts in ¶1308.02 Distributions of Debt Instruments from Partnerships, [B] Debt of the Partnership:

> …The real issue, then, is whether interest will be imputed on partnership notes to partners that do not bear adequate stated interest. As noted above, the better view is that interest should not be imputed.
>
> If a partnership's note distributed to a partner is respected for all tax purposes, and if the partner's interest in the partnership is not reduced as a result of the distribution (as would be the case in a situation involving a pro rata distribution of notes to all partners), the determination of its issue price is unclear. The note is not issued for cash or property because the partner is not giving anything to the partnership in exchange for the note. There is no partnership analogue to section 1275(a)(4), which deems a corporation's note distributed to a shareholder as being issued in exchange for property. Hence, section 1273(b) does not provide any rule for determining the note's issue price.[258] Reg. § 1.1273-2(d)(1), which is broader than the corresponding statutory rule, effectively treats any debt instrument not issued for money or publicly traded property or subject to section 1274 as having an issue price equal to its stated redemption price.
>
> If the debt distributed provides for qualified stated interest (QSI), then its stated redemption price at maturity equals its stated principal amount and little is at stake here. The stated interest is respected as interest, and the stated principal amount is respected as principal. Even if the interest is at a rate below the AFR (or is zero), no interest is imputed under section 1274 because the debt was not issued in exchange for property and no interest is imputed under section 7872 because a loan from a partnership to a partner is not one of the categories of loans subject to that section, absent regulations treating the loan as a significant tax effect loan.[259] The only real problem arises if the debt provides for stated interest that is not QSI. Because all payments other than QSI are included in a debt's stated redemption price at maturity,[260] the effect of treating the debt's issue price as being equal to its stated redemption price at maturity would be to recharacterize all stated interest on the debt as principal. It is doubtful that this result was intended. The more sensible rule is to treat the debt instrument as issued for its stated principal amount in this situation.
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> [258] See ¶ 203. Section 1273(b)(1) and (2) apply to debt instruments not issued for property, but the rules in those paragraphs depend on the price at which the instruments were offered for sale or actually sold, and this does not apply in the present case. Section 1273(b)(4) is generally the rule that applies if no other rule applies (and it deems the issue price to be equal to the stated redemption price at maturity), but it only applies to debt issued for property.
>
> [259] See ¶ 402.02.
>
> [260] See ¶ 202.01.

Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

It appears that a basis adjustment would apply at the retiring partner's death, which might eliminate a considerable part of the gain to be recognized on future installments (to the extent that gain is not attributable to the deceased partner's share of items constituting income in respect of a decedent)[4026] and might also lead to depreciation and goodwill amortization deductions.[4027] Thus, installment sales lock in gain as income in respect of a decedent, whereas Code § 736 payments appear eligible for a basis step-up. A partnership agreement might even convert Code § 736(a) payments to Code § 736(b) payments upon death, perhaps reducing the installments to take into account the smaller tax burden imposed on the seller.

Suppose that the partnership agreement provided for a Code § 736(b) payment with respect to goodwill. Each Code § 736(b) installment would give rise to a new goodwill asset that could be amortized over 180 months.[4028] Thus, the parties could get some tax arbitrage by the buyer getting ordinary deductions over 15 years when the seller gets capital gain, but query what the time value of money would be like in a business deal, which generally requires a faster payback. If assets have a faster depreciation period but the number of assets to track is high, consider abandoning the use of Code § 736(b) payments and simply using Code § 736(a); see part II.Q.8.b.ii.(c) Comparing Code § 736(a) with (b) Strategically.

Presumably, this lack of installment sale treatment would allow partnership redemptions to avoid the interest on deferred tax liabilities that Code § 453A imposes on installment sales. A prominent treatise states:[4029]

> A selling partner who receives deferred payments and reports gain under § 453 may be subject to acceleration of deferred gain under the pledge rule in § 453A(d) and may be required to pay interest on his deferred tax liability under § 453A(c). There are no analogous provisions applicable to deferred distributions to partners whose partnership interests are liquidated under § 736.

[4026] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, fn. 4153.

[4027] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, especially fn. 4155.

[4028] Reg. § 1.734-1(e)(1), referred to by McKee, Nelson & Whitmire, ¶25.02. Allocations of Section 734(b) Adjustments to Partnership Assets: Section 755, *Federal Taxation of Partnerships & Partners* (WG&L), interpreting the consequence of Rev. Rul. 93-13, which provides:

> If a partnership that has in effect an election to adjust basis under section 754 of the Internal Revenue Code completely liquidates the interest of a partner by agreeing to make a series of cash payments that are treated as distributions under section 736(b)(1), the section 734(b) basis adjustments to partnership property respond in timing and amount with the recognition of gain or loss by the retiring partner with respect to those payments.

If the Code § 736(b) payments were contingent, perhaps Reg. § 1.197-2(f)(2) would apply to amortize the new payments over the remaining months of the 180-month period.

[4029] McKee, Nelson & Whitmire, ¶16.02. Transfers of Partnership Interests by Sale or Exchange: Tax Consequences of Liquidations Compared, *Federal Taxation of Partnerships & Partners*.

The treatise later states:[4030]

> In general, amounts that are computed like interest and paid to a partner for the use of partnership capital constitute guaranteed payments under § 707(c). Because a retired partner who receives post-retirement liquidation distributions is treated as a continuing partner (and not as a partnership creditor) for Subchapter K purposes until his interest is completely liquidated, it seems that any "interest" paid with respect to deferred § 736(b) distributions should be treated as guaranteed payments to the retired partner for the use of his unreturned capital. This notion is buttressed by the fact that § 736(a)(2) treats all payments "made in liquidation of the interest of a retiring partner" as § 707 guaranteed payments if they are determined without regard to partnership income and are not paid for the retiring partner's interest in partnership property under § 736(b).
>
> If deferred liquidation payments cannot bear tax-recognized interest, it follows that the imputed interest rules of §§ 483, 1272, and 7872 do not apply to deferred liquidation distributions under § 736. [In other words, deferred payments under Code § 736 should not be recharacterized as part principal and part interest.] From a policy perspective, inapplicability of these rules may not be as offensive as might first appear, since the timing of any tax benefits and burdens of deferred liquidation payments under § 736 are matched. Thus, because deferred liquidation payments are not treated as liabilities, the continuing partners cannot increase the bases of their partnership interests by the amount of deferred payments under § 752(a). In addition, the partnership is entitled to adjust the basis of its assets under § 734(b) only when the deferred payments are actually made and the retired partner actually recognizes gain or loss. Finally, if amounts payable to a retired partner include interest-like payments, such payments constitute § 736(a)(2) payments that will be included in the income of the retired partner at the same time that they are deducted by the partnership under the matched timing rules of § 707(c).

I am not aware of any primary authority addressing the above issue.

II.Q.8.b.ii.(e). Effect of Code § 736 Payments, Installment Sale Payments, or Deferred Compensation on Balance Sheet

Generally, Code § 736(a)(1) payments that are structured as preferred distributions of profits are considered equity and do not affect the entity's net worth.

On the other hand, Code § 736(a)(2) guaranteed payments and Code § 736(b) installment sale payments would be liabilities on the entity's balance sheet. Similarly, in a cross-purchase, the buyers would have liability on their balance sheets (which can also impede the use of guaranties). Finally, deferred compensation agreements, which

[4030] McKee, Nelson & Whitmire, ¶22.02[4][c] Interest on Deferred Section 736(b) Payments, *Federal Taxation of Partnerships & Partners*. For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

are the corporate attempt to replicate Code § 736(a)(2) guaranteed payments, would also constitute a liability on the entity's balance sheets.

Liabilities on balance sheets can impede access to credit before and during the buy-out period. That a business is transitioning from the successful founder to new management doesn't help that situation.

Thus, Code § 736(a)(1) payments that are structured as preferred distributions of profits might very help the business' operations relative to the other ways of structuring buyouts.

II.Q.8.b.ii.(f). Planning for the 3.8% Tax on Net Investment Income and Passive Loss Rules When Using Code § 736 Payments

For purposes of the 3.8% tax on net investment income,[4031] see part II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411.

See also part II.K.1.d Applying Passive Loss Rules to a Retiring Partner under Code § 736.

II.Q.8.b.ii.(g). Code § 736 Payments As Retirement Income – Possible FICA and State Income Tax Benefits

Compensatory payments to be made for the rest of a partner's life, which generally would be Code § 736(a) payments, might be excluded from FICA but would be subject to Code § 409A. See part II.L.7 SE Tax N/A to Qualified Retiring or Deceased Partner.

No state may impose income tax on any retirement income of an individual who is not a resident or domiciliary of that state (as determined under that state's laws).[4032] "Retirement income" includes income from a written plan, program, or arrangement that is in effect immediately before retirement begins and provides retirement payments in recognition of prior service to be made to a retired partner,[4033] if the income is from an

[4031] See part II.I 3.8% Tax on Excess Net Investment Income.

[4032] 4 U.S.C. § 114(a). Missouri Private Letter Ruling No. LR 3570 (1/2/2007) held that this statute protected the following payments from state income tax:

> Applicant is a participant of a Retirement Plan (RP) and is also a participant of an Insurance Plan (collectively, the Plans). The purpose of the Plans is to supplement retirement benefits from the Pension Plan (Pension Plan) and the Retirement Plan for eligible corporate officers in recognition of service to their employer. The administrator of the RP is the Corporation and the administrator of the insurance plan is a committee within the Pension Plan.
>
> ….
>
> In this case the Plans are plans or arrangements as described in IRC section 3121(v)(2)(C) and the monthly payments meet the requirements of section 114(b)(1)(I)(i) of Title 4 of the United States Code. Therefore, for purposes of state income tax, the monthly payments from the Plans received by Applicant will be treated as retirement income as defined in section 114(b) of Title 4 of the United States Code.

[4033] 4 U.S.C. § 114(b)(4) provides:

excess benefit plan[4034] or if the income is part of a series of substantially equal periodic payments payable at least annually for either the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and a designated beneficiary of the recipient) or a period of not less than 10 years.[4035]

II.Q.8.b.ii.(h). Interaction of Death with Code § 736 Payments

Generally, the retiring partner's payments would consist of:

- Code § 736(a) payments (taxable as ordinary income), grossed up for income taxes as illustrated in the different purchase prices used in parts II.Q.1.a.i.(f) Partnership Use of Same Earnings as S Corporation in Sale of Goodwill and II.Q.1.a.i.(g) Partnership Use of Same Earnings as C Corporation (Either Redemption or No Tax to Seller per Part II.Q.7.j Exclusion of Gain on the Sale of Certain Stock in a C Corporation) in Sale of Goodwill, would be paid during the retiring partner's life, and

- Code § 736(b) payments, not grossed up but generally tax-free because the deceased partner's successor in interest has received a basis step-up, would be made after the retiring partner's death.[4036]

Perhaps the partnership has life insurance to pay a retired partner. The life insurance is received tax-free (so long as the partnership complies with the rules on employer-owned life insurance, which apply to any 5% partner, whether or not the partner actually works in the business).[4037] Thus, the partnership does not need to deduct payments it makes to the retired partner's beneficiaries. Furthermore, the basis step-up mentioned above, if my assumption is correct, means that there is no capital gain tax for the retired partner's beneficiaries to avoid. Therefore, consider converting Code § 736(a) payments to Code § 736(b) payments when a partner dies, perhaps reducing the payments to take into account that the seller does not need to be grossed up to pay the seller's taxes on the distribution.

> For purposes of this section, the term retired partner is an individual who is described as a partner in section 7701(a)(2) of the Internal Revenue Code of 1986 and who is retired under such individual's partnership agreement.

[4034] 4 U.S.C. § 114(b)(1)(I)(ii) refers to:

> a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k) , 401(m) , 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

I have assumed, without verification, that withdrawal from a partnership counts as termination of employment, consistent with the treatment of partners as employees eligible to participate in a qualified retirement plan. Please let me know what you discover when you research this issue.

[4035] 4 U.S.C. § 114(b)(1)(I)(i).

[4036] For the basis step-up, see fns. 4026 and 4027 in part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale.

[4037] See part II.Q.4.g Income Tax Trap for Business-Owned Life Insurance.

II.Q.8.b.iii. Partnership Alternative to Seller-Financed Sale of Goodwill

Is goodwill an asset that belongs to the individual owner or to the entity? Where a non-compete agreement is not in place and business is largely attributable to the close personal relationships that the owner has developed and maintained for decades, goodwill belongs to the owner personally.[4038] Where a contract allocates large amounts to the entity's goodwill and the owner enters into a noncompete agreement to preserve the entity's goodwill, the owner's receipt of noncompetition payments is ordinary income rather than the sale of personal goodwill.[4039] Given that the buyer's deductions relating to goodwill are the same as for a noncompetition agreement,[4040] the seller should consider maximizing the extent to which payments directly to the seller are for personal goodwill rather than a covenant not to compete.[4041]

As a practical matter, often the buyer will be able to pay the promissory note for goodwill only if the business is sufficiently profitable. If the business is not profitable, the seller would need to sue the buyer to enforce the note, and all that lawsuit would accomplish would be a judgment against someone who cannot pay it. The seller's most effective

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[4038] See part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?

[4039] *Muskat v. U.S.*, 554 F.3d 183 (1st Cir. 2009), *aff'g* 101 AFTR 2d 2008-1606 (D.N.H. 2008). When Muskat sold his business to Jac Pac and agreed not to compete, nothing in the contract mentioned that Muskat was selling personal goodwill. The trial court described the negotiations for the sale:

> During the negotiation process, the parties were well-aware of Jac Pac's business goodwill, to which more than $15,000,000 of the purchase price was allocated. Warren testified that he was not aware of any goodwill in the transaction other than Jac Pac's goodwill. The noncompetition agreement defines Goodwill as an asset of Jac Pac including its goodwill and business as a going concern. The purpose of the noncompetition agreement was to protect Jac Pac's Goodwill in the transaction. Muskat acknowledged in the agreement that the noncompetition provisions were necessary to preserve and protect the proprietary rights and the goodwill of [MAC] (including [Jac Pac's goodwill]) and the Related Entities as going concerns. The consideration paid under the agreement was expressly for the covenants not to compete, with no mention of personal goodwill.

The District Court applied First Circuit precedent requiring the taxpayer to produce strong proof before applying tax treatment that varied from the transaction's legal documentation. The First Circuit agreed with the District Court and also clarified what strong proof means: [T]o constitute 'strong proof' a taxpayer's evidence must have persuasive power closely resembling the 'clear and convincing' evidence required to reform a written contract on the ground of mutual mistake.

In *Duffy v. U.S.*, 120 Fed. Cl. 55 (Ct. Fed. Cl. 2015), *aff'd* 117 A.F.T.R.2d 2016-397 (Fed. Cir. 2016), the recipient of proceeds in a settlement in a case for retaliatory firing asserted that the settlement was for personal injury or as compensation for impaired personal goodwill, the latter because he could not find a job because his former employer would not give him a reference. However, the settlement agreement provided that the payment was for the exclusive purpose of avoiding the expense and inconvenience of further litigation. The Court of Claims used that language to throw out the taxpayer's personal injury and goodwill assertions and held for the IRS. The Federal Circuit cited the quoted language and also noted, Mr. Duffy simply extinguished his claims, and any goodwill in his business remained with him.

[4040] Compare Code § 197(d)(1)(A) (goodwill) with Code § 197(d)(1)(E) (covenant not to compete).

[4041] One might also consider whether applicable state law allows the buyer more latitude in imposing restrictions relating to sale of goodwill than for a noncompetition agreement and whether the seller is trading off state law rights for favorable tax treatment.

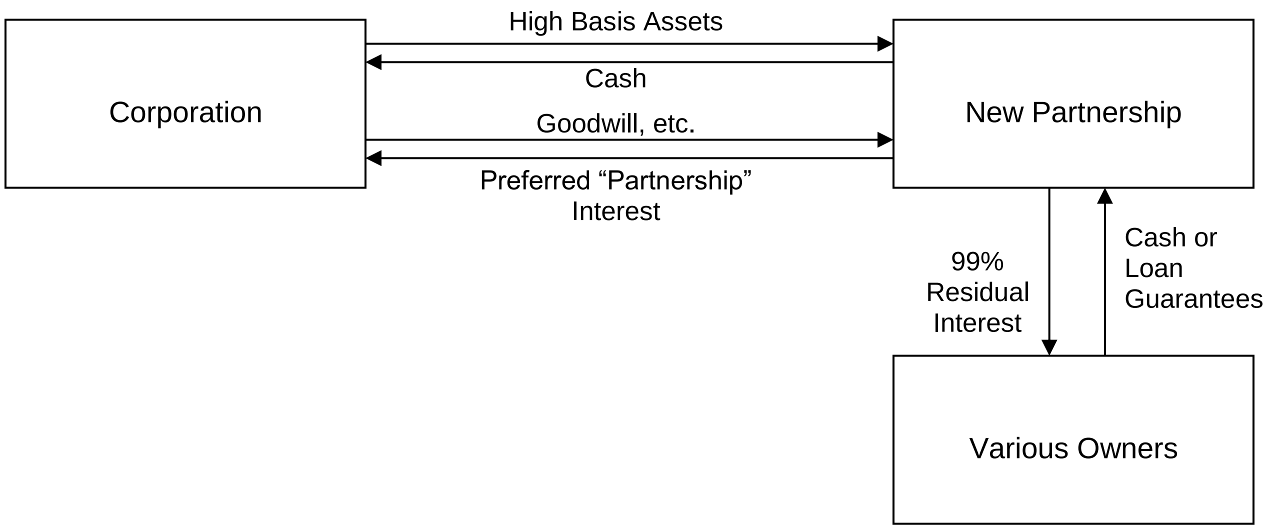
recourse might be to take over the business, which the judgment on the promissory note is unlikely to accomplish without further legal action.

The seller might prefer a mechanism in which:

- The seller has a quicker route to gaining control over the business if the buyer does not attain the results necessary to pay the seller.

- The deal is more tax-efficient than the traditional sale of goodwill.

This mechanism recognizes that, although the transfer of goodwill is technically a debt-financed deal, it really carries risks similar to an equity interest. Below is a diagram showing the transaction, in which the seller contributes the goodwill to a new entity in exchange for what for tax purposes is considered a preferred partnership interest.[4042]



This new arrangement needs to involve a real sharing of profits. Therefore, ideally the existing corporation would continue to own a residual interest. The amount and duration of the retained residual interest depend on the facts and circumstances.

The sale of high basis assets is optional. The high basis assets can instead be included in the contribution to capital. Because preferred partnership rates are higher than interest rates, the new partnership – essentially the various owners who own a 99% residual interest in the new partnership in the agreement – would be incurring a higher cost of capital than if the partnership bought the assets for a note. On the other hand, transferring all assets in the business in one fell swoop is appealing and might be the most practical; for how to transfer assets by operation of law to avoid issues that might arise from piecemeal or inadvertently incomplete transfers, see part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[4042] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

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Usually this structure is not for new owners but rather so that the existing owners can own the business in a more tax-efficient structure. The shareholders, as individual owners of the new entity, sign a covenant not to compete (together with other provisions protecting the new entity's intellectual property, etc.) in consideration for their interest in the new entity, as well as contributing some reasonable amount of cash. When an individual retires, that person's capital account is returned over time, and the perpetual residual profits interest is converted to a preferred profits interest until a target amount is reached. This new preferred profits interest would consist of Code § 736(a) payments (taxable as ordinary income), grossed up for income taxes, and Code § 736(b) payments, not grossed up; see part II.Q.8.b.ii.(h) Interaction of Death with Code § 736 Payments.

For the new entity's structure, see part II.E Recommended Structure for Entities, except that this arrangement involves the corporate partner owning not only the 1% of profits commonly shared but also a preferred partnership interest.

Let's look at the non-tax financial issues, then discuss the tax issues in addition to the advantages discussed in parts II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis and II.Q.7.h Distributing Assets; Drop-Down into Partnership.

II.Q.8.b.iii.(a). Non-Tax Financial Issues When Using a Preferred Partnership to Acquire Goodwill and Other Assets

The seller receives preferred payments equal to the lesser of the entity's net operating cash flow or a target amount before any amounts are distributed to the buyer. Because the payments are targets and not mandatory, they do not constitute debt or a fixed obligation; rather, they are a return of investment to the owners. Stock purchases for a note and deferred compensation constitute liabilities on financial statement that can impair financing– enough that such arrangements might be considered highly unattractive. This liability might very well be required to be disclosed in financial statements even if the event triggering the notes or deferred compensation have not occurred and are unlikely to occur soon. Clients and advisors tend not to consider this issue when planning, so be sure to raise it early and have the CPA directly address this issue.

If the target is not attained, then:

- The deficiency is added to the following year's target amount.

- The seller might be given control over certain aspects of running the business. This could be as modest as limiting the buyer's compensation for services rendered or as far-reaching as taking over control of part or all of the business' operations. The partial or total shift on control would be a focal point of negotiations.

These provisions would be built directly into the partnership agreement. So that they know that authority has not been transferred to the seller, third-party lenders would require assurances that the buyer is complying with the agreement with the seller, thus providing an independent check on the buyer's compliance with the deal.

After the seller has received all that has been bargained-for, the seller would no longer be an owner of the entity.

II.Q.8.b.iii.(b). Tax Issues When Transferring Assets to New Entity

Suppose the seller is an S corporation. If all of an S corporation's assets were sold to a new entity, the corporation would recognize income taxable to its shareholder. The sale of goodwill would be taxable, but the new entity's deduction for that payment would be spread over 180 months (15 years).[4043] Furthermore, if the IRS were to find that goodwill was transferred to the new entity at a substantial value, without the S corporation retaining a sufficient interest in the new entity, then:

- 1. The S corporation would have income equal to the goodwill.

- 2. The shareholders would have immediate dividend income equal to the goodwill, which they then contributed to the new entity without receiving an immediate deduction (the deduction would be spread over 180 months).

If the entity transfers its assets to a new LLC, retaining a preferred interest at no more than 150% of the AFR[4044] that distributes only to the extent of operating cash flow, a sale is presumed not to have occurred.[4045] If the S corporation is receiving a return whose present value (using the AFR) is equal to the value of the contributed goodwill (if any), the S corporation should not be treated as having distributed such goodwill to its shareholders. It might be advisable to give the corporation a small but significant profits interest in the LLC.

This concept of transferring to a new LLC also works better when the transferring entity is a partnership. Suppose the transferring entity sells all of its assets in exchange for a promissory note, and the buyer is unable to make all of the payments. Any basis remaining in the note would need to be written off as a bad debt.[4046] Contrast that to a partnership redemption, in which distributions or payments generally are applied to basis first and generate a gain only after recovering basis,[4047] subject to possible application of the disguised sale rules for payments made in the first two years.[4048]

II.Q.8.c. Related Party Sales of Non-Capital Assets By or To Partnerships

Gain on the sale of property is ordinary income if it is not a capital asset in the hands of the transferee and the sale is between:[4049]

[4043] Code § 197 provides for 15 years, and Reg. § 1.197-2(f)(1)(i) applies this starting with a particular month.
[4044] AFR meaning the applicable federal rate provided under the tax laws as an arms-length interest rate.
[4045] See part II.M.3.e.i.(b) Distributions Presumed <u>Not</u> to Be Disguised Sales.
[4046] CCA 201328031.
[4047] See parts II.Q.8.b.i Distribution of Property by a Partnership and II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.
[4048] See part II.M.3.e Exception: Disguised Sale, explaining the rules and simple steps to avoid their application.
[4049] Code § 707(b)(2).

- a partnership and a person owning, directly or indirectly, more than 50% of the capital interest, or profits interest, in such partnership, or

- two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interest or profits interests.

Property subject to this rule includes trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade of business.[4050]

The corporate provision most closely related to this one is part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), including possible ordinary income taxation when selling to a controlled corporation interests in a partnership holding depreciable property.[4051]

II.Q.8.d. Partnership Division

For an overview with helpful charts and diagrams, see Borden, "Navigating State Law and Tax Issues Raised by Partnership and LLC Reorganizations," *Business Entities* (Jul./Aug. 2014).[4052]

II.Q.8.d.i. Partnership Division - Generally

In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50% or less in the capital and profits of the prior partnership) are a continuation of the

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[4050] Reg. § 1.707-1(b)(2).
[4051] See text accompanying fns. 3681-3682.
[4052] RIA Checkpoint *Catalyst*, ¶ 218:123 Tax Characterization of Division Transaction, discussed a ruling:

> In IRS Letter Ruling 201619001, the IRS respected the form of a transaction when a partnership division was one step of a larger transaction. In the ruling, an existing partnership (X) divided into two partnerships, X and M, in a transaction in which the partners of X before the division owned identical interests in both X and M after the division. Following the division, M transferred all of its assets to a third partnership (OP) in exchange for partnership interests in OP and other property (stock of the principal partner of OP, a real estate investment trust (REIT stock)). M then liquidated, distributing the partnership interests to some of its partners and the REIT stock to other partners. The partners receiving the REIT stock agreed to treat the transaction as if they sold their partnership interests in M to OP (see ¶ 218:114). The IRS ruled that the transaction would be treated in accordance with its form—i.e., as a division followed by a merger—and that the partners receiving the REIT stock would be treated as having sold their interests to the resulting merged partnership. IRS Letter Ruling 201619001
>
>> Comment: The IRS could have disregarded the division and recharacterized the transaction in IRS Letter Ruling 201619001 as a transfer of property by X directly to OP in exchange for partnership interests and other property (the REIT stock). In that case, the transaction would have been treated as a part-sale, part-contribution under IRC § 707(a)(2)(B). See Topic #206, Transactions Between Partner and Partnership, at ¶ 206:150. Presumably, the form of the transaction was intended to permit the gain attributable to the receipt of the REIT stock to be taken into account solely by the partners of X that received the stock.

prior partnership.[4053] Thus, generally a partnership can be divided without immediate income tax recognition.[4054]

However, some divisions might be taxable.[4055] Also, tax elections might be revoked and re-started for the new partnership. Furthermore, a division could re-start the seven-year waiting period for measuring Code § 704(c) responsibility; however, if each partner's overall interest in each partnership property does not change, then Code § 704(c)

[4053] Code § 708(b)(2)(B). Even an apparently taxable division might have less adverse tax effects than one might have thought. When a court ordered a partnership's assets sold and three of five partners bought all of the assets and continued operation of the business, the transaction was not treated as a sale of partnership assets to the three remaining partners but rather was considered as a sale or a liquidation of the partnership interests of the two withdrawing partners. Rev. Rul. 66-264.

[4054] Reg. § 1.708-1(d).

[4055] If a foreign person is directly or indirectly involved, see the discussion of when Code § 721(a) does not apply to any deemed contribution to a partnership in part II.M.3.g Exception: Foreign Partner (among various other exceptions to Code § 721(a).

responsibility would not be affected.[4056] Below are the rules governing whether the above events occur.[4057]

II.Q.8.d.ii. Which Partnership Keeps Original Partnership's Tax Identity?

When a partnership divides into two or more partnerships, any resulting partnership(s)[4058] shall be considered a continuation of the prior partnership[4059] if the

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[4056] The preamble to T.D. 8925 provides:

> To the extent that a partnership division merely affects a restructuring of the form in which the partners hold property (that is, each partner's overall interest in each partnership property does not change), the IRS and Treasury agree that a partnership division should not create new section 704(c) property or section 737 net precontribution gain. However, it is not clear that this result is necessarily appropriate where a division is non-pro rata as to the partners, where some property is extracted from or added to the partnerships in connection with the division, or where new partners are added to the ownership group in connection with the division. The IRS and Treasury intend to study this issue and request comments in this regard.

McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 13.06 Partnership Terminations and Continuations Resulting From Mergers and Divisions, opines:

> The authors believe that, unless there are extenuating circumstances, a division should never be the occasion for the creation of new § 704(c) property or § 737 net precontribution gain. The justification for this conclusion flows from the very nature of a division; it is a restructuring of the form in which partners hold property through partnerships. There are no additions or deletions of property to or from the partnership pool. There is no change in the composition of the partners as a group. Instead of owning all the property through a single partnership, the partners now own it through several partnerships. Why should a transaction that involves so little change be the occasion for the imposition of such draconian rules?
>
> The authors' view is consistent with the rules applicable to § 708(b)(1)(B) terminations which, unlike divisions, involve substantial changes in the composition of the partner group. Both the § 704(c)(1)(B) Regulations and the § 737 Regulations provide that these provisions do not apply to the deemed distribution of interests in the new partnership that is caused by the termination. Subsequent distributions by the new partnership may trigger § 704(c)(1)(B) or § 737 with respect to partners in the new partnership who were partners in the terminated partnership, but only to the same extent they would have been triggered without the termination. [citing Reg. §§ 1.704-3(c)(3), 1.737-2(a).] A similar rule should apply to divisions. While further developments are anticipated, they are not expected any time soon.

[4057] See McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), ¶ 13.06 Partnership Terminations and Continuations Resulting From Mergers and Divisions. Also note that Reg. § 1.708-1(d)(6) provides:

> If any transactions described in paragraph (d)(3) of this section are part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form prescribed in such paragraph, the Commissioner may disregard such form, and may recast the larger series of transactions in accordance with their substance.

[4058] As defined in Reg. § 1.708-1(d)(4)(iv), which provides that a resulting partnership is a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership. For example, where a prior partnership divides into two partnerships, both partnerships existing after the division are resulting partnerships.

[4059] As defined in Reg. § 1.708-1(d)(4)(ii), which provides that the prior partnership is the partnership subject to division that exists under applicable jurisdictional law before the division.

members of the resulting partnership(s) had an interest of more than 50% in the capital and profits of the prior partnership.[4060]

Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership.[4061]

If the members of none of the resulting partnerships owned an interest of more than 50% in the capital and profits of the prior partnership, none of the resulting partnerships will be considered a continuation of the prior partnership, and the prior partnership will be considered to have terminated.[4062]

Where members of a partnership which has been divided into two or more partnerships do not become members of a resulting partnership which is considered a continuation of the prior partnership, such members' interests shall be considered liquidated as of the date of the division.[4063]

The resulting partnership that is treated as the divided partnership[4064] shall file a return for the taxable year of the partnership that has been divided and shall include the name, address, and employer identification number (EIN) of the prior partnership.[4065]

All other resulting partnerships that are regarded as continuing and new partnerships shall file separate returns for the taxable year beginning on the day after the date of the division with new EINs for each partnership.[4066]

All resulting partnerships that are regarded as continuations of a prior partnership are subject to preexisting elections that were made by that prior partnership.[4067] A

[4060] Reg. § 1.708-1(d)(1).
[4061] Reg. § 1.708-1(d)(1).
[4062] Reg. § 1.708-1(d)(1).
[4063] Reg. § 1.708-1(d)(1).
[4064] As defined in Reg. § 1.708-1(d)(4)(i), which provides as follows: The divided partnership is the continuing partnership which is treated, for Federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the assets-over form) or indirectly (under the assets-up form). If the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership. If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership, then the resulting partnership that is a continuation of the prior partnership will be treated as the divided partnership. If a partnership divides into two or more partnerships without undertaking a form for the division that is recognized under Reg. § 1.708-1(d)(3), or if the resulting partnership that had, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.
[4065] Reg. § 1.708-1(d)(2)(i). The return shall include the names, addresses, and EINs of all resulting partnerships that are regarded as continuing. The return shall also state that the partnership is a continuation of the prior partnership and shall set forth separately the respective distributive shares of the partners for the periods before and including the date of the division and after the date of division.
[4066] Reg. § 1.708-1(d)(2)(i).

subsequent election that is made by a resulting partnership does not affect the other resulting partnerships.[4068]

II.Q.8.d.iii. Assets-Over vs. Assets-Up Division

II.Q.8.d.iii.(a). Assets-Over Divisions

Generally, in an "assets-over" division, an existing partnership transfers some portion of its assets and liabilities (directly or by distributing an interest in an entity the partnership owns) to a new partnership, and immediately thereafter distributes interests in the new partnership to some or all of its partners.

When in doubt, the division is an "assets-over" division.[4069]

In an assets-over division, the following transactions are deemed to have occurred:

- Where at least one resulting partnership is a continuation of the prior partnership:
    - The divided partnership[4070] contributes certain assets and liabilities to a recipient partnership(s)[4071] in exchange for interests in such recipient partnership(s).
    - Immediately thereafter, the divided partnership distributes the interests in such recipient partnership(s) to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.[4072]

4067 Reg. § 1.708-1(d)(2)(ii).
4068 Reg. § 1.708-1(d)(2)(ii).
4069 Reg. § 1.708-1(d)(3)(i). The preamble, T.D. 8925, provides:

> …it is appropriate to require consistency in applying either the Assets-Over Form or the Assets-Up Form to characterize a transfer of assets to a resulting partnership. However, where a single partnership is divided in a transaction that involves a transfer of assets (either actual or deemed) to multiple partnerships, the transfer to each resulting partnership should be viewed separately. As with mergers involving more than two partnerships, it is consistent with the purposes of these regulations, in the context of divisions, to allow the transfer to one resulting partnership to be characterized under the Assets-Over Form while characterizing the transfer to another resulting partnership under the Assets-Up Form. The proposed regulations provided an example that illustrates when such a division accomplished under both the Assets-Over Form and the Assets-Up Form will be respected. The final regulations do not change the example. See § 1.708-1(d)(5) Example 7 of the final regulations. The final regulations also add an example to illustrate when a division accomplished under both the Assets-Over Form and the Assets-Up Form will not be respected.

4070 See fn. 4064.
4071 As defined in Reg. § 1.708-1(d)(4)(iii), which provides that a recipient partnership is a partnership that is treated as receiving, for Federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form).
4072 Reg. § 1.708-1(d)(3)(i)(A).

- Where none of the resulting partnerships is a continuation of the prior partnership:
  - The prior partnership will be treated as contributing all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships.
  - Immediately thereafter, the prior partnership will be treated as liquidating by distributing the interests in the new resulting partnerships to the prior partnership's partners.[4073] Distributions of partnership interests trigger Code § 743 adjustments.[4074]

Code § 737 and Reg. § 1.737-2 do not apply to a transfer by a partnership (transferor partnership) of all of the Code § 704(c) property contributed by a partner to a second partnership (transferee partnership) in a Code § 721 exchange, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the Code § 704(c) property to the transferor partnership.[4075] A later distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to Code § 737 to the same extent that a distribution from the transferor partnership would have been subject to Code § 737.[4076]

II.Q.8.d.iii.(b). Assets-Up Divisions

Generally, in an "assets-up" division, an existing partnership distributes assets and liabilities to some or all of its partners, who then contribute them to a new partnership.

If the divided partnership[4077] distributes certain assets (such that state law causes the partners to be treated as the owners of such assets)[4078] to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership and immediately thereafter such partners contribute the distributed assets to one or more

[4073] Reg. § 1.708-1(d)(3)(i)(B).
[4074] See parts II.Q.8.e.i Distribution of Partnership Interests and II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss).
[4075] Reg. § 1.737-2(b)(2).
[4076] Reg. § 1.737-2(b)(3).
[4077] Which Reg. § 1.708-1(d)(4)(i) requires to be a continuing partnership.
[4078] The preamble in T.D. 8925 says:

> While the IRS and Treasury believe that it should be necessary for a partnership to actually convey ownership of the partnership's assets to its partners in order to follow the Assets-Up Form, it should not be necessary for the partners to actually assume the liabilities of the partnership in order to follow such form. Pursuant to section 752 and the regulations thereunder, a partner essentially is deemed to have directly incurred a share of the partnership's liabilities. Requiring the partners to actually assume debt that they already are deemed to have incurred is unnecessary. Such a requirement also could create a trap for the unwary. If a partner momentarily assumes an amount of the partnership's debt that is less than the partner's share of such debt under section 752 (and other partners momentarily assume an amount of debt in excess of their shares), the partner could inappropriately recognize gain as a result of the deemed distribution.

partnerships in exchange for interests in such recipient partnership(s), the transaction is respected as an "assets-up" division.[4079]

If none of the resulting partnerships is a continuation of the prior partnership, then despite the partners' transitory ownership of some or all of the prior partnership's assets, the form of a partnership division will be respected for Federal income tax purposes if:[4080]

- The prior partnership distributes certain assets (such that state law causes the partners to be treated as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the prior partnership, and

- Immediately thereafter, such partners contribute the distributed assets to a resulting partnership(s) in exchange for interests in such resulting partnership(s).

However, if the prior partnership does not liquidate for state law purposes, then, with respect to the assets and liabilities that, in form, are not transferred to a new resulting partnership, the prior partnership will be treated as transferring these assets and liabilities to a new resulting partnership in an assets-over division.[4081]

II.Q.8.d.iii.(c). Effect of Basis Issues on Type of Division

If the basis of the partnership's assets ("inside basis") exceeds the basis of the partnership interests ("outside basis") involved, then one would tend to want to preserve the inside basis, and an assets-over division would tend to be attractive.

If the outside basis exceeds the inside basis, then one might seek to have the outside basis applied to the partnership's assets in an assets-up division, which involves a liquidating distribution.

See part II.Q.8.b.i.(g) Characteristics of Distributed Property.

II.Q.8.d.iii.(d). Checklist of Issues in Choosing Assets-Over vs. Assets-Up

If any division described above is part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form prescribed above, the IRS may disregard such form, and may recast the larger series of transactions in accordance with their substance.[4082]

[4079] Reg. § 1.708-1(d)(3)(ii)(A). That form is respected for transfers to a particular recipient partnership only if all assets held by the prior partnership that are transferred to the recipient partnership are distributed to, and then contributed by, the partners of the recipient partnership.
[4080] Reg. § 1.708-1(d)(3)(ii)(B). That form is respected for transfers to a particular recipient partnership only if all assets held by the prior partnership that are transferred to the recipient partnership are distributed to, and then contributed by, the partners of the recipient partnership.
[4081] Reg. § 1.708-1(d)(3)(ii)(B).
[4082] Reg. § 1.708-1(d)(6).

The following are among issues to consider in planning partnership divisions:[4083]

- Any mixing bowl gain in current transaction?[4084]
    - Assets up: Are contributed assets distributed to another partner, or other assets contributed to a Code § 704(c) partner within 7 years?
    - Assets over: If one looks through distributed partnership interest, would underlying asset distribution trigger Code § 704(c)(1)(B) or Code § 737 gain?
    - These issues apply only if the partners do not have identical percentage interests in each partnership.[4085]
- Is there any potential gain under Code § 731(c), relating to a distribution of marketable securities? An assets-over division that distributes a partnership the value of which is at least 20% marketable securities might be an indirect distribution of marketable securities.[4086]

[4083] A selected list from Borden, O'Conner, and Schneider, Partnership and LLC Reorganizations, 2013 *LLC Institute* (10/18/2013).

[4084] See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737.

[4085] See fn. 4056.

[4086] See part II.Q.8.b.i.(a) Code § 731, including fns. 3873 and 3874. Letter Ruling 200223036 included the following facts and holding:

> To effect an assets-over form of division, LLC proposes contributing certain assets, including marketable securities, and liabilities to LLC 2 in exchange for 100 percent of the membership interests in LLC 2. Immediately thereafter, LLC will distribute the interests in LLC 2 to Son, Son's Trusts, and Mother's Trust (Distributee Partners) in partial or complete liquidation of their interests in LLC. Consequently, LLC's partnership division will yield two resulting partnerships, LLC and LLC 2. The respective members of LLC and LLC 2 immediately after the division will have had an interest in capital and profits of the prior partnership (LLC before the division) of more than 50 percent. Therefore, we assume that each of the two resulting partnerships will be considered a continuation of the prior partnership. In addition, as the partnership that will transfer the assets and liabilities in the division, LLC should constitute the divided partnership. As the partnership that will be treated as receiving the assets and liabilities, LLC 2 should constitute the recipient partnership.
>
> Because the term money includes marketable securities, LLC's distribution of the interests in LLC 2 to the Distributee Partners will have potential gain consequences under § 731(a). LLC's shares of stock in three public companies meet the definition of marketable securities under § 731(c). In addition, more than 90 percent of the value of LLC 2 will be attributable to the marketable securities, stock shares, it will receive in the division. Therefore, the membership interests in LLC 2 themselves should constitute marketable securities (in an amount equal to their fair market value on the distribution date), the distribution of which should constitute a distribution of money.
>
> A limitation applies to the amount of the distribution of marketable securities (membership interests) that is treated as a distribution of money. The amount of such a distribution is reduced under § 731(c)(3)(B) by a distributee partner's share of the built- in gain in the securities held by the partnership. LLC is concerned that the partnership referred to in § 731(c)(3)(B) in determining the reduction amount may include both continuing partnerships, LLC and LLC 2, thereby eliminating most of the anticipated limitation on any § 731(a) gain resulting from the proposed division.

- Consider future mixing bowl ramifications from creation of new 7 year mixing bowl clock.[4087]
  - Can form be changed to minimize costs?
  - What are future distribution plans?
- Consider effect of debt shifts under Code § 752, because deemed distributions from relief of debt might trigger income.
- Any Code § 708(b)(1)(B) terminations of lower-tier partnerships?
- Compare state or local taxes based on form - particularly transfer taxes.
- Consider potential application of new Code § 704(c)(1)(C) if one or more assets are depreciated, even if overall net appreciation. Code § 704(c)(1)(C) locks in built-in loss to contributing partner and could create differences depending on form chosen.[4088]
- Consider Code § 704(c) generally.
  - If assets up, individual partners are Code § 704(c) contributing partners on specific assets.
  - If assets over, consider Code § 704(c) step in the shoes rules.
  - In either case, if the division is pro rata, no new Code § 704(c) responsibility should be created.[4089]
- If assets up transaction, consider disguised sale rules: were appreciated assets contributed within prior two years?[4090]
- Will assets up transaction result in a shift, at least transitorily, of hot asset sharing or trigger any Code § 751(b) gain?[4091]

II.Q.8.e. Transfers of Partnership Interests

II.Q.8.e.i. Distribution of Partnership Interests

Except as otherwise provided in regulations, for purposes of Code § 708 (termination of partnership), Code § 743 (adjustment to inside basis of partnership property when the outside basis of the partnership interest changes), and any partnership income tax

[4087] See part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737.
[4088] See fn. 4171.
[4089] See fn. 4056.
[4090] See part II.M.3.e Exception: Disguised Sale.
[4091] See part II.Q.8.e.ii Transfer of Partnership Interests: Effect on Transferring Partner and part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

matters specified in regulations, any distribution of an interest in a partnership (not otherwise treated as an exchange) is treated as an exchange.[4092]

The Conference Report adopting this rule focused on a distribution of a partnership interest by a partnership or corporation.[4093] The relevant regulation focuses on distributions by partnerships;[4094] corporate distributions are already taxable as sales or exchanges through corporate income tax provisions.[4095] However, the statute's literal language is not so limited (and CCA 201726012 took a broad approach),[4096] so this rule also appears to apply to any distribution (other than a specific bequest) of a partnership interest by an estate or trust.[4097] Therefore, when a trust or estate distributes at a 50% or more partnership interest, the partnership terminates, resetting all partnership

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[4092] Code § 761(e) provides:

> *Distributions of partnership interests treated as exchanges*. Except as otherwise provided in regulations, for purposes of—
>
> (1) section 708 (relating to continuation of partnership),
>
> (2) section 743 (relating to optional adjustment to basis of partnership property), and
>
> (3) any other provision of this subchapter specified in regulations prescribed by the Secretary,
>
> any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange.

[4093] Tax Reform Act of 1984, P.L. 98-369, 7/18/1984.

[4094] Reg. § 1.761-1(e) provides:

> *Distribution of partnership interest*. For purposes of section 708(b)(1)(B) and § 1.708-1(b)(1)(iv), the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership. However, the deemed distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is treated as an exchange of the interest in the new partnership for purposes of section 743.

A new partnership formed as the result of the termination of a partnership under Code § 708(b)(1)(B) is not required to use the same method as the terminated partnership with respect to Code § 704(c) property deemed contributed to the new partnership by the terminated partnership under Reg. § 1.708-1(b)(1)(iv); see fn. 2755 in part II.P.1.a.i Allocations of Income in Partnerships.

[4095] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders. Note that Code § 761(e) was enacted in 1984, before tax-free corporate liquidations were abolished in 1986, so the reference to corporate distributions did make sense when Code § 761(e) was enacted.

[4096] CCA 201726012 (under the signature of David R. Haglund), in addressing, "Issue 1: Whether the transfer of a partnership interest in a complete liquidation to which § 332(a) applies or a reorganization to which § 368(a)(1)(A) and/or (D) applies is a transfer by sale or exchange for purposes of § 743(b)," held:

> The regulations under § 761 do not limit the definition of exchange to taxable exchanges for purposes of § 743. In particular, no provisions limit the definition of an exchange between related parties or members of a consolidated group. The transactions at issue here involved the distribution of a partnership interest as part of the complete liquidation of a corporate partner, and the transfer of a partnership interest as part of the reorganization of a corporate partner. Consequently, these transactions constitute an exchange for purposes of § 743 under the provisions of § 761(e).

[4097] For further analysis, see McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶23.05. Special Problems Relating to the Income Taxation of Partnership Interests Held by Estates and Trusts. For how distributions affect allocating tax items under Code § 706, see part III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership.

elections and stretching the period over which depreciation is deducted.[4098] The distribution is added to all other transfers constituting a sale or exchange under Code §708 within a period of 12 consecutive months to determine whether such a termination occurs.[4099] To avoid such a consequence, one might spread distributions over a period exceeding 12 months.

If a partnership does not make a Code § 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which also might be an event triggering a basis adjustment. The basis adjustment is not tied to any change in basis but rather generally catches up the "inside basis" to the "outside basis,"[4100] so every estate or (former) revocable trust has a chance to make up for the partnership's failure to make a Code § 754 election. Note also that, if a Code § 754 election is in place as of date of death, technically the basis adjustments need to be done not only as of date of death but also as of date of distribution. However, if the adjustments are made as of date of death and the distribution is a carryover basis event, then the fact that outside basis equals inside basis means that no further Code § 743(b) is required.[4101]

However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange for purposes of Code § 708.[4102]

Except as noted above, regulations do not appear to expand or contract this rule's scope.

[4098] Reg. § 1.708-1(b)(1); see part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.
[4099] Reg. § 1.708-1(b)(1).
[4100] See part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss), particularly the paragraph in which lies the text accompanying fn. 4149.
[4101] See fn. 4150 and accompanying text.
[4102] Reg. § 1.708-1(b)(2), which was last amended after Code § 761(e) was enacted. Does a distribution from a trust qualify for this exception? I view a trust termination as a disposition of a partnership interest by gift (including assignment to a successor in interest). However, Willis & Postlewaite, ¶ 16.01[7] Termination by Gift, Transfer on Death, or Distribution from Estate or Trust, *Partnership Taxation* (WG&L), does not share my confidence. The Conference Report adopting Code § 761 in 1984 does not expressly address trusts, saying that Code § 761 provides:

> that for purposes of section 708, section 743, or any other provision of subchapter K specified in regulations (not just section 743 as in the House bill and Senate amendment) a distribution of a partnership interest by a partnership or corporation will be treated as a sale or exchange of the interest.

Reg. § 1.708-1(b)(2) was Reg. § 1.708-1(b)(1)(ii) before it was re-designated by T.D. 8925 (1/4/2001). It had the same provision since its adoption in 1956. The 2001 redesignation related to comprehensive rules on partnership mergers and divisions and did not mention Code § 761. When T.D. 8717 (5/8/1997) amended other provisions of Reg. § 1.708-1, it also amended Reg. § 1.761-1, without touching this language. So my best guess is that Treasury did not view Code § 761 as having an impact on that particular sentence.
Distributions from trusts tend to be viewed as gifts. See part II.J.8.d Distribution in Kind.

II.Q.8.e.ii. Transfer of Partnership Interests: Effect on Transferring Partner

II.Q.8.e.ii.(a). Unitary Basis

A partner has a single basis in a partnership interest (determined under Code § 705), even if such partner is both a general partner and a limited partner of the same partnership.[4103] (A partner also has a single capital account that reflects all of the partner's interests, "regardless of the class of interests owned by such partner (*e.g.*, general or limited) and regardless of the time or manner in which such interests were acquired.")[4104]

However, portions of the unitary basis may have different holding periods if acquired at different times.[4105]

When one transfers a partnership interest, the basis allocated to the transferred interest is based on the relationship between the value of the transferor's partnership interest and the value of the transferred interest.[4106] Thus, when one transfers partnership

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[4103] Rev. Rul. 84-53, citing Rev. Rul. 84-52.

[4104] Reg. § 1.704-1(b)(2)(iv)(b), which is reproduced in the text accompanying fn. 418 in part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts).

[4105] Reg. § 1.1223-3. See McKee, Nelson & Whitmire, ¶ 4.01[2][a] Contributing Partner's Holding Period for His Partnership Interest, *Federal Taxation of Partnerships & Partners* (WG&L). For other aspects of split holding periods, including options to buy, see Bittker & Lokken, ¶ 49.5 Split Holding Periods, *Federal Taxation of Income, Estates, and Gifts* (WG&L), Rev. Ruls. 62-140 and 75-524, and *Commissioner v. Williams*, 256 F.2d 152 (1958), *aff'd on rehearing*, 285 F.2d 582 (5th Cir. 1961).

[4106] Rev. Rul. 84-53 allocates this basis as follows:

> Under section 1.61-6(a) of the regulations, when a partner makes a taxable disposition of a portion of an interest in a partnership, the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest. However, if such partnership has liabilities, special adjustments must be made to take into account the effect of those liabilities on the basis of the partner's interest.
>
> In cases where the partner's share of all partnership liabilities does not exceed the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the transferor partner shall first exclude from the adjusted basis of such partner's entire interest an amount equal to such partner's share of all partnership liabilities, as determined under section 1.752-1(e) of the regulations. A part of the remaining adjusted basis (if any) shall be allocated to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of the interest to the fair market value of the entire interest. The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest (under section 752(d) of the Code and section 1.1001-2 of the regulations) equals the adjusted basis of the transferred portion of the interest.
>
> On the other hand, if the partner's share of all partnership liabilities exceeds the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the adjusted basis of the transferred portion of the interest equals an amount that bears the same relation to the partner's adjusted basis in the entire interest as the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest bears to the partner's share of all partnership liabilities, as determined under section 1.752-1(e).

interests that are discounted relative to one's holding, one also transfers a proportionately smaller portion of basis to the transferee. Note also that, if a transfer is made to a grantor trust, the consequences of the transfer apply only when the trust ceases to be taxed to the grantor.[4107]

Presumably the basis could be divided if the buyer uses an S corporation for a subsequent investment into the partnership. Other consequences of that structure are in part II.L.5 Self-Employment Tax: Partnership with S Corporation Blocker, especially part II.L.5.a S Corporation Blocker Generally.

Also, dividing a partnership would isolate the basis with respect to groups of assets in that the groups of assets are in separate partnerships; any such division should result in percentage interests that are the same in each partnership before or after the division.[4108]

II.Q.8.e.ii.(b). Character of Gain on Sale of Partnership Interest

Although the sale of stock in a corporation (whether or not an S election is in place)[4109] is pure capital gain or loss, the sale of a partnership interest often has an ordinary income component. The gain is ordinary to the extent attributable to the selling partner's indirect interest in the partnership's unrealized receivables, certain depreciable assets, and inventory items;[4110] the rest generally receives capital gain treatment.[4111] If any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer (or any other related person) in a disfavored trade or business, the holding period for long-term capital gain treatment may be extended to over three years (instead of over one year); see part II.M.4.f.ii.(b) Certain Sales of Compensatory Partnership Interests Recharacterized from Long-Term to Short-Term Gains.

"Unrealized receivables" includes previously untaxed rights to payment from the sale of:[4112]

1. Inventory or other ordinary income items, or

2. Services rendered, or to be rendered.

For Reg. § 1.752-1 after October 2016 changes, see part II.C.3 Allocating Liabilities (Including Debt). I have not yet reviewed their interaction with Rev. Rul. 84-53.

[4107] See part III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment, especially fn. 4919.

[4108] See part II.Q.8.d Partnership Division, especially fn. 4056.

[4109] Code § 341, before its repeal, provided exceptions for collapsible corporations.

[4110] Code § 751(a); for details on the assets subject to these rules, see part II.Q.8.b.i.(f) Code § 751 – Hot Assets. See also fn. 3860.

[4111] Code § 741.

[4112] Code § 751(c). Untaxed means to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Reg. § 1.751-1(c)(1). Reg. § 1.751-1(c) describes various aspects of various kinds of unrealized receivables.

Depreciable assets to which this provision applies are primarily those the sale of which would trigger depreciation recapture, such as depreciation on tangible personal property or accelerated depreciation on the sale of real property.[4113] However, sometimes depreciable real property without accelerated depreciation might be subject to more onerous provisions.[4114]

"Inventory items" includes not only inventory[4115] but certain other ordinary income items,[4116] whether those assets would receive that treatment in the hands of the partnership or the selling partner.[4117] Under prior law, this provision applies only if those assets are substantially appreciated,[4118] meaning that their fair market value exceeds 120% of the adjusted basis to the partnership of such property.[4119] However, now inventory items do not have to be substantially appreciated to impute ordinary income on the portion of the sale of the partnership interest attributable to such items;[4120] thus, the sale of a partnership interest is treated less favorably than a redemption,[4121] since a redemption triggers ordinary income attributable to inventory items only if the inventory items are substantially appreciated.[4122]

When a partner transfers part or all of the partner's interest via gift, part of that transfer will be treated as a sale if the partner's share of partnership liabilities exceeds the adjusted basis of the partner's partnership interest. The transfer is treated as such because liability is shifting from the donor to the donee, and the donor is treated as having received cash to the extent that the donor's share of liabilities is reduced. The shift can be analyzed in two potential ways. One way would be to argue the shift is governed by Code § 752(b), which treats a reduction in a partner's share of partnership liabilities as a deemed cash distribution. In this case, the donor would recognize gain to the extent the distribution exceeded his partnership interest adjusted basis. However, another view is that only a portion of the basis of the partner's partnership interest

[4113] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets. The flush language of Code § 751(c) refers to mining property, stock in a DISC, section 1245 property, stock in certain foreign corporations, section 1250 property, farm land, franchises, trademarks, or trade names, and an oil, gas, or geothermal property, but only to the extent of the amount which would be treated as gain to which certain recapture provisions would apply if, at the time of the sale of the partnership interest, such property had been sold by the partnership at its fair market value. Similar treatment applies any market discount bond and any short-term obligation to the extent of the amount would have been treated as ordinary income; however, this sentence does not apply with respect to the redemption of a partnership interest under Code § 736.
[4114] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill), particularly fn. 3681 the sale of partnership interests to a controlled corporation, which is which is further reaching than Code § 751.
[4115] Code § 751(d)(1).
[4116] Code § 751(d)(2).
[4117] Code § 751(d)(3).
[4118] Reg. § 1.751-1(a)(1).
[4119] Reg. § 1.751-1(d)(1).
[4120] Before P.L. 105-34 was amended in 1997, Code § 751(a)(2) applied to impute ordinary income on the sale of a partnership interest with respect to inventory items of the partnership which have appreciated substantially in value. P.L. 105-34 struck which have appreciated substantially in value from Code § 751(a)(2).
[4121] Milo, The Tax Cost of Hot Assets upon the Disposition of a Partnership Interest, *The Tax Advisor* (August 2010).
[4122] Code § 751(b)(3).

should be allocated to the sale portion of the transfer, and gain is recognized to the extent the shift in liabilities exceeds the allocated portion of the adjusted basis.[4123]

For the effect of a transfer on the allocation of income reported on the involved partners' K-1s, see part III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership, found within part III.B.2.j Tax Allocations upon Change of Interest.

Rev. Rul. 91-32 held that gain or loss of a foreign partner that disposes of its interest in a partnership that is engaged in a trade or business through a fixed place of business in the United States will be United States source effectively connected income (ECI) gain or will be ECI loss that is allocable to United States source ECI gain, to the extent that the partner's distributive share of unrealized gain or loss of the partnership would be attributable to ECI (United States source) property of the partnership. However, *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (7/13/2017),[4124] repudiated Rev. Rul. 91-32.[4125] Before getting to that analysis, it explained that Code § 741 works solely

[4123] Code § 752(d).

[4124] The Official Tax Court Syllabus described the case as follows:

> In 2001 P, a foreign corporation, purchased an interest in PS, a U.S. limited liability company that was treated as a partnership for U.S. income tax purposes. From 2001 to 2008 income was allocated to P from PS, and P paid income tax in the United States. In 2008 P's interest was redeemed by PS, and P received two liquidating payments, one in July 2008 and the second in January 2009 but deemed to have been made on December 31, 2008. P realized gain totaling over $6.2 million, of which $2.2 million was deemed attributable to U.S. real property interests (and which P now concedes is taxable income). P contends that the remainder—"disputed gain" of $4 million—is not taxable for U.S. purposes. P timely filed a Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation", for 2008, wherein it reported its distributive share of PS's income, gain, loss, deductions, and credits, but did not report any income it received from the redemption of its partnership interest (i.e., neither the now-conceded real estate gain nor the disputed gain). P did not file a return or pay any income tax in the United States for 2009. Ps reporting position was recommended to it by an experienced certified public accountant ("C.P.A.") who was recommended to P by its U.S. lawyer.
>
> R prepared a substitute for return pursuant to sec. 6020(b) for P's 2009 year, and issued a notice of deficiency for 2008 and 2009, determining, inter alia, that P must recognize its gain on the redemption of its partnership interest for U.S. tax purposes as U.S.-source income that was effectively connected with a U.S. trade or business, consistent with Rev. Rul. 91-32. P timely filed a petition with this Court.
>
> *Held*: P's disputed gain was capital gain that was not U.S.-source income and that was not effectively connected with a U.S. trade or business. This Court will not follow Rev. Rul. 91-32. P is therefore not liable for U.S. income tax on the disputed gain.
>
> Held, further, as to the now-conceded tax liability for gain on the real estate, P is not liable for the sec. 6662(a) penalty for 2008 or the additions to tax under sec. 6651(a)(1) and (2) for 2009, because P reasonably relied on the erroneous advice of the C.P.A.

[4125] The court summarized:

> Our level of deference to agency interpretations of law varies. Where the interpretation construes an agency's own ambiguous regulation, that interpretation is accorded deference, *Rand v. Commissioner*, 141 T.C. 376, 380-381 (2013) (citing *Auer v. Robbins*, 519 U.S. 452, 461 (1997)). On the other hand, where a revenue ruling improperly interprets the text of relevant statutes and has inadequate reasoning, we afford it no deference at all. *PSB Holdings, Inc. v. Commissioner*, 129 T.C. 131, 145 (2007). Between these poles, we follow revenue rulings to the extent that they have the "power to persuade". See *id.* at 144.

at the entity level (which is the focus of this part Character of Gain on Sale of Partnership InterestII.Q.8.e.ii.(b) and why that case is mentioned here), treating the partnership interest as a single unitary asset, without looking through to the underlying assets, absent any overriding provision:[4126]

Rev. Rul. 91-32 is not simply an interpretation of the IRS's own ambiguous regulations, and we find that it lacks the power to persuade. Its treatment of the partnership provisions discussed above in part II.B is cursory in the extreme, not even citing section 731 (which, as we set out, yields a conclusion of "gain or loss from the sale or *exchange of the partnership interest*" (emphasis added)). The ruling's subchapter K analysis essentially begins and ends with the observation that "[s]ubchapter K of the Code is a blend of aggregate and entity treatment for partners and partnerships." We criticize the ruling's treatment of the subchapter N issues in notes 22 and 24 below. We decline to defer to the ruling. We will instead follow the Code and the regulations to determine whether the disputed gain is effectively connected income.

[4126] The court reasoned:

The Commissioner posits that the only way to reconcile the two provisions is to interpret section 741 as applicable only to the character of the gain recognized—i.e., as capital rather than ordinary. That is, the Commissioner maintains that while section 741 expressly requires that the gain "shall be considered as gain or loss from the sale or exchange of a capital asset", the statute does not preclude treating the (capital) gain as arising not from the sale of the partnership interest per se (which the entity theory would yield) but from the partnership's underlying assets that give value to the partnership interest (which the aggregation theory would yield).

It is true that, in providing that the gain "shall be considered as gain * * * from the sale or exchange of a capital asset", section 741 does not specify which asset. However, there are four flaws in the Commissioner's approach that cause us to reject it. First, he exaggerates the conflict between an "entity theory" construction of section 741 and the existence of an exception in section 897(g). In its own terms, section 741 acknowledges one exception ("except as otherwise provided in section 751"),[16] so section 741 is only a general rule, not a rule of absolute and universal application. Congress is always free, having enacted a general rule, to enact exceptions.

[16] Section 751 is a specific exception to section 741 that causes unrealized receivables and inventory items to be addressed separately from the remainder of the partnership interest when that interest is sold or liquidated. In the context of liquidating distributions, the partnership is deemed to have bought the liquidated partner's share of those assets from that partner, so that that partner has gain of a character and amount consistent with such a hypothetical sale. The IRS did not assert application of section 751(b) in the SNOD, and the Commissioner has not asserted it as an alternative position in this case. Consequently, we do not consider section 751 further. We note that by the express terms of section 741, section 751 is (like section 897(g); see supra note 11) an exception, and it mandates an "aggregation" approach for characterizing only gain "attributable to" unrealized receivables or inventory items". This statute thus presumes the existence of a general rule to which this aggregation approach is an exception. Section 751 does not provide (and the Commissioner does not contend that it provides) a general rule that all gain from a partner's sale of its partnership interest shall be considered an amount received from the sale of the partnership's properties of whatever types.

Second, the Commissioner's reading of section 741 gives insufficient effect to one word in the statute. Section 741 provides that income realized on the sale of a partnership interest "shall be considered as gain * * * from the sale or exchange of a capital *asset*". (Emphasis added.) Congress used the singular "asset", rather than the plural "assets". This singular wording is more consistent with the treatment of the sale of a partnership interest according to the entity theory, under which the selling partner is deemed to have sold only one asset (its partnership interest) rather than being deemed to have sold its interest in the multiple underlying assets of the partnership. See also *P.B.D. Sports, Ltd. v. Commissioner*, 109 T.C. 423, 438 (1997) ("Generally, subchapter K employs the entity approach in treatin[g] transfers of partnership interests. The sale of a partnership interest is treated as the sale of a single capital asset rather than as a transfer of the individual assets of the partnership. See secs. 741 and 742."); *Unger v. Commissioner*, T.C. Memo. 1990-15 (listing section 741 as an example of the entity theory in the Internal Revenue Code), *aff'd*, 936 F.2d 1316 (D.C. Cir. 1991). And absent some overriding mandate, section 731 directs that gain or loss on a distribution (such as the one at issue) "shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner" (that is, as directed by section 741).

Third, Congress has explicitly carved out a few exceptions to section 741 that, when they apply, do require that we look through the partnership to the underlying assets and deem such a sale as the sale of separate interests in each asset owned by the partnership. If Congress had intended section 741 to be interpreted as a look-through provision, these exceptions in sections 751 and 897(g) would be superfluous. See *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001).

Accordingly, the enactment of section 897(g) actually reinforces our conclusion that the entity theory is the general rule for the sale or exchange of an interest in a partnership. Without such a general rule, there would be no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 otherwise prescribes.

Fourth, section 731(a)—brought into this analysis by the express wording of section 736(b)(1)—makes explicit that the "entity theory" generally applies to a partner's gain from a distribution:

> Any gain or loss recognized under this subsection shall be considered as gain or loss *from the sale or exchange of the partnership interest* of the distributee partner.

Sec. 731(a) (emphasis added). This wording could hardly be clearer. The partnership provisions in subchapter K of the Code provide a general rule that the "entity theory" applies to sales and liquidating distributions of partnership interests—i.e., that such sales are treated not as sales of underlying assets but as sales of the partnership interest. Of course, Congress may enact exceptions or different rules, such as for foreign partners, and we consider that possibility below; but we begin our analysis with this generality from subchapter K.

The Commissioner's interpretation of the Code acknowledges the same sequence we have followed—i.e., that section 736(b)(1) leads to section 731, which in turn leads to section 741, but he evidently thinks such an analysis stops short. The Commissioner apparently maintains that, after applying those sections in that order, one must still return to section 736(b)(1)—so that, while section 741 mandates the capital character of the income, in the end the distribution is still characterized as "payments * * * made in exchange for the interest of such partner in partnership property". Sec. 736(b)(1) (emphasis added). The emphasized phrase certainly does appear in section 736(b)(1), and the analysis in this case begins there precisely because GMM did indeed receive payments that, given the nature of a partnership, can be said to have been made ultimately in exchange for GMM's interest in the partnership's various items of property. However, sections 736(b)(1), 731(a), and 741 tell us what to do with such payments for tax purposes; and as we have shown, they direct us to a conclusion: "gain or loss from the sale or exchange of the partnership interest", sec. 731(a), which is "a [singular] capital asset", sec. 741. We see no reason to abandon that conclusion, return to section 736(b)(1), and halt at the phrase that most nearly coincides with the Commissioner's position.[17]

[17] Indeed, when we read section 736(a) and (b) together, it becomes clear that the role of the words "partnership property" in section 736(b) is to distinguish distributions made for such property from those made out of a partner's "distributive share" of entity-level

In sum, section 736(b)(1) provides that payments such as those giving rise to the disputed gain "*shall* * * * be considered as a distribution by the partnership"; section 731(a) provides that such gain "shall be considered as gain * * * from the sale or exchange of the partnership interest of the distributee partner"; and section 741 provides that such gain "*shall* be considered as gain * * * from the sale or exchange of a capital asset". (Emphasis added.) Accordingly, GMM's gain from the redemption of its partnership interest is gain from the sale or exchange of an indivisible capital asset—i.e., GMM's interest in the partnership.

II.Q.8.e.ii.(c). Availability of Installment Sale Deferral for Sales of Partnership Interests

Generally, sales of partnership interests are eligible for installment sale deferral under Code § 453 (subject to the limitations of Code §§ 453A and 453B).[4127]

However, the income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to some of the

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partnership income (as in section 736(a)(1)) or as a "guaranteed payment" (as in section 736(a)(2)). A partner's "distributive share", sec. 736(a)(1), is governed by sections 704(b) and 701; the tax treatment of a "guaranteed payment", sec. 736(a)(2), is provided in section 707(a); and payments for partnership property, sec. 736(b), are "considered as a distribution by the partnership"—i.e., are treated as provided in section 731. In none of these instances is the ultimate tax treatment of the transfer of money or property from a partnership to a partner prescribed solely by reference to section 736.

The Commissioner also argues that section 741 should not be applied to characterize the income at issue because applying it in that manner would contradict "Congress' intent in enacting section 865", the sourcing rule we discuss below in part IV.B. The Commissioner argues that, when addressing a partnership question under subchapter K of the Code (which deals primarily with partners and partnerships) and applying a Code section (such as section 865) that is outside of subchapter K, one must look to "the nature of the partnership interest involved, together with the intent and purpose of the non-subchapter K section being applied." Using this rule, the Commissioner explains that not section 741 but rather section 736(b)(1) more appropriately characterizes the type of income here—i.e., as a payment for GMM's interest in the "partnership property". We see no basis for the Commissioner's selection of this particular phrase from section 736(b)(1) as the guiding star for navigating the intersection of partnership taxation and the taxation of international transactions, and we have already explained why this phrase is at the beginning and not the end of the analysis. More important, the Commissioner cites no authority for his posited rule, which seems (at least as he uses it here) to shortcut or distort the subchapter K analysis by invoking a purpose (not explicitly enacted) that he discerns in subchapter N. The Commissioner has not convinced us to reconsider the argument that we rejected 38 years ago when it was advanced by the taxpayer in Pollack. Addressing ourselves to the statutory text, we conclude that subchapter K mandates treating the disputed gain as capital gain from the disposition of a single asset, and in part IV.B below we apply the provisions of section 865 accordingly.

[4127] Rev. Rul. 76-483. For more discussion on these limitations and recommended strategies, see part II.G.14 Limitations on the Use of Installment Sales.

partnership's "hot assets" under Code § 751 [4128] that would not be eligible for the installment sale treatment if sold directly.[4129]

The IRS has asserted that installment sale treatment is not available for partnership interests to the extent that the cash-basis partnership's underlying assets constitute unrealized receivables for payment for services rendered;[4130] consider whether that is a

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[4128] See part II.Q.8.b.i.(f) Code § 751 – Hot Assets.

[4129] Rev. Rul. 89-108 held that the income from the sale of a partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's substantially appreciated inventory under Code § 751(d) that would not be eligible for the installment sale treatment if sold directly. It explained:

> Under section 741 of the Code, the sale of a partnership interest generally is treated as the sale of a single capital asset without regard to the nature of the underlying partnership property. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70 (1954). In this respect, the tax treatment of the sale of a partnership interest differs from that accorded the sale of a sole proprietorship. See, *e.g.*, *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945), which held that the sale of an entire business as a going concern was the sale of the individual assets of the business. See also Rev. Rul. 68-13, 1968-1 C.B. 195, which holds that the installment sale of a sole proprietorship is generally considered to be a sale of individual assets of the proprietorship for purposes of applying section 453.
>
> Section 751 of the Code was enacted to prevent the conversion of certain potential ordinary income into capital gain upon the sale or exchange of a partnership interest. This section, in effect, severs certain income items from the partnership interest. H.R. Rep. No. 1337, *supra*, at 70, 71, and S. Rep. No. 1622, 83d Cong., 2d Sess. 99 (1954). Thus, to the extent a partnership interest represents substantially appreciated inventory or unrealized receivables described in section 751, the tax consequences to the transferor partner are the same tax consequences which would be accorded an individual entrepreneur. H.R. Rep. No. 1337 at 71, and S. Rep. 1622, *supra*, at 99. In effect, the transferor partner is treated as disposing of the property described in section 751 independently of the rest of his partnership interest. S. Rep. No. 1622 at 98, 99. *George Edward Quick Trust v. Commissioner*, 54 T.C. 1336 (1970), *acq.* 1970-2 C.B. xxi, *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); *Woodhall v. Commissioner*, T.C. Memo. 1969-279, *aff'd*, 454 F.2d 226 (9th Cir. 1972).
>
> Gain recognized under section 741 of the Code on the sale of a partnership interest is reportable under the installment method. See Rev. Rul. 76-483, 1976-2 C.B. 131. However, because section 751 effectively treats a partner as if the partner had sold an interest in the section 751 property of the partnership, the portion of the gain that is attributable to section 751 property is reportable under the installment method only to the extent that income realized on a direct sale of the section 751 property would be reportable under such method. Because the installment method of reporting income would not be available on a sole proprietor's sale of the inventory, the installment method is not available for reporting income realized on the sale of a partnership interest to the extent attributable to the substantially appreciated inventory which constitutes inventory within the meaning of section 453(b)(2)(B).
>
> Accordingly, P's income from the sale of the partnership interest may not be reported under the installment method to the extent it represents income attributable to the partnership's substantially appreciated inventory which would not be eligible for installment sale treatment if sold directly. The balance of the income realized by P from the sale of the partnership interest is reportable under the installment method.

[4130] In CCAs 200722027 and 200728001, the IRS asserted that installment sale treatment is not available for partnership interests to the extent that the cash-basis partnership's underlying assets constitute unrealized receivables for payment for services rendered, based on its interpretation of some cases as holding that compensation for services could not be reported valid argument in light of *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (2017) (repudiating Rev. Rul. 91-32).[4131]

Although publicly traded stock is not eligible for installment sale treatment,[4132] the sale of an interest in a partnership owning publicly traded stock might not preclude deferral.[4133] For partnerships that have a lot of hot assets – especially those with significant depreciable property, a Code § 736 redemption[4134] often would generate a much better result.[4135]

II.Q.8.e.iii. Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations

II.Q.8.e.iii.(a). Illustration of Inside Basis Issue

For a more generic description of inside basis and outside basis, see my blog article, "Tax basis: The key to reducing gain on sale or deducting asset purchases."[4136]

Here is an example:

Suppose each of A and B contributes $500,000 to a partnership that buys land worth $1 million without any debt.

Each of A and B has $500,000 basis in his/her/its partnership interest. This is called "outside basis."

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under the installment method. See *Sorensen v. Commissioner*, 22 T.C. 321 (1954) (a reviewed decision), *followed Mingo v. Commissioner*, T.C. Memo. 2013-149, *aff'd* 773 F.3d 629 (5th Cir. 2014) (the latter also holding that the disallowance of the installment method is a change of accounting method triggering adjustments under Code § 481, to which the statute of limitations does not apply).

4131 The case is discussed more fully in part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest, especially fns. 4124-4126.

4132 Code § 453(k)(2).

4133 The legislative history to the Tax Reform Act of 1986, P.L. 99-514, suggests that the sale of a partnership interest would be eligible for installment treatment as follows:

> The committee intends that any Treasury regulations would not deny use of the installment method if the seller could not have sold, or caused the sale of, the publicly traded stock or securities directly. For example, a retiring partner in a large investment partnership makes an installment sale of his partnership interest, a substantial portion of the value of which is attributable to stocks and securities held by the partnership. Provided that the retiring partner, could not have sold or caused the sale of the partnership's assets directly, the gain on the sale of the partnership interest may be reported on the installment method.

The letter ruling described in fn. 2981 held that the installment method applied to the sale of stock in an S corporation that appears to have held only marketable securities, suggesting that Code § 453(k)(2) would not apply absent regulations being promulgated.

4134 See part II.Q.8.b.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

4135 See part II.Q.8.b.ii.(d) Comparing Code § 736(b) to an Installment Sale, especially fn. 4010.

4136 http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions/post/2017-01-10/tax-basis-the-key-to-reducing-gain-on-sale-or-deducting-asset-purchases.

The partnership's $1 million basis in the land is called "inside basis," because it is the basis of assets inside the partnership.

Suppose the land increases in value to $1.5 million, and C buys B's partnership interest for $750,000. C's outside basis is $750,000; however, C's inside basis – C's share of the partnership's basis in the land – would be $500,000, the same as B's inside basis.

Thus, if the partnership sold the land for $1.5 million, the partnership would recognize a $500,000 gain – the $1.5 million proceeds minus the land's $1.0 million inside basis. Each of A and C would report $250,000 of gain ($500,000 gain multiplied by their respective 50% interest in the partnership).

C, who paid $750,000 for essentially one-half of the land, is paying tax on C's $750,000 one-half of the proceeds, which is an unfair result.

C has two ways out of this dilemma. One way is to liquidate the partnership or fully redeem C's partnership interest. C's outside basis is $1 million, consisting of C's $750,000 purchase price[4137] and $250,000 of gain.[4138] C recognizes a $250,000 loss, which is C's $1 million outside basis minus the $750,000 cash that C receives in liquidation. For an S corporation analogy, see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation.

The other way is, on the partnership tax return for the year in which C buys B's interest (if this election is not already in place), the partnership elects to adjust C's share of the inside basis of the land. Thus, C would have a separate, additional $250,000 inside basis in the land, so that C's inside basis would be $750,000 ($500,000 from B's inside basis plus $250,000 additional special asset). This option is not available to a C or an S corporation. For more details on when an inside basis step-up applies, see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss). For a single member LLC, any change to outside basis would automatically apply to the inside basis.[4139]

However, Code § 338(h)(10) provides a special opportunity when all of the stock in an S corporation is sold and the S corporation is liquidated. The election allows the parties to treat all of the S corporation's assets as having been sold to the person that bought the S corporation stock, enabling the buyer to get a new tax basis on the assets. Meanwhile, the deemed gain on sale of the S corporation's assets increases the basis of the stock in the S corporation, so that often the shareholders are not taxed on the stock's sale and might even have a loss on the sale.[4140] The main downside[4141] to the selling

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[4137] Code § 742.

[4138] Code § 705(a)(1)(A).

[4139] See fn. 1395 in part II.H.2.h Basis Step-Up for Property Held Outside an Entity; Moving Liabilities Outside of an Entity to Maximize Deductions for Estate Tax Purposes, the latter which points out that results may be better not holding assets in an entity.

[4140] Reg. § 1.338(h)(10)-1(d)(5)(i) provides:

> *In general*. If T is an S corporation target, S corporation shareholders (whether or not they sell their stock) take their pro rata share of the deemed sale tax consequences into account under section 1366 and increase or decrease their basis in T stock under section 1367. Members of the selling consolidated group, the selling affiliate, or S corporation shareholders are treated as if, after the deemed asset sale in

shareholders is that the deemed asset sale might trigger ordinary income taxation (including without limitation depreciation recapture of Code § 1245 property, which is generally depreciable tangible personal property) or higher capital gain taxation (including without limitation the sale of Code § 1250 property, which generally is depreciable real estate), whereas they generally would have paid lower regular long-term capital gain rates on the sale of their S corporation stock had they not made the Code § 338(h)(10) election.

Code § 338(h)(10) is also available for C corporations, but it does not provide the same benefits to the sellers, in that the corporation's recognition of gain on its deemed sale of assets does not increase its shareholders' stock basis.

II.Q.8.e.iii.(b). Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss)

Upon a partner's death (including the death of the grantor of a revocable trust[4142] or of the beneficiary of a QTIP trust[4143]) or on the sale or exchange of a partnership interest, the partnership's property's basis is adjusted under Code § 743 if the partnership has in effect a Code § 754 election[4144] and makes a Code § 754 election on the return that

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> paragraph (d)(3) of this section and before the close of the acquisition date, they received the assets transferred by old T in the transaction described in paragraph (d)(4)(i) of this section. In most cases, the transfer will be treated as a distribution in complete liquidation to which section 331 or 332 applies.

See part II.Q.7.a.vii Corporate Liquidation for the tax consequences of the deemed liquidation.

[4141] For former C corporations that have made their S election too recently, beware of part II.P.3.c.ii Built-in Gain Tax.

[4142] Rev. Rul. 79-84, which reasoned as follows in arriving at that conclusion:

> Before A's death, A had powers over T of the types described in sections 676 and 677 of the Code, and T was therefore a grantor trust. Additionally, T held a partnership interest. Under the principles of Rev. Rul. 77-402, A is considered to have been the partner during this period for federal income tax purposes. Further, at the time of A's death T ceased to be a grantor trust. The partnership interest is thus considered to have been transferred from A to T at that time. As a result, a transfer of a partnership interest occurred upon the death of a partner.

Query whether an irrevocable trust for the benefit of A's spouse, which would have been a grantor trust under Code § 677 but excluded from A's estate, would qualify for this treatment.

[4143] The IRS seems to believe that a Code § 743(a) adjustment would apply when a QTIP trust holds a partnership interest and the surviving spouse dies, even though the individual who died is not actually a partner. See Letter Ruling 200019029 (approving a late Code § 754 election without addressing the literal language of Code § 743(a)). Note that Code § 1014(b)(10), which provides a basis adjustment for QTIP assets when the surviving spouse dies, was enacted after Code § 743(a). Thus, considering the surviving spouse to be a partner for purposes of Code § 743(a) is consistent with the philosophy of Code § 1014(b)(10) and should, as a matter of tax policy, be the correct result, even though it seems inconsistent with the literal language of Code § 743(a). See also part II.Q.8.e.i Distribution of Partnership Interests regarding the effect of a distribution on Code § 743.

[4144] Code § 743(a) does not address whether an adjustment of basis in partnership property may occur by reason of other transfers without a Code § 754 election. For example, the statute does not address whether an adjustment would be made with respect to a transfer by gift (i.e., not a transfer by sale or exchange or the death of a partner which are referenced in Code § 743) even if a Code § 754 election is in place. Code § 1015(d), allowing a basis adjustment for gift tax paid, was not in existence when Code § 743 was enacted That might be why Code § 743 does not covers the taxable period that includes the date of death, which election might be filed up to 12 months after the due date.[4145] When a partnership interest is community property and receives an outside basis adjustment of both halves, both halves are eligible for a corresponding inside basis adjustment by reason of that death.[4146] See also part II.Q.8.e.i Distribution of Partnership Interests regarding the effect of a distribution on Code § 743, including a suggestion that a trust's or estate's distribution of a partnership interest (other than distributing specifically bequeathed property) triggers application of a Code § 743 adjustment. Thus, even though ideally one should make a Code § 754 as of the year if death (if one decides to make the election), if the suggestion described in the preceding sentence is correct then one may also make a Code § 754 election as of the year in which the revocable trust or estate distributes property (other than a specific bequest). A corporate liquidation would also be a triggering event – even if it is a nontaxable event.[4147]

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discuss the gift situation. The legislative history when Code § 1015(d) was adopted makes no mention at all of this partnership issue. The issue would seem to be: would an inside adjustment of partnership property be made in the absence of a statute (since no statute is applicable) under general tax principles? That is further complicated by the fact that tax principles sometimes use an aggregate theory and sometimes an entity theory with respect to partnerships. Although perhaps a position might be taken that the payment of gift tax should trigger an inside basis adjustment, if I were to take that position I would disclose it on Form 8725. A safer approach might be to follow the payment of gift tax by a transfer, which part II.Q.8.e.i Distribution of Partnership Interests discusses generally would give rise to an inside basis adjustment.

[4145] Reg. § 1.754-1(b); REG-116256-17 (10/12/2017) issued proposed regulations, on which taxpayers may now rely, dropping the regulation's requirement that a partner sign the Code § 754 election. Reg. § 301.9100-2(a)(2)(vi) grants an automatic 12- month extension from the due date of the partnership's return, including extensions (Reg. § 301.9100-2(a)(1)), with the election made on an amended return (Reg. § 301.9100-2(c)).

In addition to making the election, the partnership must attach a statement to its tax return that reports the name and taxpayer identification number of the transferee partner, the basis adjustment computation, and the allocation of the basis adjustment to the partnership's properties. Reg. § 1.743-1(k)(1). The transferee partner has an obligation to provide written notice to the partnership of the information needed to compute the basis adjustment, as listed in Reg. § 1.743-1(k)(2). Once that notice is given, the partnership can rely on that information in preparing the adjustment, as long as no partner who is responsible for federal income tax reporting has any knowledge that the information is clearly erroneous. Reg. § 1.743-1(k)(3). Failure to attach this statement would not appear to invalidate the Code § 754 election; this result is inferred by the fact that Reg. § 1.743-1(k)(2) provides procedures for when errors or omissions are made in complying with obligations under Reg. § 1.743-1(k).

Does the long term holding period under Code § 1233(9), that applies when assets are included in a decedent's estate, also apply to the portion of the basis of a partnership's assets that constitutes a basis adjustment under Code § 743? Rev. Rul. 68-79 says that, generally, the change in the holding period of a partnership interest does not change the partnership's holding period in its assets. However, it does not address the impact, if any, on a Code § 754 election. With one exception, regulations under Code §§ 743, 755 and 1233 do not address this issue. Reg. § 1.743-1(j)(4)(i)(B)(1) restarts the holding period for depreciable property when there is a positive adjustment but does not change it when there is a negative adjustment, Reg. § 1.743-1(j)(4)(ii)(B).

[4146] Rev. Rul. 79-124.

[4147] CCA 201726012 (under the signature of David R. Haglund), in addressing, "Issue 1: Whether the transfer of a partnership interest in a complete liquidation to which § 332(a) applies or a

If the basis of the transferee partner's partnership interest is greater than the former partner's share of the basis of the partnership's assets, then the election will give the new partner a stepped-up basis in the partnership assets.[4148] This basis adjustment is not necessarily tied to the change in basis between the old and new partner; rather, it is based on the relationship between the basis in the partnership interest (the "outside basis") and basis of the partnership's assets allocable to that partner (the "inside basis"). Of course, a change in basis of the partnership interest affects this relationship. However, prior changes in basis of the partnership also count. In fact, a substituted basis transaction, in which the basis in the partnership interest might or might not change, triggers the basis adjustment;[4149] however, no adjustment is made in a substituted basis transaction if the outside basis equals the inside basis.[4150] If a partnership does not make a Code § 754 election when a partner dies, consider asking the partnership to make the election when the decedent's estate or (former) revocable trust funds bequests by distributing the partnership interest, which also might be an event triggering a basis adjustment;[4151] as described above, that basis adjustment is not tied to any change in basis but rather generally catches up the "inside basis" to the "outside basis."

In a sale or exchange situation, the transferee partner's basis step-up in partnership assets is based on the extent to which the partner's basis in the partnership interest exceeds the basis of the partner's share of the partnership's assets; any contingent payments cause a basis increase to the extent they constitute gain to the seller and potentially deductible interest to the extent they constitute interest income to the

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reorganization to which § 368(a)(1)(A) and/or (D) applies is a transfer by sale or exchange for purposes of § 743(b)," reasoned:

> Sale or exchange is not defined in § 743, the regulations thereunder, or the legislative history of the provision. Section 743 was enacted to ameliorate the tax consequences to a transferee partner by giving a partnership the option to eliminate discrepancies between a transferee partner's inside and outside basis when the partnership's inside basis in its property is not equal to the fair market value of the property. Jt. Comm. On Taxation, *Summary of the New Provisions of the Internal Revenue Code of 1954*, at 92 (1955).
>
> General Counsel Memorandum 35921 (July 29, 1974) held that for purposes of § 743(b), a transfer of a partnership in a liquidation under former § 333 was not a transfer of an interest by sale or exchange. As demonstrated by the GCM, whether the distribution of a partnership interest by a liquidating corporation was a sale or exchange was considered an open question prior to the Deficit Reduction Act of 1984 (1984 Act). See, *e.g.*, John S. Pennell and Terence F. Cuff, "Tax Results of Liquidation of Corporate Partner Still Unclear Despite DRA 1984," *Journal of Taxation*, Vol. 62, No. 2 (February 1985).

[4148] Code § 743(b). Note that previously non-amortizable self-created goodwill becomes purchased amortizable goodwill. Letter Ruling 9715008 (but only if the remaining partners and the selling partner are not related under Code § 197(f)(9)(C)).

[4149] Reg. § 1.755-1(b)(5). Reg. § 1.755-1(b)(5)(iv), Example (2) provides a basis adjustment as the result of a wholly nontaxable contribution to a partnership under Code § 721.

[4150] Reg. § 1.755-1(b)(5)(ii) provides, If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5).

[4151] See part II.Q.8.e.i Distribution of Partnership Interests.

seller.[4152] If the transfer is caused because of a partner's death, the basis step-up is based on the fair market value of the deceased partner's partnership interest as of the date of death, plus the transferee partner's share of partnership liabilities, minus any allocable income in respect of a decedent items;[4153] although liabilities are included in the basis of a partnership interest, they do not generate a basis increase in the partnership's assets.

A partner's share of income in respect of a decedent under Code § 691 (including unrealized receivables) does not receive a basis step-up.[4154] Unrealized receivables are not eligible for a basis step-up, but goodwill that is not being amortized is eligible for a basis step-up.[4155]

When a person's partnership interest is liquidated, the basis of the partnership interest is allocated to the assets that person receives:[4156]

- This has led to the observation that, if one is going to liquidate the partnership anyway, a Code § 754 election might not be necessary. However, if the partnership sells its assets and then liquidates, then this strategy might not work as well for state income tax purposes as it does for federal income tax purposes;[4157] a Code § 754 election might be particularly important if the owner of the partnership interest resides in a state other than the state in which the partnership does business.

- These rules can generate opportunities to enhance the basis of an asset to be sold (but might be attacked if used to accelerate or duplicate recognition of loss):[4158]

    - A partner who receives low basis assets can uses the basis in his partnership interest to increase the basis in those assets. If a Code § 754 election is not in effect, then this basis increase is not matched by a corresponding decrease in

[4152] Letter Ruling 9715008, which also held that contingent payments made more than 6 months after the date of the sale would be divided into additional principal and unstated interest under Reg. § 1.1275-4(c).
[4153] Code § 743; Reg. § 1.742-1. Code § 691 income in respect of a decedent includes the portion of the distributive share of partnership income of the decedent partner's successor in interest that is attributable to the decedent for the period ending with the date of the decedent's death. Letter Ruling 9715008. *See also* Rev. Rul. 66-325 (no basis step-up for accounts receivable under Code § 743 because Code § 736(a) applied); *Long v. Commissioner*, 71 T.C. 1 (1978), *aff'd* 660 F.2d 416 (10th Cir. 1981) (estate increased its basis in partnership interest to extent it paid liabilities); *Hesse v. Commissioner*, 74 T.C. 1307 (1980) and Letter Ruling 9102018 (no basis step-up for distributive share of income that is attributable to decedent for the period ending with the date of his death – obsoleted by later changes to Code § 706 since the income is reported on the decedent's final return and therefore not an unrecognized item at death).
[4154] Reg. § 1.755-1(b)(4)(i).
[4155] Example provided in Reg. § 1.755-1(b)(4)(ii).
[4156] Code § 732(b).
[4157] By analogy, when an S corporation sells its assets to a third party and liquidates, it can replicate in many ways the partnership result for federal income purposes but not necessarily for state income tax purposes. Compare part II.H.8.a.i Solution That Works for Federal Income Tax Purposes with part II.H.8.a.ii State Income Tax Disconnect.
[4158] See part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.

the distributed asset. Absence of a Code § 754 election might[4159] or might not[4160] be considered abusive in such a case.

- If a partnership interest with a low basis is liquidated in exchange for high basis assets, a Code § 754 election will take into account the basis reduction in the distributed asset and increase the basis in its remaining assets by a corresponding amount.

Once a Code § 754 election is made, it cannot be revoked without IRS consent. This is extremely important to remember, since the election can lead to a step-down in the basis of partnership assets if the basis of the transferee's interest is less than the transferor's partnership property adjusted basis.

Because a Code § 754 election is irrevocable, consider dividing a partnership before making the election; divisions generally are income tax-free.[4161] Reasons to avoid Code § 754 elections except to the extent necessary include:

- Avoiding record-keeping requirements regarding events where basis changes are not worth the complexity.

- Reducing the possibility of events causing an inside basis step-down. However, sometimes basis reductions must be made as if a Code § 754 election were in effect.[4162] To avoid possible unwanted inside basis reductions, one should consider monitoring a partnership's unrealized losses and realizing losses to the next necessary to keep net unrealized losses comfortably below $250K.

The partnership and the transferee partner, including a decedent's estate, should consider extending their income tax returns so that any IRS adjustments to basis, including the value of assets in the decedent's gross estate, can be reflected in the transferee partner's income tax returns; ignoring the interplay of these statutes of limitations can cause the taxpayer to lose the benefit of the basis step-up.[4163] For example, suppose decedent died December 1, 2004, and the partnership sold assets December 31, 2004. The estate tax return is due August 1, 2005 (nine months after

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[4159] See example in fn. 3919 (absence of Code § 754 election considered a duplication of loss). However, Congress has since attacked this abuse (see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000), so the concerns expressed in the example might be less likely to be applied now.

[4160] See fn. 3918.

[4161] See part II.Q.8.d Partnership Division.

[4162] See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[4163] In *Malm v. U.S.*, 420 F.Supp. 1040 (D.C. N.D. 2005), the court stated:

> Harry Malm died on August 5, 1998. His estate included shares of Medtronic stock. The IRS disputed the estate's valuation of that stock. The dispute wound up in court, and on July 23, 2003, this Court ruled that the IRS' stock valuation was correct….As a result of this ruling, the Medtronic stock had a higher fair market value than reported by the estate on its federal estate tax return. Therefore, the estate's federal income tax return overstated the amount of the gain on the sale of this stock….The estate filed its income tax return on November 14, 1999. Since the estate did not file a claim for a refund on that return until February 12, 2004, its claim is barred by the statute of limitations.

death) and may be audited as late as August 1, 2008. The estate's income tax return for calendar year 2004 is due April 15, 2005 and may be amended only as late as April 15, 2008. Thus, audit adjustments on the estate tax return might be made between April 15, 2008 and August 1, 2008, but the estate could not amend its income tax return to reflect any increase in basis due to the audit. The partnership should extend the due date of its return.[4164] Additionally, the estate could file an extension for its initial income tax return, so that the return is filed timely between August 1, 2005 and October 15, 2005 (six months being the latest date for an extension). An alternative to extending the estate's income tax return might be for the estate to choose a fiscal year ending on or after April 30, 2005; note that a Code § 645 election would be required if the decedent's partnership interest were held in a revocable trust.

In reviewing anything in this part II.Q.8.e.iii.(b), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

II.Q.8.e.iii.(c). When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000

Generally, Code § 754 election adjusts the basis of a partnership's assets when certain events occur that change the basis of any interest in that partnership.[4165] The idea is that the value of the partnership's assets was reflected in the change of basis in the partnership interest; therefore, some element of the basis in the partnership's assets should reflect the change of basis in the partnership interest.

In one limited case involving straddles, the IRS ruled that failure to make a Code § 754 election constituted an abuse.[4166]

When a Code § 754 election is in place, any Code § 743 adjustments that apply to the transfers of partnership interests require the partnership to essentially create a separate set of books for each partner,[4167] whereas any Code § 734 adjustments (increasing or decreasing inside basis as a result of a change in the basis of distributed property) apply to the partnership as a whole.[4168] For more details on the implementation of a

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[4164] The partnership will need to make any Code § 754 election no later than the extended due date of the return. If the election does not look worthwhile but upon audit it starts looking worthwhile, the IRS will not grant Code § 9100 relief. Letter Ruling 200626003. However, if the partnership's assets are included in the decedent's gross estate under Code § 2036, the partnership's assets will receive a basis adjustment. *Id.*

[4165] For more on Code § 754 elections, see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

[4166] Notice 2002-50; see also Reg. § 1.701-2(e)(1) and the discussion of the anti-abuse regulations described in part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.

[4167] Reg. § 1.743-1(j).

[4168] Code § 734(b) provides:

> *Method of adjustment*. In the case of a distribution of property to a partner by a partnership with respect to which the election provided in section 754 is in effect or with respect to which there is a substantial basis reduction, the partnership shall—
>
> (1) increase the adjusted basis of partnership property by—

Code § 743(b) basis step-up, see part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

CCA 201521012 explained the interaction of Code § 734(b) with Code § 481 adjustments for change in accounting method.[4169] Also, in reviewing anything in this part II.Q.8.e.iii.(c), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1) , and

(B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732, or

(2) decrease the adjusted basis of partnership property by—

(A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731(a)(2) , and

(B) in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732(d)).

Paragraph (1)(B) shall not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect.

[4169] When the IRS determined that a partnership had improperly deferred gain:

When there is a change in accounting method to which IRC § 481(a) is applied, income for taxable years preceding the year of change must be determined under the accounting method that was then used, and income for the year of change and the following taxable years must be determined under the new accounting method as if the new method had always been used. Accordingly, Taxpayer's IRC § 734(b) adjustments for years preceding the year of change must be computed using the accounting method that was then used. Taxpayer's IRC § 734(b) adjustments for the year of change and subsequent years must be redetermined consistent with the new accounting method.

In computing the net § 481(a) adjustment, a taxpayer must take into account all relevant accounts. See Rev. Proc. 2002-18, section 2.04(1), Rev. Proc. 97-27, 1997-1 C.B. 680, section 2.05(1). Here, the IRC § 481(a) adjustment represents the difference in gain or loss for all of the underlying securities that would have been recognized under the new method, less the gain or loss that was recognized under the prior method as of the beginning of the year of change. Taxpayer's IRC § 734(b) adjustments for taxable years prior to the year of change, as calculated under the prior method, are fully taken into account in calculating the basis in the securities. In addition, beginning in the year of change, Taxpayer's basis in its securities will be modified to reflect the gain or loss recognized in connection with the change in accounting method.

The determination of whether a partnership has a change in accounting method does not depend on whether the partnership made an election under IRC § 754, whose only purpose and effect is to eliminate distortions caused by partnership distributions and sales of partnership interests. The partners of a partnership using a given accounting method ultimately recognize the same amount of cumulative taxable income over the life of the partnership whether or not the partnership makes an election under IRC § 754. A change in accounting method under IRC § 446 occurs when Taxpayer/partnership no longer treats certain securities transactions as options and thus, stops deferring the gains, losses, income, or deductions associated with those transactions.

The taxpayer can take advantage of a basis step-up, without the partnership making a Code § 754 election, by receiving a distribution of appreciated assets within two years after death or sale or exchange of the partnership interest; see part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election. Such a distribution would tend to undermine valuation discounts, which might be good (higher basis step-up) or bad (potentially higher estate tax).

If a partnership holds assets with built-in losses greater than $250,000, one must consider harvesting those losses before engaging in any disposition or acquisition of any interest in the partnership, including the death of a partner. The rest of this section explains why.

The American Jobs Creation Act added three new mandatory basis adjustment rules that can cause serious problems if a partnership does not have a Code § 754 election in effect.[4170] The first rule applies to limit the transfer of built-in losses on property contributed to a partnership after October 22, 2004.[4171] The second rule applies when a partnership distributes cash or property after October 22, 2004 that results in the transferee either recognizing a loss or receiving a stepped-up basis in the property greater than $250,000.[4172] The third rule applies when a partner dies or transfers an interest in a partnership after October 22, 2004 and the partnership has built-in losses greater than $250,000.[4173]

Limited exceptions apply to certain electing investment partnerships and securitization partnerships.[4174] One of these provisions encourages taxpayers to structure marketable securities partnerships as follows: all contributions are cash in exchange for partnership interests issued within 24 months of formation; the partnerships buys investment assets but does not engage in a trade or business; no partner can readily redeem that partner's

[4170] For more details, see IRS Notice 2005-32; see also Rosenberg, AJCA Imposes New Burdens for Partnership Basis Adjustments Under Sections 734 and 743, *Journal of Taxation*, vol. 101, No. 6, 12/2004 at 334, which was followed by Lipton and Golub, Dealing With the Service's Interim Guidance on Downward Basis Adjustments Under 734 and 743, *Journal of Taxation*, vol. 103, No. 1, 7/2005 at 33; Schneider, New Basis Rules Aim at Transfer and Duplication of Built-in Losses, *Taxes – The Tax Magazine*, May 2005 at 39. Also note that Reg. § 1.701-2(d), Ex. 8 also considers failure to make a Section 754 election to be an abuse, but Ex. 9 does not consider failure to make a Section 754 election to be an abuse. Similarly, if a tax-indifferent party attempts to shift built-in losses to a U.S. taxpayer who has not incurred an economic loss so that the U.S. taxpayer may claim a deduction of the built-in losses from the distressed assets, the transaction might be a listed transaction under Notice 2008-34.
[4171] Code § 704(c)(1)(C). For a discussion of proposed regulations, see Kim and Carrasco, Proposed Regulations on Contributions of Built-in Loss Property: Paving a Framework for Super C, *TM Memorandum* (BNA), 10/20/2014, Vol. 55, No. 21. See also the American Bar Association Section of Taxation's Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004, *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).
[4172] Code § 734(b).
[4173] Code § 743(a) and (b), as amended.
[4174] Code §§ 734(e) and 743(e), (f).

partnership interest; and the partnership has a term of no more than 15 years;[4175] this structure has other advantages as well.[4176]

These adjustments can be particularly disturbing when a partnership interest is sold to a related party. Let's start with an example from IRS Notice 2005-32 that tracks the legislative history:

> PRS is a partnership which does not have an election under § 754 in effect. PRS has no liabilities. The fair market value of PRS's assets is $4 million and the adjusted basis of PRS's assets is $4.3 million. Under § 743(d), PRS has a substantial built-in loss because the adjusted basis of the partnership property exceeds the fair market value of the partnership property by more than $250,000. A, a partner of PRS, sells a 25 percent partnership interest in PRS to B for its fair market value of $1 million. Under § 743(b), an adjustment is required to the adjusted basis of PRS's assets with respect to B....

Presumably that adjustment would be to reduce the basis of the partnership's assets by $75,000, which is the excess of A's $1,075,000 pro rata share of the basis of the partnership's assets (25% of $4,300,000) over the sale price ($1,000,000).

This provision was intended to prevent double deductions as follows, assuming that the basis of A's partnership interest is 25% of the basis of the partnership's assets:

- A has a $75,000 loss, since A's basis of $1,075,000 (25% of $4.3 million) exceeds A's $1,000,000 proceeds.

- B reports a $75,000 loss when PRS sells its assets.

What if, however, B were a related party, and Code § 267 prevented A from deducting the loss? Generally, the perceived double deduction would not apply, since A cannot deduct A's $75,000 loss. Therefore, as a matter of policy, the $75,000 mandatory basis adjustment should not apply. However, the statute does not appear to have any exceptions that take into account a Code § 267 loss disallowance, so it appears that B would be stuck with the negative basis adjustment. Thus, neither A nor B recognizes this loss.[4177]

The situation is worsened when one applies valuation adjustments, since (unlike the example in Notice 2005-32) A's partnership interest is worth less than a pro-rata-share of the underlying assets. For example, suppose A sold A's partnership interest to B for $750,000? Then a special allocation of basis adjustment would reduce B's share of the basis from A's original $1,075,000 to only $750,000. So, at first glance, the basis reduction is $325,000 ($1,075,000 minus $750,000), which exceeds the $300,000 ($4.3 million minus $4 million) substantial built-in loss that triggered the whole situation.

[4175] Code § 743(e).
[4176] Distributions of marketable securities might be considered nontaxable distributions of property rather than potentially taxable distributions of cash. See text accompanying footnotes 3877-3879.
[4177] B would be able to take advantage of this disallowed loss if and to the extent that B later sells B's partnership interest for a gain. Code § 267(d).

However, the basis reduction cannot decrease an asset's basis below its fair market value,[4178] so this provision is not as onerous as it might have seemed.

One might sell the partnership's loss assets so that the partners recognize the loss, then buy other assets that have similar investment attributes but do not constitute "substantially identical stock or securities" under the wash sale rules of Code § 1091. That should avoid the mandatory basis reductions and give A the losses that would otherwise have been disallowed.

II.Q.8.e.iii.(d). Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest

For when a transfer triggers a Code § 743 inside basis adjustment, see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000. This part II.Q.8.e.iii.(d) assumes that one has determined that a Code § 743(b) adjustment applies. In reviewing anything in this part II.Q.8.e.iii.(d), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

Before getting into how the allocations work, consider various reporting issues:

- Make a Code § 754 election on the partnership return covering the year of transfer, if not yet in effect.

- A transferee that acquires, by sale or exchange, an interest in a partnership with a Code § 754 election in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange.[4179] A transferee that acquires, on the death of a partner, an interest in a partnership with a Code § 754 election in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner.[4180] In making the

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[4178] See fn. 4195 in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[4179] Reg. § 1.743-1(k)(2)(i) (also referred to by Reg. § 1.755-1(d)), which further provides:

> The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the transferee and (if ascertainable) of the transferor, the taxpayer identification numbers of the transferee and (if ascertainable) of the transferor, the relationship (if any) between the transferee and the transferor, the date of the transfer, the amount of any liabilities assumed or taken subject to by the transferee, and the amount of any money, the fair market value of any other property delivered or to be delivered for the transferred interest in the partnership, and any other information necessary for the partnership to compute the transferee's basis.

[4180] Reg. § 1.743-1(k)(2)(ii), which further provides:

> The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the deceased partner and the transferee, the taxpayer identification numbers of the deceased partner and the transferee, the relationship (if any) between the transferee and the transferor, the deceased partner's date of death, the date on which the transferee became the owner of the partnership interest, the fair market value of the partnership interest on the applicable date of valuation set forth in section 1014, and the manner in which the fair market value of the partnership interest was determined.

adjustments under Code § 743(b) and any statement or return relating to such adjustments under this section, a partnership may rely on the written notice described above to determine the transferee's basis in a partnership interest, unless any partner who has responsibility for the partnership's federal income tax reporting has knowledge of facts indicating that the statement is clearly erroneous.[4181] A partnership is not required to make Code § 743(b) adjustments (or any statement or return relating to those adjustments) with respect to any transfer until it has been notified of the transfer.[4182] If the transferee fails to provide the partnership with the written notice described above, the partnership must attach a statement to its return in the year that the partnership is otherwise notified of the transfer.[4183]

- A partnership that must adjust the bases of partnership properties under Code § 743(b)) must attach a statement to the partnership return for the year of the transfer setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated.[4184]

As noted in part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000, special rules apply when built-in losses are involved. For a discussion of proposed regulations implementing Code § 743(b) adjustments in such cases, see the American Bar Association Section of Taxation's "Comments on Proposed Regulations on Certain Partnership Provisions of the American Jobs Creation Act of 2004," *Tax Lawyer*, vol. 69, No. 1, p. 5 (Fall 2015).

In implementing the Code § 743(b) adjustments:[4185]

[4181] Reg. § 1.743-1(k)(3).

[4182] Reg. § 1.743-1(k)(4), which provides that a partnership is notified of a transfer when either:

(i) The partnership receives the written notice from the transferee required under paragraph (k)(2) of this section; or

(ii) Any partner who has responsibility for federal income tax reporting by the partnership has knowledge that there has been a transfer of a partnership interest.

[4183] Reg. § 1.743-1(k)(5), which describes the attachment, as well as what to do when the transferee supplies the information.

[4184] Reg. § 1.743-1(k)(1)(i); in addition to referring to this requirement, Reg. § 1.755-1(d) indicates that this statement should include the partnership properties to which the adjustment is allocated under section 755, which is what this part II.Q.8.e.iii.(d) is all about. See Reg. § 1.743-1(k)(1)(ii) for special rules for oil and gas properties that are depleted at the partner level under Code § 613A(c)(7)(D).

[4185] Reg. § 1.743-1(j)(1). Reg. § 1.743-1(j)(2) provides more details:

> *Computation of partner's distributive share of partnership items*. The partnership first computes its items of income, deduction, gain, or loss at the partnership level under section 703. The partnership then allocates the partnership items among the partners, including the transferee, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the transferee's distributive share of the items of partnership income, deduction, gain, or loss, in accordance with paragraphs (j)(3) and (4) of this section, to reflect the effects of the transferee's basis adjustment under section 743(b). These adjustments to the transferee's distributive shares must be reflected on Schedules K and K-1 of the partnership's return (Form 1065). These adjustments to the transferee's distributive shares do not affect the

No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating income, deduction, gain, and loss, the transferee will have a special basis for those partnership properties the bases of which are adjusted under section 743(b) and this section. The adjustment to the basis of partnership property under section 743(b) has no effect on the partnership's computation of any item under section 703.

In other words, the partnership keeps two or more separate sets of books for transferee partner: one that applies to all partners based on the partnership's transactions and is reflected in their capital accounts, and one or more than applies to each partner separately based on that partner's events that affect outside basis (that do not involve transfers of the partnership's assets) and is reflected in the partnership's basis records specially allocated to the applicable partners. When a partnership interest is transferred, the transferor's capital account attributable to the transferred interest (which might be part or all of the transferor's capital account, depending on what portion is transferred) shifts to the transferee.[4186]

The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of death, increased by the estate's share of partnership liabilities, and reduced to the extent that such value is attributable to IRD.[4187] Thus, the basis increase has two effects:

- Restoring Basis Arising from Liabilities. To the extent a partner assumes a liability, that partner is deemed to have contributed cash equal to the liabilities that person is allocated. To the extent a partner's allocable share of liabilities is reduced, that person is deemed to have received a cash distribution, reducing basis or triggering gain if and to the extent basis is insufficient to absorb the distribution. During life, distributions or losses might have reduced or eliminated basis generated by the assumption of liabilities. By passing through a decedent's estate, a partnership interest's basis due to allocated liabilities is fully restored.

- Basis Adjustment Due to Value. The partnership interest's value, which includes appropriate reductions for the balance sheet effect of liabilities and appropriate increases or decreases for control or lack thereof, reductions for lack of marketability, and any other features, is added to the amount of allocable liabilities.

The partnership increases the adjusted basis of its property by the excess of the basis to the transferee partner of the partner's interest in the partnership over the partner's

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transferee's capital account. [additional references re: accounting for long-term contracts]

CCA 201726012 (under the signature of David R. Haglund) stated:

> Adjustments to the adjusted tax basis of partnership property under § 743 are not reflected in the capital account of the transferee partner or on the books of the partnership. § 1.704-1(b)(2)(iv)(m)(2). No adjustment is made to the common basis of partnership property, and the § 743(b) adjustment has no effect on the partnership's computation of any item under § 703. § 1.743-1(j)(1). Section 743(b) adjustments are personal to the transferee partners and are not subject to reallocation under § 704(b).

4186 Reg. § 1.704-1(b)(2)(iv)(*l*). See also Reg. § 1.704-1(b)(5), Ex. (13).

4187 Reg. § 1.742-1.

proportionate share of the adjusted basis of the partnership property.[4188] Consistent with the rule for outside basis stated above, a transferee's share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities.[4189] Generally, a transferee's interest as a partner in the partnership's previously taxed capital is equal to:[4190]

- The amount of cash that the transferee would receive on a liquidation of the partnership following a certain hypothetical transaction, to the extent attributable to the acquired partnership interest; increased by

- The amount of tax loss,[4191] that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest); and decreased by

- The amount of tax gain,[4192] that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest).

The hypothetical transaction referred to in the first bullet point above means the disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets.[4193]

Note that the basis adjustment does not refer to the basis change that triggered the adjustment. Rather, the basis adjustment seeks to reconcile the cumulative effect of anything that changed inside and outside basis.

Code § 755 and the regulations thereunder determine the allocation of the Code § 743(b) basis adjustment among the individual items of partnership property.[4194] Generally, any Code § 743(b) change in the adjusted basis of partnership property will be allocated in a manner which has the effect of reducing the difference between the fair market value in any other manner permitted by regulations.[4195]

[4188] Code § 743(b).
[4189] Reg. § 1.743-1(d)(1).
[4190] Reg. § 1.743-1(d)(1).
[4191] Including any remedial allocations under Reg. § 1.704-3(d).
[4192] Including any remedial allocations under Reg. § 1.704-3(d).
[4193] Reg. § 1.743-1(d)(2).
[4194] Code § 743(c); Reg. § 1.743-1(e).
[4195] Code § 755(a), which the regulations follow by allocating according to gain or loss arising from a hypothetical sale. This concept prevents an outside basis decrease due to valuation discounts from reducing the basis of assets with unrealized gain (although such a discount may reduce any basis increase); see part II.H.3 Valuation Discounts – Friend or Enemy, especially fn. 1421. Similarly, a distribution shifting basis to distributed assets under Code § 732 that ordinarily would reduce inside basis cannot reduce the basis of assets with unrealized gain; see parts II.H.2.f Partnership Basis Shifting Opportunities and II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property (with fn. 3893 referring to this footnote).

In applying this rule, changes in the adjusted basis of property consisting of capital assets and Code § 1231(b) property (property used in a trade or business), or any other property of the partnership, is allocated to partnership property of a like character, except that the basis of any such partnership property shall not be reduced below zero.[4196] Reg. § 1.755-1(a)(1) provides:

- First, the partnership must determine the value of each of its assets.

- Second, the basis adjustment is allocated between the two classes of property consisting of capital assets and Code § 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). Furthermore, properties and potential gain treated as unrealized receivables under Code § 751(c) and the regulations thereunder are treated as separate assets that are ordinary income property. References to "capital gain" or :ordinary income " property appear to disregard whether there is an unrealized gain or loss.

- Third, the portion of the basis adjustment allocated to each class is allocated among the items within the class.

Valuation issues include:

- If the assets of the partnership constitute a trade or business,[4197] then the partnership is required to use the residual method to assign values to the partnership's section 197 intangibles (goodwill, etc.).[4198] The IRS is not bound by the

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[4196] Code § 755(b).

[4197] As defined in Reg. § 1.1060-1(b)(2), which provides that a group of assets constitutes a trade or business if:

> (A) The use of such assets would constitute an active trade or business under section 355; or
>
> (B) Its character is such that goodwill or going concern value could under any circumstances attach to such group.

See part II.Q.7.f.iii Active Business Requirement for Code § 355.

[4198] Reg. § 1.755-1(a)(2), which further provides:

> To do so, the partnership must, first, determine the value of partnership assets other than section 197 intangibles under paragraph (a)(3) of this section. The partnership then must determine partnership gross value under paragraph (a)(4) of this section. Last, the partnership must assign values to the partnership's section 197 intangibles under paragraph (a)(5) of this section. For purposes of this section, the term section 197 intangibles includes all section 197 intangibles (as defined in section 197), as well as any goodwill or going concern value that would not qualify as a section 197 intangible under section 197.

Reg. § 1.755-1(a)(3) provides:

> For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

Code § 7701(g) provides:

> *Clarification of fair market value in the case of nonrecourse indebtedness*. For purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

parties' allocation of purchase price, even if the parties are bound by a statement required to be filed with the IRS.[4199]

- Except for certain Code § 743(b) basis adjustments resulting from substituted basis transactions,[4200] partnership gross value generally is equal to the amount that, if assigned to all partnership property, would result in a liquidating distribution to the partner equal to the transferee's basis in the transferred partnership interest immediately following the relevant transfer (reduced by the amount, if any, of such basis that is attributable to partnership liabilities).[4201] However, in certain circumstances, such as where income or loss with respect to particular section 197 intangibles are allocated differently among partners, partnership gross value may vary depending on the values of particular section 197 intangibles the partnership held.[4202] Also, where a partnership interest is transferred as a result of the death of a partner, the transferee's basis in its partnership interest is determined without regard to Code §1014(c), and is deemed to be adjusted for that portion of the interest, if any, that is attributable to items representing income in respect of a decedent under Code § 691.[4203]

[4199] Reg. § 1.1060-1(c)(4) provides:

Effect of agreement between parties. If, in connection with an applicable asset acquisition, the seller and purchaser agree in writing as to the allocation of any amount of consideration to, or as to the fair market value of, any of the assets, such agreement is binding on them to the extent provided in this paragraph (c)(4). Nothing in this paragraph (c)(4) restricts the Commissioner's authority to challenge the allocations or values arrived at in an allocation agreement. This paragraph (c)(4) does not apply if the parties are able to refute the allocation or valuation under the standards set forth in *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (a party wishing to challenge the tax consequences of an agreement as construed by the Commissioner must offer proof that, in an action between the parties to the agreement, would be admissible to alter that construction or show its unenforceability because of mistake, undue influence, fraud, duress, etc.).

[4200] Reg. § 1.755-1(a)(4)(ii):

applies to basis adjustments under section 743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in the interest or to the basis of other property held at any time by the transferee (substituted basis transactions). In the case of a substituted basis transaction, partnership gross value equals the value of the entire partnership as a going concern, increased by the amount of partnership liabilities at the time of the exchange giving rise to the basis adjustment.

[4201] Reg. § 1.755-1(a)(4)(i)(A).

[4202] Reg. § 1.755-1(a)(4)(i)(B), which further provides:

In these special situations, the partnership must assign value, first, among section 197 intangibles (other than goodwill and going concern value) in a reasonable manner that is consistent with the ordering rule in paragraph (a)(5) of this section and would cause the appropriate liquidating distribution under paragraph (a)(4)(i)(A) of this section. If the actual fair market values, determined on the basis of all the facts and circumstances, of all section 197 intangibles (other than goodwill and going concern value) is not sufficient to cause the appropriate liquidating distribution, then the fair market value of goodwill and going concern value shall be presumed to equal an amount that if assigned to goodwill and going concern value would cause the appropriate liquidating distribution.

[4203] Reg. § 1.755-1(a)(4)(i)(C).

If the aggregate value of partnership property other than section 197 intangibles[4204] is equal to or greater than partnership gross value,[4205] then all section 197 intangibles are deemed to have a value of zero for purposes of this allocation.[4206] Otherwise, the aggregate value of the partnership's section 197 intangibles (the residual section 197 intangibles value) is deemed to equal the excess of partnership gross value over the aggregate value of partnership property other than section 197 intangibles.[4207] The residual section 197 intangibles value must be allocated first among section 197 intangibles other than goodwill and going concern value[4208] and then to goodwill and going concern value.[4209]

Substituted basis transactions and other transactions have different methodologies.[4210] Subject to certain exceptions for substituted basis transaction:[4211]

[4204] Reg. § 1.755-1(a)(3) provides:

> For purposes of this section, the fair market value of each item of partnership property other than section 197 intangibles shall be determined on the basis of all the facts and circumstances, taking into account section 7701(g).

[4205] Gross value as determined in Reg. § 1.755-1(a)(4).

[4206] Reg. § 1.755-1(a)(5)(i).

[4207] Reg. § 1.755-1(a)(5)(i).

[4208] Reg. § 1.755-1(a)(5)(ii) provides:

> *Values assigned to section 197 intangibles other than goodwill and going concern value*. The fair market value assigned to a section 197 intangible (other than goodwill and going concern value) shall not exceed the actual fair market value (determined on the basis of all the facts and circumstances) of that asset on the date of the relevant transfer. If the residual section 197 intangibles value is less than the sum of the actual fair market values (determined on the basis of all the facts and circumstances) of all section 197 intangibles (other than goodwill and going concern value) held by the partnership, then the residual section 197 intangibles value must be allocated among the individual section 197 intangibles (other than goodwill and going concern value) as follows. The residual section 197 intangibles value is assigned first to any section 197 intangibles (other than goodwill and going concern value) having potential gain that would be treated as unrealized receivables under the flush language of section 751(c) (flush language receivables) to the extent of the basis of those section 197 intangibles and the amount of income arising from the flush language receivables that the partnership would recognize if the section 197 intangibles were sold for their actual fair market values (determined based on all the facts and circumstances) (collectively, the flush language receivables value). If the value assigned to section 197 intangibles (other than goodwill and going concern value) is less than the flush language receivables value, then the assigned value is allocated among the properties giving rise to the flush language receivables in proportion to the flush language receivables value in those properties. Any remaining residual section 197 intangibles value is allocated among the remaining portions of the section 197 intangibles (other than goodwill and going concern value) in proportion to the actual fair market values of such portions (determined based on all the facts and circumstances).

[4209] Reg. § 1.755-1(a)(5)(i), (iii).

[4210] Reg. § 1.755-1(b)(1)(i) provides:

> For basis adjustments under section 743(b) resulting from substituted basis transactions, paragraph (b)(5) of this section shall apply. For basis adjustments under section 743(b) resulting from all other transfers, paragraphs (b)(2) through (4) of this section shall apply.

[4211] Reg. § 1.755-1(b)(1)(i).

- The portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero.

- The portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.

If the Code § 743(b) basis adjustment does not result from a substituted basis transaction, then the allocation of that adjustment between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss[4212] that the transferee partner would receive (to the extent attributable to the acquired partnership interest) if, immediately after the transfer of the partnership interest, all of the partnership's property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property (the hypothetical transaction):[4213]

1. The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss[4214] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction.[4215] The amount of the basis adjustment to each item of property within the class of ordinary income property is equal to:

   A. The amount of income, gain, or loss[4216] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item;[4217] reduced by

   B. The product of:[4218]

      - Any decrease to the amount of the basis adjustment to ordinary income property required pursuant to fn 4230; multiplied by

      - A fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership's items of ordinary income property.

2. The amount of the basis adjustment to capital gain property is equal to the total amount of the basis adjustment under Code § 743(b) minus he amount of the basis

[4212] Including remedial allocations under Reg. § 1.704-3(d).
[4213] Reg. § 1.755-1(b)(1)(ii), which further provides:
See § 1.460-4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferee from a contract accounted for under a long-term contract method of accounting as a result of the hypothetical transaction.
[4214] Including any remedial allocations under Reg. § 1.704-3(d).
[4215] Reg. § 1.755-1(b)(2)(i).
[4216] Including remedial allocations under Reg. § 1.704-3(d).
[4217] Reg. § 1.755-1(b)(3)(i)(A).
[4218] Reg. § 1.755-1(b)(3)(i)(B).

adjustment allocated to ordinary income property.[4219] The amount of the basis adjustment to each item of property within the class of capital gain property is equal to:[4220]

A. The amount of income, gain, or loss[4221] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item;[4222] minus

B. The product of:[4223]

- The total amount of gain or loss[4224] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property; multiplied by

- A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property.

An asset with respect to which the transferee partner has no interest in income, gain, losses, or deductions shall not be taken into account in calculating this product.[4225] Furthermore, the amount of any decrease in basis allocated to an item of capital gain property above[4226] may not exceed the partnership's adjusted basis in that item; if a decrease in basis allocated above to an item of capital gain property would otherwise exceed the partnership's adjusted basis in that item, the excess must be applied to reduce the remaining basis, if any, of other capital gain assets pro rata in proportion to the bases of such assets (as adjusted under these rules).[4227]

3. In no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis[4228] in capital gain property.[4229] If a decrease in basis allocated to capital gain property would otherwise exceed the partnership's

[4219] Reg. § 1.755-1(b)(2)(i).
[4220] Reg. § 1.755-1(b)(3)(ii).
[4221] Including remedial allocations under Reg. § 1.704-3(d).
[4222] Reg. § 1.755-1(b)(3)(ii)(A).
[4223] Reg. § 1.755-1(b)(3)(ii)(B).
[4224] Including remedial allocations under Reg. § 1.704-3(d).
[4225] Reg. § 1.755-1(b)(3)(iii)(A).
[4226] In the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under Reg. § 1.704-3(d) from the hypothetical transaction.
[4227] Reg. § 1.755-1(b)(3)(iii)(B)
[4228] In the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under Reg. § 1.704-3(d) from the hypothetical transaction.
[4229] Reg. § 1.755-1(b)(2)(i)(B).

basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.[4230]

4. Where a partnership interest is transferred as a result of the death of a partner, under Code § 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under Code § 691.[4231]

The rest of this part II.Q.8.e.iii.(d) covers substituted basis transactions.[4232] Initially, this was limited to Code § 743(b) basis adjustments resulting from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest.[4233] For exchanges on or after June 9, 2003, it also applies to Code § 743(b) basis adjustments that result from exchanges in which the transferee's basis in the partnership interest is determined by reference to other property held at any time by the transferee, including when a partnership interest:[4234]

- Is contributed to a corporation in a Code § 351 transaction,
- Is contributed to a partnership in a Code § 721(a) transaction, or
- Is distributed by a partnership in a Code § 731(a) transaction.

The substituted basis transaction's effect depends on whether the Code § 743(b) basis adjustment is zero, positive, or negative:[4235]

- If the overall Code § 743(b) basis adjustment is zero, then no adjustment to the basis of partnership property will be made.
- If the overall Code § 743(b) basis adjustment is positive, the increase is allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss[4236] that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. If an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase is allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class.
- If the overall Code § 743(b) basis adjustment is negative, the decrease is allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss[4237] that would be allocated to the transferee (to the extent

[4230] Reg. § 1.755-1(b)(2)(i).
[4231] Reg. § 1.755-1(b)(4)(i), referring to Reg. § 1.742-1.
[4232] Reg. § 1.755-1(b)(5).
[4233] Reg. § 1.755-1(b)(5)(i).
[4234] Reg. § 1.755-1(b)(5)(i).
[4235] Reg. § 1.755-1(b)(5)(ii).
[4236] Including any remedial allocations under Reg. § 1.704-3(d).
[4237] Including any remedial allocations under Reg. § 1.704-3(d).

attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. If a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease is allocated to each class in proportion to the net loss that would be allocated to the transferee from the sale of all assets in each class.

Any substituted basis increase within a class is allocated in the following order:[4238]

1. To properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the extent of the transferee's share of each property's unrealized appreciation), then any remaining increase

2. In proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class.

Any substituted basis decrease within a class is allocated in the following order:[4239]

1. To properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation), then any remaining decrease

2. In proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

However, if a substituted basis decrease must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.[4240] Also, if a Code § 743(b) transferee's negative basis adjustment cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.[4241]

CCA 201726012 (under the signature of David R. Haglund) asserted that Reg. § 1.1502-13 did not permit increased deductions for depreciation and amortization that are attributable to Code § 743(b) adjustments arising from the transfer of a partnership interest in an intercompany reorganization to which Code § 368 applies and from the distribution of a partnership interest in an intercompany liquidation to which Code § 332(a) applies. It also asserted that the basis adjustment provisions of Code § 743(b) do not conflict with the carryover basis provisions of Code § 362(a) when a partnership interest is transferred in an intercompany reorganization to which Code § 368 applies or with the carryover basis provisions of Code § 334(b)(1) when a

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[4238] Reg. § 1.755-1(b)(5)(iii)(A).
[4239] Reg. § 1.755-1(b)(5)(iii)(B).
[4240] Reg. § 1.755-1(b)(5)(iii)(C).
[4241] Reg. § 1.755-1(b)(5)(iii)(D).

partnership interest is distributed in an intercompany liquidation to which Code § 332(a) applies.[4242]

II.Q.8.e.iii.(e). Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election

The basis of partnership property is adjusted as the result of a distribution of property to a partner if a Code § 754 election is in effect with respect to such partnership or if there is a substantial basis reduction with respect to such distribution:[4243]

(1) To the extent that the adjustment is an increase, the partnership increases the basis of its property by:[4244]

- (A) the amount of any gain recognized to the distributee partner with respect to such distribution under Code § 731(a)(1), and

- (B) in the case of distributed property to which Code § 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by Code § 732(d) – see further below) over the basis of the distributed property to the distributee, as determined under Code § 732.[4245]

(2) To the extent that the adjustment is a decrease, the partnership increases the basis of its property by:[4246]

[4242] CCA 201726012 reasoned:

> In the case of property transferred in a reorganization to which § 368 applies, in which no gain or loss is recognized, the basis of such property in the hands of the transferee generally is the same as it would be in the hands of the transferor under § 362(a). Similarly, in the case of property distributed to a corporate parent from a subsidiary in a complete liquidation to which § 332(a) applies, in which no gain or loss is recognized, the basis of such property in the hands of the distributee generally is the same as it would be in the hands of the distributor under § 334(b)(1).
>
> Thus, with respect to the transfer of the Partnership1 interest from SubsidiaryH to SubsidiaryF in the Reorganization (to which § 368 applies), and the distribution of the Partnership1 interest from SubsidiaryC to SubsidiaryE in the Liquidation (to which § 332 applies), the transferee's and distributee's basis in their Partnership1 interest is the same as it would be in the hands of the respective transferor and distributor.
>
> Application of § 743(b), by contrast, has no effect on the basis of a *partnership interest* transferred in a reorganization or distributed in a complete liquidation. Rather, in such cases, if the partnership has a § 754 election in effect, § 743(b) provides for an increase or decrease in the adjusted basis of *partnership property*.

[4243] Code § 734(a), see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

[4244] Code § 734(b)(1).

[4245] The rule in (B) does not apply to any distributed property which is an interest in another partnership with respect to which a Code § 754 election is not in effect.

[4246] Code § 734(b)(2).

- (A) the amount of any loss recognized to the distributee partner with respect to such distribution under Code § 731(a)(2), and

- (B) in the case of distributed property to which Code § 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under Code § 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by Code § 732(d)).

Code § 755 allocates the basis adjustment described above.[4247] Generally, any Code § 743(b) change in the adjusted basis of partnership property will be allocated in a manner which has the effect of reducing the difference between the fair market value in any other manner permitted by regulations;[4248] this concept prevents any increase in the basis of assets that are distributed from reducing the basis of the partnership's assets with unrealized gain. In applying Code § 755 allocations to Code § 734(b) basis adjustments:

(1) Where a distribution of partnership property results in an adjustment to the basis of undistributed partnership property under Code § 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose.[4249] Where a distribution results in an adjustment under Code § 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.[4250]

(2) If a basis increase is allocated within a class, the increase is allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation), and any remaining increase must be allocated among the properties within the class in proportion to their fair market values.[4251] If a basis decrease is allocated within a class, the decrease is allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's

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[4247] Code § 732(c).

[4248] See fn. 4195, found in part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest.

[4249] Reg. § 1.755-1(c)(1)(i), which continues:

> Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

[4250] Reg. § 1.755-1(c)(1)(ii).

[4251] Reg. § 1.755-1(c)(2)(i).

unrealized depreciation), and any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).[4252]

(3) Where Code § 734(b)(2) requires a decrease in the basis of partnership assets and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of that property is reduced to zero (but not below zero).[4253]

(4) Where an increase or a decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, or because the basis of all the property of a like character has been reduced to zero, the adjustment is made when the partnership later acquires property of a like character to which an adjustment can be made.[4254]

If a transferee partner receives a distribution of property (other than money) from the partnership within two years after the partner acquired the partner's interest or part thereof in the partnership by a transfer with respect to which a Code § 754 election was not in effect, the partner may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the Code § 754 election were in effect.[4255] For these purposes, a "transfer of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner."[4256] Also, if a Code § 754 election is not in place, a partner is required to apply this rule to a distribution to him, whether or not made within two years after the transfer, if at the time of his acquisition of the transferred interest:[4257]

[4252] Reg. § 1.755-1(c)(2)(ii).

[4253] Reg. § 1.755-1(c)(3).

[4254] Reg. § 1.755-1(c)(4).

[4255] Reg. § 1.732-1(d)(1)(iii). Reg. § 1.732-1(d)(1)(iv) provides:

> If an election under section 732(d) is made upon a distribution of property to a transferee partner, the amount of the adjustment with respect to the transferee partner is not diminished by any depletion or depreciation of that portion of the basis of partnership property which arises from the special basis adjustment under section 732(d), since depletion or depreciation on such portion for the period prior to distribution is allowed or allowable only if the optional adjustment under section 743(b) is in effect.

The final regulations did not change the proposed regulations much. The preamble to the proposed regulations, REG 209682-94, provides:

> Section 732(d) provides a special rule that applies to determine the basis of property distributed to a transferee partner who acquired any part of its partnership interest in a transfer when an election under section 754 was not in effect. When the special rule applies, the basis of distributed property is adjusted immediately before the distribution to reflect the basis that the property would have had if the partnership had a section 754 election in effect at the time the transferee acquired the partnership interest. As a result, the basis of the distributed property in the hands of the partnership immediately before the distribution more closely approximates its fair market value. Consequently, the transferee's basis in the distributed property will also more closely approximate its fair market value.

[4256] Reg. § 1.732-1(d)(1)(i).

[4257] Reg. § 1.732-1(d)(4). The preamble to the proposed regulations, REG 209682-94, provided:

- The fair market value of all partnership property (other than money) exceeded 110% of its adjusted basis to the partnership,

- An allocation of basis under Code § 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such an allowance, and

- A Code § 743(b) basis adjustment would change the basis to the transferee partner of the property actually distributed.

If property is distributed to a transferee partner who makes a Code § 732(d) election, and if such property is not the same property which would have had a special basis adjustment, then the special basis adjustment applies to any like property received in the distribution, provided that the transferee, in exchange for the property distributed, has relinquished his interest in the property with respect to which he would have had a special basis adjustment.[4258] This rule applies whether the property in which the transferee has relinquished his interest is retained or disposed of by the partnership.[4259]

Special rules apply to unrealized receivables and substantially appreciated inventory items.[4260] Also, in reviewing anything in this part II.Q.8.e.iii.(e), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.

> The purpose of § 1.732-1(d)(4) was to prevent distortions caused by section 732(c) that might inflate the basis of depreciable, depletable, or amortizable property above its fair market value. At the time that the regulations were adopted, such distortions might occur because section 732(c) allocated basis among distributed properties based on their relative bases. The changes made to section 732(c) by the Taxpayer Relief Act of 1997, Public Law 105-34, section 1061, 111 Stat. 788, 945-46 (1997), make the distortions targeted by the regulations less likely to occur. As a result, the Service and Treasury request comments on the proper scope of section 732(d), and specifically, under what circumstances, if any, the Secretary should exercise its authority to mandate the application of section 732(d) to a transferee.

T.D. 8847 described and responded to the requested comments:

> Several commentators suggested that the mandatory application of section 732(d) no longer should be required, because the changes made to section 732(c) by the Taxpayer Relief Act of 1997, Public Law 105- 34, 111 Stat. 788, 945-46 (1997), make the distortions targeted by the regulations less likely to occur. However, other commentators noted that distortions caused by section 732(c) still may occur. Accordingly, the rule contained in § 1.732-1(d)(4), which requires the mandatory application of section 732(d) in certain cases, remains in effect.

[4258] Reg. § 1.732-1(d)(1)(v).

[4259] Reg. § 1.732-1(d)(1)(v). For a shift of transferee's basis adjustment under Code § 743(b) to like property, see Reg. § 1.743-1(g).

[4260] See fns. 3898-3900, found in part II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property.

II.Q.8.e.iii.(f). Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold

When an asset sale is desirable for tax purposes but a stock sale is necessary for nontax purposes, Code § 338(g) permits a corporation that buys another corporation from the target's parent in a qualified purchase to elect to treat the stock purchase as an asset purchase.

Similarly, the owners of an S corporation should consider making a Code § 338(h)(10) election when selling their S corporation stock to a corporation.[4261]

The election causes the stock sale to be treated as if the S corporation sold all its assets while owned by the sellers and while still an S corporation. Gain is therefore recognized by the S corporation and taxed to the selling shareholders, which creates additional basis in their S corporation stock. The actual sale of the stock is ignored for tax purposes and the shareholders are treated as receiving the sale proceeds in liquidation of the S corporation.

Thus, the selling shareholders will be taxed on a deemed asset sale and liquidation, rather than on a stock sale. Unless they bought a portion of their stock at a premium over the value of the corporation's assets, the Code § 338(h)(10) election will generally not significantly affect the amount of gain on which they would be taxed. However, it will cause a portion of their gain to be ordinary income, rather than capital gain, to the extent that a sale of the S corporation's assets would generate ordinary income, and state income tax surprises might occur; for a discussion of the some of the issues mentioned in the sentence, see similar issues raised in part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation. But, the whole point was to replicate an asset sale for tax purposes, so the Code § 338(h)(10) election merely allows a different form to be used for the deemed asset sale.

If the purchaser is not a corporation, a Code § 336(e) election might allow the buyer to replicate the results of a Code § 338(h)(10) election.[4262] The selling corporation or S corporation shareholder(s) must dispose of stock of another corporation (target) in a qualified stock disposition.[4263] "Qualified stock disposition" means any transaction or series of transactions in which stock meeting the requirements of Code § 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation or by the S corporation shareholders in a disposition,[4264] during the 12-month disposition period.[4265] "Disposition" means any sale, exchange, or distribution of stock, but only if:[4266]

[4261] Reg. § 1.338(h)(10)-1(c)(1) authorizes a Code § 338(h)(1) election when a corporation buys all of the stock of the target corporation.

[4262] Reg. § 1.336-1(a) provides that the effects of Code § 338(h)(10) and the regulations thereunder generally apply to Code § 336(e) elections.

[4263] Reg. § 1.336-2(a), referring to Reg. § 1.336-1(b)(6) in defining a qualified stock disposition.

[4264] Within the meaning of Reg. § 1.336-1(b)(5).

[4265] Reg. § 1.336-1(b)(6).

[4266] Reg. § 1.336-1(b)(5).

(A) The basis of the stock in the hands of the purchaser is not determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom the stock is acquired or under Code § 1014(a) (property acquired from a decedent);

(B) Subject to an exception for certain Code § 355(d)(2) and (e)(2) transactions,[4267] the stock is not sold, exchanged, or distributed in a transaction to which Code § 351, 354, 355, or 356 applies and is not sold, exchanged, or distributed in any transaction described in regulations in which the transferor does not recognize the entire amount of the gain or loss realized in the transaction; and

(C) The stock is not sold, exchanged, or distributed to a related person.

Both the rules governing Code § 338(h)(10) elections and Code § 336(e) elections[4268] provide that stock acquired by a purchasing corporation from a related corporation is generally not considered acquired by purchase.[4269] The seller cannot be a person the ownership of whose stock would, under Code § 318(a) (other than Code § 318(a)(4)), be attributed to the buyer.[4270] (Also, in reviewing anything in this part II.Q.8.b.i.(d), consider whether part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits may be relevant.)

A Code § 336(e) election for an S corporation target is made by completing the following requirements:[4271]

- All of the S corporation shareholders, including those who do not dispose of any stock in the qualified stock disposition, and the S corporation target must enter into a written, binding agreement, on or before the due date (including extensions) of the Federal income tax return of the S corporation target for the taxable year that includes the disposition date, to make a Code § 336(e) election;

- The S corporation target must retain a copy of the written agreement; and

- The S corporation target must attach the Code § 336(e) election statement, to its timely filed (including extensions) Federal income tax return for the taxable year that includes the disposition date. A Reg. § 301.9100-3 extension of time to file the election may be available.[4272]

[4267] Reg. § 1.336-1(b)(5)(ii) provides that:

> a distribution of stock to a person who is not a related person in a transaction in which the full amount of stock gain would be recognized pursuant to section 355(d)(2) or (e)(2) shall be considered a disposition.

[4268] Reg. § 1.336-1(b)(5)(iii) provides:

> *Transactions with related persons*. In determining whether stock is sold, exchanged, or distributed to a related person, the principles of section 338(h)(3)(C) and § 1.338-3(b)(3) shall apply.

[4269] Reg. § 1.338-3(b)(3).

[4270] Code § 338(h)(3)(A)(iii). See Harris & Kessler, Constructive Ownership under Section 318, *Business Entities* (WG&L), Mar/Apr 2016.

[4271] Reg. § 1.336-2(h)(3).

[4272] Letter Rulings 201652014 and 201711007, the latter holding:

Instead of the seller(s) being treated as selling stock, the target is treated as selling its assets to an unrelated person in a single transaction at the close of the disposition date (but before the deemed liquidation described below)[4273] in exchange for the aggregate deemed asset disposition price.[4274] The target realizes the deemed disposition tax consequences from the deemed asset disposition before the close of the disposition date while the target is owned by seller or the S corporation shareholders.[4275] If the target is an S corporation, its S election continues in effect through the close of the disposition date (including the time of the deemed asset disposition and the deemed liquidation) notwithstanding the usual rules for S corporation terminations.[4276] Also, if the target is an S corporation (but not a qualified subchapter S subsidiary (QSub)[4277]), any direct or indirect subsidiaries of the target that the target has elected to treat as QSubs remain qualified QSubs through the close of the disposition date.[4278] If the target is an S corporation, its shareholders (whether or not they sell or exchange their stock) take their pro rata share of the deemed disposition tax consequences into account under Code § 1366 and increase or decrease their basis in target stock under Code § 1367.[4279]

Immediately after the deemed asset disposition described above, the target is treated as acquiring all of its assets from an unrelated person in a single, separate transaction at the close of the disposition date in exchange for an amount equal to the adjusted grossed-up basis.[4280] The target remains liable for the tax liabilities it had before this

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WITHIN 45 DAYS OF THE DATE ON THIS LETTER, S Corporation Target and the S Corporation Shareholder must enter into a written, binding agreement to make a section 336(e) election and S Corporation Target must file the section 336(e) election statement in accordance with § 1.336-2(h). The section 336(e) election statement must be attached to S Corporation Target's tax return for B Year. In addition, a copy of this letter must be attached to S Corporation Target's return. Alternatively, if S Corporation Target files its return electronically, it may satisfy the requirement of attaching a copy of this letter to the return by attaching a statement to its return that provides the date and control number (PLR-131803-16) of this letter ruling.

WITHIN 120 DAYS OF THE DATE ON THIS LETTER, all relevant parties must file or amend, as applicable, all returns and amended returns (if any) necessary to report the transaction consistently with the making of a section 336(e) election for the taxable year in which the transaction was consummated (and for any other affected taxable year).

The above extension of time is conditioned on the taxpayers' (*i.e.*, Purchaser's, S Corporation Target's, and S Corporation Shareholder's) tax liability (if any) being not lower, in the aggregate, for all years to which the section 336(e) election applies than it would have been if the Election had been timely filed (taking into account the time value of money). No opinion is expressed as to the taxpayers' tax liability for the years involved. A determination thereof will be made by the applicable Director's office upon audit of the federal income tax returns involved.

4273 Reg. § 1.336-2(b)(1)(iii).
4274 Reg. § 1.336-2(b)(1)(i)(A).
4275 Reg. § 1.336-2(b)(1)(i)(A).
4276 Reg. § 1.336-2(b)(1)(i)(A).
4277 See part II.A.2.h Qualified Subchapter S Subsidiary (QSub).
4278 Reg. § 1.336-2(b)(1)(i)(A).
4279 Reg. § 1.336-2(b)(1)(iii)(A).
4280 Reg. § 1.336-2(b)(1)(ii).

deemed sale and purchase (including the tax liability for the deemed disposition tax consequences).[4281]

The target and seller (or S corporation shareholders) are treated as if, before the close of the disposition date, after the deemed asset disposition described above, and while target is owned by seller or S corporation shareholders, the target transferred all of the consideration deemed received in the deemed asset disposition to seller or S corporation shareholders, any S corporation election for the original target terminated, and the original target ceased to exist.[4282] This transfer to the seller or S corporation shareholders is characterized for Federal income tax purposes in the same manner as if the parties had actually engaged in the transactions deemed to occur above and taking into account other transactions that actually occurred or are deemed to occur.[4283]

Thus, the following transactions are deemed to have occurred:

1. The target sells its assets to a hypothetical buyer.

2. The target is treated as having bought its assets from a hypothetical seller.

3. The target liquidates, while the old shareholders are deemed to continue owning the stock.

The time for taking into account liabilities in the hypothetical asset transaction and the amount of the liabilities taken into account is determined as if the consideration included the discharge of the liabilities by the unrelated person.[4284] For example, if no amount of a liability is properly taken into account in amount realized as of the beginning of the day after the disposition date, the liability is not initially taken into account in determining the purchase price, but it may be taken into account at some later date.[4285] At the January 2017 American Bar Association Section of Taxation meeting, a discussion of Code § 336(e) gave this example:[4286]

- Deemed asset purchase price equals cash paid plus "liabilities" assumed.

- Liabilities do not include amounts which are not currently deductible or amounts not borrowed from a third party.

[4281] Reg. § 1.336-2(b)(1)(ii).

[4282] Reg. § 1.336-2(b)(1)(iii)(A).

[4283] Reg. § 1.336-2(b)(1)(iii)(A), which continues:

> For example, the transfer may be treated as a distribution in pursuance of a plan of reorganization, a distribution in complete cancellation or redemption of all of its stock, one of a series of distributions in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation, or part of a circular flow of cash. In most cases, the transfer will be treated as a distribution in complete liquidation to which sections 331 or 332 and sections 336 or 337 apply.

[4284] Reg. § 1.336-3(d)(2).

[4285] Reg. § 1.336-3(d)(2).

[4286] Slides discussed by Bakal, Bakke, Mottahedeh, and Weiss are saved as Thompson Coburn LLP document no. 6563470.

- Assume that the asset are worth 100, are associated with 20 of liabilities, and that the purchaser pays 80 for the target's stock.

- On the target's deemed liquidation after filing a conversion election, assets distributed are worth 100, but basis is limited to 80, which potentially triggers 20 of gain.

The meeting gave the following examples of liabilities that may trigger this gain:

- Environmental and other contingent liabilities

- Deferred compensation (Code § 404(a)(5))

- Obligations to perform future services (*Pierce*)

- Economic performance (Code § 461(h))

However, it was suggested that such a mismatch may occur in a straight asset sale as well.

A minority shareholder who retains its target stock does not recognize gain or loss with respect to its shares of target stock; thus, the minority shareholder's basis (except as noted below) and holding period for that target stock are not affected by Code § 336(e) election. [4287] Notwithstanding this treatment of the minority shareholder, if a Code § 336(e) election is made, target will still be treated as disposing of all of its assets in the deemed asset disposition.[4288] If the target is an S corporation, any K-1 items the minority shareholder reports by reason of the deemed sale will affect the shareholder's basis.[4289]

A handy list comparing Code § 338(h)(10) elections and Code § 336(e) elections is found at Harper & Andersen, "Section 336(e)-Another Tool in the Toolbox," *BNA Daily Tax Report* (5/28/2014).[4290]

At the May 2017 American Bar Association Section of Taxation meeting, a discussion of Code §§ 336(e), 338(h)(10), 453(h), and 453B(h), included:[4291]

- Helpful flowcharts showing the transactions deemed to occur in Code § 336(e) or 338(h)(10) elections.

[4287] Reg. § 1.336-3(d)(3).
[4288] Reg. § 1.336-3(d)(3).
[4289] Note the parenthetical in this quote from Reg. § 1.336-2(b)(1)(iii)(A):

> If old target is an S corporation, S corporation shareholders (whether or not they sell or exchange their stock) take their pro rata share of the deemed disposition tax consequences into account under section 1366 and increase or decrease their basis in target stock under section 1367.

[4290] A copy of which is saved as Thompson Coburn LLP document no. 6344607.
[4291] "Converting Stock Sales to Assets Sales (and Back Again)," slides discussed by Dolan, Harper, and Waters, is saved as Thompson Coburn LLP document no. 6617969.

- Potential surprises, how to avoid them using a one-day note for 100% of the transaction, and disadvantages of doing so.[4292]

- State approaches.

One way to avoid the complexity of these elections and disparate state law treatment may be to create a new parent corporation, convey or merge the old corporation into a new single-member, tax-disregarded LLC, and then sell the LLC to the buyers. The first two steps constitute a tax-free Code § 368(a)(1)(F) transaction.[4293] Selling the LLC to the buyers means that the buyer is not concerned with the old corporation's status as an S corporation.[4294]

II.Q.8.e.iii.(g). Certain Changes in Inside Basis May Reduce Foreign Tax Credits

A "covered asset acquisition" may disqualify a portion of the foreign tax credit.[4295]

For purposes of this rule, "covered asset acquisition" means:[4296]

(A) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,

(B) any transaction which-

(i) is treated as an acquisition of assets for purposes of this chapter, and

(ii) is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,

(C) any acquisition of an interest in a partnership which has an election in effect under section 754, and

(D) to the extent provided by the Secretary, any other similar transaction.

Prop. Reg. § 1.901(m)-2(b) would add:[4297]

[4292] If the buyer was willing to pay cash and the seller wanted the one-day note, the buyer's willingness to pay cash does not prevent the seller from using the installment method – only the actual deal counts. Rev. Rul. 73-396.
[4293] See parts II.E.7.c.i.(b) Use F Reorganization to Form LLC and II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.
[4294] For example, the S corporation may have had an ineligible shareholder. See parts II.A.2.g Shareholders Eligible to Hold S Corporation Stock and III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, the latter explaining how one might think that a trust is a wholly-owned grantor trust but may be incorrect.
[4295] Code § 901(m)(1).
[4296] Code § 901(m)(2).
[4297] These supplement Reg. § 1.901(m)-2T(b) (which is not repeated in the text because it does not seem to add to the statute):

> *Covered asset acquisitions*. Except as provided in paragraph (d) of this section, the transactions set forth in this paragraph (b) are CAAs.

(4) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of U.S. income tax and as the acquisition of an interest in a fiscally transparent entity for purposes of a foreign income tax;

(5) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as a partnership distribution of one or more assets the U.S. basis of which is determined by section 732(b) or 732(d) or which causes the U.S. basis of the partnership's remaining assets to be adjusted under section 734(b), provided the transaction results in an increase in the U.S. basis of one or more of the assets distributed by the partnership or retained by the partnership without a corresponding increase in the foreign basis of such assets; and

(6) Any transaction (or series of transactions occurring pursuant to a plan) to the extent it is treated as an acquisition of assets for purposes of both U.S. income tax and a foreign income tax, provided the transaction results in an increase in the U.S. basis without a corresponding increase in the foreign basis of one or more assets.

Generally, international structures and most of subchapter C are beyond the scope of this paper. This part II.Q.8.e.iii.(g) Certain Changes in Inside Basis May Reduce Foreign Tax Credits is merely one consideration when an international structure is affected by the tools described in parts II.Q.8.b.i.(d) Basis in Property Distributed from a Partnership; Possible Opportunity to Shift Basis or Possible Loss in Basis When a Partnership Distributes Property, II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets (Code § 754 Election or Required Adjustment for Built-in Loss) and II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

II.Q.8.e.iv. Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (repealed by the 2017 tax reform law)

Caution – This part II.Q.8.e.iv was repealed by the 2017 tax reform law.

If a sale or exchange of 50% or more of the total interest in partnership capital ***and***[4298] profits occurs (in the aggregate) within a 12-month period, the partnership is deemed to

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(1) A qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies (section 338 CAA);

(2) Any transaction that is treated as an acquisition of assets for U.S. income tax purposes and as an acquisition of stock of a corporation (or the transaction is disregarded) for foreign income tax purposes;

(3) Any acquisition of an interest in a partnership that has an election in effect under section 754 (section 743(b) CAA);

(4)-(6) [Reserved].

[4298] For example, the sale of a 30% interest in partnership capital and a 60% interest in partnership profits is not the sale or exchange of 50% or more of the total interest in partnership capital and profits. Reg. § 1.708-1(b)(2).

have terminated.[4299] However, a disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, the liquidation of a partnership interest, and the contribution of property to a partnership do not constitute such a sale or exchange is not a sale or exchange for purposes of this test.[4300]

If a partnership is terminated by a sale or exchange of an interest, the partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership is deemed to distribute interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up:[4301]

- Subject to the points made below in this part II.Q.8.e.iv, see parts II.Q.8.b.i Distribution of Property by a Partnership and II.M.3 Buying into or Forming a Partnership for the deemed distribution from the old partnership and contribution to the new partnership, respectively (which tend to be tax-free transactions).

- Book values and capital accounts from the old partnership carry over to the new partnership.[4302] Therefore, no Code § 704(c) accounting for newly contributed property applies; instead, the terminating entity's Code § 704(c) accounting carries over.[4303]

- These deemed transactions do not trigger Code § 704(c)(1)(B)[4304] or Code § 737[4305] taxation on the distribution of property within seven years after contribution, which makes sense given the continuation of Code § 704(c) accountability.

- The partner who acquired the partnership interest in the sale or exchange that triggered the deemed termination would obtain a basis adjustment in the partnership's assets that this partner is deemed to acquire if a Code § 754 election is in place.[4306] A partner with a Code § 743 basis adjustment in the partnership's property will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership,[4307] regardless of whether the new partnership makes a Code § 754 election.[4308] See part II.Q.8.e.iii.(d) Code § 743(b) Effectuating Code § 754 Basis Adjustment on Transfer of Partnership Interest, which describes inside basis adjustments.[4309]

4299 Code § 708(b)(1)(B).
4300 Reg. § 1.708-1(b)(2).
4301 Reg. § 1.708-1(b)(4).
4302 Reg. § 1.704-1(b)(2)(iv)(l).
4303 Reg. § 1.704-3(a)(3)(i). See part (iii) of the example in Reg. § 1.708-1(b)(4).
4304 Reg. § 1.704-4(c)(3).
4305 Reg. § 1.737-2(a).
4306 Reg. § 1.708-1(b)(5).
4307 Referring to Reg. § 1.708-1(b)(1)(iv).
4308 Reg. § 1.743-1(h)(1).
4309 See part II.Q.8.e.iii.(a) Illustration of Inside Basis Issue.

- Any start-up expenditures being amortized under Code § 195(b) or organizational expenses being amortized under Code § 709(b)(1) continue to use the same schedule.[4310] However, depreciation of tangible property starts over,[4311] as does the

[4310] Reg. § 1.708-1(b)(6). See also Reg. §§ 1.197-2(g)(2) and 1.197-2(k), Example (16), the latter providing:

> (i) A and B are partners with equal shares in the capital and profits of general partnership P. P's only asset is an amortizable section 197 intangible, which P had acquired on January 1, 1995. On January 1, 2000, the asset had a fair market value of $100 and a basis to P of $50. On that date, A sells his entire partnership interest in P to C, who is unrelated to A, for $50. At the time of the sale, the basis of each of A and B in their respective partnership interests is $25.
>
> (ii) The sale causes a termination of P under section 708(b)(1)(B). Under section 708, the transaction is treated as if P transfers its sole asset to a new partnership in exchange for the assumption of its liabilities and the receipt of all of the interests in the new partnership. Immediately thereafter, P is treated as if it is liquidated, with B and C each receiving their proportionate share of the interests in the new partnership. The contribution by P of its asset to the new partnership is governed by section 721, and the liquidating distributions by P of the interests in the new partnership are governed by section 731. C does not realize a basis adjustment under section 743 with respect to the amortizable section 197 intangible unless P had a section 754 election in effect for its taxable year in which the transfer of the partnership interest to C occurred or the taxable year in which the deemed liquidation of P occurred.
>
> (iii) Under section 197, if P had a section 754 election in effect, C is treated as if the new partnership had acquired two assets from P immediately preceding its termination. Even though the adjusted basis of the new partnership in the two assets is determined solely under section 723, because the transfer of assets is a transaction described in section 721, the application of sections 743(b) and 754 to P immediately before its termination causes P to be treated as if it held two assets for purposes of section 197. See paragraph (g)(3) of this section. B's and C's proportionate share of the new partnership's adjusted basis is $25 each in one asset, which continues to be amortized over the 10 years remaining in the original 15-year amortization period. For the other asset, C's proportionate share of the new partnership's adjusted basis is $25 (the amount of the basis increase resulting from the application of section 743 to the sale or exchange by A of the interest in P), which is amortized over a new 15-year period beginning in January 2000.
>
> (iv) If P did not have a section 754 election in effect for its taxable year in which the sale of the partnership interest by A to C occurred or the taxable year in which the deemed liquidation of P occurred, the adjusted basis of the new partnership in the amortizable section 197 intangible is determined solely under section 723, because the transfer is a transaction described in section 721, and P does not have a basis increase in the intangible. Under section 197(f)(2) and paragraph (g)(2)(ii) of this section, the new partnership continues to amortize the intangible over the 10 years remaining in the original 15-year amortization period. No additional amortization is allowable with respect to this asset.

[4311] In proposing regulations that T.D. 8717 (5/8/1997) finalized, [PS-5-96], Termination of a Partnership under Section 708(b)(1)(B), stated:

> In addition, the proposed regulations will not change the effect of a termination on the depreciation of partnership property by the new partnership. Property deemed contributed to the new partnership will continue to be subject to the anti-churning provisions of section 168(f)(5), which generally require the new partnership to depreciate the property as if it were newly-acquired property under the same depreciation system used by the terminated partnership. This result is required by statute and is not affected

method for accounting for book-tax differences when depreciating assets.[4312] The terminating partnership cannot depreciate any assets it places in service during the termination year;[4313] rather the new partnership depreciates them, including receiving bonus depreciation[4314] for any assets placed in service during the termination year.[4315]

- For purposes of certain procedures regarding changing accounting methods, a technical termination constitutes cessation of a trade or business.[4316]

- The new partnership retains the old partnership's tax ID.[4317] Each of the old and new partnership files a short period return, with the new partnership filing a return for its taxable year beginning after the date of termination of the terminated partnership.[4318]

Contrast this with a corporation (whether or not an S election is in place). It is not deemed to terminate when its shareholders change, although a change in shareholders could impair the use of net operating losses, etc.[4319]

II.Q.8.e.v. Partnership Mergers

For partnership mergers, see IRS Notice 2005-15 and any related proposed regulations.[4320] For an overview of mergers, with helpful charts and diagrams, see

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> by the specific mechanics of a termination under section 708(b)(1)(B). See Code sections 168(f)(5); 168(i)(7); 168(e)(4) and (f)(10)(repealed 1986).

Code § 168(i)(7) provides that the transferee steps into the shoes of the transferor when depreciating an asset to which Code § 332, 351, 361, 721, or 731 applies. However, Code § 168(i)(7)(B) provides that this rule does not apply in the case of a partnership's termination under Code § 708(b)(1)(B). By negative implication, such a termination restarts the depreciation period. See McKee, Nelson & Whitmire, ¶ 13.05[2][k] Effect on Depreciation of Partnership Property, *Federal Taxation of Partnerships & Partners* (WG&L).

4312 Reg. § 1.704-3(a)(2).

4313 Reg. § 1.168(d)-1(b)(3)(ii) includes:

> No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year.

4314 See part II.G.4 Code § 179 Expensing Substitute for Depreciation; Bonus Depreciation.

4315 Reg. § 1.168(k)-1(b)(5)(iii).

4316 See Section 3.04(2)(f) of Rev. Proc. 2015-13, the other provisions of which Rev. Proc. 2015-33 clarified. Lovett, "Technical Termination of LLCs and Partnerships: Overview, Mechanics and Opportunities," *TM Real Estate Journal* (BNA) (2/1/2017), suggests that the termination's closing the tax year will require that two separate installments of a prior Code § 481(a) adjustment be taken into account in one calendar year.

4317 Reg. § 301.6109-1(d)(2)(iii); see also the Example in Reg. § 1.708-1(b)(4).

4318 Notice 2001-5.

4319 Code § 382.

4320 See also CCA 201315026. RIA Checkpoint *Catalyst*, ¶ 218:111 Merger or Consolidation of Partnerships, described a ruling:

> In IRS Letter Ruling 201619001, a real estate investment trust (REIT) formed a partnership (OP), then transferred cash and its own stock to the partnership in exchange for a partnership interest. A second partnership (M) then transferred all of its assets to OP in exchange for OP partnership interests and the REIT stock. M then liquidated, distributing the REIT stock to some of its partners and the OP partnership interests to the remaining partners. The IRS ruled that the transaction was a merger of OP and M under Reg. § 1.708-1(c). IRS Letter Ruling 201619001.

Borden, "Navigating State Law and Tax Issues Raised by Partnership and LLC Reorganizations," *Business Entities* (Jul./Aug. 2014), suggesting using an "assets-over" form to preserve basis or holding period and an "assets-up" type to change basis or holding period.[4321] Below are some details.

If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50% in the capital and profits of the resulting partnership.[4322] Generally, if this resulting partnership can be considered a continuation of more than one of the merging or consolidating partnerships, it shall be considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership, and any other merging or consolidating partnerships shall be considered as terminated.[4323] However, if the members of none of the merging or consolidating partnerships have an interest of more than 50% in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.[4324]

The taxable years of any merging or consolidating partnerships which are considered terminated shall be closed in under Code § 706(c) the regulations thereunder, and those partnerships shall file their returns for a taxable year ending upon the date of merger or consolidation.[4325] Any resulting partnership shall file a return for the taxable year of the merging or consolidating partnership that is considered as continuing.[4326]

A merger is an "assets-over" merger unless it as an "assets-up" merger.[4327] In an "assets-up" merger, the merged or consolidated partnership that is considered terminated as described above distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership, and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.[4328] The form of such a partnership merger or consolidation will

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Comment: In IRS Letter Ruling 201619001, M was formed immediately before the merger as the result of the division of a third partnership (X) into two separate partnerships. The IRS respected the form of the transaction as a division followed by a merger. The apparent purpose of this form was to permit the partners of X receiving REIT stock (who were also partners of M after the division) as having sold their partnership interests in M to OP under Reg. § 1.708-1(c)(4) (see ¶ 218:114) For further discussion, see Substance Over Form Exception in ¶ 218:113.

[4321] For a description of the two types of transactions, see part II.Q.8 Exiting From or Dividing a Partnership, especially part II.Q.8.d.iii Assets-Over vs. Assets-Up Division.

[4322] Reg. § 1.708-1(c)(1).

[4323] Reg. § 1.708-1(c)(1).

[4324] Reg. § 1.708-1(c)(1).

[4325] Reg. § 1.708-1(c)(2).

[4326] Reg. § 1.708-1(c)(2), which also provides that the resulting partnership shall keep its original taxpayer identification number and include certain tax disclosures.

[4327] Reg. § 1.708-1(c)(3)(i).

[4328] Reg. § 1.708-1(c)(3)(ii).

be respected for federal income tax purposes despite the partners' transitory ownership of the terminated partnership's assets.[4329]

When two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law, without undertaking a form for the merger or consolidation, or undertake a form for the merger or consolidation that is not an assets-up merger, any merged or consolidated partnership that is considered terminated is treated as undertaking the assets-over form for Federal income tax purposes.[4330] Under the assets-over form, the merged or consolidated partnership that is considered terminated contributes (or is treated as contributing) all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.[4331]

Code §§ 704(c)(1)(B) and 737 and Reg. §§ 1.704-4 and 1.737-2 do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in Code § 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.[4332] A later distribution of Code § 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to Code § 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to Code § 704(c)(1)(B).[4333] Similarly, a later distribution of property by the transferee partnership to a partner of the transferee partnership that was formerly a partner of the transferor partnership is subject to Code § 737 to the same extent that a distribution from the transferor partnership would have been subject to Code § 737.[4334]

In an assets-over merger, a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership that occurs as part of a merger or consolidation will be respected as a sale of a partnership interest if the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold, and if the selling partner in the terminated partnership, either before or at the same time as the transaction, consents to treat the transaction as a sale of the partnership interest.[4335]

[4329] Reg. § 1.708-1(c)(3)(ii).
[4330] Reg. § 1.708-1(c)(3)(i).
[4331] Reg. § 1.708-1(c)(3)(i).
[4332] Reg. §§ 1.704-4(c)(4), 1.737-2(b)(1).
[4333] Reg. § 1.704-4(c)(4).
[4334] Reg. § 1.737-2(b)(3).
[4335] Reg. § 1.708-1(c)(4), referring to Code § 741 and Reg. § 1.741-1 for determining the selling partner's gain or loss on the sale or exchange of the partnership interest; see part II.Q.8.e.ii.(b) Character of Gain on Sale of Partnership Interest. Letter Ruling 201619001 (described in fn. 4320) respected a sale under Reg. § 1.708-1(c)(4), when the contribution agreement relating to a merger will specify (i) that the partnership is purchasing its interest in another partnership from each particular partner in the purchasing partnership and (ii) the consideration that is transferred for each interest purchased.

When merging, consider whether any relief of debt or other actual or deemed distributions within two years might constitute a disguised sale. See part II.M.3.e Exception: Disguised Sale. However, some divisions might be taxable to the extent that they rely on Code § 721(a) nonrecognition.[4336]

The IRS expects to issue regulations, effective for distributions from partnerships made after January 19, 2005, providing the following regarding Code § 704(c) gain and reverse-Code § 704(c) gain:[4337]

> The regulations will apply the principles of Rev. Rul. 2004-43 to distributions of property following assets-over partnership mergers. The regulations will apply to distributions of property with newly created § 704(c) gain or loss whether or not that gain or loss is treated as reverse § 704(c) gain or loss as the result of a revaluation by the transferor partnership. The regulations also will apply to distributions of property with original § 704(c) gain or loss that existed upon contribution to the transferor partnership. However, the regulations will provide that if the transferor partnership in an assets-over merger holds contributed property with original § 704(c) gain or loss, the seven year periods in §§ 704(c)(1)(B) and 737 do not restart with respect to that gain or loss as a result of the merger.
>
> The regulations will provide that § 704(c)(1)(B) does not apply to newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In addition, the regulations will provide that for purposes of § 737, net precontribution gain does not include newly created § 704(c) gain or loss in property contributed by the transferor partnership to the continuing partnership in an assets-over partnership merger involving partnerships owned by the same owners in the same proportions. In order for merging partnerships to qualify for the exceptions described in this paragraph, each partner's percentage interest in the transferor partnership's capital, profits, losses, distributions, liabilities, and all other items must be the same as the partner's percentage interest in those items of the continuing partnership.

The survivor of merged partnerships may want to see whether it qualifies for special Code § 704(c) accounting for securities partnerships.[4338]

[4336] If a foreign person is directly or indirectly involved, see the discussion of when Code § 721(a) does not apply to any deemed contribution to a partnership in part II.M.3.g Exception: Foreign Partner (among various other exceptions to Code § 721(a).

[4337] Notice 2005-15. Query whether the regulations would be retroactive, given all of the time that has passed. For a description of reverse-Code § 704(c) allocations, see part II.Q.8.b.i.(e) Code §§ 704(c)(1)(B) and 737 – Distributions of Property When a Partner Had Contributed Property with Basis Not Equal to Fair Market Value or When a Partner Had Been Admitted When the Partnership Had Property with Basis Not Equal to Fair Market Value, especially fns. 3932-3935.

[4338] See fn. 2796 (especially Letter Ruling 201710008), found in part II.P.1.a.i Allocations of Income in Partnerships.

When two or more partnerships merge or consolidate in an assets-over merger, increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger under the Code § 752 rules allocating liabilities to partners and determining whether a change in liabilities constitutes a distribution or contribution.[4339] For more information, see part II.C.3 Allocating Liabilities (Including Debt).

If any merger described above is part of a larger series of transactions and the substance of the larger series of transactions is inconsistent with following the form prescribed above, the IRS may disregard the form and recast the larger series of transactions according to their substance.[4340]

II.Q.9. Trust Selling a Business

See parts:

- II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets,
- II.J.15 QSST Issues That Affect the Trust's Treatment Beyond Ordinary K-1 Items, and
- II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.

See also parts:

- II.I.8.e NII Components of Gain on the Sale of an Interest in a Partnership or S Corporation,
- II.I.8.d.iv Treatment of Code § 736 Redemption Payments under Code § 1411, and

[4339] Reg. § 1.752-1(f).

[4340] Reg. § 1.708-1(c)(6)(i), providing the following example in Reg. § 1.708-1(c)(6)(ii):

> A, B, and C are equal partners in partnership ABC. ABC holds no section 704(c) property. D and E are equal partners in partnership DE. B and C want to exchange their interests in ABC for all of the interests in DE. However, rather than exchanging partnership interests, DE merges with ABC by undertaking the assets-up form described in paragraph (c)(3)(ii) of this section, with D and E receiving title to the DE assets and then contributing the assets to ABC in exchange for interests in ABC. As part of a prearranged transaction, the assets acquired from DE are contributed to a new partnership, and the interests in the new partnership are distributed to B and C in complete liquidation of their interests in ABC. The merger and division in this example represent a series of transactions that in substance are an exchange of interests in ABC for interests in DE. Even though paragraph (c)(3)(ii) of this section provides that the form of a merger will be respected for Federal income tax purposes if the steps prescribed under the assets-up form are followed, and paragraph (d)(3)(i) of this section provides a form that will be followed for Federal income tax purposes in the case of partnership divisions, these forms will not be respected for Federal income tax purposes under these facts, and the transactions will be recast in accordance with their substance as a taxable exchange of interests in ABC for interests in DE.

- II.I.8.g Structuring Businesses in Response to 3.8% Tax.

II.R. Choice of Entity Hypothetical

Alice, Ben and Connie want to form a business manufacturing and selling widgets. They have been friends for many years. Even though they consider themselves family, technically they are not related to each other.

Alice is a natural at sales. She has many contacts and could sell any product that she believes is beneficial to the customer. Alice is terrific at selling not only to potential customers but also potential investors.

Ben is great at putting together and running organizations. He always knows what is going on in the business, tracking current progress, making short-term and long-term financial projections, and keeping everyone focused on the company's goals. Ben is talented at securing financing and making investors feel comfortable that they are receiving accurate information.

Connie is a creative genius. She has scientific knowledge, engineering skills, and a keen mind for how to make machines and manufacturing and packaging processes work. Connie will enable the company to be a low cost producer for generic products and to efficiently tailor manufacturing processes to fit special customer needs.

Initial Formation - Year 1

Connie came up with a revolutionary widget that every household should have, and Alice has informally discussed with various retailers how they might help market the product. Ben has arranged a $1,000,000 bank loan, but the bank is going to make Alice, Ben and Connie personally guarantee loan repayment. Alice, Ben and Connie have agreed to take no compensation the first year, $50,000 each the second year, and then see where the business is headed. The business requires a $500,000 machine, as well as five employees to run it, initially under Connie's supervision. The business leases its space.

How should they set up their deal in Year 1?

Types of entities: sole proprietorships, partnerships, C corporations and S corporations. Business ownership and management structure. Tax on formation. Allocating gain when entity later sells contributed property. Ability to deduct losses: basis and at-risk limitations; net operating losses at entity vs. shareholder level; Code § 1244 stock. Allocating gain and loss from ongoing operations; tax distribution clauses. Self-employment/FICA tax: partnership vs. limited partnership vs. S corporation vs. C corporation.

Outside Investors - Year 2

Due to additional capital needs to take the business to the next level, Alice has been working on securing two investors who would put up capital of $250,000 each. They seek an annual preferred return of 20%, as well as one-fifth each of the business' residual value.

How should they bring in the investors? What governance/approval mechanisms would the investors want to protect themselves?

Tax on later contribution to entity. Allocation of income from operations, including preferred returns and, if taxed as a partnership, disguised sale issues. Restrictions on shareholders (S corporations).

Buying Out Outside Investors - Year 5

In Year 5, the business is earning $600,000 per year net profit, after paying $100,000 annual compensation to each of Alice, Ben and Connie. Alice, Ben and Connie are not getting along with the outside investors and want to buy them out. They believe the business will continue to expand and do not wish to share this growth with the investors when the company is later sold, and they are tired of paying a 20% return to the investors.

How should Alice, Ben and Connie go about buying out the investors? How would the form of organization affect this?

Structurally, it would require an agreement on the part of the investors to be bought out. The founders could have an option built into the original financing arrangements allowing them to buy back at certain formula, or upon certain triggers. Discuss dispute resolution mechanisms as well as buy-out options. Contrast S corporation or C corporation buy-out with after-tax dollars with LLC buy-out with pre-tax dollars under Code § 736, which can eliminate capital gain tax on part or all of the complete liquidation of an LLC member's interest.

Bigger Workforce; Family Business Succession Planning - Year 10

In Year 10, the business is earning $2,000,000 net profit, after paying $250,000 annual compensation to each of Alice, Ben and Connie. It has full sales and manufacturing forces and excellent office support, for a total of 50-100 employees. Everyone loves these new widgets; Connie keeps finding ways to improve the product; and Alice keeps finding new customers. Ben, however, is tired of trying to keep up with their unbridled energy. Ben's son, George, just received an MBA from a leading business school. Ben thinks that George should take over Ben's job and would like to transfer some of his equity to him. Alice and Connie agree to let George work his way into the business, getting experience in various office functions and eventually moving up to Ben's job in five years if George works out well.

How should they handle George's new role and Ben's phasing out of his own role? What if George turns out to be a slacker?

Estate planning issues: tax rates and exemption levels, ability to make gifts, transferring business opportunities or leveraged businesses, asset protection planning using trusts, passing to spouse and children, fair vs. equal, dividing into voting and nonvoting ownership interests, need for single class of equity interest (consider nonvested stock), and estate tax issues with related party buy-sell agreements. Alice, Ben and Connie want to institute some kind of nonqualified deferred compensation plan for themselves. Develop simple performance bonus for George, payable within 2½ months after close of year with no option for deferral. Important to set goals based on where Alice, Ben and

Connie want George to be in five years. If George turns out to be a slacker, he gets no bonus. When Ben wants to transfer some of his shares to George, consider the issues of restrictions on transfer, rights of first refusal, etc.

Purchase of Retiring Founder's Interest; Business Succession Planning to Current Key Employee - Year 15

In Year 15, Alice gets bored. She wants to sell her share of the business to Ben, George and Connie and retire to a tropical island, along with the main characters in John Grisham's first two books. Sally, an employee who has been a top salesman for years, wants to take Alice's job. However, Sally has no money to invest to buy out Alice. Furthermore, Sally wants some financial incentives based on the company's sales and profitability.

Should the company, the other owners, or Sally buy out Alice? What kind of incentives should Sally be given?

Availability of capital gain rates when entity sells assets. Tax on splitting up or dissolving. Code § 736 payments. Consider phantom shares or restricted stock for Sally. George needs to be ahead of Sally because he is the son of the founder and, in his mind, the heir apparent. Include George in same plan developed for Sally. Also see issues from Year 10.

Purchase of Deceased Founder's Interest, Including Possible Sale of Business - Year 20

In Year 20, Connie dies. The stresses of keeping up with changing technology and foreign competition left her exhausted.

How should the remaining owners handle buying out Connie's ownership interest, which under her estate plan would pass to her husband, Herman?

Instead, should they sell the business? To the employees or to outside investors? Possible merger?

What if the remaining owners prefer to retire, turning the business over to the employees?

Estate tax deferral. Restricted stock (or phantom stock) immediately vested. Also see issues from Year 15.

III. Estate Planning Implications

The first section of this portion deals with drafting and administering trusts and estates, including income taxation and fiduciary responsibility. The second section deals with transfer tax issues, including transfers during life, estate tax issues, and special valuation issues (including the effect of buy-sell agreements). The third section discusses fairness within families, including allocating assets when businesses are involved and potential conflicts of interest involved in those allocation decisions.

The AICPA has Trust, Estate and Gift Tax Resources.[4341]

III.A. Drafting and Administering Trusts and Estates

Drafting trusts to hold business interests involves melding the grantor's wishes with the related income tax consequences, especially when holding stock in S corporations. Trustees need to consider diversifying, but when a special purpose of the trust is to hold a business interest, the trustees will want to make sure that the businesses are professionally run in a manner that is both economically sound for the beneficiaries but also minimizes the trustees' liability.

III.A.1. General Benefits of Trusts

Increasingly, people are becoming aware of the need to protect their assets from claims by creditors or spouses. Clients can do a big favor for their surviving spouses or children by leaving assets in trust instead of outright. The trust agreement can provide them with virtually complete control over the trust. Or, if clients wish, the trust agreement could be very restrictive. It all depends on what they want.

For example, a wife leaves her entire estate outright to her husband upon her death. They orally agree that he will leave her remaining assets to their children at his death. Unfortunately, that's a moral, not a legal, agreement. Suppose the husband remarries after the wife's death. Under Missouri law, upon his death, his new spouse would have the right to about 1/3 of his estate. This would be contrary to the clients' originally agreed goal of having all of their assets pass to their children at her death.

What about estate taxes? A credit shelter trust can protect future appreciation from estate tax, for those concerned about it. Lawyers can include various options to attain basis step-up through selective estate inclusion, to the extent it later turns out to be beneficial.

Clients can avoid these problems and reduce or avoid estate tax by leaving their property in trust for the surviving spouse. If they wish, the surviving spouse can be the sole trustee, take distributions for support as the surviving spouse determines, and change how the trust's assets pass at the surviving spouse's death to take into account changes in their children's family circumstances. Because the assets are in a trust the first spouse created, if the second spouse remarries, the new spouse would not have a claim on them upon the second spouse's death. Because the first spouse used his or her estate tax exclusion amount to create the trust, it will be excluded from the surviving spouse's estate at the surviving spouse's death, and the surviving spouse can use his or her exclusion amount to cover the assets that the surviving spouse owned outside of that trust.

What about leaving assets to children? Even adult children may need protection from creditors and spouses. Suppose a child starts a new business. The child's creditors will demand personal guarantees. If the client leaves assets to the child outright, they would

[4341] See http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TRUSTESTATEANDGIFT/Pages/default.aspx.

be at risk. Likewise, if the child marries, the child's spouse might persuade the child to put the money in a joint account. If the child later divorces, the child will need to split this account with the soon-to-be ex-spouse.

When I asked a client whether he liked the idea of trusts for his children, he told me about his neighbor. The neighbor bought a house for his daughter and her husband. The house was titled jointly in their names. When the daughter divorced, the neighbor bought his ex-son-in-law's half so that the daughter could own the house outright. In other words, the neighbor paid for his daughter's house one and a half times!

Clients can avoid these, and other (special needs trusts), problems by leaving your property in a separate trust for each child. If the client wishes, his or her child can be the sole trustee of the child's trust, take distributions to support the child as the child determines, and change how the trust's assets pass at the child's death. The child might even be able to pass the trust's assets free from estate tax, even if the child's separate assets use up the estate tax exclusion amount.

I often authorize an independent person to make unlimited distributions to the beneficiary, to facilitate tax planning or decanting.

Many states now allow trusts to last forever. However, flexible drafting can let each generation change the rules for the next.

By using trusts, we can help clients protect their families from predators. We can also build in flexibility to allow them to react to changes that nobody can foresee, so that we can help clients give their families a legacy that they might enjoy forever.

III.A.2. Liability Issues

In most states, trusts may hold interests in general partnerships or sole proprietorships only if the governing instrument or a state statute grants the trustee authority to do so, because of the liability risks involved. Even investments in limited liability entities may be considered too risky unless they have a proven track record. The propriety of an authorized investment in a closely-held business is determined by applying the same standard of care as for other assets.[4342]

Under the Uniform Prudent Investor Act (UPIA), [4343] a trustee "shall invest and manage trust assets as a prudent investor would by considering the purposes, terms, distribution requirements, and other circumstances of the trust;" and in making such decisions, the trustee "shall exercise reasonable care, skill and caution."[4344] Additionally, a trustee's investment and management decisions regarding individual assets are to be evaluated with respect to the trust portfolio as a whole and "as part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[4345] While making investment decisions and managing trust assets, the trustee should consider

[4342] See generally, Bogert, *The Law of Trusts and Trustees*, § 679 (Rev. 2d. Ed. 1982).
[4343] Citations to the Uniform Prudent Investor Act (UPIA) are to the version adopted in 1994, published April 18, 1995, by the National Conference of Commissioners on Uniform State Laws.
[4344] UPIA §2(a).
[4345] UPIA §2(b).

factors such as general economic conditions, tax consequences, the role of the asset in the overall trust portfolio, and the expected return from the asset.[4346] Perhaps the most important factor to be considered is the asset's special relationship or value to the purposes of the trust or to one or more of the beneficiaries, when the special purpose of the trust is to hold a business interest.[4347] This factor ties in with the UPIA's other requirement that the trustee diversify the trust investments unless special circumstances indicate the trust's purposes would be better served without diversification.[4348] Thus, when the trust's specific purpose is to hold a business interest, a lack of diversity in the assets of the trust will not run afoul of the UPIA's requirements. Finally, the UPIA imposes a "duty of impartiality" when the trust has more than one beneficiary. The trustee is to act impartially in performing his or her duties and in doing so should take into account any differences in the beneficiaries' interests. For example, the trustee has to consider any potential conflicts between the interests of beneficiaries interested in trust income versus those interested in trust principal.[4349] This duty of impartiality will affect the trustee's investment and management conduct with regard to principal and income allocations – especially with regard to tax burden allocations.

The Uniform Trust Code (UTC)[4350] provides default rules governing the trustee's duties and powers, but allows for many of those rules to be modified by terms of the trust.[4351] Among those duties are the duty of loyalty and the duty of impartiality among beneficiaries, a duty identical to the UPIA's duty of impartiality.[4352] With regard to the duty of loyalty, the trustee must act in furtherance of the best interests of the beneficiaries. Specifically, when the trust holds a business interest, the trustee has a duty to vote shares and use proper care to promote beneficiary interests; and when the trust is the sole owner of an entity, the trustee should elect or appoint a director or manager to manage the entity in the best interests of the beneficiaries.[4353] In a corporate context, the trustee must vote for corporate directors who will follow policy consistent with the trustee's duty of impartiality. The UTC also emphasizes that when a trustee has special skills or expertise in an area, he or she should use those skills in managing the trust.[4354] In recognition of the trustee's ability to hold business interests, the UTC gives the trustee the power to continue business and take actions that would be taken by shareholders, members, or property owners and allows the trustee to exercise rights of an absolute owner with respect to stocks or other securities.[4355] One might consider including a provision addressing the compensation a person earns as trustee, as a director, and as an officer or other employee of the company – who makes the payments and how do the payments relate to each other. These duties might conflict with the corporate directors' duties to *all* the shareholders.

[4346] UPIA §2(c) .
[4347] UPIA §2(c)(8).
[4348] UPIA §3.
[4349] UPIA § 6.
[4350] Citations to the Uniform Trust Code are to the version adopted in 2004, as amended or revised in 2005, published March 7, 2005, by the National Conference of Commissioners on Uniform State Laws.
[4351] UTC §105.
[4352] UTC §802, §803.
[4353] UTC §802(g).
[4354] UTC §806.
[4355] UTC §816(6), (7).

With regard to partnership interests specifically, National Banks may find it difficult to hold a partnership interest. The Office of the Comptroller of the Currency (OCC) regulates these banks and has stated that, as a general partner, a bank's liability is not limited to the principal of a particular account, but that it would object to a bank investing in general partnerships unless local law limited the bank's liability.[4356] As a limited partner, a bank usually would not have a say in the management of the assets. When a bank does hold a limited partnership interest, the OCC will not object if such investment is authorized by the governing instrument, local law or by written consent of account beneficiaries. Additionally, the bank would still be subject to the prudent investment standard, and the investment would have to meet the objective of the entity to match the outsider's offer.[4357] Distributions are mandatory, but the person controlling the entity may establish reasonable reserves.

Some people give the donee the right to sell the interest to the donee for cash equal to the appraised value, which right lasts 15-45 days – whatever the practitioner feels is similar to what would be a reasonable period within which to exercise *Crummey* rights.[4358]

III.A.3. Trusts Holding Stock in S Corporations

Estates, including not only decedents' estates but also bankruptcy estates, are qualified shareholders during a reasonable period of administration.[4359]

The rest of this part III.A.3 deals with trusts.

III.A.3.a. Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures

A wholly owned grantor trust is among the types of trusts that can hold stock in an S corporation. For a description of the types of trusts that qualify, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

Below are discussions of what types of trusts can qualify as wholly owned grantor trusts, what it means to be "wholly" owned, how a trust can fall short, and what step an S corporation should take to avoid a trust falling short if it is at risk for doing so.

[4356] Note that a partnership may register as a limited liability partnership (LLP) to limit the general partner's liability. When a limited partnership registers as an LLP, it might be called a limited liability limited partnership (LLLP).

[4357] If a right of first refusal contains a fixed price instead of just the right to match the offering price, and that fixed price is less than the offering price, failure to exercise that right generally would constitute a gift. Letter Ruling 9117035.

[4358] *Crummey v. Commissioner*, 397 F.2d 82, (9th Cir. 1968); see *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991) (reviewed decision approving annual exclusion for gifts to grandchildren who had *Crummey* rights exercisable for 15 days and otherwise had only contingent remainder interests); *Mikel v. Commissioner*, T.C. Memo. 2015-64 (sustaining annual exclusion for withdrawal rights provided to 60 beneficiaries; alternative dispute resolution process did not prevent beneficiaries from having enforceable rights).

[4359] Code §§ 1361(b)(1)(B), 1361(c)(3); Reg. §§ 1.1361-1(b)(1)(ii), 1.1361-1(b)(2).

III.A.3.a.i. Qualifying as a Wholly Owned Grantor Trust

This part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures discusses a trust that qualifies as a shareholder solely because all of the trust is treated under the grantor trust rules as owned by an individual who is a citizen or resident of the United States.[4360] If a trust has more than one deemed owner but they have substantially separate and independent shares, the trusts are treated as separate trusts[4361] and may separately qualify as wholly owned grantor trusts.[4362]

[4360] Implementing Code § 1361(c)(2)(A)(i), Reg. § 1.1361-1(h)(1)(i) provides:

> *Qualified subpart E trust*. A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock.

[4361] Implementing the flush language at the end of Code § 1361(d)(3), Reg. § 1.1361-1(j)(3) includes:

> For purposes of sections 1361(c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust.

[4362] In approving a community property trust as an eligible shareholder before and after divorce, Letter Ruling 9729025 held:

> Under the trust agreement, H and W retain the power to revoke TR and revest the trust's property in themselves. Therefore, H and W are treated, under section 676, as the owners of TR until their divorce. Because TR is treated as owned entirely by H and W between d2 and d3, TR is a trust described in section 1361(c)(2)(A)(i).
>
> Under section 663(c) and section 1.663(c)-1(a) of the Income Tax Regulations, shares of a single trust are treated as separate trusts if the trust has more than one beneficiary and the different beneficiaries have substantially separate and independent shares. Section 1.663(c)-3 provides that the applicability of the separate share rule generally depends upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an instrument directs a trustee to divide the trust estate into separate shares for each beneficiary and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income or to do both, separate shares will exist under section 663(c).
>
> Upon the dissolution of H's and W's marriage, the community property held by TR (including the X stock) was divided equally on the trustee's books and each half was treated as the separate property of H and W. As a result, H was entitled to all of the income from his separate share of the trust property and so much of the principal as he directed. Likewise, W was entitled to all of the income from her separate share of the trust property and so much of the income as she directed. Therefore, H's and W's shares of TR are substantially separate and independent shares within the meaning of section 663(c).

I am not sure that I agree with the logic of why the trust qualified while they were married, although ultimately the result was probably correct. The ruling points out that Code § 1361(c)(1) treats spouses as one shareholder for purposes of Code § 1361(b)(1)(A). However, the ruling determined eligibility under Code § 1361(c)(2)(A)(i), so presumably applying the spousal unity rule for purposes of Code § 1361(b)(1)(A) would not have been relevant to the ruling. Therefore, in case the ruling's spousal unity reasoning was incorrect, consider having any community property trusts held as separate and independent shares during life.

If not a foreign trust,[4363] such a grantor trust automatically qualifies as an S corporation shareholder,[4364] and the trust's deemed owner is treated as the shareholder for all tax purposes,[4365] including the 100-shareholder limitation.[4366]

A revocable trust would qualify as a grantor trust taxed to its grantor.[4367] An irrevocable trust might qualify as a grantor trust taxed to the grantor under the normal rules of Code §§ 671-677, to the beneficiary under Code § 678, or to the beneficiary through a QSST election made by the beneficiary.

A trust might be taxable to a beneficiary under Code § 678 if the beneficiary has a withdrawal right with respect to all gifts to the trust (a *Crummey* trust);[4368] whether such withdrawal rights impair spendthrift protection requires additional analysis.[4369] Examples of Code § 678 trusts include:

- Grantor creates a "vested" trust for a grandchild, as follows: The grandchild can withdraw the entire gift and all earnings on the gift. This withdrawal right lapses in full after a reasonable interval. The grandchild is the sole beneficiary during his or her life and has a general power of appointment upon death. For income tax purposes, one may treat the trust as deemed owned 100% by the beneficiary.[4370] The gift qualifies for the annual exclusion.[4371] For estate tax purposes, the trust is includible in the beneficiary's estate.[4372] If and to the extent that the gift qualifies for the annual exclusion, the gift is also exempt for generation-skipping transfer (GST) purposes, without using any GST exemption.[4373] If and to the extent that the lapse exceeds the greater of $5,000 or 5% of the trust's assets (subject to coordination

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4363 Reg. § 1.1361-1(h)(2) precludes a foreign trust, as defined in Code § 7701(a)(31), from holding stock, even it otherwise would qualify as a shareholder.
4364 Code § 1361(c)(2)(A)(i).
4365 Code § 671. Grantor trusts may use their deemed owners' social security numbers as their taxpayer identification numbers. Reg. § 1.671-4(b)(2)(A). However, a QSST must file Form 1041 and attach a statement of the items treated as having been received directly by its beneficiary. Reg. § 1.671-4(b)(6). One might consider filing Form 1041 for other grantor trusts as well to get the statute of limitations running on grantor trust treatment.
4366 Code § 1361(c)(2)(B)(i).
4367 Code § 676.
4368 See discussion of IRS Letter Rulings in 730-2nd T.M., S corporation*s: Formation and Termination*, II.E.1.b(3), and in *Federal Income Taxation of S corporations* ¶ 3.03[10] (4th ed., Warren, Gorham & Lamont). A trustee-beneficiary's power to make distributions to himself under an ascertainable standard might make the trustee-beneficiary a Code § 678 owner to the extent of that distributions would be authorized under that standard. Letter Rulings 8211057 and 200747002 (Code § 678(a)(2) lapse followed by the beneficiary-trustee being able to make distributions to himself under an ascertainable standard was sufficient to allow the trust to hold stock in an S corporation). For more details, see part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.
4369 See parts III.B.2.i.viii Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights.
4370 See parts III.B.2.i.vi Portion Owned When a Gift Over $5,000 is Made.
4371 For qualification of withdrawal rights for the annual exclusion and whether an interest in a business entity qualifies for the annual exclusion, see part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers, especially the paragraph accompanying fn. 4775.
4372 Code § 2041(a)(2).
4373 Code § 2642(c).

with other lapses by that beneficiary),[4374] the beneficiary has made an incomplete gift[4375] and for GST purposes becomes the transferor;[4376] however, because the trust is included in the beneficiary's estate for estate tax purposes, the beneficiary's GST exemption needs to be allocated upon death anyway.

- Grantor makes a gift of less than $5,000 to the trust[4377] and later sells stock in an S corporation to the trust.[4378]

- Decedent bequeaths to a trust over which the beneficiary holds an unlimited withdrawal right, making the trust taxable to the beneficiary under Code § 678(a)(1), building in features that would trigger Code § 678(a)(2) after the withdrawal rights lapse.[4379]

Note that the settlor's grantor trust powers trump any beneficiary's grantor trust powers.[4380]

A beneficiary may also be treated as the owner by making a "QSST" election[4381] to have the grantor trust rules apply. See part III.A.3.e.i QSSTs.

III.A.3.a.ii. How a Trust Can Fall Short of Being Wholly Owned by One Person

If a person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus.[4382] However, for a trust to meet the wholly owned grantor trust rules, one person must be the deemed owner of both income and principal.[4383]

4374 Code § 2514(e).
4375 Reg. 25.2511-2(b).
4376 See Reg. § 26.2652-1(a)(5), Example (5).
4377 See part III.B.2.i.v Funding the Trust with Small Gifts.
4378 See part III.B.2.i.iv Sale to a Beneficiary Grantor Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives.
4379 See part III.B.2.i.vii Funding the Trust with a Large Initial Gift or Bequest.
4380 Code § 678(b).
4381 Code § 1361(d)(1). If the beneficiary dies and the trust continues, with another beneficiary stepping into his or her place, the QSST election remains in place, Reg. § 1.1361-1(j)(9); but, if the trust terminates by reason of the beneficiary's death, then a new QSST election must be filed. Reg. § 1.1361-1(j)(9)(ii), Example (2). One might consider including a clause that, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to Reg. § 1.1361-1(j)(9)(ii), Example (1).
4382 Reg. § 1.671-3(b).
4383 Code § 1361(c)(2)(A)(i). Letter Ruling 200226006 held that a trust that was partly a nongrantor trust and partly a grantor trust did not satisfy this rule, even though the grantor trust portion was created by contributing S corporation stock and the nongrantor portion was created by contributing other assets. (Generally I would recommend separating grantor and nongrantor trusts anyway; the facts in that letter ruling were particularly problematic in that the trust appears to be partially a GST-exempt trust and partially a Code § 2036 trust.) This ruling is consistent with Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 4470, which is found in part III.A.3.e.i.(a) QSSTs Generally). Letter Ruling 200942020 approved an irrevocable grantor trust as an S corporation shareholder when it had multiple *Crummey* power holders, holding that

If the grantor's spouse is a beneficiary, the trust is not necessarily deemed wholly owned,[4384] so an additional grantor trust power might be advisable.[4385] The trust might very well cease qualifying as a wholly-owned grantor trust upon separation or divorce,[4386] so that an ESBT election might be necessary after divorce or separation.[4387]

If a trust qualifies as being deemed wholly owned by the beneficiary, consider what might happen if the provision upon which the beneficiary's deemed ownership is based includes some ambiguity.[4388] Also, if the beneficiary does not have a withdrawal right over every gift to the trust and over the income and gains generated by each such gift or if the beneficiary has a withdrawal right that lapses in an incorrect manner, the trust might not be deemed wholly owned by the beneficiary.[4389]

III.A.3.a.iii. Steps an S Corporation Might Take to Avoid a Trust Falling Short of Being a Wholly-Owned Grantor Trust

An S corporation might insist that certain protective measures be taken in case a trust falls short of being deemed wholly owned by one person.

If the trust is intended to be deemed owned wholly by the beneficiary, the beneficiary might file a QSST election, just in case the trust is not deemed wholly owned by the beneficiary. A beneficiary cannot elect QSST treatment if the grantor is taxed as the owner; however, a beneficiary make elect QSST treatment if the beneficiary is taxed as the owner.[4390] However, the beneficiary might not want to make the QSST election during any time when the trust is buying stock from the beneficiary, because a QSST election complicates the purchase and might make the process of getting the value of the stock out of the beneficiary's estate take twice as long.[4391]

For a trust deemed owned by its settlor (or a trust deemed owned by its beneficiary where QSST status is undesirable to impractical), the trust might file an ESBT election, just in case the trust is not a wholly-owned grantor trust taxable to only one person. Although estate planners commonly rely on swap powers, they are not foolproof.[4392] A

Code § 678(b) caused the grantor's deemed owner status to trump the beneficiaries' deemed owner status.

4384 Letter Ruling 201208013.

4385 See part III.B.2.h How to Make a Trust a Grantor Trust.

4386 See fn. 4470, discussing how Reg. § 1.1361-1(k)(1), Example (10), applies Code § 682 to a trust owning stock in an S corporation.

4387 See parts III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation (especially part III.A.3.b.v An Electing Small Business Trust) and III.A.3.e.ii.(a) Qualification as an ESBT.

4388 See part III.B.2.i.xi Dealing with Code § 678(a)(2) Uncertainty.

4389 See part III.B.2.i.vi Portion Owned When a Gift Over $5,000 is Made.

4390 Reg. § 1.1361-1(j)(6)(iv).

4391 See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).

4392 Whether a swap power is effective depends on the facts and circumstances, as described in Reg. § 1.675-1(b)(4)(iii). Part III.B.2.h.ii Swap Power quotes this regulation and describes why estate planners do not mind relying on it as the sole grantor trust feature. Letter Ruling 9548013 held (highlighting added):

> Based upon the facts and representations you submitted, we conclude that A will be treated as the owner of TR1 and B will be treated as the owner of TR2 provided that the District Director determines that the circumstances indicate that A and B hold the power

grantor trust may make an ESBT election.[4393] However, grantor trust treatment trumps ESBT taxation.[4394] That doesn't mean that the ESBT election is not technically in effect[4395] - it just means that the election has no current income tax consequences.

These protective measures are not necessarily beneficial to anyone other than the S corporation:

- A grantor trust can use regular income taxation for the first two years after the grantor's death and get more favorable income tax treatment as a regular trust.[4396] Obtaining that more favorable income tax treatment is why one might not want to make an ESBT election when one creates an irrevocable grantor trust.

- Some grantor trusts might qualify as a QSST or an ESBT upon termination of grantor trust status.[4397] The regulations limit how often one can switch back and forth between QSST and ESBT status. Initially making the ESBT election means that, after switching to a QSST once, the trust must wait 36 months before switching back to a QSST or later back to an ESBT again. Absent the initial ESBT election, the beneficiary could make a QSST election upon termination of grantor trust status and later switch to ESBT status with waiting 36 months.

If the sole risk to being wholly owned is the separation or divorce of a beneficiary from the grantor, an irrevocable grantor trust that includes the grantor's spouse as a beneficiary might provide that separation or divorce terminates the spouse's interest. That provision might avoid the need for an ESBT election upon which the S corporation otherwise might have required.

III.A.3.a.iv. Why to Be Extraordinarily Sensitive to Protecting the S Election

Some people point to the generous relief the IRS provides for inadvertent terminations and decide that going to great lengths to protect the S election is not necessary.[4398]

However, a buyer might be very sensitive to the S election's validity, particularly in a stock sale that is treated as an asset purchase.[4399] Fixing any problems that the buyer's tax counsel perceives to exist (whether or not the problem actually exists) can delay a

of administration over the entire corpus of their respective trusts in a nonfiduciary capacity. Therefore, A and B will be considered the owners of their respective trusts until their deaths, the termination of the trusts, or they release their administrative power, whichever comes first.

To protect an S election against an adverse finding by the District Director, one might want the additional protection that an ESBT election provides.

4393 Reg. §§ 1.1361-1(m)(2)(v) (general approval for grantor trust to make an ESBT election), 1.1361-1(m)(8), Example (3) (Code § 678 trust may make an ESBT election).

4394 Reg. § 1.641(c)-1(c). A partial grantor trust is illustrated in Reg. §1.641(c)-1(*l*), Example (1).

4395 A trust may not make a protective ESBT election. Reg. § 1.1361-1(m)(2)(v) (the same regulation that allows grantor trusts to make ESBT election).

4396 Code § 1361(c)(2)(A)(ii). See Code § 641(c) for ESBTs' unfavorable income tax treatment.

4397 See part III.A.3.e.iv Flexible Trust Design When Holding S Corporation Stock.

4398 See part III.A.3.c.iii.(b) Flowchart Showing Relief for Late QSST & ESBT Elections and the related discussion preceding that.

4399 See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.

transaction, during which time other issues might arise that might cause the seller to lose a sale to a strategic buyer at a premium price. I became much more aware of this issue when a transaction worth hundreds of millions of dollars faced a possible delay due to an issue caused by prior counsel and I was asked to obtain a private letter ruling to fix it; I was able to get a private letter ruling in only six weeks from the date of submission, but until I did the client was very nervous about the six-month delay projected by those who insisted on the PLR. If I had not been able to get the PLR that quickly (which I have no assurance of being able to replicate) and that deal had cratered, I wonder what the repercussions would have been to prior counsel and then realized that any of us could be in that situation someday if there is even the slightest concern.

A solution that may satisfy the buyer (but does not cure the seller's S corporation problem) involves moving all of the corporation's assets into a single member LLC, which can be done using state law conversion/merger statutes and then selling that LLC.[4400] That solution may address other issues as well.[4401]

III.A.3.b. Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation

To qualify as S corporation shareholders for any length of time,[4402] generally[4403] an irrevocable trust must either be a grantor trust or an electing small business trust (ESBT). Planning to avoid the 3.8% tax on net investment income[4404] requires additional planning regarding participation in the business; it may be advisable to have the trustee materially participate even if the trust is a grantor trust.[4405]

If not a foreign trust,[4406] any of the trusts described below may be a shareholder. See also part III.B.2.j.ii.(e) Change in Qualification of Trust to Hold S Corporation Stock During Taxable Year, which is part of part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[4400] See fns. 4293-4294 in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[4401] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold, especially fns. 4286-4291.
[4402] Trusts can qualify as S shareholders by electing to be taxed as an estate under Code § 645 (which election has a limited duration under Code § 645(b)(2)), by being a continuation of a grantor trust under Code § 1361(c)(2)(A)(ii), or a testamentary trust under Code § 1361(c)(2)(A)(iii) – for the latter, see part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.iii A Trust With Respect To Stock Transferred To It Pursuant To The Terms Of A Will, But Only For The 2-Year Period Beginning On The Day On Which Such Stock Is Transferred To It.
[4403] A voting trust does not have time limits on how long it is an eligible shareholder under Code § 1361(c)(2)(A)(iv).
[4404] See part II.I 3.8% Tax on Excess Net Investment Income (NII).
[4405] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.
[4406] Reg. § 1.1361-1(h)(2) precludes a foreign trust, as defined in Code § 7701(a)(31), from holding stock, even it otherwise would qualify as a shareholder.

III.A.3.b.i. A Trust All Of Which Is Treated Under The Grantor Trust Rules As Owned By An Individual Who Is A Citizen Or Resident of the United States

See part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures.

III.A.3.b.ii. A Trust That Was A Grantor Trust With Respect To All Of Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death

Code § 1361(c)(2)(A)(ii). This includes a former QSST.[4407] Generally, such a trust is an eligible shareholder only for the 2-year period beginning on the day of the deemed owner's death. It does not include a trust that did not own the stock during the deemed owner's life and received the stock pursuant to the terms of a will,[4408] which is subject instead to the time period described in part III.A.3.b.iii A Trust With Respect To Stock Transferred To It Pursuant To The Terms Of A Will, But Only For The 2-Year Period Beginning On The Day On Which Such Stock Is Transferred To It. However, if the trust is subject to an election under Code § 645,[4409] then the trust is taxed as an estate and can hold the stock during the entire period during which the trust is taxable as an

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[4407] Reg § 1.1361-1(j)(7)(ii) provides:

> If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, is not a qualified subpart E trust, and does not qualify as an ESBT, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. During the period that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. If, after the 2-year period, the trust continues to hold S corporation stock and does not otherwise qualify as a permitted shareholder, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

[4408] Regs. §§ 1.1361-1(k)(1), Example 3, paragraph (i), provides:

> *2-year rule under section 1361(c)(2)(A)(ii) and (iii)*. F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 2003. The trust continues in existence after F's death but is no longer a qualified subpart E trust. On August 1, 2003, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which the trust could be treated as a permitted shareholder of Corporation P is July 31, 2005 (that is, the last day of the 2-year period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which the trust could be treated as a permitted shareholder of Corporation O is June 30, 2005 (that is, the last day of the 2-year period that begins on the date of F's death).

[4409] See part II.J.7 Election to Treat a Revocable Trust as an Estate.

estate.[4410] Whether the trust qualifies as a former grantor trust or as an estate, the grantor's estate is treated as the owner for purposes of the 100-shareholder limitation.[4411]

Note that, if the grantor's gross estate (for federal estate tax purposes) might be subject to estate tax, it is common for the trustee to hold the S stock for more than two years after the grantor's death. This is done to avoid the trustee incurring personal liability under the tax laws, because a final determination of estate tax might not be made until after the two-year period has expired. Therefore, the trustee should consider making a Code § 645 election, as described in the preceding paragraph.

Suppose S corporation stock a trust held at its deemed owner's death was transferred upon that death to two trusts created by the agreement that created the original trust. Would those trusts be treated as continuations of the original grantor trust under Code § 1361(c)(2)(A)(ii)? Letter Ruling 201709016[4412] assumed, without explanation, that the answer is "yes." Given that trust law treats the new trusts as separate trusts and legal title was transferred from the original trust, the former grantor trust does not appear to have continued its existence as to the transferred shares, so I would not rely on that assumption when planning.

Even when keeping the S corporation stock in such a trust or estate is permitted, doing so might come at an income tax cost. If the S corporation does not distribute all of its income, part or all its income might be taxed at the highest rate.[4413] One might save significant annual income taxes by distributing the S corporation stock to one or more QSSTs, each of which is taxed at its beneficiary's income tax rate (without regard to how much cash the S corporation distributes),[4414] which might be significantly lower. However, if estate tax is or might be due, consider the risks that the executor takes in distributing property before estate tax is paid in full.[4415]

For additional cash flow issues relating to a trust that was a grantor trust before the deemed owner's death, see also part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

III.A.3.b.iii. A Trust With Respect To Stock Transferred To It Pursuant To The Terms Of A Will, But Only For The 2-Year Period Beginning On The Day On Which Such Stock Is Transferred To It

Code § 1361(c)(2)(A)(iii). In such a case, the testator's estate is treated as an owner for purposes of the 100-shareholder limitation.[4416] Because a revocable trust that has made

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4410 Regs. §§ 1.1361-1(k)(1), Example 3, paragraph (ii) and 1.645-1(e)(2)(i); Letter Ruling 200529006.
4411 Code § 1361(c)(2)(B)(ii).
4412 In Letter Ruling 201709016, the two successor trusts qualified as QSSTs, but no QSST election was made within two years after the original deemed owner's death. The ruling allowed late QSST elections to be made, retroactive to two years after the original deemed owner's death.
4413 See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.
4414 See part III.A.3.e.i.(a) QSSTs Generally.
4415 See generally III.B.3.c.iv Federal Estate Tax Liens.
4416 Code § 1361(c)(2)(B)(iii).

a Code § 645 election is treated as an estate, any transfer from that estate by reason of termination of the election or by bequest under that revocable trust is treated as transferred pursuant to the terms of a will.[4417]

III.A.3.b.iv. A Trust Created Primarily To Exercise The Voting Power Of Stock Transferred To It

Code § 1361(c)(2)(A)(iv). In such a case, each beneficiary of the voting trust is treated as the owner for purposes of the 100-shareholder limitation.[4418]

To qualify as a voting trust, the beneficial owners must be treated as the owners of their respective portions of the trust under the grantor trust rules, and the trust must have been created pursuant to a written trust agreement entered into by the shareholders, that:[4419]

(A) Delegates to one or more trustees the right to vote;

(B) Requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on behalf of, the beneficial owners of that stock;

(C) Requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

(D) Terminates, under its terms or by state law, on or before a specific date or event.[4420]

Let's explore the requirement that the beneficial owners be treated as the owners of their respective portions of the trust under the grantor trust rules.[4421] This is automatic for the settlors of the trust,[4422] but not automatic when the settlors transfer their beneficial interests (voting trust certificates) to others. One treatise suggests making the beneficiaries entitled to distributions, but that might not satisfy the requirement that the trust agreement require payment of distributions to the beneficiaries; therefore, one might consider giving the beneficiaries the right to withdraw any distributions the trust receives from the S corporation, followed by a requirement that the trustee pay to the beneficiaries any such distributions.[4423] It has also been suggested that the voting trust

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[4417] Reg. § 1.1361-1(h)(1)(iv)(B).
[4418] Code § 1361(c)(2)(B)(iv).
[4419] Reg. § 1.1361-1(h)(1)(v).
[4420] I am not aware of any authoritative interpretation of on or before a specific date or event. Presumably the trust might provide that the trust terminates when it holds no voting stock or perhaps when each individual in a named list of people has died.
[4421] Reg. § 1.1361-1(h)(1)(v)(C). If the beneficiary originally transferred the stock to the trust, then it is a grantor trust under Code § 677. Otherwise, the trust needs to qualify as an investment trust; see part II.D.4.a Investment Trusts, which also describes the income tax consequences when a voting trust that is an investment trust sells stock. This regulation was adopted by TD 8600 (7/20/1995). For the IRS' interpretation before then, see Letter Ruling 9344020.
[4422] Code § 677(a) combined with Reg. § 1.1361-1(h)(1)(v)(B).
[4423] When the beneficiary has the right to withdraw such distributions, Code § 678(a)(1) would treat the beneficiary as the owner. After that withdrawal right has lapsed, the IRS' Letter Ruling position would support a position that Code §§ 678(a)(2) and 677(a) would treat the beneficiary as the owner.

might qualify as an investment trust, in which case a transferee would be treated as a grantor and therefore the trust would automatically qualify.[4424]

III.A.3.b.v. An Electing Small Business Trust

Code § 1361(c)(2)(A)(v). In such a case, each potential current beneficiary of the trust is treated as the owner for purposes of the 100-shareholder limitation.[4425] The 100-shareholder limitation is made less severe by a family attribution rule, treating a person, his or her spouse, and his or her descendants as one shareholder.[4426] A charitable

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[4424] See part II.D.4.a Investment Trust. Letter Ruling 201226019 approved this approach, holding:

1. During the lives of A and B and after their deaths, Voting Trust will be classified as an investment trust under § 301.7701-4(c) for U.S. federal income tax purposes.
2. During the lives of A and B (assuming they are the only holders of the Certificates during their lives), Voting Trust will be considered a qualified voting trust under § 1361(c)(2)(A)(iv) and § 1.1361-1(h)(1)(v). Accordingly, Voting Trust will be a permitted S corporation shareholder. If, during their lives, A or B transfer all or a portion of their Certificates to a transferee that is a permitted S corporation shareholder, the transferee will be treated as a successor grantor of the Voting Trust. Therefore,
   (i) Voting Trust will continue to be a voting trust described in § 1361(c)(2)(A)(iv) and a permitted S corporation shareholder, and
   (ii) the Certificate holders will include in their gross income and report their proportionate share of the S corporation income that is allocated to the Company shares held by the Voting Trust.
3. After the death of A or B, when the executor of their respective Wills (the Executor) holds the Certificates held by A or B, as applicable, prior to their deaths, A's and B's respective estates (if the period during which such estates hold the Certificates does not exceed the period actually required to fully administer the estates as described in § 1.641(b)-3(a)) will be treated as successor grantors of the Voting Trust. After the Executor distributes the Certificates held by A or B in accordance with the terms and provisions of their estate planning documents, as applicable, such transferees of the Certificates will be treated as successor grantors of their portions of the Voting Trust. Therefore,
   (i) Trust will continue to be a voting trust described in § 1361(c)(2)(A)(iv) and a permitted S corporation shareholder, and
   (ii) the Certificate holders will include in their gross income and report their proportionate share of the S corporation income that is allocated to the Company shares held by the Voting Trust.

[4425] Code § 1361(c)(2)(B)(v) applied in Reg. § 1.1361-1(m)(4)(vii). The 2017 tax reform act amended Code § 1361(c)(2)(B)(v) to make it not apply for purposes of Code § 1361(b)(1)(C), the latter which does not allow an S corporation to "have a nonresident alien as a shareholder." Thus, an ESBT may have a nonresident alien as a beneficiary, which makes sense because the trust is paying tax at the highest possible rate, notwithstanding having such a beneficiary.

[4426] Code § 1361(c)(1). see 2004 Blue Book (General Explanation of Tax Legislation Enacted in the 108th Congress), p. 189, footnote 321. Reg. § 1.1361-1(e)(3)(i) interprets the family attribution rule:

> *In general*. For purposes of paragraph (e)(1) of this section, stock owned by members of a family is treated as owned by one shareholder. Members of a family include a common ancestor, any lineal descendant of the common ancestor (without any generational limit), and any spouse (or former spouse) of the common ancestor or of any lineal descendants of the common ancestor. An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than six generations removed from the

remainder trust cannot own stock in an S corporation, so an ESBT election would not help it; instead, consider donating the stock to a charity in exchange for a charitable gift annuity, after considering unrelated business taxable income issues.[4427]

III.A.3.b.vi. Retirement Plans

Retirement plans are trusts, so let's discuss those for a moment. First, IRAs are qualified under Code § 408, not § 401(a). Therefore, IRAs are not eligible shareholders, as they are not trusts that qualify under these rules.[4428] Second, qualified retirement plans are eligible shareholders[4429] but are taxed on unrelated business taxable income,[4430] including ***all*** income from S corporations, whether or not it normally constitutes unrelated business income.[4431] However, employee stock ownership plans (ESOPs) are not subject to this tax.[4432] Furthermore, transitory ownership by an IRA of S corporation stock rolled over from an IRA will not terminate the S election.[4433]

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youngest generation of shareholders who would be members of the family determined by deeming that individual as the common ancestor. For purposes of this six-generation test, a spouse (or former spouse) is treated as being of the same generation as the individual to whom the spouse is or was married. This test is applied on the latest of the date the election under section 1362(a) is made for the corporation, the earliest date that a member of the family (determined by deeming that individual as the common ancestor) holds stock in the corporation, or October 22, 2004. For this purpose, the date the election under section 1362(a) is made for the corporation is the effective date of the election, not the date it is signed or received by any person. The test is only applied as of the applicable date, and lineal descendants (and spouses) more than six generations removed from the common ancestor will be treated as members of the family even if they acquire stock in the corporation after that date. The members of a family are treated as one shareholder under this paragraph (e)(3) solely for purposes of section 1361(b)(1)(A), and not for any other purpose, whether under section 1361 or any other provision. Specifically, each member of the family who owns or is deemed to own stock must meet the requirements of sections 1361(b)(1)(B) and (C) (regarding permissible shareholders) and section 1362(a)(2) (regarding shareholder consents to an S corporation election). Although a person may be a member of more than one family under this paragraph (e)(3), each family (not all of whose members are also members of the other family) will be treated as one shareholder. For purposes of this paragraph (e)(3), any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by that individual, and any eligible foster child of an individual (within the meaning of section 152(f)(1)(C)), shall be treated as a child of such individual by blood.

4427 See part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity.

4428 Reg. § 1.1361-1(h)(1)(vii), which became final on August 13, 2008, provides that individual retirement accounts (including Roth IRAs) are not eligible S corporation shareholders, unless they satisfy the exception created in Code § 1361(c)(2)(A)(vi) for bank stock that was held by the IRA as of October 22, 2004. That regulation is extremely unlikely to be challenged as, for various reasons, a reviewed opinion of the Tax Court concluded that IRAs, including Roth IRAs, were not eligible shareholders before that regulation was promulgated. *Taproot Administrative Services, Inc. v. Commissioner*, 133 T.C. 202.

4429 Code § 1361(c)(6)(A), referring to organizations described in Code § 401(a).

4430 Code § 511(a)(1), 501(a).

4431 Code § 512(e)(1).

4432 Code § 512(e)(3).

4433 Rev. Proc. 20014, Section 4 provides:

III.A.3.b.vii. Charitable Trusts

Charities are permitted shareholders.[4434] The S corporation's business activities are not attributable to the charity in determining the nature of the charity's activities, which means that a lot of S corporation business income does not destroy the charity's otherwise exempt status.[4435]

III.A.3.b.viii. Observations About Trusts As S Corporation Shareholders

The shareholder agreement does not need to specify these trusts, as the reference to causing the corporation not to be a "small business corporation" as defined in Code § 1361(b)(1) should be sufficient to limit which kinds of trusts may be owners without going into all the detail described above. However, when preparing shareholders' estate plans, make sure the beneficiaries of the estate plans qualify.

III.A.3.c. Deadlines for Trust Qualifying as S Corporation Shareholder

Below are some flowcharts illustrating trust qualification as a shareholder of an S corporation. The flowcharts do not consider trusts that are tax-exempt.

The Service will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock where the participant directs that such stock be distributed to an IRA in a direct rollover, provided that:

.01. The terms of the ESOP require that the S corporation repurchase the stock immediately upon the ESOP's distribution of the stock to an IRA;

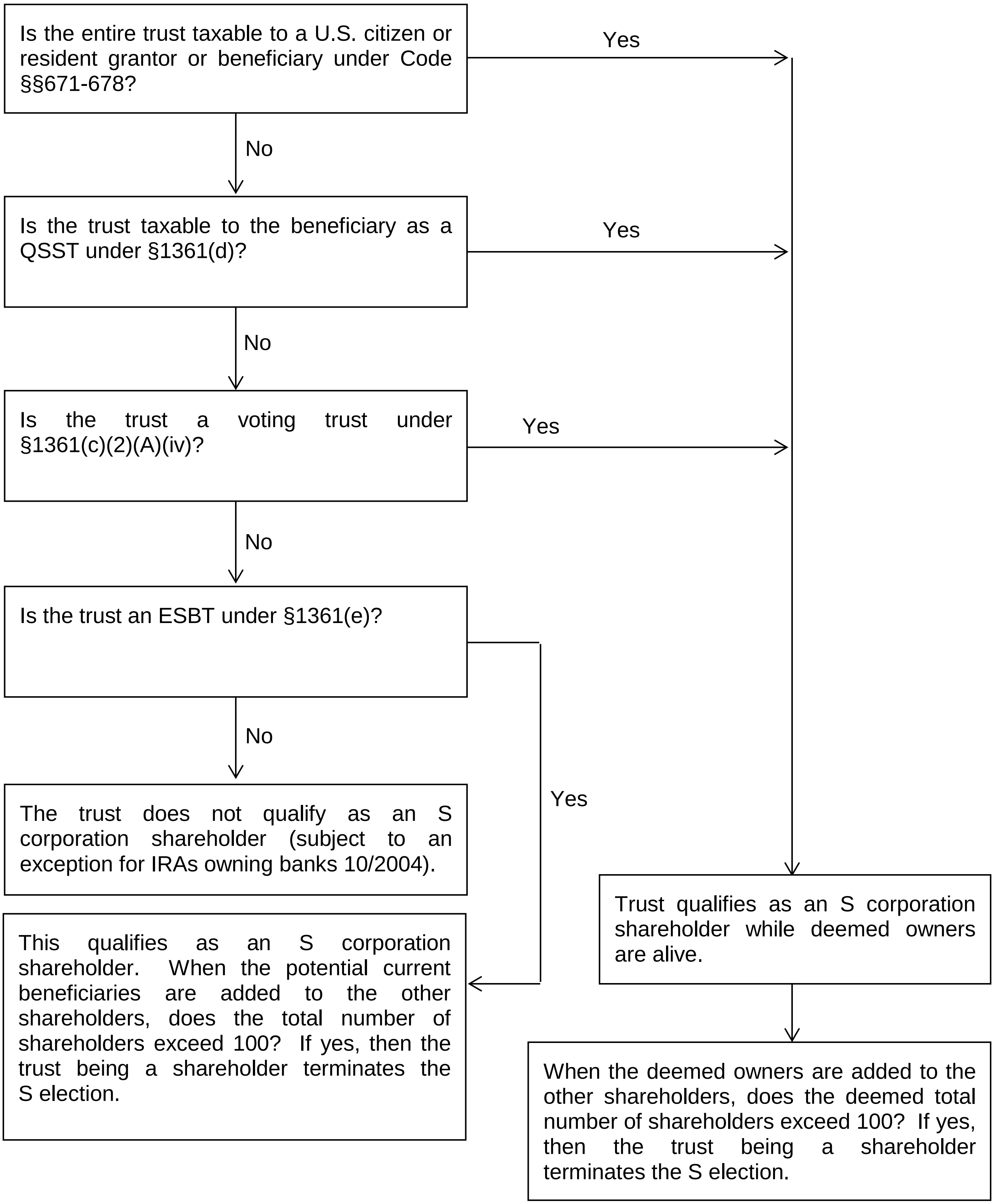
.02. Either, pursuant to the terms of the ESOP, the S corporation actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution, or, pursuant to the terms of the ESOP, the ESOP is permitted to assume the rights and obligations of the S corporation to repurchase the S corporation stock immediately upon the ESOP's distribution of the stock to an IRA and the ESOP actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution; and

.03. No income (including tax-exempt income), loss, deduction, or credit attributable to the distributed S corporation stock under § 1366 is allocated to the participant's IRA.

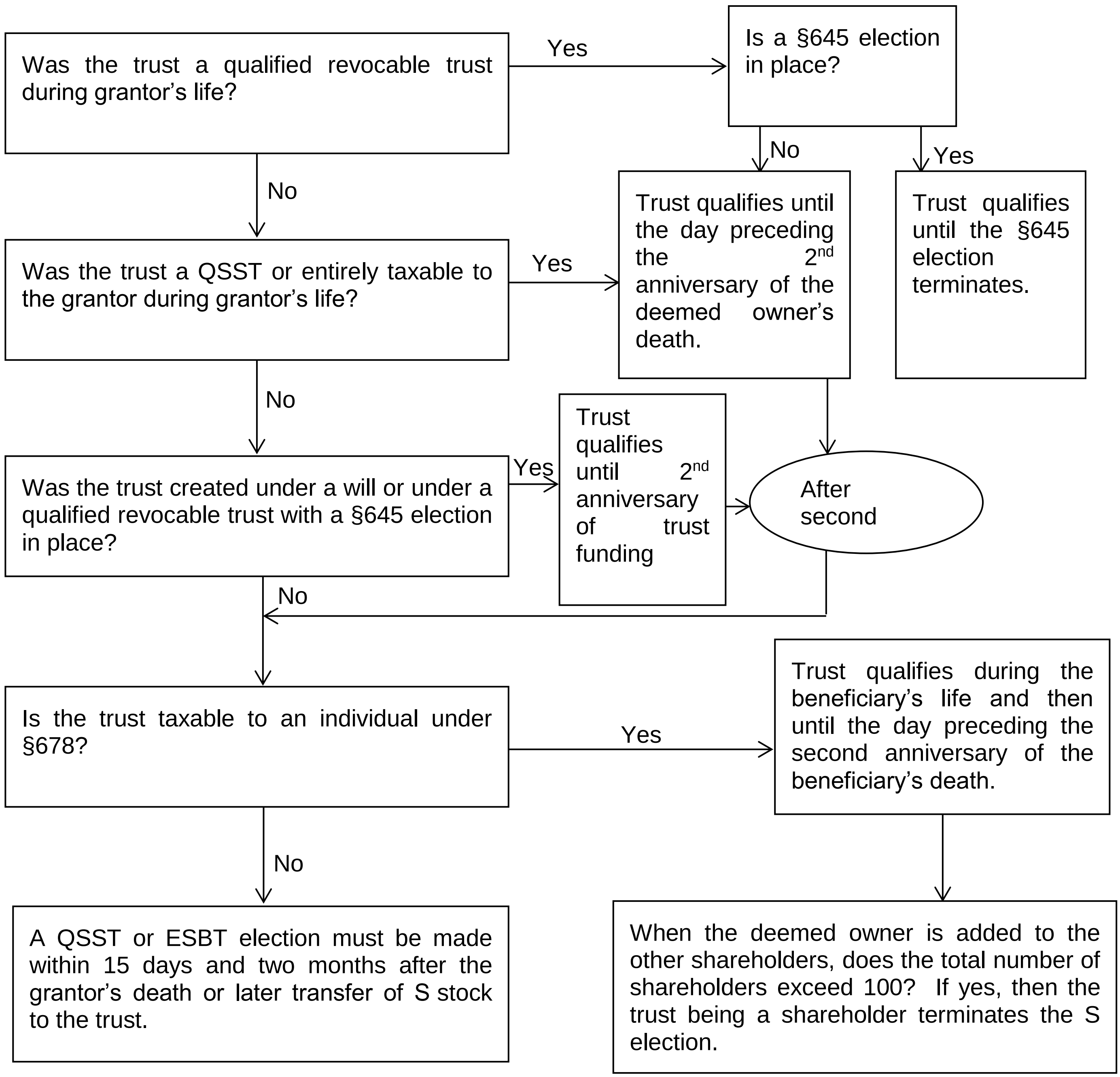
[4434] Code § 1361(c)(6) provides that an organization, which not only is described in Code § 401(a) or 501(c)(3) but also is exempt from taxation under Code § 501(a), may be a shareholder in an S corporation.

[4435] Letter Ruling 201441018.

III.A.3.c.i. Flowchart of Inter Vivos Trusts (Trusts Created while Grantor is Alive)



III.A.3.c.ii. Flowchart of Testamentary Trusts (Trusts Created on Grantor's Death or Continued after QSST Beneficiary's Death)



III.A.3.c.iii. Deadlines for QSST and ESBT Elections

III.A.3.c.iii.(a). General Description of Deadlines for QSST and ESBT Elections

A separate QSST election must be made with respect to each S corporation in which the trust owns stock.[4436] Although initially an ESBT election needs to be filed at every IRS Service Center that receives the returns of the S corporations the trust owns, no future ESBT elections are required when the trust acquires stock in another S Corporation.[4437]

The beneficiary must make a QSST election no later than fifteen days and two months after the trust received the stock.[4438] The trustee of an ESBT must file the ESBT election within the same time framework.[4439] If the trust is a wholly owned grantor trust or meets some other exception allowing it to be an eligible shareholder,[4440] the deadline would be based on whenever the election's effective date is required or desired. If the trust is already an eligible shareholder and the QSST or ESBT election is made with an effective date that is later than when the trust first acquired the stock, when drafting the QSST or ESBT election I generally include the fact of that qualification when I say when the trust first acquired the stock, so that any IRS reviewer of the election will see that there does not appear to be any time gap in the trust's eligibility as a shareholder.

If an ESBT or QSST election is made late or is in some manner defective, the S corporation status can be retroactively reinstated if the termination or invalidity was inadvertent, within a reasonable period of time after discovery of the terminating event or invalid election steps were taken to rectify the situation, and the corporation and shareholders agree to adjustments that the IRS may require for the period;[4441] retroactive reinstatement is required to prevent the accumulated adjustments account (AAA) from being wiped out.[4442] The corporation and all persons who were shareholders of the corporation at any time during the period must consent to make to any adjustments that the IRS may require.[4443] Each consent should be in the form of a statement agreeing to make the adjustments:[4444]

4436 Reg. § 1.1361-1(j)(6)(i).

4437 Reg § 1.1361-1(m)(2)(i).

4438 Reg. § 1.1361-1(j)(6)(ii)(C). A QSST election by a person who is under a legal disability by reason of age may be made on that person's behalf by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent. Reg. § 1.1361-1(j)(6)(i).

4439 Reg. § 1.1361-1(m)(3)(i) provides that trust is an ESBT on the effective date of the ESBT election.

4440 See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

4441 Reg. § 1.1362-4(a).

4442 For AAA's importance, see part II.Q.7.b Redemptions or Distributions Involving S Corporations. For the idea that termination of the S election wipes out AAA, see part II.P.3.c.v Conversion from S Corporation to C Corporation then Back to S Corporation.

4443 Reg. § 1.1362-4(e). However, if relief under Rev. Proc. 2013-30 applies, Section 6.01(4) of that procedure requires:

> Statements from all shareholders during the period between the date the S corporation election was to have become effective or was terminated and the date the completed Election Form is filed that they have reported their income on all affected returns

- The statement must be signed by the shareholder and corporation.
- A shareholder's consent statement should include the name, address, and taxpayer identification numbers of the corporation and shareholder, the number of shares of stock owned by the shareholder, and the dates on which the shareholder owned any stock.
- The corporate consent statement should include the name, address, and taxpayer identification numbers of the corporation and each shareholder.

A late ESBT or QSST election may be made within 3 years and 75 days after the effective date of the election, without the $28,300 fee generally required for letter rulings under Code § 9100, illustrated by the following chart provided by the IRS:[4445]

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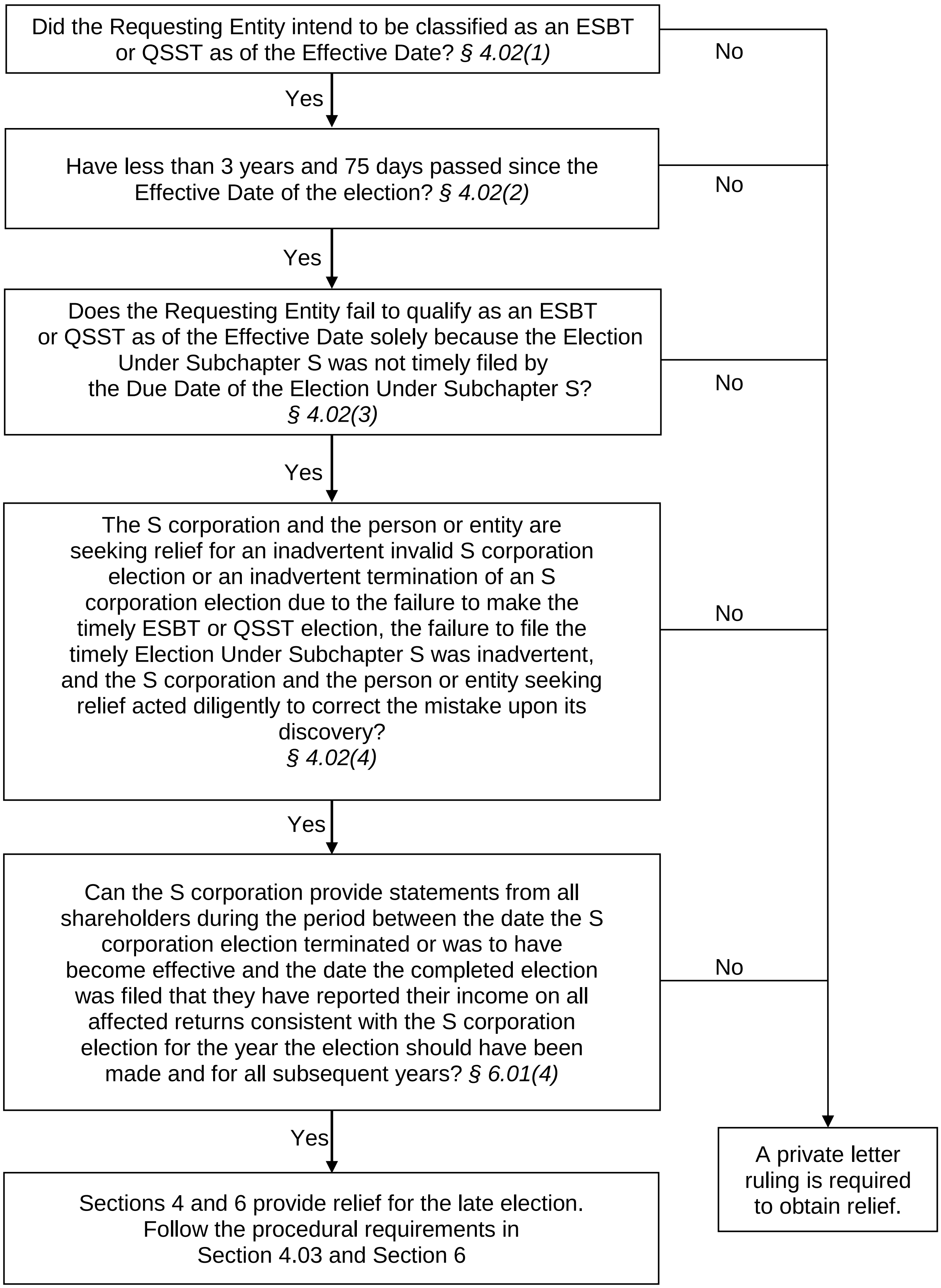
consistent with the S corporation election for the year the election should have been made and for all subsequent years.

Presumably, these statements are in lieu of consenting to adjustments. One might consider supplementing the statements by agreeing to make adjustments as required by Reg. § 1.1362-4(e), but supplementing the statements does not appear to be required. The relevant IRS web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.

[4444] Reg. § 1.1362-4(e).

[4445] Rev. Proc. 2013-30, modifying and superseding Rev. Procs. 2003-43, 2004-48, and 2007-62. One might consider checking the most recent annual Revenue Procedure for issuing letter rulings, the successor to Rev. Proc. 2016-1, for any updates to user fees and to verify the status of Rev. Proc. 2013-30. Also, some taxpayers might qualify for reduced user fees. The relevant IRS web page is https://www.irs.gov/businesses/small-businesses-self-employed/late-election-relief.

III.A.3.c.iii.(b). Flowchart Showing Relief for Late QSST & ESBT Elections



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III.A.3.d. Special Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests

III.A.3.d.i. Various Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests

If one bequeaths S corporation stock, consider expressly providing that any distributions with respect to that stock are to be passed on to the beneficiary receiving that stock. Not only does such a provision ensure fairness if the trust/estate administration lasts any significant amount of time, it also prevents a potentially unfair tax result from occurring, as described below.

A bequest of a partnership interest or S corporation stock that is "ascertainable under the terms of a testator's will as of the date of his death, or under the terms of an inter vivos trust instrument as of the date of the inception of the trust" is a specific bequest that does not count as a distribution that carries with it distributable net income;[4446] the "date of the inception" rule means that the exercise of an inter vivos limited power of appointment does not fall within this exception. On the other hand, income allocated to a beneficiary *does* count a distribution that carries with it distributable net income.[4447] The bequest of the partnership interest or S corporation stock does not constitute a separate share, but distributions bequeathed to the recipient of that business interest *do* constitute a separate share.[4448]

See parts III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation (especially part III.B.2.j.ii.(e) Change in Qualification of Trust to Hold S Corporation Stock During Taxable Year) and III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership.

The distributive share of partnership or S corporation income that does not constitute trust accounting income:[4449]

> is allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under the terms of the governing instrument or applicable local law. The amount of such gross income allocated to each share is based on the relative value of each share that could potentially be funded with such amounts.

4446 Reg. § 1.663(a)-1(b)(1), delineating items that qualify for the exclusion under Reg. § 1.663(a)-1(a). See Reg. § 1.663(a)-1(b)(3), Example (1).

4447 Reg. § 1.663(a)-1(b)(2)(i), defining items that do not qualify for the exclusion under Reg. § 1.663(a)-1(a).

4448 Reg. § 1.663(c)-5, Example (8). Reg. § 1.663(c)-4(a) provides:

> Separate shares include… the income on bequeathed property if the recipient of the specific bequest is entitled to such income …. Conversely, a gift or bequest … of property as defined in section 663(a)(1) is not a separate share.

4449 Reg. § 1.663(c)-2(b)(4), which applies to:

> the allocation of the portion of gross income includible in distributable net income that is not attributable to cash received by the estate or trust (for example, original issue discount, a distributive share of partnership tax items, and the pro rata share of an S corporation's tax items).

Tying together the separate share rules[4450] with the above rules regarding distributive shares of partnership or S corporation income, one can distill the following rules:[4451]

- DNI equal to undistributed income is allocated among the separate shares according to the amount of income to which each share is entitled.
- DNI equal to distributions from an S corporation or partnership constituting trust accounting income is allocated among the separate shares according to the amount

[4450] See generally part II.J.9.a Separate Share Rule.

[4451] Reg. § 1.663(c)-5, Examples (4) and (5) provide:

Example 4. (i) *Facts*. Testator, who dies in 2000, is survived by a spouse and one child. Testator's will provides for a pecuniary formula bequest to be paid in not more than three installments to a trust for the benefit of the child of the largest amount that can pass free of Federal estate tax and a bequest of the residuary to the surviving spouse. The will provides that the bequest to the child's trust is not entitled to any of the estate's income and does not participate in appreciation or depreciation in estate assets. During the 2000 taxable year, the estate receives dividend income of $200,000 and pays expenses of $15,000 that are deductible on the estate's federal income tax return. The executor partially funds the child's trust by distributing to it securities that have an adjusted basis to the estate of $350,000 and a fair market value of $380,000 on the date of distribution. As a result of this distribution, the estate realizes long-term capital gain of $30,000.

(ii) *Conclusion*. The estate has two separate shares consisting of a formula pecuniary bequest to the child's trust and a residuary bequest to the surviving spouse. Because, under the terms of the will, no estate income is allocated to the bequest to the child's trust, the distributable net income for that trust's share is zero. Therefore, with respect to the $380,000 distribution to the child's trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662. Because no distributions were made to the spouse, there is no need to compute the distributable net income allocable to the marital share. The taxable income of the estate for the 2000 taxable year is $214,400 ($200,000 (dividend income) plus $30,000 (capital gain) minus $15,000 (expenses) and minus $600 (personal exemption)).

Example 5. The facts are the same as in Example 4, except that during 2000 the estate reports on its federal income tax return a pro rata share of an S corporation's tax items and a distributive share of a partnership's tax items allocated on Form K-1s to the estate by the S corporation and by the partnership, respectively. Because, under the terms of the will, no estate income from the S corporation or the partnership would be allocated to the pecuniary bequest to child's trust, none of the tax items attributable to the S corporation stock or the partnership interest is allocated to the trust's separate share. Therefore, with respect to the $380,000 distribution to the trust, the estate is allowed no deduction under section 661, and no amount is included in the trust's gross income under section 662.

Example 6. The facts are the same as in Example 4, except that during 2000 the estate receives a distribution of $900,000 from the decedent's individual retirement account that is included in the estate's gross income as income in respect of a decedent under section 691(a). The entire $900,000 is allocated to corpus under applicable local law. Both the separate share for the child's trust and the separate share for the surviving spouse may potentially be funded with the proceeds from the individual retirement account. Therefore, a portion of the $900,000 gross income must be allocated to the trust's separate share. The amount allocated to the trust's share must be based upon the relative values of the two separate shares using a reasonable and equitable method. The estate is entitled to a deduction under section 661 for the portion of the $900,000 properly allocated to the trust's separate share, and the trust must include this amount in income under section 662.

of income to which each share is entitled.[4452] DNI equal to distributions from an S corporation or partnership not constituting trust accounting income would be allocated to each share according to "its portion of gross income that is includible in distributable net income and its portion of any applicable deductions or losses."[4453] Note that distributions from an S corporation or partnership that do not constitute trust accounting income but constitute gross income would constitute DNI only if they are (a) not from the sale of a capital asset,[4454] or (b) from the sale of a capital asset but satisfy the rules for including capital gain in DNI.[4455]

- Note that the amounts deducted by the trust or estate and included in the beneficiary's income are the lesser of the beneficiary's allocable share of DNI and the amount actually distributed.[4456] If and to the extent that the trust or estate does not make distributions (or is not required to make) to the beneficiary attributable to DNI, the distributive shares of partnership or S corporation income are trapped inside the trust or estate to the extent not distributed (or required to be made). Thus, the estate or trust is taxed on that income, even though the recipient of the specific bequest ultimately benefits from the undistributed income.

However, practical logistics might suggest not allocating distributions to the recipient of the specific bequest. It is not unusual for tax distributions to be made after yearend. For example, A dies January 31, 2016. The partnership or S corporation makes distributions April 1, 2016 to the owners to pay taxes incurred with respect to 2015 income. A's estate or revocable trust will need that cash to pay its 2015 tax that is due April 15, 2016. Therefore, if A's estate plan bequeathed the partnership or S corporation to B, B should be allocated all of the distributions with respect to the partnership or S corporation, other than distributions relating to 2015 tax and other than distributions relating to tax on income earned between January 1, 2016 and January 31, 2016. Furthermore, these distributions might also draw an allocation of DNI. Thus, consider a clause along these lines (after further thought if the specific bequest is to a QTIP trust):[4457]

> If any partnership interest or stock in any S corporation is specifically allocated to one or more persons, the person(s) entitled to the allocation shall also be entitled to any distributions from the date of the allocation until the date the partnership interest or stock is distributed; however, any distributions that were intended for the payment of tax imposed on taxable items with respect to periods before the

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[4452] Reg. § 1.663(c)-2(b)(2) provides that:

> gross income includible in distributable net income that is income within the meaning of section 643(b) … is allocated among the separate shares in accordance with the amount of income that each share is entitled to under the terms of the governing instrument or applicable local law.

For income under Code § 643(b), see part II.J.8.c.i Capital Gain Allocated to Income Under State Law; although focused on capital gain, it discusses Code § 643(b) generally as well.

[4453] Reg. § 1.663(c)-2(b)(1).

[4454] See part II.J.8.a Capital Gain Constitutes DNI Unless Excluded.

[4455] See part II.J.8.c.ii Capital Gain Allocated to Corpus but Treated Consistently as Part of a Distribution to a Beneficiary.

[4456] See part II.J.9.a Separate Share Rule, especially the text accompanying fns. 1949-1951.

[4457] If the specific bequest is to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

event that caused that allocation shall be paid to the person reporting those items.

Also note that state corporate law might not permit distributions using record dates (determining who is the shareholder of record) more than a certain number of days before the distribution. For example, Missouri law does not allow a corporation to make a distribution with a record date more than 70 days before the date of distribution.[4458] If these statutes apply, one might consider declaring a distribution in the form of a promissory note, the principal of which is any taxes, interest, and penalties imposed on the shareholders by reason of any examination of any prior year returns. This method might also be needed for taxes during the current year, depending on whether the tax laws allow the corporation to close its books as of the date of death. One might also consider converting the corporation into an LLC taxed as an S corporation using a tax-free reorganization,[4459] because LLC laws might not impose such a requirement.

III.A.3.d.ii. Special Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock to or from QSSTs

If the terminating trust is a QSST,[4460] coordinate these concerns with those found in part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, which also includes a reference to marital deduction issues relating to the payment of income.[4461]

If the trust terminates in favor of one or more QSSTs, consider whether, during post-mortem administration, part or all of the income might be trapped inside the trust at high income tax rates if the S corporation does not distribute all of the income shown on the K-1 that the corporation issues the trust.[4462] A similar issue arises for partnerships, which may be placed into one or more S corporations using a QSST strategy. Quickly funding the QSST(s) may tax the income at the beneficiary's rate instead of the trust's rate; see part III.A.4.a General Strategies Regarding Fiduciary Income Taxation of Business Interests.

III.A.3.e. QSSTs and ESBTs

III.A.3.e.i. QSSTs

After reviewing a variety of QSST issues that apply during the beneficiary's life, see part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

III.A.3.e.i.(a). QSSTs Generally

After determining a trust's eligibility for its beneficiary to make a "qualified subchapter S trust" (QSST) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections.

[4458] R.S.Mo. § 351.250.

[4459] See part II.P.3.i Change of State Law Entity without Changing Corporate Tax Attributes – Code § 368(a)(1)(F) Reorganization.

[4460] See part III.A.3.e.i QSSTs.

[4461] See fn. 4492.

[4462] See part III.A.4 Trust Accounting Income Regarding Business Interests, as well as parts II.J.11 Trust Business Income Tax Nuances and III.A.3.e QSSTs and ESBTs.

A QSST may have only one beneficiary[4463] (who also must be a U.S. citizen or resident) who may receive income or corpus during the beneficiary's lifetime, and all of its income[4464] must be distributed currently to that beneficiary[4465] while the trust[4466] holds

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[4463] Code § 1361(d)(3)(A) and Reg. § 1.1361-1(j)(1)(ii), (iii). A trust cannot qualify as a QSST if it provides that, if the trust does not hold shares of an S corporation, the trust may terminate during the life of the current income beneficiary and distribute its corpus to persons other than the current income beneficiary. Rev. Rul. 89-55. Consistent with this limitation, Reg. § 1.1361-1(j)(2)(iii) restricts powers of appointment:

> If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

Note, however, that failure to make a trust a spendthrift trust (and therefore allowing the beneficiary's interest to be assignable) will not disqualify the trust as a QSST unless it gets assigned (and then it might or might not disqualify the trust). Reg. § 1.1361-1(j)(2)(iv). On the other hand, Letter Ruling 9437021 viewed the possibility of distribution from the QSST to another trust for that same beneficiary as an error, but ruled that it was harmless error in that case because the recipient trust never existed and therefore could never receive a distribution (see also fn. 4465 regarding the distribution of income other than directly to the beneficiary); however, one might not want to assume that the IRS' national office will repeat this kind and gentle approach. Thus, one may need to avoid authorizing the merger or decanting of any trust that has a QSST election in place. For decanting, see fn. 1817, found in part II.J.4.i Modifying Trust to Make More Income Tax Efficient. However, the Uniform Trust Decanting Act allows decanting to be done by trust amendment rather than actual transfer of assets, in which case a QSST need not prevent decanting; for details on decanting by mere amendment, see fn. 1818, found in part II.J.4.i Modifying Trust to Make More Income Tax Efficient.

Also, the grantor trust treating a person other than the current income beneficiary as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock does not disqualify the trust from making a QSST election. Reg. § 1.1361-1(j)(2)(vi). Does that, by negative implication, suggest that the settlor (who is not the beneficiary) being treated as deemed owner of the portion of a trust that includes the S corporation stock precludes a QSST election? Reg. § 1.1361-1(j)(4) suggests that prohibition exists; Reg. § 1.1361-1(k)(1), Example (10), paragraph (iii) (reproduced in fn. 4470) confirms that result.

[4464] All of the trust's income, not just the income from the S stock, must be distributed or distributable currently. Letter Ruling 9603007. This refers to trust accounting income, not taxable income. Reg. § 1.1361-1(j)(1)(i). Letter Ruling 200446007 held that the amount of a deemed dividend under Code § 1361(d)(3)(B) was not required to be distributed. Letter Ruling 200451021 clarifies that, when Code § 302(d) taxes a partial liquidation as a distribution rather than as a redemption, the trust itself is not taxed on any income on the distribution if the trust has sufficient AAA to absorb the basis reduction (Ruling Request 1) and the proceeds from the sale of stock in partial liquidation are principal that the QSST does not need to distribute (Ruling Request 2).

[4465] Code § 1361(d)(3). Letter Ruling 9014008 ruled that a distribution to a grantor trust created by the beneficiary would not qualify, but Letter Rulings 9442036, 9444022, 9444024, and 9444059 permitted distributions to a disability trust because the beneficiary did not have legal capacity. This requirement does not preclude secured sales in which all income is used to buy the stock (part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls)), nor does it prevent the trust from agreeing to make payments to a third party if stock the trust bought is resold within a certain number of years after the trust's purchase (Letter Ruling 200140040).

[4466] In Letter Ruling 200404037, the IRS accepted the representation that applicable state law deemed a life estate in the shares of stock to give rise to a trust relationship between the life

S stock.[4467] The income distribution rule is that all income either actually is distributed each year or is required to be distributed each year;[4468] inadvertent termination relief may be available if the income is not distributed and catch-up distributions are made.[4469] Special rules apply to an inter vivos QTIP or another trust for a spouse.[4470]

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tenant and the remaindermen and that the deemed trust satisfies the requirements for treatment as a QSST. Letter Ruling 200247030 elaborated on the basis for this deemed trust treatment:

> It is represented that under State law, a life tenant, with the power to sell or dispose of property devised to him or her for life with remainder to designated persons, is a trustee or quasi trustee and occupies a fiduciary relationship to the remaindermen. In the exercise of that power, the life tenant owes to the remaindermen the highest duty to act honorably and in good faith. A life tenant is a trustee in the sense that he cannot injure or dispose of property to the injury of the rights of the remaindermen, but differs from a pure trustee in that he may use property for his exclusive benefit and take all income and profits.

[4467] Rev. Rul. 92-20 held that a provision in a trust agreement authorizing the trustee to accumulate trust income if the trust does not hold any shares of an S corporation does not, by itself, preclude the trust's qualification as a QSST.

[4468] Code § 1361(d)(3)(B); Reg. § 1.1361-1(j)(1)(i), the latter which expressly recognizes that income distributed in the first 65 days of the year may be treated under Code § 663(b) as being distributed in the immediately preceding year. Letter Rulings 8508048, 8836057, and 199927011 approved trusts in which the income must be distributed currently, but the beneficiary may elect in any year to have the trustee retain all or any portion of the income of the trust (it is not clear whether the trusts expressly permitted their beneficiaries to elect that retention or whether that was simply a practice that was contemplated); for related issues not discussed in the rulings, see part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts, especially part III.B.2.i.viii Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed.

[4469] Letter Ruling 201710001.

[4470] Reg. § 1.1361-1(j)(4) approves testamentary QTIP trusts but, for inter vivos ones, prohibits a QSST election during marriage and requires one to ensure that the grantor is treated as wholly owning the trust:

> However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677.

Reg. § 1.1361-1(k)(1), Example (10), provides:

> (i) *Transfers to QTIP trust*. On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.
>
> (ii) *Transfers to QTIP trust where husband and wife divorce*. Assume the same facts as in paragraph (i) of this Example 10, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may

Some annual expenses are ordinarily allocated one-half to income and one-half to principal. Generally, these include (1) the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee, and (2) expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests.[4471] If S corporation distributions are the trust's only source of cash, this rule is impractical, because the trust would be unable to pay the portion of the expense allocated to principal. Accordingly, I often suggest that the trustee make an adjustment, allocating the entire expense to income, which might be authorized under either state law[4472] or the governing instrument.[4473] If the business or the stock is sold later, the proceeds are taxable to the trust, rather than the beneficiary; at that time, some of the proceeds might be allocated to income to make up for these prior allocations of administrative expenses, which would help move taxable items from the trust's high rates to the beneficiary's potentially lower rates.[4474]

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only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election within 2 months and 15 days after the date of the divorce.

(iii) *Transfers to QTIP trust where no corpus distribution is permitted*. Assume the same facts as in paragraph (i) of this Example 10, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

Paragraph (iii) illustrates two points. First, to qualify as a wholly owned grantor trust (see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust), the trust must have not only its income but also its principal deemed owned wholly by the same individual (see part III.A.3.a.ii How a Trust Can Fall Short of Being Wholly Owned by One Person, especially fn. 4383); therefore, when drafting a trust for a spouse that holds stock in an S corporation for which an ESBT election is not in effect, one should consider including a grantor trust power beyond merely Code § 677, to make sure that the entire trust is taxed to the grantor (see part III.B.2.h How to Make a Trust a Grantor Trust). Second, no part of a QSST may be deemed owned by a person other than the beneficiary; see fn. 4463.

Paragraph (ii) offers insight into the application of Code § 677(a) after divorce. See part III.B.2.h.viii Code § 682 Limitations on Grantor Trust Treatment, the result of which is that, if distributions are made after separation, the trust no longer qualifies as a wholly owned grantor trust and a QSST election is unavailable; therefore, an ESBT election must be made. For the interaction of divorce with Chapter 14, see parts III.B.7.b.iv Divorce Planning to Avoid Code § 2701 and III.B.7.d Code § 2702 Overview, especially the text accompanying fns. 5645-5650.

[4471] Section 501 of the Uniform Principal and Income Act, which can be found at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008).

[4472] See part II.J.8.c.i.(a) Power to Adjust.

[4473] See parts II.J.8.c.i.(d) Exceptions in the Governing Instrument and II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially fns. 1878-1883 (language that might be included in one's forms authorizing such an adjustment, as well as the consequences of using such language).

[4474] See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and II.J.16 Fiduciary Income Taxation When Selling Interest in a Pass-Through Entity or When the Entity Sells Its Assets. See also part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received

A trust that has substantially separate and independent shares, each of which is for the sole benefit of one beneficiary, may qualify as a QSST with respect to each separate share.[4475] For example, a grantor sets up an irrevocable trust for the benefit of his four children, who are the only children he will ever have. Each child receives one-fourth of the income and corpus distributions. Each child would be considered the owner of one-fourth of the stock owned by the trust.[4476] This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion;[4477] see part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust for an example of a vested trust.

To avoid the requirement that all of the trust income – not just its S corporation income – be distributed to the beneficiary, it is not uncommon for a trust agreement to divide the trust so that the QSST is a separate trust. For inter vivos QSSTs, this approach might have additional state income tax benefits; see part II.J.15.b QSSTs and State Income Tax Issues.

The beneficiary of a QSST is taxed on all of the QSST's K-1 income and losses from the S corporation[4478] (although the trust still needs to get its own tax ID).[4479] However, when

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by a Party That Does Not Bear the Burden Under the Principal & Income Act. For form language that might facilitate this allocation, see fn. 1878, found in part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law.

[4475] Code § 1361(d)(3). Although the statute cites to the separate share rules under Code § 663(c) (see part II.J.9.a Separate Share Rule), the test is more stringent than that. Code § 663(c) provides for that distributions to other beneficiaries be ignored in determining separate share treatment if the possibility of distribution is remote. Rev. Rul. 93-31 holds:

> A substantially separate and independent share of a trust, within the meaning of section 663(c) of the Code, is not a QSST if there is a remote possibility that the corpus of the trust will be distributed during the lifetime of the current income beneficiary to someone other than that beneficiary.

For example, if an inter vivos QSST includes a clause requiring the payment of estate tax if the grantor dies during the beneficiary's life, and that payment clause might benefit the grantor's estate beyond whatever applicable law would provide but for that clause, the IRS' view is that mere possibility of such a diversion might disqualify the QSST from inception. Letter Ruling 201451001 (which I obtained to obtain inadvertent termination relief at the insistence of the CPAs for the company that was acquiring my client). However, paying transfer tax on the beneficiary's death should not cause any QSST problem. Letter Ruling 9014008 (GST tax).

[4476] However, it would not work if trust provided that the birth of another child after the trust is created would cause the trust to be divided five ways, essentially diverting one-fourth of each existing trust. Rev. Rul. 89-45.

[4477] Code § 2642(c)(2) provides that the GST annual exclusion applies to a trust that uses *Crummey* withdrawal rights only if the grandchild (or other skip person) is the sole beneficiary of the trust, and the trust's assets must be includible in the beneficiary's gross estate upon her death. Code § 2654(b) provides that substantially separate and independent shares of different beneficiaries shall be treated as separate trusts under the GST rules. Suppose a grantor sets up an irrevocable trust for the benefit of his four grandchildren. Each grandchild receives one-fourth of the income and corpus distributions; the trust distributes all of its income each year; and each of the four living grandchild would be considered the owner of one-fourth of the stock owned by the trust. If a grandchild who dies before or after trust termination holds a general power of appointment over one-fourth of the trust's assets, the trust will qualify for the GST annual exclusion and as a QSST.

[4478] Code § 1361(d)(1)(B). Reg. § 1.1361-1(j)(7)(i) provides:

the QSST sells the stock, the trust itself is taxable on any gain on the sale,[4480] including any gain the corporation incurs after adopting a plan of complete liquidation[4481] or from the deemed asset sale resulting from a Code § 338(h)(10) election;[4482] If the corporation actually sells its assets without adopting a plan of liquidation, I am unsure of the result. For additional planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business, II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI), and II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax). From the above, one can glean that depreciation recapture on the actual or deemed sale of personal property is ordinary income that is principal but might be best taxed to the beneficiary, who might either be in a lower tax bracket or might have losses from operations during the year of sale passing through the grantor trust portion to offset; thus, consider including in one's trust the flexibility to distribute principal or to reallocate principal to income.[4483]

The beneficiary must make a separate QSST election with respect to each corporation whose stock the trust holds.[4484]

See part II.A.2.e Estate Planning Strategies Available Only for S Corporation Shareholders for a brief introduction to a QSST's unique benefits. To explore a QSST's unique attributes as a grantor trust deemed owned by its beneficiary, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs.

Also note that a QSST election might enhance (or perhaps reduce) the trust's ability to deduct charitable contributions made by the S corporation.[4485]

> The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

Reg. § 1.1361-1(j)(8) further provides:

> If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.

[4479] Reg. § 1.671-4(b)(6)(iii).

[4480] Reg. § 1.1361-1(j)(8). However, for purposes of recognizing any losses suspended due to the at-risk rules of Code § 465 or the passive activity rules of Code § 469, the regulation treats the beneficiary as having sold the stock so that the suspended losses can be triggered. For more details on such sales, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets.

[4481] Letter Rulings 9721020 and 199905011. This includes gain from the actual sale of assets as well as gain on the Code § 336 deemed sale of assets distributed to shareholders. Of course, Code § 331 gain on the deemed sale of stock on dissolution is also taxed to the trust.

[4482] Letter Rulings 9828006, 199920007, and 201232003.

[4483] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes parts discussing allocating to income what otherwise would be principal receipts.

[4484] Reg. § 1.1361-1(j)(6)(i). Inadvertent termination relief is available when the trust acquires stock in another S corporation if a timely QSST election is not made with respect to that other S corporation. Letter Ruling 201618003.

[4485] See part II.Q.7.c S Corporations Owned by a Trust Benefitting Charity, especially the text accompanying fn. 3559.

III.A.3.e.i.(b). QSST Issues When Beneficiary Dies

QSSTs have excellent post-mortem planning flexibility:

- A QSST may hold stock for two years after the beneficiary's death without making any election at all.[4486]

- If a QSST continues as separate QSST-eligible shares for each beneficiary after termination but before the new QSST trusts are actually funded, no new election is required until actual funding of the new trusts; in other words, the QSST election stays in effect, with the individual remaindermen taxed as the QSST beneficiaries until actual post-mortem trust funding occurs.[4487]

The latter is a very important tool. Consider what happens after the beneficiary dies and before the stock is retitled in the remaindermen's names. If the S corporation does not distribute all of its taxable income, the trust might not be able to obtain an income distribution deduction to carry out all of the income to the remaindermen, thereby trapping the income[4488] at the trust's presumably higher income tax rates.[4489] Keeping the QSST election intact post-mortem before stock retitling to make sure that individual beneficiaries are taxed directly on the S corporation's K-1 income might save income tax during that period.

However, challenges arise when the remaindermen are not the residual beneficiaries of the beneficiary's estate plan. The S corporation might make distributions to pay the shareholders' income taxes after the beneficiary dies, and then how will the beneficiary's estate pay tax on the beneficiary's allocable share[4490] of the S corporation's income? What happens when a QSST's beneficiary dies, the beneficiary's estate is taxed on pre-mortem income, and the remaindermen are different than the beneficiaries of the beneficiary's estate? This might occur, for example, in a second marriage situation. Although the Uniform Principal and Income Act discusses issues along these lines to a certain extent,[4491] drafting to address this issue would be advisable:

- If the beneficiary does not control disposition of the trust's assets, the beneficiary might consider negotiating income tax reimbursement provisions with the trustee as a condition of making the QSST election.

[4486] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was A Grantor Trust With Respect To All Of Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death.

[4487] See Reg. § 1.1361-1(j)(9)(ii), contrasting Example (1) with Example (2).

[4488] See parts III.A.4 Trust Accounting Income Regarding Business Interests and III.D.2 Trust Accounting and Taxation.

[4489] Note, however, that trapping income inside trusts might be beneficial. See parts II.J.3 Strategic Fiduciary Income Tax Planning and III.A.3.e.ii.(c) When ESBT Income Taxation Might Help, the latter not directly on point but having some helpful ideas.

[4490] See part III.B.2.j Tax Allocations upon Change of Interest, especially part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[4491] Section 201 of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlaws.org/shared/docs/principal%20and%20income/upia_final_08_clean.pdf) addresses actions when a trust terminates.

- If the beneficiary does control disposition, the beneficiary might consider exerting that control to require that the remaindermen reimburse the beneficiary's estate for income tax on the pre-mortem income. On the other hand, if the QSST's remaindermen are the same as under the beneficiary's estate plan generally, the opportunity to create a debt (taxes on the earned but undistributed income) on the beneficiary's estate tax return might prove beneficial. In the latter case, the beneficiary might exercise any power of appointment he or she might have to provide for the QSST election to remain in place after the beneficiary's death during trust administration before the trust is divided.

One might consider a provision along the following lines:

(1) If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate (in this Agreement, Article 5 determines the sharing of the residue of my estate, because my will bequeaths my estate to the Revocable Trust and Article 5 bequeaths the residuary trust assets), then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's estate.

(2) If and to the extent that paragraph (1) does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas. Reg. section 1.1361-1(j)(9)(ii), Example (1), and the trusts for the beneficiaries will be amended under [the QSST provisions].

Such a provision would not cause any marital deduction problems for the trust that is terminating.[4492] However, if the trust is included in the beneficiary's estate and the beneficiary is bequeathing the stock to a QTIP trust and income otherwise payable to the QTIP trust is diverted, query whether that violates the requirement that QTIP exclusively benefit the surviving spouse.

The amount of income allocated before and after death is also potentially subject to considerable uncertainty, unless an election to close the corporation's books is made, as described in part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation, especially part III.B.2.j.ii.(d) Death of a Shareholder.

If the stock is bequeathed to a person other than the persons receiving the trust's residue, consider the issues in part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests, which addresses

[4492] Rev. Rul. 92-64 generally allows income earned during the surviving spouse's life but paid after the surviving spouse's death to be paid to either the surviving spouse's estate (if allowed under state law) or the successor beneficiary. State corporate law often limits the gap between record date (the date on the shareholder actually owned the stock) and payment date; generally, an LLC taxed as an S corporation would not face this problem. Of course, in a trust situation, with either type of entity the trust would receive the distribution and then direct it according to the beneficiaries' respective interests, if the ownership interest was not transferred between death and date of the distribution from the corporation.

timing issues relating to distributions to pay taxes on the trust's distributive share of the entity's income.

III.A.3.e.ii. ESBTs

III.A.3.e.ii.(a). Qualification as an ESBT

After determining eligibility to make an "electing small business trust" (ESBT) election, see part III.A.3.c.iii Deadlines for QSST and ESBT Elections.

To qualify to make an ESBT election, the trust cannot have as a beneficiary any person other than an individual, an estate, a charity within certain definitions.[4493] "Beneficiary" includes a person who has a present, remainder, or reversionary interest in the trust.[4494] A distributee trust is the beneficiary of the ESBT only if the distributee trust is a Code § 170(c)(2) or (3) organization.[4495] In all other situations, any person who has a beneficial interest in a "distributee trust" is a beneficiary of the ESBT, rather than the trust itself being considered to be a beneficiary.[4496] A "distributee trust" is a trust that receives or may receive a distribution from the ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.[4497]

If an impermissible shareholder might become a potential current beneficiary, one might consider taking steps to exclude that person from being a potential current beneficiary ("PCB") of the ESBT portion.[4498] A potential trap applies when an ESBT terminates in favor of trusts (the "downstream trusts"). After the event terminating the ESBT (such as the primary beneficiary's death) and before the trust distributes its assets to the downstream trusts, the downstream trusts might become PCBs, applying the following rules:

(1) Generally, a trust that exists is a distributee trust if it becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT.[4499] A trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit.[4500] A trust that is not yet funded not currently a distributee trust.[4501]

4493 Code § 1361(e)(1)(A)(i). Permitted charities include an organization described in Code § 170(c)(2) , (3) , (4) , or (5) or, if it has a contingent interest in the trust and is not a potential current beneficiary, a Code § 170(c)(1) organization.
4494 Reg. § 1.1361-1(m)(1)(ii)(A).
4495 Reg. § 1.1361-1(m)(1)(ii)(B).
4496 Reg. § 1.1361-1(m)(1)(ii)(B).
4497 Reg. § 1.1361-1(m)(1)(ii)(B).
4498 Letter Ruling 200913002 held that such a modification did not affect GST grandfathering.
4499 Reg. § 1.1361-1(m)(4)(iv)(A).
4500 Reg. § 1.1361-1(m)(4)(iv)(A).
4501 Reg. § 1.1361-1(m)(4)(iv)(A). Letter Rulings 200816012 and 200913002 approved as an ESBT a trust prohibiting distributions to a nonresident alien for so long as (1) the trust has an ESBT election in effect, and (2) a non-resident alien is not permitted to be a PCB of an ESBT under the Code and Regs. (I do not know why the rulings cited Reg. § 1.1361-1(m)(4)(iv) instead of Reg. § 1.1361-1(m)(4)(v). I wonder whether that is a typo.)

(2) If the trust qualifies a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, then the persons who would be its PCBs if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT.[4502] However, if the distributee trust is a former grantor trust[4503] or is a testamentary trust,[4504] in either case during the special initial 2-year period, then the relevant estate is treated as the ESBT's PCB during that period.[4505]

(3) If the distributee trust is not a trust described in part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.[4506] However, if the distributee trust would be a valid QSST or ESBT if the relevant election were made and the election is not made because the trust does not hold S stock, then the distributee trust does not count as a PCB,[4507] and the distributee trust's PCBs would count as PCBs of the trust that

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[4502] Reg. § 1.1361-1(m)(4)(iv)(C).

[4503] See part III.A.3.b.ii A Trust That Was A Grantor Trust With Respect To All Of Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death.

[4504] See part III.A.3.b.iii A Trust With Respect To Stock Transferred To It Pursuant To The Terms Of A Will, But Only For The 2-Year Period Beginning On The Day On Which Such Stock Is Transferred To It.

[4505] Reg. § 1.1361-1(m)(4)(iv)(C).

[4506] Reg. § 1.1361-1(m)(4)(iv)(B).

[4507] Reg. § 1.1361-1(m)(4)(iv)(D) provides:

> For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

Letter Ruling 200912005 approved a distributee trust that would have been eligible to make an ESBT election even though its sole remainderman was a charity (it did not, as drafted, qualify as a charitable remainder trust).

Reg. § 1.1361-1(m)(8), Example (6) provides:

> (i) *Distributee trust that would itself qualify as an ESBT*. Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to A, B, and Trust-2, a trust for the benefit of C, D, and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, A, B, C, D, and E are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).
>
> (ii) *Distributee trust that would not qualify as an ESBT or a QSST*. Assume the same facts as in paragraph (i) of this Example 6 except that D is a nonresident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, X's S corporation election terminates.
>
> (iii) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust*. Assume the same facts as in paragraph (i) of this Example 6 except that Trust-2 is a trust treated as owned by A under section 676 because A has the power to revoke Trust-2 at any time prior to A's

does hold the S stock.[4508] Another option is for the main trust to partially fund the distributee trust and have the distributee trust then qualify as a shareholder.[4509]

Each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[4510] A potential current beneficiary means any person who at any time during a particular taxable year may receive a distribution of principal or income from the trust, whether the distribution was mandatory or discretionary.[4511]

Regulations had provided that an open-ended inter vivos power of appointment violates the 100-shareholder limitation; however, Congress modified that provision for years beginning after December 31, 2004 to provide that powers of appointment are considered during a period only to the extent exercised during that period,[4512] and the regulations now reflect this change.[4513] If a distribution can be made to an existing trust, that trust must be qualify under the general rules for trusts as S corporation shareholders;[4514] similar to the power of appointment rule, that rule does not apply until the distributee trust has been created.[4515]

> death. On January 1, 2003, A dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of A's death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), A's estate. Thus, B and A's estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

4508 Reg. § 1.1361-1(m)(4)(iv)(B) provides:

> If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B)(ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

See Reg. § 1.1361-1(m)(8), Example (6), parts (i) and (iii), reproduced in fn. 4507.

4509 Reg. § 1.1361-1(m)(8), Example (5) provides:

> *Potential current beneficiaries and distributee trust holding S corporation stock*. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to A directly or to any trust created for the benefit of A. On January 1, 2003, M creates Trust-2 for the benefit of A. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. A, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). Additionally, because A is already counted as an S corporation shareholder because of A's status as a potential current income beneficiary of Trust-1, A is not counted again by reason of A's status as the deemed owner of Trust-2.

4510 Code § 1361(c)(2)(B)(v).

4511 Code § 1361(e)(2).

4512 Code § 1361(e)(2).

4513 Reg. § 1.1361-1(m)(4)(vi)(A).

4514 Reg. § 1.1361-1(m)(4)(iv)(B).

4515 Reg. § 1.1361-1(m)(4)(iv)(A), which further provides:

An ESBT cannot have a beneficiary whose interest was acquired by purchase.[4516] This prohibition does not have anything to do with whether the trust has purchased or might later purchase S stock.[4517]

> For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

[4516] Code § 1361(e)(1)(A)(ii). For whether a change in a beneficiary's interest in a trust might cause an interest in the trust to be obtained by purchase in violation of this rule, see Potter, Trust Decanting of S corporation Shareholders: Avoiding Inadvertent Termination of the Company's S Election, *TM Memorandum* (BNA) (12/29/2014) or *TM Estates, Gifts and Trusts Journal* (BNA) (3/12/2015).

Letter Rulings 201436006 and 201436007 ruled that the following transactions did not constitute a prohibited purchase of an interest in a trust:

> X created Trust 1 on D1. Trust 1 is a grantor trust wholly owned by X. X proposes to create Trust 2 which will be a grantor trust wholly owned by X. X proposes to contribute S corporation stock to Trust 2 and sell the Trust 2 remainder interest to Trust 1. Trust 2 will elect to be an electing small business trust (ESBT) under 1361(e) upon creation.
>
> ….
>
> [W]e conclude that the sale of the Trust 2 remainder interest to Trust 1 will not disqualify Trust 2 from being an ESBT under § 1361(e) during the period when Trust 1 is a grantor trust as to X because the sale of the remainder interest is not a purchase within the meaning of § 1361(e). The sale of the remainder interest is not a purchase within the meaning of 1361(e) because the sale is not governed by § 1012(a). However, to the extent that the sale is treated as a gift, the sale will be covered by § 1015(a). In addition, we conclude that Trust 2 will not cease to be or fail to qualify as an ESBT after the termination of Trust 1's grantor trust status because Trust 1's acquisition of the remainder is not a purchase within the meaning of § 1361(e).

[4517] Reg. § 1.1361-1(m)(1)(iii) provides:

> *Interests acquired by purchase*. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

T.D. 8994 (5/13/2002) stated:

> Two commentators requested clarification on whether a trust is eligible to be an ESBT if it acquires property in a part-gift, part-sale transaction, such as a gift of encumbered property or a net gift, in which the donor transfers property to a trust provided the trust pays the resulting gift tax. Section 1361(e)(1)(A)(ii) provides that a trust is eligible to be an ESBT only if "no interest in the trust was acquired by purchase." Section 1361(e)(1)(C) defines <u>purchase</u> as "any acquisition if the basis of the property acquired is determined under section 1012." The proposed regulations provide that if any portion of a beneficiary's basis in the beneficiary's interest is determined under section 1012, the beneficiary's interest was acquired by purchase. The final regulations clarify that the prohibition on purchases applies to purchases of a beneficiary's interest in the trust, not to purchases of property by the trust. A net gift of a beneficial interest in a trust, where the donee pays the gift tax, would be treated as a purchase of a beneficial interest under these rules, while a net gift to the trust itself, where the trustee of the trust pays the gift tax, would not.

III.A.3.e.ii.(b). ESBT Income Taxation - Overview

ESBT income taxation is complicated. An ESBT is treated as two separate trusts for purposes of chapter 1 of the Code.[4518] The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust.[4519] The grantor trust rules trump this treatment.[4520] The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[4521]

The income from the Schedule K-1 that the S corporation files for the trust is separately taxed to the trust at the highest individual income tax rate for that type of income.[4522] Very few deductions are allowed against this income, and the income distribution deduction is not available;[4523] the IRS has taken the position that net operating losses (NOLs) are not allowable deductions,[4524] but capital loss carryforwards appear to be allowable.[4525]

State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion are taken into account by the S portion.[4526] These items may be allocated in any manner that is reasonable in light of all the

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The Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-96), December 18, 1996 (Blue Book), stated:

> No interest in the trust may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc. The trust itself may acquire property (including stock of an S corporation) by purchase.

[4518] Code § 641(c); Reg. § 1.641(c)-1(a).

[4519] Reg. § 1.641(c)-1(a).

[4520] Reg. § 1.641(c)-1(a).

[4521] Reg. § 1.641(c)-1(a).

[4522] Code § 641(c)(1); Reg. § 1.641(c)-1(e).

[4523] Code § 641(c)(2).

[4524] The IRS has taken the position that a net operating loss (NOL) carryover arising from pre-ESBT activity is not deductible because an NOL carryover is not one of the specifically enumerated expenses. CCA 200734019 (consider whether the logic in that CCA might also be applied to NOLs generated from post-ESBT activity).

Making a Code § 645 election for a revocable trust to be taxed as an estate avoids this issue for short-term post-mortem planning, since estates can hold S stock during a reasonable administration period, whereas revocable trusts are limited to two years under Code § 1361(c)(2)(A)(ii). Trusts created under a revocable trust are considered trusts created under wills pursuant to Reg. § 1.1361-1(k)(1), Example 3, paragraph (ii) if a Code § 645 election is in place and therefore can hold S stock for up to two years after funding before making an ESBT or QSST election, flexibility that is not present absent a Code § 645 election.

See also the text accompanying fn. 4530 for how to avoid the ESBT generating an NOL when it has significant losses from its S corporation stock; this generally requires advance planning.

[4525] Reg. § 1.641(c)-1(d)(3)(i) disallows deductions for losses capital losses that exceed gains by more than $3,000 under Code § 1211(b) but does not refer to capital loss carryforwards under Code § 1212. Nothing directly addresses whether capital losses incurred before making an ESBT election but relating to S corporation items can be deducted against capital gain incurred while an ESBT.

[4526] Reg. § 1.641(c)-1(d)(4)(i).

circumstances, including the terms of the governing instrument, applicable local law, and the trustee's practice with respect to the trust if it is reasonable and consistent.[4527]

Complications arise if the ESBT is a grantor trust in whole or in part or if the trust is a charitable lead trust or other trust eligible for a charitable income tax deduction. The charitable deduction applies only the charitable contributions passing through a K-1 from the S corporation to the trust and not to contributions made by the trust.[4528] Effective for tax years beginning after December 31, 2017, an ESBT's contribution deduction does not apply Code § 642(c) but rather uses limits based on the rules that apply to individuals.[4529]

For application of the passive loss rules to ESBTs, see part II.K.2.b.v Electing Small Business Trusts (ESBTs) and the Passive Loss Rules. In light of the IRS' position on NOLs for ESBTs,[4530] consider whether the trustee should be passive, as discussed in part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good (and note

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4527 Reg. § 1.641(c)-1(h).

4528 The charitable deduction is not allowed against ESBT income if made directly by the trust. See Code § 641(c)(2)(C) and Reg. § 1.641(c)-1(d)(1), disallowing all deductions except those expressly listed (but the deduction should be allowed against the non-S portion of the trust). However, Reg. § 1.641(c)-1(d)(2)(ii) describes charitable deductions passing through a K-1 the ESBT receives from an S corporation:

> *Special rule for charitable contributions*. If a deduction described in paragraph (d)(2)(i) of this section [referring to K-1 items] is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1) [the unlimited charitable deduction for trusts]. The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

Code § 512(e)(1)(B)(i) provides all S corporation K-1 income is per se unrelated business income, so Code § 681 and Reg. § 1.681(a)-2(a) would apply the individual contribution limits, rather than the unlimited Code § 642(c), to such deductions. However, the rules of Code § 642(c) other than the limits continue to apply (but would not if the change to Code § 642(c) in the Senate bill approved December 1-2, 2017 is enacted). For more information about Code § 681, mentioned in the last sentence of this regulation, see part II.Q.7.c.i Income Tax Trap - Reduction in Trust's Charitable Deduction.

4529 Code § 641(c)(2)(E) provides:

> (i) Section 642(c) shall not apply.
> (ii) For purposes of section 170(b)(1)(G), adjusted gross income shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the trust and which would not have been incurred if the property were not held in such trust shall be treated as allowable in arriving at adjusted gross income.

The Senate report adopting this rule said:

> The Senate amendment provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

4530 See fn. 4524.

that an ESBT avoiding NOLs might be at the cost of incurring the 3.8% tax on net investment income).[4531]

If the nongrantor trust portion of an ESBT is included in a person's estate, the ESBT election might prevent a basis step-up of depreciable property.[4532]

III.A.3.e.ii.(c). When ESBT Income Taxation Might Help

ESBT income taxation can be favorable in the right circumstances. For example:

- The trust's income might be taxed at lower state income rates (or not at all) inside the trust than in the beneficiary's hands, or

- The beneficiary might be in the top income tax bracket, and reporting additional income would cause the beneficiary to lose some itemized deductions, AMT exemption, or personal exemptions.

In either case, the ESBT can make distributions to the beneficiary without passing S corporation income to the beneficiary. To maximize this flexibility, the trustee might consider dividing the ESBT into two separate trusts – one that holds S stock and one that holds any distributions that the trustee intends to reinvest, based on the following analysis:

1. Distributions from a trust that generates investment income (other than S corporation K-1 income) will carry out income to the beneficiary.

2. If the investments are held in a separate trust, that trust can accumulate income and trap the investment income.

3. Therefore, when the trustee of the trust that holds S stock receives a distribution, the trustee would retain enough to pay income tax and administrative expenses, distribute to the beneficiary as appropriate, and then transfer the balance of the cash to the trust that generates investment income.

This three-part analysis applies when the S corporation distributes all of its income. It would not apply if the corporation distributes only enough for its shareholders to pay tax and uses the rest to grow the business (or its marketable securities portfolio). For trusts that are somewhere in between, it might or might not be helpful.

III.A.3.e.iii. Comparing QSSTs to ESBTs

A QSST tends to be used when:

- The trust is a marital trust or other trust whose income is required to be distributed currently to one beneficiary with no other current beneficiary. Under the marital trust

[4531] See part II.I 3.8% Tax on Excess Net Investment Income (NII), especially parts II.I.8 Application of 3.8% Tax to Business Income and II.J.14 Application of 3.8% Tax to ESBTs.
[4532] See part II.J.11.a.ii.(c) Trust vs. Separately Recognized Business Entity Holding Depreciable Property, particularly fns. 1974-1975.

rules,[4533] all income must be distributed annually, which means that, under normal trust rules, the income that the spouse is required to receive is taxable to her, just like any other mandatory income beneficiary.[4534]

- The beneficiary's income tax rate is lower than the trust's income tax rate. Because trust income above a modest threshold is taxed at the highest possible rates that apply to individuals,[4535] a beneficiary in a lower bracket should save taxes.

A QSST is not the best for trusts intended to accumulate their income, including trusts with multiple current beneficiaries. In most such cases, such trusts should be ESBTs.

ESBTs might avoid the 3.8% NII tax[4536] by appointing a trustee who is active in the business if the beneficiary is not active in the business.[4537] A QSST's income is not subject to the 3.8% NII tax if the beneficiary is active in the business[4538] or has income below the threshold;[4539] however, because the trustee's participation is what counts when the QSST sells the stock, consider making the trustee active well in advance of a potential sale.[4540] Also note that, if the trust directly or indirectly owns real estate that is rented to the S corporation, a QSST election might complicate a trust's qualification for the self-rental exception, which exception would enable the taxable rental income avoid the 3.8% NII tax, so the trustee might consider retaining some stock in an ESBT, rather than moving all of the stock into a QSST.[4541] See also part II.K.3 NOL vs. Suspended Passive Loss - Being Passive Can Be Good.

See part III.A.3.e.i.(b) QSST Issues When Beneficiary Dies, for a discussion of various issues one should consider when a beneficiary makes a QSST election.

Other than possible complexity regarding taxes on the earned but undistributed income, a QSST generally has more flexibility than an ESBT. A QSST offers options for deferring S corporation trust tax elections.[4542] If the trustee of an irrevocable grantor trust makes an ESBT election as a protective measure,[4543] the trust's ESBT taxation

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[4533] Code §§ 2056(b)(1) and 2523(b).
[4534] Code § 651.
[4535] Code § 1(e)(2).
[4536] For the 3.8% tax on net investment income (NII), see II.I 3.8% Tax on Excess Net Investment Income. For calculating the tax on an ESBT, see fn 1991 (which also refers to an example in the proposed regulations) and the accompanying text.
[4537] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[4538] A QSST is a grantor trust deemed owned by the beneficiary. The 3.8% tax looks to the character of the income in the hands of the deemed owner; see fn. 1555.
[4539] See part II.I.3 Tax Based on NII in Excess of Thresholds.
[4540] See part II.J.17 Planning for Grantor and Nongrantor Trusts Holding Stock in S Corporations in Light of the 3.8% Tax.
[4541] See part II.I.8.g Structuring Businesses in Response to 3.8% Tax, particularly the text accompanying fns. 1699-1700.
[4542] See text accompanying fns. 4486-4487.
[4543] A trustee cannot make a conditional ESBT election. Reg. § 1.1361-1(m)(2)(v). If the trustee of a grantor trust makes an unconditional current ESBT election, the election is in effect but does not control the trust's taxation to the extent trumped by the grantor trust rules. Reg. § 1.641(c)-1(c).

continues after death,[4544] in effect springing into place without any of the savings that other former irrevocable grantor trusts (including QSSTs) have.[4545]

On the other hand, ESBTs might provide more flexibility that QSSTs in avoiding adverse taxation of certain related party sales of depreciable or amortizable property or in replicating an inside basis step-up if the stock receives a basis step-up. For related party sales, see part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property (Including Goodwill).[4546] For inside basis step-up opportunities,[4547] see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation, explaining how to replicate an inside basis step-up for property to the extent that Code § 1239 is not triggered, as well as state income tax issues that can complicate matters when the taxpayer is not a resident of the state in which the property is located.[4548]

A QSST complicates purchases made out of earnings, as described in part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST. In ESBTs, interest on the promissory note is deductible only for tax years beginning after December 31, 2006.[4549] A better solution is a trust taxable to its beneficiary under Code § 678.[4550] Also, it might be possible for the income beneficiary to sell S corporation stock to the QSST and not recognize gain or loss on the sale.[4551]

III.A.3.e.iv. Flexible Trust Design When Holding S Corporation Stock

Consider a GST-exempt trust with only one beneficiary, with discretionary distributions of income and principal under an ascertainable standard. An independent person is authorized to direct that, for a period of no less than 36 months, all of the income is required to be distributed, based on the following:

- The minimum period of time between ESBT and QSST conversions is 36 months. This minimum period applies between conversions but does not apply to the first conversion. In other words, once the first ESBT or QSST election is made, a conversion to the alternate form (QSST or ESBT) can be

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[4544] Reg. § 1.1361-1(m)(8), Example (4).

[4545] part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation, especially part III.A.3.b.ii A Trust That Was A Grantor Trust With Respect To All Of Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death regarding a grantor trust's continuing eligibility to hold S stock for two years after the deemed owner's death. Normal trust income tax rules, which generally are more favorable than ESBT income tax rules, apply during that time. See text accompanying fns. 4522-4525 for ESBT taxation.

[4546] For a comparison of ESBTs and QSSTs, see text accompanying fn. 3665.

[4547] Part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations explains such issues.

[4548] See part II.H.8.a.ii State Income Tax Disconnect.

[4549] Reg. § 1.641(c)-1(d)(4)(ii) provides, (ii) *Special rule for certain interest*. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion. This was repealed for tax years beginning after December 31, 2006 by Code § 641(c)(2)(C)(iv).

[4550] See fn 4368.

[4551] See part III.B.2.i.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.

made at any time. However, once one converted from a QSST to an ESBT or vice versa, the 36-month period applies in reversing the conversion.[4552]

- Mandatory distributions ensure no missteps in distributing income to maintain QSST status, because mandatory income trusts are not required to prove actual distributions of all of the income. However, a trust that actually distributes all of its income qualifies even without a mandatory distribution clause.[4553]

- Before converting, split the trust if it has assets other than S corporation stock, so that the other assets are not subjected to the QSST distribution scheme.

- The independent person would also be authorized to turn off the mandatory income direction for any trust taxable year that begins after the date the mandatory income direction is turned off. (Otherwise, the IRS might argue that the mandatory income provision is illusory because it could get turned off at any time during the year.)

This would open up the opportunity to toggle between QSST and ESBT taxation, while allowing any ESBT income to accumulate inside an environment protected from estate taxes and creditors. After a trust has been an ESBT for 36 months, it may be divided into a separate trust for each beneficiary, and each new trust can separately either continue as an ESBT or become subject to a QSST election.[4554] Thus, every three years the trustee can consider how much of the trust should be a QSST and how much an ESBT and then ask the independent person to adjust the mandatory income direction as appropriate. This toggling decision would take into account the expected annual S corporation income, the beneficiary's adjusted gross income, and the beneficiary's participation in the business (see below).

Note that, if the beneficiary has an inter vivos limited power of appointment, the beneficiary can hold the power of appointment during an initial ESBT period,[4555] but once the trust converts to a QSST the beneficiary must permanently renounce the power of appointment.[4556]

S corporation business income is free from the 3.8% tax on net investment income (NII) if the recipient significantly participates in the S corporation's business activity.[4557] For a QSST, one would look to the beneficiary's participation, whereas for an ESBT the IRS would look to the participation of a trustee;[4558] however, for a QSST, the IRS would look to trustee participation when the trust sells S corporation stock or the S corporation sells

[4552] Reg. §§ 1.1361-1(j)(12)(iii), 1.1361-1(m)(7)(iii).
[4553] See fn. 4468.
[4554] Letter Ruling 201122003.
[4555] See text accompanying fns. 4512-4513.
[4556] See fm. 4463.
[4557] See part II.I.8 Application of 3.8% Tax to Business Income (application of the 3.8% tax on net investment income), especially part II.I.8.f Summary of Business Activity Not Subject to 3.8% Tax.
[4558] See parts II.J Fiduciary Income Taxation (application of the 3.8% tax on net investment income) (particularly fn. 1555 and later sections of part II.J dealing with the sale of QSST or ESBT stock) and II.K.2 Passive Loss Rules Applied to Trusts or Estates Owning Trade or Business (determining when a trust materially participates).

substantially all of its business assets.[4559] If the beneficiary materially participates in the business, then either QSST or ESBT taxation could avoid the tax, the latter if the beneficiary is appointed as a trustee for purposes of holding the S corporation stock and satisfies the rules for trustee participation.[4560] If the beneficiary does not materially participate in the business, the S corporation income would constitute NII; however, the beneficiary might be in a sufficiently low tax bracket that the 3.8% tax on NII might not apply to the beneficiary at all.

Additionally, if the beneficiary already owns stock in the S corporation, the trust might buy the stock from the beneficiary, perhaps without any capital gain tax on the sale.[4561]

Finally, QSSTs provide more post-mortem tax options than ESBTs, so pre-mortem toggling to QSST status can provide this enhanced flexibility.[4562]

III.A.3.e.v. Converting a Multiple Beneficiary ESBT into One or More QSSTs

III.A.3.e.v.(a). Strategic Issues

Every dollar of ESBT income is taxed at 37% federal income tax and 3.8% tax on net investment income ("NII").[4563] The beneficiaries' federal income tax brackets might be significantly lower,[4564] and the NII tax would not apply except to the extent that their modified adjusted gross income exceeds $200,000 for a single individual or $250,000 for a married person filing jointly.

However, any trustee and tax preparation fees might be deductible by the beneficiaries as miscellaneous itemized deductions (and disallowed for AMT purposes) rather than being deducted directly against the S corporation income.[4565]

This might increase the state income tax on the business income. As an ESBT, only the trust's state income tax posture is considered. Depending on the ESBT's state of residence, the ESBT might not be responsible for tax on the trust's income (particularly investment income) that is not sourced to a particular state. If the trust is converted to QSSTs, each beneficiary would need to file an income tax return for each state in which the S corporation does business, reporting his or her share of each state's income, thereby complicating each beneficiary's income tax return preparation. Additionally, each beneficiary who lives in a state with income tax would need to pay state income tax on his or her share of income, ameliorated in whole or in part by a credit for income taxes paid to other states.

[4559] See part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
[4560] See parts II.K.2.b.i Participation by a Nongrantor Trust: Authority and II.K.2.b.ii Participation by a Nongrantor Trust: Planning Issues.
[4561] See part III.B.2.i.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.
[4562] See text accompanying fn. 4542.
[4563] See part II.I 3.8% Tax on Excess Net Investment Income. It's possible that some ESBT income might be below the adjusted gross income threshold. See part II.J.14 Application of 3.8% Tax to ESBTs.
[4564] Consider the effect of phase-outs based on adjusted gross when evaluating the beneficiaries' income tax rates.
[4565] Reg. § 1.67-2T(b)(1).

The ESBT might have been accumulating income or perhaps distributing income to separate GST-exempt trusts for beneficiaries, the latter so that each beneficiary decides on a case-by-case basis whether to accumulate income in a protected trust. This accumulation might be important for estate tax reasons, as well as perhaps for nontax reasons. Now, however:

- With the $5+ million estate tax exemption, this accumulation strategy has less estate tax benefit, if the beneficiaries do not have estates near the exemption.

- Trusts that accumulate income face the same increase in federal income tax and NII tax as described above if they are ESBTs or have more than $12,000[4566] in taxable income, so the accumulation strategy would have additional income tax costs.

III.A.3.e.v.(b). Implementation

The trustee might consider the following:

- Evaluate the trustee's authority to divide trusts and to convert separate trusts into QSSTs. If the trust has beneficiaries of more than one generation (*e.g.*, children and grandchildren), the trustee needs to consider any fiduciary duties to the lower generations (*e.g.*, grandchildren) in dividing the trust into separate trusts for the upper generation (*e.g.*, children). The trustee might obtain ratification from all adult beneficiaries to protect the trustee. The parent (who is not a beneficiary) of any minor or unborn descendant would sign on behalf of that descendant; this can be problematic if the child who is a beneficiary is divorced or otherwise having marital troubles. A consent by a beneficiary might raise Code § 2702 issues; this is less of a concern if the beneficiary had not been receiving distributions and never expected to receive distributions before that beneficiary's parent's death.

- If centralized management is a concern:

    - Determine whether the trustee is authorized to commingle the QSSTs, treating them as separate shares.[4567] The trustee might maintain a single new bank account for new deposits, which would then either distribute anything it receives or reimburse the existing account for administrative expenses the trust incurs. The division of shares would be done simply by recording the shares on a spreadsheet.

    - See whether the beneficiaries have the right to change the trustees of their separate trusts, which rights they might not have had in the main trust.

- Determine whether paying 100% of annual trustee fees and administrative expenses regarding the QSST portion out of income reasonably and fairly

[4566] $12,150 in 2014; $12,300 in 2015 per Rev. Proc. 2014-61, Section 3.01, Table 5; $12,400 in 2016 per Rev. Proc. 2015-53, Section 3.01, Table 5; presumably higher in future years.
[4567] This is permitted under the last sentence of Code § 1361(d)(3) and Reg. § 1.1361-1(j)(3).

balances the interests of the income and remainder beneficiaries, as the trust might not have another source to pay those fees; the trustee would want to reserve the right to allocate them to principal in the year of sale.[4568] Normally such fees and expenses are allocated one-half to income and one-half to one-half to principal.[4569] Perhaps the corporation would pay the fees, but note that the payment might need to be a separately stated K-1 item, if the character of the fees would change on a beneficiary's income tax return.[4570]

III.A.3.e.v.(c). Timing Tax Deductions in Year of Conversion

Consider which expenses would be better deductions against ESBT or QSST income and pay them in the appropriate time period.

K-1 items need to be pro-rated.[4571]

Presumably, administrative expenses relating to S corporation income would be allocated to the time before and after the conversion and any expenses allocable to the QSST portion would be deductible by the beneficiary.

III.A.3.e.vi. QSST as a Grantor Trust; Sales to QSSTs

Because the beneficiary pays tax on not only the S corporation's distributed income but also its undistributed income, a QSST can be a way to:

- Avoid high trust income tax rates and take advantage of a full run through the beneficiary's graduated tax rates.

- Allow the beneficiary to deduct a loss before the trust's termination, if the stock has sufficient basis.

- Have the beneficiary pay tax on any reinvested earnings used to grow the S corporation, increasing the trust's value and reducing the beneficiary's gross estate.

[4568] Gain on sale of stock, including any gain reported on a K-1 form the S corporation issues reporting gain by reason of a Code § 338(h)(10) election to treat a stock sale as an asset sale, is taxable to the trust, rather than the being taxable as the grantor trust portion. See parts II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax) and III.A.3.e.i QSSTs, particularly the text accompanying fns. 4480-4482, dealing with sales of not only S corporation stock but also of an S corporation's business in an asset sale. For additional planning issues, see parts II.G.5 Gain or Loss on the Sale or Exchange of Property Used in a Trade or Business and II.J.8.a.i Whether the Capital Gain Is from the Sale or Exchange of a Capital Asset (discussing whether the gain is included in DNI). Of course, the trust might obtain a distribution deduction by distributing the sale proceeds; see part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI), especially part II.J.8.a.ii Whether the Gain from the Sale or Exchange of a Capital Asset Is Allocated to Corpus.

[4569] Section 501 of the Uniform Principal & Income Act.

[4570] See text accompanying fn. 4565 and Code § 1366(a)(1)(A).

[4571] See part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

- Prevent the grantor of a trust for a spouse from being taxed on any reinvested taxable income after divorce.[4572] If the beneficiary/former spouse may also receive principal distributions, the beneficiary may elect to treat the trust as a QSST, thereby ensuring that the taxable items of the trust's assets inside an S corporation owned by the trust are taxable to the beneficiary, whether or not actually distributed to the beneficiary.[4573]

- Allow the beneficiary to sell S corporation stock (and, indirectly, other assets) to the trust on what appears to be a tax-free basis.[4574] A sale to an irrevocable grantor trust is a powerful estate planning technique.[4575] Clients sometimes balk at selling assets to a trust where they are not beneficiaries, because they might need the assets for their living expenses. For a client who refuses to part with all of the enjoyment of sufficient assets, consider suggesting that he or she sell assets to a trust in which he or she is a beneficiary and is the deemed owner - a beneficiary grantor trust.[4576]

The grantor trust aspects can be powerful planning techniques but are also subject to some significant disadvantages.[4577]

Beneficiary grantor trusts involve complex tax issues, including the risk that the Internal Revenue Service, which generally has stopped issuing private letter rulings regarding such trusts,[4578] might at some point take a position inconsistent with its many past favorable private letter rulings. The complexity involved often includes a sale being highly leveraged (sometimes using a trust funded with no more than $5,000), which might invite IRS scrutiny.

QSSTs do not face the funding issues that apply to many other beneficiary grantor trusts. They can be funded very substantially and still be entitled to grantor trust treatment.

[4572] Code § 677 treats the grantor as owners of any items that can be distributed to or held for eventual distribution to the grantor or the grantor's spouse. Code § 672(e)(1)(A) treats as the spouse any individual who was the spouse of the grantor at the time of the creation of such power or interest. Thus, divorce does not terminate grantor trust treatment. However, Reg. § 1.682(a)-1(a)(1) provides that the grantor is not taxed as the owner to the extent that income is paid, credited, or required to be distributed and therefore taxed to the former spouse.

[4573] See fn. 4470, noting the contrast between paragraphs (ii) and (iii) within Example (10).

[4574] See part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).

[4575] See part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[4576] See part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

[4577] See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

[4578] Rev. Proc. 2015-3, Section 4.01(39), provides that ordinarily the IRS will not rule on:

> Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

III.A.3.e.vi.(a). Grantor Trust Issues Involved in a Sale of S Stock to a QSST

If a QSST buys the beneficiary's stock from the beneficiary after making a QSST election for its then-existing S stock (issued by the same corporation), that would be a disregarded transaction for income tax purposes, following the general principle under Rev. Rul. 85-13 that a transaction between a trust and its deemed owner (for income tax purposes) is disregarded (for income tax purposes).[4579]

The regulation that treats the beneficiary as the Code § 678(a) provides that the trust's selling or distributing the stock is attributable to the trust, not the beneficiary,[4580] but does not discuss the consequences of the trust buying S corporation stock. This regulation overrode Rev. Rul. 92-84, which applied grantor trust treatment to a QSST's sale of S corporation stock; however, the logic of Rev. Rul. 92-84 might continue to apply (as a matter of good analysis, not as a matter of precedent) to the extent that the regulation is silent. The preamble to the regulation[4581] overrode Rev. Rul. 92-84 for practical reasons: if the trust no longer holds S stock during the deferred consummation of an installment sale, how could QSST treatment apply? That should not be a concern when the trust is buying stock. Although the IRS might have concerns about the asymmetry involved (the trust buying stock from the beneficiary having a different result than the trust selling stock to the beneficiary), those concerns would not appear to be supported by the IRS' official pronouncements.[4582]

[4579] Code § 1361(d)(1)(B) provides, for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the [QSST] election … is made.

[4580] For gain on sale of stock or assets and for related planning opportunities, see text accompanying fns. 4480-4482.

[4581] T.D. 8600.

[4582] This asymmetry already exists under Rev. Rul. 85-13. In that ruling, initially the trust was not a grantor trust. The grantor bought stock from the trust in exchange for an unsecured promissory note. The note's existence is what made the trust a grantor trust deemed owned by its grantor and caused the transaction to be disregarded. On the other hand, if the trust had bought stock from its grantor, its grantor would have recognized gain on the sale, because a promissory note owed by the trust to the grantor would not have triggered grantor trust status. This asymmetry did not prevent that ruling from becoming the IRS' formal position.

Notice 97-24 points out that Rev. Rul. 85-13 avoids assets receiving a basis step-up. In the case of a beneficiary selling to a QSST, if the beneficiary did not pay capital gain tax on the sale to the trust, then the stock the trust acquires, which will be outside of the estate tax system, will not receive a new basis and therefore will be taxed more highly to the trust if sold after beneficiary's death (or after any other event terminating grantor trust status).

Based on a long line of law, Rev. Rul. 85-13 held that the deemed owner was the deemed owner of the trust's property. See fn. 4914.

The bottom line is that the beneficiary would be deemed to own the stock that the beneficiary sells to the trust both before and after the proposed transaction. One cannot have a recognition event when one sells closely-held business stock, which Rev. Rul. 90-7 expressly held is deemed owned by a trust's deemed owner, to oneself. Rev. Rul. 85-13 recognized this longstanding principle when it reasoned:

> A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925).

The *Dobson* case itself involved closely-held business stock. Rev. Rul. 2007-13 reaffirmed this concept, and it should be applied to the sale to a QSST as well.

If an income beneficiary who sells S corporation stock to an existing QSST that already owns stock in the same S corporation, the above analysis might be more comfortable. Three companion private letter rulings, in approving the merger of one QSST into another, used analysis that supports this concept:[4583]

> Under 1.1361-1(j)(7), the X shares which make up the corpus of Exempt QSST A and Exempt QSST B are treated as directly owned by Y. Any transfer of the X shares, pursuant to a merger under Article 5.6, would effectively be a transfer of the shares from Y to Y.

What is the tax treatment of interest payments on a promissory note a QSST uses to buy stock in an S corporation?[4584] The IRS has taken the position that, when the QSST buys stock from a third party using a promissory note, the note is part of the S corporation portion that is deemed owned by the QSST's beneficiary and therefore is deductible by

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[4583] Letter Rulings 200441013, 200441014, and 200441015.

[4584] In all fairness, the beneficiary should get the deduction, especially in light of the separate share rules under Code § 663. However, an argument can be made that only S corporation K-1 items are treated as part of the Code § 678 share allocated to the beneficiary. Code § 1361(d)(1)(B) provides, "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made...." On the other hand, Code §§ 1361(d)(1)(B) and 641(c)(1)(A) use very similar language. Therefore, when an issue is not expressly addressed by authority, the ESBT and QSST rules should be read consistently. The principle behind the ESBT regulation quoted in fn 4549 tends to support the beneficiary's deduction of interest under Code § 1361(d)(1)(B) (or a disregard of the interest income and deduction under Code § 678 if the seller is the beneficiary), because the Regulation's allocation of the interest to the S portion remains intact.

Furthermore, often a trust that holds stock in an S corporation is split off as a separate QSST, which never accumulates any income, because all of the income is distributed to the beneficiary. Allocating income to a nonexistent non-S portion would not make sense in those situations. That contrasts with ESBTs, where generally there is no reason for the S stock to be held in a separate trust.

Allocating the interest deduction to the non-S corporation portion of the trust would result in a mismatch, in that the interest the trust pays is allocated to income that the beneficiary, not the trust, is treated as owning for income tax purposes. It would appear to run counter to the spirit of the debt-tracing rules of Reg. § 1.163-8T, which would characterize the interest as related to the S corporation. If the interest is allocated to the non-S corporation portion of the trust, its deductibility should relate to the nature of the income passing through on the K-1 the trust receives from the company. To the extent the K-1 income is income from a trade or business, presumably the interest would be expense from trade or business that would generate a net operating loss carryover if the trust did not have sufficient other income. Reg. § 1.163-8T(a)(4)(i). Notice 89-35 supports this approach:

> In the case of debt proceeds allocated under section 1.163-8T to the purchase of an interest in a passthrough entity (other than by way of a contribution to the capital of the entity), the debt proceeds and the associated interest expense shall be allocated among all the assets of the entity using any reasonable method. Reasonable methods of allocating debt among the assets of a passthrough entity ordinarily include a pro-rata allocation based on the fair market value, book value, or adjusted basis of the assets, reduced by any debt of the passthrough entity or the owner allocated to such assets.

If the trust generates a net operating loss (NOL) carryforward due to the interest expense, be sure not to make an ESBT election, as Chief Counsel Advice 200734019 takes the position that the NOL carryforward is not deductible against ESBT income.

the beneficiary.[4585] Informal conversations indicated that this position was the result of discussions at the highest levels of IRS policy-makers. Interest expense is deductible on Schedule E, Part II of the beneficiary's individual income tax return.[4586]

This position - that the promissory note is part of the S corporation portion that the beneficiary is deemed to own - gives me confidence that a beneficiary's sale to a QSST would be disregarded under Rev. Rul. 85-13 because the beneficiary would be considered to be selling to himself or herself.[4587]

III.A.3.e.vi.(b). Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made)

Using QSSTs involves challenges that do not apply to other Code § 678 trusts. Consider the disadvantages of an S corporation as an investment vehicle that is shared among family members:

- Inability to Divide S Corporation. An S corporation that does not engage in a trade or business would not be able to be divided income-tax free under Code § 355.[4588] This would trap all family members in a single investment entity, unable to manage investments suitable for each person's goals.

- Tax Cost of Distributing Investments. A distribution of investments would be taxed as a sale.[4589] Thus, distributing marketable securities to family members so that they go their separate ways would subject them to capital gain tax on the deemed sale of the investments. Distributing depreciable property might subject them to tax on ordinary income.[4590]

[4585] CCA 201327009 allows the beneficiary to deduct the interest when the QSST buys from a third party using a promissory note. The IRS declined to rule on the loan's effect under the at-risk rules out of concern that taxpayers would set up a Code § 465(c)(4) device to limit liability. Because the trust had no other assets, debt tracing was not a concern, and all of the interest was allocated to the S corporation activity. The IRS also declined to address the passive loss rules.

[4586] The 2013 instructions to Form 1040, Schedule E, Part II say:

> Interest expense relating to the acquisition of shares in an S corporation may be fully deductible on Schedule E. For details, see Pub. 535.

Publication 535, for use in preparing 2013 returns, says to report interest expenses from S corporation business borrowing on Schedule E (Form 1040), line 28, entering interest expense and the name of the S corporation in column (a) and the amount in column (h). Presumably this would also apply to loans to a QSST to acquire stock in an S corporation.

[4587] This background on CCA 201327009 results from informal discussions with an attorney, who has since left the IRS, when I asked whether the IRS would consider approving a sale to a QSST. The IRS informally indicated that it would decline to issue such a ruling if I sought it, because it was not totally certain of the result and does not wish to encourage sales to Code § 678 trusts. It was suggested that the IRS never would have approved a sale to an irrevocable grantor trust if it had realized that the technique would become so popular.

[4588] See part II.Q.7.f Corporate Division, including part II.Q.7.f.iii Active Business Requirement for Code § 355.

[4589] See part II.Q.7.h.iii Taxation of Corporation When It Distributes Property to Shareholders.

[4590] See part II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.

However, pre-mortem planning might help. Suppose the trust is a credit shelter trust or a GST-exempt trust and the beneficiary's estate is subject to estate tax. If the QSST sells its investments that have unrealized gain, the income (capital gain) tax liability will be a debt deductible on the beneficiary's estate tax return. Harvesting gain would prevent the distribution of securities from being a taxable event at the shareholder level. However, the distribution of securities in a corporation would generate income tax to the extent that the fair market value of the distribution exceeds the basis (and might generate dividend income if and to the extent the corporation had been a C corporation and the distribution constituted a distribution of earnings and profits); on the other hand, the recognition of gain on the sale of securities would increase the stock's basis.[4591] Just be sure that the pre-mortem gain harvesting is not pursuant to a plan of liquidation[4592] or a sale of stock combined with a Code § 338(h)(10) election;[4593] either event would subject to sale of assets to stock at the trust's level, rather than the beneficiary's level.[4594]

- Inability to Swap. Although a beneficiary does not recognize gain or loss when selling S corporation stock to a QSST, the trust would recognize income on selling S corporation stock back to the beneficiary.[4595]

- All Income Must Be Distributed. A QSST must distribute to its beneficiary all of its trust accounting income. This can be controlled by the S corporation not making distributions to the trust. The IRS might argue that failure to make a distribution constitutes a gift. Note, however, that the IRS considers 3%-5% to be a reasonable range for income distributions.[4596] If the right to require income lapses annually and the undistributed income does not exceed 5%, then presumably the lapse (if a lapse at all) would be with the lapsing withdrawal right 5-and-5 safe harbor of Code § 2514(e).

- Personal Use Assets. Placing personal use assets inside an S corporation would require the charging of rent. The S corporation would recognize rental income, and those paying rent would not be able to deduct that rent. If the beneficiary uses a trust asset for personal purposes, he does not need to pay rent, since the point of the trust is to benefit him.

These limitations are not imposed on Code § 678(a)(2) trusts. When their assets are divided among family members, the division is done on a tax-free basis and they can each go their separate ways quite easily.

4591 See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
4592 See fn. 4481, found within part III.A.3.e.i.(a) QSSTs Generally. This is important because an S corporation that used be a C corporation can avoid dividend taxation by engaging in a liquidation; see fn. 3499, found within part II.Q.7.a.vii Corporate Liquidation.
4593 See fn. 4482, found within part III.A.3.e.i.(a) QSSTs Generally.
4594 In addition to the citations within fns. 4592 and 4593, see part II.J.15.a QSST Treatment of Sale of S Stock or Sale of Corporation's Business Assets (Including Preamble to Proposed Regulations on NII Tax).
4595 Reg. § 1.1361-1(j)(8); see fns. 4480-4482.
4596 See part II.J.8.c.i Capital Gain Allocated to Income Under State Law, especially the text accompanying fn. 1877.

Consider who pays income tax for the year in which the beneficiary dies.[4597] These considerations also apply when the beneficiary of a Code § 678(a)(2) trust dies, although the beneficiary of the latter has a broader power of appointment than the former.

Income tax difficulties in splitting an S corporation after the beneficiary's death might be addressed as follows:

- Form a Partnership. By forming an entity taxed as a partnership with the beneficiary, other family members, or other trusts, a QSST might be able to access investment opportunities not otherwise available to it or might be able to facilitate their access to investment opportunities not available to them. Although such a partnership could preserve the expected annual cash flow, the commitment to retaining funds in the partnership would reduce the fair market value of the S corporation's partnership interest. This value reduction would also reduce the tax if the corporation distributes some or all of assets when the QSST divides upon the beneficiary's death. Such a partnership should be formed well in advance of the beneficiary's death.[4598] When the beneficiary dies, perhaps the S corporation would distribute some of its partnership interests right away so that the trust could immediately fund part of the bequests; then, later, after the trustee is satisfied that all tax and other fiduciary liabilities have been resolved, the S corporation could distribute the remaining partnership interests.[4599] Furthermore, the partnership could later divide in a variety of ways on a tax-free basis,[4600] so that each family member can implement his or her own investment strategy over time; however, if the family members do not have strategies that either are consistent with each other's or complement each other's, pursuing different investment strategies would rend to require asset sales that might generate capital gain tax.[4601]

- Create Separate Corporations. Suppose a trustee decides to contribute its assets to an S corporation with the expectation that the beneficiary will make a QSST election. Instead, consider forming a separate S corporation for the future benefit of each of the beneficiary's children. When the beneficiary dies, each of the beneficiary's children will be allocated a separate S corporation, thereby eliminating the need to divide the corporation or distribute its assets. This solution merely postpones the issue, because these issues would need to be addressed when a child of the beneficiary dies (or if a child predeceases the beneficiary, but that postponement might be sufficiently beneficial to address concerns for a while).

See also parts II.A.2.e.ii Estate Planning and Income Tax Disadvantages of S Corporations, II.A.2.e.iii Which Type of Entity for Which Situation? and III.A.3.d Special

[4597] See part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.
[4598] See part II.Q.7.h Distributing Assets; Drop-Down into Partnership, especially fn 3694.
[4599] Distributing in stages would tend to alleviate the concerns described in fn 3694.
[4600] See part II.Q.8 Exiting From or Dividing a Partnership.
[4601] If the strategies are consistent with each other's, then the partnership could simply divide pro rata. If the strategies complement each other's, then each person could take the assets that interest him or her. Anything else would require post-division adjustments, most likely accomplished through sales.

Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

III.A.3.e.vi.(c). Required Structure for a Sale to a QSST (Including Possible Pitfalls)

In QSSTs, all income must be distributed to the beneficiary.[4602] Therefore, at first glance, it would appear impossible for a QSST to use its S corporation distributions to buy stock.

However, if a QSST buys stock in a secured sale in which it pledges all of its S corporation distributions, the trust never receives the distributions, so the trust has no income receipts to pay to the beneficiary.[4603] Private letter rulings have readily accepted this theory for mandatory income trusts;[4604] this theory should apply to a discretionary income trust.[4605]

[4602] Reg. § 1.1361-1(j)(1)(i) provides

> All of the income (within the meaning of § 1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366….

[4603] The trust would need to pay any future cash receipts of principal to the beneficiary to make up for this diversion of amounts that would otherwise constitute trust accounting income. Adopting Section 502(b) of the Uniform Principal and Income Act (last amended or revised in 2008; see http://www.uniformlawcommission.com/Act.aspx?title=Principal and Income Amendments (2008)), RSMo section 469.453.2 provides:

> If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

[4604] This accounting treatment is consistent with Letter Rulings 200140040 (which not only diverted dividends to repay the seller but also required that the trust pay additional purchase price if it resold the stock within a certain period of time after buying the stock), 200140043, and 200140046 (trust's purchases from another shareholder), as well as 9140055 (distributions used to pay bank loan used to buy stock), which rulings essentially treated the repayment of principal on the notes as income disbursements rather than principal disbursements. See also Letter Ruling 9639013, permitting the use of income to repay notes on a seller-financed sale to QSSTs, CCA 201327009 did not expressly consider this issue. However, based on the facts and conclusion, it implicitly assumed that the use of S corporation distributions to repay the note was permitted.

Other rulings dealing with principal and income issues include Letter Rulings 9140055 (beneficiary repayment of trust distribution to pay interest QSST owed bank), 200446007 (deemed dividend is not fiduciary accounting income and therefore not required to be distributed), and 200451021 (redemption treated as distribution for income tax purposes, but proceeds were principal not required to be distributed).

[4605] What if the trust would be relying on the payment of actual income to satisfy Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i)? One might be concerned that the trust would be receiving no income and therefore would be making no distributions of income. On the other

A significant disadvantage is that this method might take twice as long as a normal sale to a grantor trust. In most states, the trustee must transfer from principal to income an amount equal to the income paid to reduce the principal balance of the note (as used in this part III.A.3.e.vi.(c), the "adjustment amount").[4606] Thus, although note payments complete the sale (the obligation to the beneficiary in the beneficiary's capacity as a creditor), they create an obligation that the trust owes to the beneficiary as a beneficiary:

- Worst Case Scenario – Simplistic view. In other words, first the trust repays the note, then the trust repays the beneficiary the income that was diverted from the beneficiary (as a beneficiary) to pay the note. Thus, the original note principal is not removed from the estate tax system until both the note and the adjustment amount to the beneficiary are fully paid. However, if the adjustment amount is not expected to paid made for a while, consider that the possible inclusion of the adjustment amount in the beneficiary's estate might very well be the present value of that principal distribution, which might be significantly less than the amount of the principal that is owed.

- Actual Law – Not So Bad? The trust's obligation is to transfer to income principal equal to the adjustment amount. This means that, when the trust receives cash generally classified as principal, it must reclassify that cash as income, to the extent of the adjustment amount. That principal receipt might never happen during the beneficiary's life, and the trust might never be required to pay the beneficiary.

Consider the following ways to repay this additional obligation, if it exists:

1. Suppose the trust is a discretionary income trust. Perhaps an independent trustee would be able to toggle on and off the mandatory income feature (which, of course, is not possible in a one-lung QTIP plan[4607] but might be possible using a *Clayton*-QTIP plan).[4608] After the note is repaid, the independent trustee might turn off the mandatory income obligation. If the beneficiary never needs the income under the standards provided by the trust, the trust might accumulate funds thereafter and never pay cash equal to the full adjustment amount. However, the IRS might argue that such a modification undermines the point of recharacterizing the principal as income,[4609] so consider a compromise: Instead of the trustee accumulating income under the discretionary standards and perhaps never paying the adjustment amount, the trustee and beneficiary come to the following agreement: The trustee agrees to pay future income to the beneficiary to the extent of the adjustment amount, notwithstanding the fact that the trustee has determined that the beneficiary would

hand, all of the company's distributions that are payable to the trust would in fact wind up in the hands of the trust's sole beneficiary; it will simply get there as a note repayment, rather than as a distribution. Thus, relying on the payment of actual income would not appear to violate the spirit of Code § 1361(d)(3)(B) and Reg. § 1.1361-1(j)(1)(i).

[4606] See fn. 4603.

[4607] For an explanation of a one-lung plan, including some of its advantages and disadvantages, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.

[4608] For a description of a *Clayton*-QTIP plan, see the paragraph accompanying fn. 4624.

[4609] Reg. § 1.643(b)-1 provides, "Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized." See part II.J.8.c.i.(e) Fiduciary Income Tax Recognition of the Trust Agreement and State Law, especially the text accompanying fn. 1876.

not receive income under the trust's new distribution standards. That income is payable until the earlier of the beneficiary's death or amounts equal to the adjustment amount have been paid. The trustee might sign a revocable letter directing the company to pay the beneficiary directly any distributions of income (up to the adjustment amount) that normally would have gone to the trust.

2. If the trust is a mandatory income trust, see whether the corporation will make a distribution to all shareholders in partial liquidation of the entity or merely redeem the trust's stock, depending whether it is important to keep proportionate stock ownership. Such a distribution or redemption might very well constitute a nontaxable return of AAA (reinvested S corporation taxable income).[4610] For example, a partial liquidation would be a principal distribution for trust accounting purposes (even if it is a distribution of AAA for income tax purposes) that could then be used to repay the principal obligation.

3. If the trust has other assets, then gain from the sale of other assets would be used to repay this principal obligation. Being transferred to income[4611] or being used to determine a distribution[4612] should cause the capital gain to be taxed to the beneficiary.

When drafting a trust that might engage in such a transaction, keep in mind the above issue. Perhaps the trustee might have some flexibility in allocating receipts and disbursements between principal and income?[4613] Perhaps the trust might have a provision requiring the trustee to give the beneficiary notice of a right to principal and provide that the right to that principal adjustment lapses as provided in Code § 2514(e)?

Consider whether the IRS might attack the sale as follows: The IRS might argue that stock's value exceeded the sale price; therefore, the IRS might argue, the seller made a gift to a trust that benefits the seller, triggering Code § 2036 inclusion. One might consider using a defined value clause,[4614] instructing the trustee to distribute any excess value to a separate share of the trust, of which 10% would be structured as a completed gift (no power of appointment over the remainder) and 90% would be structured as an incomplete gift (power of appointment over the remainder - perhaps even a presently exercisable withdrawal right). With adequate disclosure, the gift tax statute of limitations would run regarding how much comprises the completed gift and incomplete gift portions.[4615] The separate share of the trust would be treated as a separate trust for QSST purposes; however, the separate share's treatment as a grantor trust as to the seller[4616] would make a QSST election unnecessary during the seller's life.

[4610] See part II.Q.7.b Redemptions or Distributions Involving S Corporations.
[4611] See part II.J.8.c.i Capital Gain Allocated to Income Under State Law.
[4612] See part II.J.8.c.iii Allocated to Principal but Actually Distributed to the Beneficiary or Used by the Trustee to Determine the Amount Distributed or Required to be Distributed to a Beneficiary.
[4613] For flexibility in allocating between income and principal, see part II.J.8.c.i Capital Gain Allocated to Income Under State Law, which includes a sample general clause (not geared toward the QSST sale issue) as well as the regulations governing such allocations.
[4614] See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.
[4615] See part III.B.4 Adequate Disclosure on Gift Tax Returns.
[4616] Code § 677.

Such a possible Code § 2036 attack may deter using this technique. If one is trying to move miscellaneous assets by contributing them to an S corporation and selling the S corporation stock to a trust, consider instead using a preferred partnership.[4617] However, if one has an operating business in an S corporation, a preferred partnership is not available[4618] unless the transferor is the sole owner or all of the owners have the same estate planning goal.[4619]

III.A.3.e.vi.(d). Using a QSST to Buy Stock When Using a "One-Lung" Marital Deduction Plan

One of my favorite estate planning tools for married couples is to bequeath the entire residue into a trust that can qualify to the QTIP marital deduction. The executor may elect a marital deduction with respect to none, part, or all of the trust. For an explanation of some of the advantages and disadvantages of such a plan, see part II.H.2.a Free Basis Step-Up When First Spouse Dies.

More recently, I have been including in the trust the authority for an independent trustee to make distributions for the surviving spouse's welfare. If the surviving spouse is the trustee, he or she may appoint as a co-trustee a person who is not a related or subordinate party,[4620] who could make a distribution for welfare and then resign.

Suppose the decedent's estate tax exemption is insufficient to cover all of the decedent's S corporation stock. Some S corporation stock is allocated to a trust excluded from the estate tax system (a "nonmarital trust"), and the rest is allocated to a marital deduction trust (a "marital trust"). The surviving spouse elects QSST treatment for each trust.[4621] The marital trust distributes its S corporation stock to the surviving spouse, who then sells it to the nonmarital trust in exchange for a promissory note.

If the client has an independent trustee who is quite comfortable with the surviving spouse and the remainderman, one might consider using *Clayton*-QTIP planning.[4622] *Clayton*-QTIP planning is where the portion that is not elected QTIP goes to a trust that has different dispositive provisions than the portion that is elected QTIP.[4623] In the nonmarital trust, an independent trustee would be able to distribute income for the surviving spouse's welfare (in addition to any other desirable discretionary distributions

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[4617] See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

[4618] A partnership is not an eligible owner of a S stock. Code § 1361(b)(1)(B); see part II.A.2.f.v Relief for Late S Corporation and Entity Classification Elections for the Same Entity.

[4619] If the transferor is the sole owner or all owners have the same estate planning goals, the S corporation itself could contribute its assets to a preferred partnership. See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

[4620] As fn. 5062 explains, the spouse's power to appoint a trustee who can distribute for the spouse's welfare will not cause the spouse to hold a general power of appointment if the trustee is not a related or subordinate party, as defined in Code § 672(c) (see fn. 1751).

[4621] Using this strategy, a QSST election is required for the nonmarital trust but not for the marital trust. However, making such an election for the marital trust tends to simplify income tax issues.

[4622] Authorizing an independent trustee to be the executor with authority to make the QTIP election should avoid any attack the IRS might make whether a spouse who is the executor had made a gift to the extent that failure to make a QTIP election causes the surviving spouse to lose his or her mandatory income rights.

[4623] Reg. § 20.2056(b)-7(d)(3) authorizes this in response to case law.

for the surviving spouse). This would help address a particular drawback to sales to QSSTs.[4624]

III.A.3.e.vi.(e). Converting Existing Trust to a QSST to Obtain Beneficiary Grantor Trust Status

Suppose the client is the beneficiary of an existing GST-exempt trust with discretionary distributions. Consider converting the trust into a QSST, by whatever legal means are available to do so. Consider the ideas discussed in parts III.A.3.e.iv Flexible Trust Design and III.A.3.e.v Converting a Multiple Beneficiary ESBT into One or More QSSTs.

Then the client can sell the client's S corporation stock to the QSST.

If the client does not have an S corporation, the client could contribute assets to an S corporation and then sell the S corporation stock to the trust. Alternatively, an existing GST-exempt trust with only one beneficiary might simply form an S corporation and the beneficiary make a QSST election, effectively converting the trust to a beneficiary grantor trust.[4625] However, in either case, be sure to consider exit strategies upon the client's death, as described in part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts.

III.A.3.e.vi.(f). QSST to Convert Terminating Trust to GST-Exempt Life Trust

Suppose the client created a trust for children that terminates at various ages. The client could create a QSST for each adult child.

See part III.A.3.e.vi.(e) Converting Existing Trust to a QSST for considerations involved in using this strategy.

III.A.4. Trust Accounting Income Regarding Business Interests

When a trust holds a business entity interest, complicated accounting and tax issues can arise. One of the main reasons for these complexities is the difference between accounting income and taxable income. Accounting income helps determine the amount of distributions a trust is required to make, under the governing instrument or state law, which in turn may determine how much taxable income is carried out to the beneficiaries of the trust. The Code defines "income required to be distributed currently" as the fiduciary accounting income that must be distributed currently pursuant to the governing instrument or state law. Because fiduciary accounting income is determined by state law or the governing instrument, differences between taxable income and accounting income generally arise. An example of such a difference would be capital gains. Capital gains are usually principal for fiduciary accounting purposes, but taxable income for income tax purposes.

[4624] See fn. 4608.

[4625] This would be ideal if the trust is already a mandatory income trust. If the trust is not a mandatory income trust, then complying with the requirement to distribute all income might be tricky.

III.A.4.a. General Strategies Regarding Fiduciary Income Taxation of Business Interests

Trusts and estates reach the top income tax brackets and are subjected to the 3.8% tax on net investment income[4626] far more rapidly than beneficiaries. See part II.J Fiduciary Income Taxation.

Part III.D Hypothetical illustrates the issues described in this part III.A.4 Trust Accounting Income Regarding Business Interests. That income tax dynamic may subject income to a higher tax bracket than if all of the income were taxed in a QSST, in which the beneficiary is the deemed owner of all of the K-1 income.[4627] Thus:

- If the trust holds S corporation stock, consider facilitating a QSST election.
- If the trust holds a partnership interest, consider placing the partnership interest in an S corporation (or in a slightly more elaborate structure)[4628] and facilitating a QSST election.

III.A.4.b. Example for Trust Accounting Income Regarding Business Interests

A similar problem can arise when a trust holds a partnership interest. Often a partnership may report significant earnings on its K-1s, but may distribute a much smaller amount in cash to its partners. For example, a trust could receive a partnership K-1 with $100,000 of taxable income, but may only receive $60,000 of cash as a distribution. The $60,000 is all the accounting income, because the amount distributed does not exceed the amount of income attributable to the trust.[4629] When this happens, the trust will have distributable income equal to $60,000, but will be unable to distribute the additional $40,000 of "phantom income" from the K-1, meaning the trust will be taxed on the $40,000. This can lead to cash flow problems when the trust has no other income, since once the trust distributes the $60,000 to the beneficiary it will have no available cash to pay the taxes. The Uniform Principal and Income Act[4630] provides a solution to this problem. Under old section 505(c)(1), a tax that is required to be paid by a trustee on the trust's share of an entity's taxable income is proportionally divided between principal and income based on the receipts allocated to each.[4631] Thus, the trustee will be able to keep some of the cash to pay the taxes on the trust's undistributed income. See below for the 2008 clarification to section 505 that makes sure that the trustee has enough money to pay the tax.

Another example, with a flowchart, is at part III.D.2 Trust Accounting and Taxation.

4626 See part II.I 3.8% Tax on Excess Net Investment Income.
4627 See part III.A.3.e.i QSSTs.
4628 The trustee might place the partnership interest into an LLC, owned by one S corporation for each expected remainderman. See part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts (Whether or Not a Sale Is Made).
4629 Uniform Principal and Income Act § 401(b). See footnote 4630.
4630 Citations to the Uniform Principal and Income Act are to the version adopted in 1997, as amended or revised in 2000, published August 21, 2003, by the National Conference of Commissioners on Uniform State Laws.
4631 See also RSMo §469.459.3(1).

III.A.4.c. 2008 Clarification of Uniform Principal & Income Act Regarding Business Entities, Taxed as Partnerships or S Corporations, Held in Trust

In the summer of 2008, the Uniform Law Commission amended Section 505 of the Uniform Principal & Income Act (the "UPAIA"); see Appendix to this article. The amendment responds to litigation over the income tax burden when a mandatory income trust holds an interest in a partnership or other pass-through entity. This article addresses the concerns underlying the changes, explains the changes, and discusses the planning implications of this change and related issues.

When a mandatory income trust holds an interest in a partnership or other flow-through entity, coordinating the UPAIA with fiduciary income tax rules can get tricky. The changes to UPAIA section 505 provide needed clarity regarding the treatment of taxes paid regarding a trust's distributive share of an entity's income; however, they do not address the other issues described in part II.J.5 Issues Arising with Mandatory Income Trusts.

III.A.4.c.i. Concerns Underlying the UPAIA Section 505 Changes

Before discussing the technical reasons for change, one must understand some of the basic income tax rules governing business entities, the rules governing the income taxation of trusts, and how they interact.

Income Tax Rules Governing Business Entities

Three different paradigms apply to business entities. A traditional corporation (also known as a "C corporation") pays income taxes on its own income. When it distributes its current or accumulated earnings, the distribution is taxed to its shareholders as a dividend. It might also make one or more distributions in partial or total liquidation, which is taxed to its shareholders as a sale of part or all of the stock rather than a dividend if certain tax law requirements are satisfied.

The Tax Reform Act of 1986 prevented C corporations from liquidating without both the shareholders and corporation being taxed. These new rules encouraged those who owned C corporations to convert them to S corporations. S corporation owners are taxed on the corporation's income rather than the corporation being taxed on the income. An example will help explain this difference:

- <u>C Corporation</u>. Suppose the corporation has one shareholder, A. A invests \$1,000x. In Year 1, the corporation earns \$100,000x and pays \$40,000x in income tax, leaving \$60,000x of after-tax earnings and a total of \$61,000x of cash. The corporation liquidates, distributing \$61,000x to A. A pays income tax of \$12,000x on the excess of the \$61,000x proceeds over the \$1,000x that A invested. After paying taxes, A has \$49,000x (\$61,000x liquidation proceeds minus \$12,000x taxes that A paid).

- <u>S Corporation</u>. Same situation, only an S election is in place. In Year 1, the corporation pays no income tax on its earnings; instead, A receives Schedule K-1 from the corporation reporting \$100,000x of gross income and pays \$40,000x income tax on the corporation's earnings. Section 1366(c) of the Internal Revenue Code of 1986, as amended (the "Code"). The corporation distributes $40,000x to A to pay the income taxes, so A has really not used any of A's own money to pay the income tax. Code Section 1368(b)(1) provides that this distribution is not taxed because it does not exceed the shareholder's tax basis. However, A's investment in the corporation has increased for income tax purposes. A's basis is now $61,000x, which is the $1,000x that A invested, plus the $100,000x income on which A was taxed, minus the $40,000x that the corporation distributed to A to pay A's income tax. Code Section 1367. The corporation then liquidates, distributing $61,000x to A ($1,000x that A invested, plus $100,000x earnings, minus $40,000x distributed to A to pay A's income taxes). A keeps the entire $61,000x without paying any income tax on the distribution, because A received the same amount as A is deemed to have invested.

In the example, the sole shareholder has received more using an S corporation than using a C corporation. The $40,000x that the S corporation distributed to A really was not intended as a benefit to A; instead, it was reimbursing A for the taxes that A paid on the corporation's income. The $40,000x is referred to below as a "tax distribution."

C and S corporations are the first two of the three paradigms. Partnerships (including limited liability companies taxed as partnerships) have similar effects on the taxation of owners for purposes of UPAIA section 505. Therefore, this article refers to S corporations and partnerships as "flow-through" entities, and uses "Schedule K-1 income" to describe the income from the flow-through entity that an owner needs to report. For reasons beyond the scope of this article, partnerships have much more flexible income tax rules regarding distributions from the entity to owners.

In the example above, let's compare distributions from C corporations with distributions from flow-through entities.

- The owner of a C corporation receives no distribution.

- The owner of a pass-through entity receives a tax distribution, so that the owner retains no cash after paying income taxes.

Suppose that, in the example above, the owner is a mandatory income trust:

- A trust that owns stock in a C corporation has no trust accounting income because it has no receipts.

- How much trust accounting income does a trust that owns a pass-through entity have that must be distributed to the beneficiary? To achieve parity with the C corporation scenario, the income taxes paid using the tax distribution would be charged against income, so that again the beneficiary receives nothing. However, that result was not clear under UPAIA section 505 before the amendment.

One must understand trust income taxation to fully understand how UPAIA section 505 works.

Income Tax Rules Governing Trusts

Suppose a trust receives Schedule K-1 reporting $100,000x income. Ignoring the trust's small exemption amount and very modest use of lower tax brackets, the trust would be required to pay $40,000x of income tax, assuming a 40% federal and state income tax rate. However, if the trust distributes $100,000x to its beneficiary, it receives a $100,000x income distribution deduction and pays no income tax;[4632] instead, the trust gives the beneficiary a Schedule K-1 reporting $100,000x income, and the beneficiary pays income tax on the $100,000x Schedule K-1 income (to the extent not offset by the beneficiary's deductions, exemptions, etc.).[4633]

Carrying this example further, suppose the trust receives only a $40,000x tax distribution and does not have other funds to distribute to the beneficiary. If the trust distributes the $40,000x to the beneficiary, then the trust receives a $40,000x income distribution deduction and must pay $24,000x income tax ($60,000x multiplied by 40%) on its remaining $60,000x ($100,000x Schedule K-1 income minus $40,000x income distribution deduction) taxable income. However, the trustee has no funds with which to pay the $24,000x income tax. In fact, the only way to prevent the trustee from not being able to pay income tax with respect to the Schedule K-1 income would be for the trustee to retain the entire tax distribution.

What are the principles that apply to determining the income distribution deduction described above? First, compute the amount of trust's distributable net income (taxable income, with certain adjustments). Next, determine the amount required to be distributed and any additional amounts actually distributed to the beneficiary. The income distribution deduction, which is always taxable to the beneficiary through the Schedule K-1 the trustee gives to the beneficiary, is the lesser of the distributable net income or the distributions described above. The rules become more complicated when one considers capital gains, tax-exempt income, or other similar issues, but the framework is similar.

Now let's apply this to a mandatory income trust. The trust accounting income, determined under the UPAIA, is an amount required to be distributed using the above principles. Some people assume that the Schedule K-1 income is the amount deemed distributed. That assumption is false. For income tax purposes, the amount of income required to be distributed is based on state law fiduciary accounting income.[4634] UPAIA Section 102(4) provides that "'income' means money or property that a fiduciary receives as a current return…." Thus, income would not exceed "money or property that a fiduciary receives" even if the Schedule K-1 income is higher.

In a trust that receives a $40,000x tax distribution, the trust has $40,000x of income receipts.[4635] How much income tax should the trustee deduct from the $40,000x receipt to determine the income that must be distributed? UPAIA section 505 answers that question. However, the answer was unclear and bred litigation, because beneficiaries receiving no cash from a mandatory income trust were understandably upset. Below,

[4632] Code §§ 651, 661.
[4633] Code §§ 652, 662.
[4634] Reg. §§ UPAIA Section 401(b).
[4635] UPAIA Section 401(b).

this article explains the UPAIA change and how attorneys drafting estate plans or representing disappointed beneficiaries might advise their clients in light of these changes and existing law.

III.A.4.c.ii. Explanation of the UPAIA Section 505 Changes

Before this amendment, the language of UPAIA section 505 was ambiguous regarding accounting for tax distributions. The amendment clarifies the overriding principle that the trustee of a mandatory income trust uses tax distributions to the extent necessary to pay income taxes and distributes any remaining income to the beneficiary. The official comments contain an algebraic formula that might be used when an interrelated calculation is required, which is whenever distributions from a pass-through are less than its Schedule K-1 income and the trustee has no other funds to distribute to the beneficiary or pay income tax on its Schedule K-1 income.

The policy behind this change is that the UPAIA should not place trustees in a position where they cannot pay the trust's income tax. Generally, it is not practical or prudent for a trustee to borrow to pay income tax when the trustee has no idea when, if ever, a distribution in excess of a tax distribution will be made. Furthermore, if the trust owned C corporation stock rather than an interest in a flow-through entity, the trust would never have received a distribution from the business entity anyway.

In the example above, suppose the business entity annually accumulated the $40,000x excess of Schedule K-1 income over the tax distribution. Suppose these accumulated amounts were later distributed to the trust. UPAIA section 506(a)(3) would authorize additional distributions to the beneficiary because the beneficiary essentially paid the tax on these accumulated amounts when the trustee used the tax distributions to pay income tax instead of distributing part or all of them to the beneficiary.

- Before turning to advising clients about these changes, let's discuss particular rules affect how these rules apply to various trusts that own stock in S corporations:

- An electing small business trust ("ESBT") does not receive an income distribution deduction with respect to its Schedule K-1 income that is distributed to its beneficiary.[4636]

- A qualified subchapter S trust ("QSST") under Code Section 1361(d), or other trust treated as wholly owned by one grantor or one beneficiary, does not pay taxes on any of its Schedule K-1 income from an S corporation. Instead, the individual beneficiary or grantor treated for income tax purposes as receiving Schedule K-1 income pays all the income taxes attributable to the Schedule K-1 income.[4637] Therefore, the trustee would distribute to the beneficiary all of the tax distribution.

- Only in very limited situations may a trust not described above be qualified to hold stock in an S corporation. The main situations involve trusts that were grantor trusts during the grantor's or beneficiary's life (but only for the two

[4636] Code § 1361(e); Reg. § 1.641(c)-1(i).
[4637] Code § 1361(d)(1)(B).

years following the deemed owner's death), estates (including a revocable trust taxed as an estate if a Code Section 645 election is made), and trusts that are funded upon termination of an estate (but only for the two years following funding).[4638]

III.A.4.c.iii. Advising Clients about the UPAIA Section 505 Changes

The common yet extreme scenario posited – where a mandatory income trust owns only an interest in a flow-through entity that limits distributions to tax distributions – presents difficult challenges for settlors, trustees, and beneficiaries. The changes to UPAIA section 505 allow the trustee to pay the trust's taxes notwithstanding these significant other challenges. One must consider why this difficult situation arises, what the trustee must do to alter the trust's investments if the trust agreement does not address the issue, and how to minimize disputes about what the trustee should do.

III.A.4.c.iii.(a). Why This Difficult Situation Arises

The first question is why the settlor would provide for a mandatory income trust, while expecting that no income will be available to distribute to the beneficiary? Scenarios include:

- *Marital Deduction Mandatory Income Requirement*. The trust is for a surviving spouse who does not need distributions but must provide for mandatory income to qualify for the marital deduction. The trust has the usual clause allowing the spouse to require the trustee to make the property productive. In some cases, using a separate trust to hold a flow-through entity without holding any other assets might be necessary to minimize the estate tax risk of buy-sell agreements.[4639] The Internal Revenue Service has taken the position that a fixed-price buy-sell agreement, in which the sale price of a decedent's equity is less than the Internal Revenue Service-determined fair market value, effectively passes property to a person other than the surviving spouse and therefore disqualifies the marital trust from being eligible for a marital deduction.[4640] If the client uses a fixed-price buy-sell agreement, the client might protect the marital deduction with respect to other assets by placing the other assets into a marital deduction trust that is separate from the trust that holds the client's equity. In such a case, the settlor should make sure that the spouse understands the trust's purposes and does not expect any distributions from the trust. If, however, the surviving spouse is adverse to the remaindermen, then the grantor settlor consider a prenuptial agreement or other ways of documenting a particular expectation of cash flow to the surviving spouse.

4638 Code Section 1361(c)(2). See part III.A.3 Trusts Holding Stock in S Corporations.

4639 In addition to the estate tax reason mentioned below, a QSST that holds only S stock (and no other assets) is not required to take any particular action to continue to qualify as an S corporation shareholder within two years after the beneficiary dies. Code §§ 1361(c)(2)(A)(ii), 1361(d)(1)(B).

4640 See part II.O.2.c Effect of Buy-Sell Agreement on Marital Deduction, especially fn 2700.

- *Future Income Expected*. The settlor does not expect income to be generated initially but expects the business entity eventually to generate income and does not expect the beneficiary to need the income until later. In this case, the settlor might consider describing the settlor's expectation regarding income so that the trustee has more guidance on what the settlor expects and can respond to concerns that the income beneficiary might raise.

- *Post-Mortem Business Sale Expected*. The settlor wanted to mandate income distributions, knowing full well that the business would need to be sold. The settlor might not have been able to find a buyer while alive, might have wanted to have a place to work for as long as the settlor lived, or might have wanted to wait until death to save income (including capital gain) tax on the sale.

III.A.4.c.iii.(b). What The Trustee Must Do To Alter The Trust's Investments If The Trust Agreement Does Not Address The Issue

The Uniform Prudent Investor Act (the "Investor Act") imposes various requirements:

- The trustee must consider "the purposes, terms, distribution requirements, and other circumstances of the trust."[4641]

- The trustee must further consider not only total return from income and appreciation of capital but also needs for liquidity and regularity of income.[4642]

- "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[4643]

- "Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act]."[4644]

- "If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries."[4645]

Thus, absent an expression of intent to the contrary, the trustee has a duty to sell enough of the business interest to generate income sufficient to fairly balance the income beneficiary's interests against the other beneficiaries' interests; note that a sale might not be required if the business already generates sufficient income to create that

[4641] Section 2(a) of the Investor Act.
[4642] Section 2(c)(5) and (7) of the Investor Act.
[4643] Section 3 of the Investor Act.
[4644] Section 4 of the Investor Act.
[4645] Section 6 of the Investor Act.

fair balance. The trustee also must sell enough of the business interest to create a diversified portfolio. Therefore, for all practical purposes, the trustee must dispose of substantially all of the business interest.

The trust agreement can expressly modify this duty to sell. It might include some or all of the following provisions:

- Expressly authorize the trustee to hold the property (for a particular period of time or indefinitely), notwithstanding its failure to produce income and notwithstanding any requirement to diversify that might otherwise apply. However, this authorization might be insufficient when the stock is performing poorly.[4646] Although the lower court's decision was reversed, it indicates what some judges might do. Also, such a provision cannot be used for marital deduction trusts if it would deprive the surviving spouse of the right to income.[4647] The author routinely includes language authorizing the spouse to require that the trustee either make the trust's property productive or convert it to income-producing property within a reasonable time.[4648]

- Subject to the marital trust concerns described above, require the trustee to hold the property (for a particular period of time or indefinitely). The authorization to hold might be viewed as requiring the trustee to consider the merits of selling even if it places less pressure to sell, whereas the requirement to hold should remove any requirement to consider selling.

- Give family members interested in the business the power to direct the trustee to hold the business interest. Some states completely relieve the trustee of liability for following directions that the trust agreement authorizes; others might implicitly impose a duty to resist instructions if the instructions appear inconsistent with the trustee's duties to various beneficiaries.

- If the trust is not a marital trust, add as beneficiaries those family members working in the business by stating that a purpose of retaining the business interest is to provide jobs for those family members. Even if the trust agreement does not provide for distributions to them, some steps should be taken to recognize their interests; otherwise, the trustee has no duty to protect their interests.[4649]

[4646] *Testamentary Trust UW Dumont* , 791 N.Y.S.2d 868 (Surr. Ct. 2004), reversed *In re Chase Manhattan Bank*, 809 N.Y.S.2d 360 (N.Y.A.D. 2006).

[4647] Regs. §§ 20.2056(b)-5(f)(5) (general power of appointment marital trusts), 20.2056(b)-7(d)(2) (same rules apply to QTIP trusts).

[4648] Reg. § 20.2056(b)-5(f)(4) suggests such a provision if the trust's assets consist substantially of unproductive property. However, Reg. § 20.2056(b)-5(f)(5) looks to the trust's overall return and approves of distributing principal to make up for lack of income from any nonproductive assets, so such a provision can relate to the trust's overall level of distributions, rather than requiring that each asset be productive.

[4649] Section 5 of the Investor Act.

III.A.4.c.iii.(c). How To Minimize Disputes About What The Trustee Should Do

The most effective way to minimize disputes is to have legally binding, unambiguous language in the trust. However, being too detailed might unduly tie the trustee's hands when the settlor really wanted to rely on the trustee's judgment. It is impossible to predict the future, and giving the trustee flexibility is often the best call.

The settlor should consider discussing with family members the settlor's intent in placing an essentially unproductive asset into a mandatory income trust. An income beneficiary who has lowered expectations might be less demanding, especially if the trustee and the other beneficiaries are all in the room when the settlor expresses this intent.

The settlor might also consider writing a precatory letter to the trustee (and beneficiaries, if appropriate) expressing this intent. Although the trustee cannot rely on this letter to change the trustee's legal obligations, a trustee usually finds comfort to the extent the letter supports the trustee's discretionary actions under the trust agreement.

For example, to maximize flexibility in a trustee who is to make the ultimate decision, the settlor would:

- include in the trust agreement express authority (but not a mandate) for the trustee to retain assets originally contributed (or sold by the settlor) to the trust, including without limitation (name of the company, its affiliates, etc.), without any requirement to diversify under the Investor Act, and

- write a precatory letter to the trustee.

Extreme caution is recommended in using such provisions with a marital deduction trust or other trust that the tax laws require to have a mandatory income provision. Being too explicit might trigger an attack on the provision as undermining the mandatory income characterization; however, including a right to make productive should suffice.[4650]

III.A.4.c.iii.(d). Fairness When the Trust Sells Its Interest in the Entity

See part II.J.8.c.i.(b) Possible Allocation to Income of Gain on Sale of Interest in Partnership or S Corporation.

III.A.4.c.iv. Conclusion

The amendment to UPAIA section 505 should prove helpful. It should avoid disputes over whether the trustee will be able to pay the trust's income taxes and place the focus where it belongs – whether a mandatory income trust should hold assets that, in the aggregate, produce no after-tax income. Trusts to hold most or all of their assets in the form of flow-through entities such as partnerships that sometimes make no more than tax distributions might be drafted with a discretionary instead of a mandatory income distribution and in any event should be drafted with careful consideration to the Uniform Prudent Investor Act.

[4650] See fn. 4648.

III.A.4.c.v. Appendix to 505 Discussion

Below are the amendments to Uniform Principal and Income Act, which are incorporated into the UPAIA at http://www.law.upenn.edu/bll/archives/ulc/upaia/2008_final.htm:

Section 505 is amended to read:

SECTION 505. INCOME TAXES

(a) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.

(b) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

(c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid ~~proportionately~~:

(1) from income to the extent that receipts from the entity are allocated only to income; ~~and~~

(2) from principal to the extent that~~:~~

~~(A)~~ receipts ~~from~~ the entity are allocated only to principal; ~~and~~

~~(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).~~

(3) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and

(4) from principal to the extent that the tax exceeds the total receipts from the entity.

(d) ~~For~~ purposes ~~of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.~~ After applying subsections (a) through (c), the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.

Comment

~~**Electing Small Business Trusts.** An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an~~

~~ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.~~

~~A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 506 and 104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.~~

Taxes on Undistributed Entity Taxable Income. When a trust owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity's taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust's tax on its share of the entity's taxable income, the trust must pay the taxes and allocate them between income and principal.

Subsection (c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income. Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries.

Example (1) – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35% tax bracket.

Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire $100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

Example (2) - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of $1 million. Partnership P distributes $500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35% tax bracket.
Trust T's tax on $1 million of taxable income is $350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses $350,000 of the $500,000 to pay its taxes and distributes the remaining $150,000 to B. The $150,000 payment to B reduces T's taxes by $52,500, which it must pay to B. But the $52,500 further reduces T's taxes by $18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due B.

Alternatively, T can apply the following algebraic formula to determine the amount payable to B:

$$D = (C-R*K)/(1-R)$$

D = Distribution to income beneficiary
C = Cash paid by the entity to the trust
R = tax rate on income
K = entity's K-1 taxable income

Applying the formula to Example (2) above, Trust T must pay $230,769 to B so that after deducting the payment, T has exactly enough to pay its tax on the remaining taxable income from P.

Taxable Income per K-1	1,000,000
Payment to beneficiary	230,769[4651]
Trust Taxable Income	$ 769,231
35% tax	269,231

Partnership Distribution	$ 500,000
Fiduciary's Tax Liability	(269,231)
Payable to the Beneficiary	$ 230,769

In addition, B will report $230,769 on his or her own personal income tax return, paying taxes of $80,769. Because Trust T withheld $269,231 to pay its taxes and B paid $80,769 taxes of its own, B bore the entire $350,000 tax burden on the $1 million of entity taxable income, including the $500,000 that the entity retained that presumably increased

[4651] D = (C-R*K)/(1-R) = (500,000 – 350,000)/(1 - .35) = $230,769. (D is the amount payable to the income beneficiary, K is the entity's K-1 taxable income, R is the trust ordinary tax rate, and C is the cash distributed by the entity).

the value of the trust's investment entity.

If a trustee determines that it is appropriate to so, it should consider exercising the discretion granted in UPIA section 506 to adjust between income and principal. Alternatively, the trustee may exercise the power to adjust under UPIA section 104 to the extent it is available and appropriate under the circumstances, including whether a future distribution from the entity that would be allocated to principal should be reallocated to income because the income beneficiary already bore the burden of taxes on the reinvested income. In exercising the power, the trust should consider the impact that future distributions will have on any current adjustments.

III.A.5. Fiduciary Duties Regarding Business Interests Held in Trust

Issues regarding the duty to diversify are discussed in part III.A.4.c.iii, Advising Clients about the UPAIA Section 505 Changes.

This author has heard of bank regulators requiring corporate trustees to revalue closely-held business interests annually, citing 12 CFR 9.6, which provides:

Sec. 9.6 Review of fiduciary accounts.

(a) *Pre-acceptance review*. Before accepting a fiduciary account, a national bank shall review the prospective account to determine whether it can properly administer the account.

(b) *Initial post-acceptance review*. Upon the acceptance of a fiduciary account for which a national bank has investment discretion, the bank shall conduct a prompt review of all assets of the account to evaluate whether they are appropriate for the account.

(c) *Annual review*. At least once during every calendar year, a bank shall conduct a review of all assets of each fiduciary account for which the bank has investment discretion to evaluate whether they are appropriate, individually and collectively, for the account.

III.A.6. Post-Mortem Trust and Estate Administration

Although the decedent's final income tax year ends with the date of death, the filing of a return and payment of tax may be made as though the decedent had lived throughout the last taxable year.[4652] If a joint return is filed, the surviving spouse may sign the first return on behalf of both of them if no court-appointed executor is serving and certain other conditions are satisfied;[4653] otherwise, the court-appointed executor signs, and if no executor is court-appointed then another person "charged with" the decedent's property may sign.[4654] A person "charged with" the decedent's property includes an heir,[4655] the

[4652] Reg. § 1.443-1(a)(2).
[4653] Reg. § 1.6013-1(d).
[4654] Reg. § 1.6012-3(b). If multiple executors are named, any one of them may sign the return. Rev. Rul. 83-41, citing Reg. § 1.6012-3(b)(1). Rev. Rul. 83-41 also allows any one fiduciary to

trustee of the decedent's revocable trust,[4656] or perhaps an agent under a durable power of attorney who does not yet know of the death.[4657] However, only a court-appointed executor may sign an amended return[4658] or consent to extend the time to assess tax.[4659]

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sign a fiduciary income tax return or extend the time to assess tax, citing Reg. § 1.6012-3(a)(1). Rev. Rul. 84-165 clarifies:

> While a consent signed by any one executor or administrator is valid for federal tax purposes, more than one executor or administrator may sign the consent.

Rev. Rul. 83-41 also discusses rules for signing consents for an active or a dissolved corporation regarding tax generally or for a partnership liable for employment or excise taxes.

[4655] CCA 201334040 (an informal letter – not a National Office pronouncement) advised:

> Q. Decedent is a non-filer who died intestate with one asset: a bank account held by the decedent, her daughter, and her daughter's husband. Field counsel considers the daughter a distributee and proposed having the daughter to sign a Form 56, Notice Concerning Fiduciary Relationship, and then sign the decedent's unfiled tax returns and Form 870 or 872.
>
> A. The daughter may sign the decedent's unfiled returns, because section 6012(b)(1) provides that "Tax returns of decedents are to be made by the decedent's executor, administrator, or other person charged with the property of the decedent." The daughter has the decedent's property. If the daughter submits balance due returns, those are acceptable without proof of authority; but if she claims credit elects or refunds, the Service may demand Form 1310 and/or documentary authority before refunding or crediting any claimed overpayment. See IRM 3.11.3.10.2(3). The Service may communicate with the daughter and her representatives about returns the daughter signs for her mother.
>
> Section 6501(c)(4)(A) provides for extending the ASED and section 6213(d) provides for waiving restrictions on assessment, but who may sign ASED extension consents and waivers for decedents is not specified in the statutes or regulations. Although Revenue Ruling 83-41, 1983-1 C.B. 349, clarified, amplified by Rev. Rul. 84-165, 1984-2 C.B. 305, held that "the Service will generally apply the rules applicable to execution of the original returns to consents to the extension of time to make an assessment", it ruled that in the absence of a court-appointed administrator for an intestate decedent, nobody may sign an ASED extension for the intestate decedent. Under the revenue rulings, the daughter may sign ASED extensions for her liability as a transferee, because it's her own liability, but she may not sign Form 870 or 872 for her mother's estate without being appointed as the personal representative (administrator) for her mother's estate by a court of competent jurisdiction. The same rules should apply to Form 870, as well. The Service should require letters of administration or equivalent proof of such appointment before accepting an 870 or 872 from the daughter.
>
> The daughter should also submit a Form 56 to document her fiduciary relationship as the personal representative of her mother's estate. The regulations require the fiduciary to retain proof of authority to act for the principal, sec. 301.6903-1(b)(2), and the same authority that would provide a foundation for Form 56 would likely suffice for Forms 870 and 872 (that is, letters of administration from a state probate court).

[4656] CCA 201334040 (an informal letter – not a National Office pronouncement) advised:

> Q: Decedent established a revocable trust into which he transferred all his assets before he died. He died testate, naming B his executor. B is also one of three trustees of the trust. The will has not been probated, and nothing passed under the will. Field counsel proposes treating the trustees as "testamentary trustees" and having them sign Form 56 and Form 870 or 872. The trust documents require the trustees to act unanimously, and the trustees have voted to appoint B the person to handle IRS matters.
>
> A: B may execute any unfiled returns for the decedent, because section 6012(b)(1) provides that "Tax returns of decedents are to be made by the decedent's executor,

See part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests. Consider whether to do a very quick funding of any QSSTs created upon death or to place a partnership interest in an S corporation owned by a QSST; see part III.A.4.a General Strategies Regarding Fiduciary Income Taxation of Business Interests. A huge downside to quick funding is the executor's personal liability if an federal debts are unpaid before the distribution[4660] or due to an estate tax lien imposed on the executor's own assets.[4661] An executor can obtain some assurance by filing Forms 4810 to get the statute of limitations on income tax matters shortened, writing a letter to the IRS (certified mail, return receipt requested) to the IRS to obtain a discharge under Code §§ 2204(a), (b) and 6905,[4662] and obtaining an agreement by the beneficiaries to pay back any distributions if the executor did not

administrator, or other person charged with the property of the decedent." The Service will accept returns signed by B as trustee in possession of the decedent's property, but the Service may require a Form 1310 and/or documentation of B's appointment by a court if the returns claim an overpayment.

As for filing a Form 870 or 872, the Service should require proof of authority, confirmed by a court (that is, letters testamentary), before accepting either an ASED extension or a waiver of restrictions on assessment.

4657 CCA 201334040 (an informal letter – not a National Office pronouncement) advised:

Q: The day after decedent died (in New Jersey) and before his attorney-in-fact learned the decedent (principal) had died, the POA (acting in Florida) executed a Form 872 extending the ASED. No probate has been opened, and no representative has been appointed.

A: The ASED extension signed by the attorney-in-fact the day after the taxpayer's death and at a time when neither the attorney-in-fact nor the IRS knew that the taxpayer had died is valid, because under both Florida law (where the attorney-in-fact acted) and New Jersey law (where the taxpayer died and may have been domiciled) acts by an attorney-in-fact done in good faith and without knowledge that the principal is dead are valid and binding. Fla. Stat. § 709.2109(4); N.J. Stat. § 46:2B-8.5(a).

Now that the attorney-in-fact is aware of the principal's death, the POA is terminated, and he is not authorized to act for the decedent. If the estate wishes to submit a Form 870 or 872, the Service should require proof of authority to bind the estate. If the decedent died intestate, then court appointment of an administrator (and letters of administration) will be required. If the decedent died testate and named an administrator, then court approval (and letters testamentary) will be required.

Conclusion: In all cases, if the purported personal representative won't provide proof of authority (letters of administration or letters testamentary from an appropriate court), then no 870 or 872 should be accepted, and notices of deficiency should issue to ensure that the assessments are valid (copies to the taxpayer's last known address and to the address of any fiduciaries, whether confirmed or not).

4658 CCA 201107020, citing *Estate of Weisel v. Commissioner*, T.C. Memo. 1990-351, and Rev. Rul. 83-41. The CCA was an informal letter – not a National Office pronouncement.

4659 Rev. Rul. 83-41; CCA 201107020 (see fn. 4658); CCA 201334040 (see fns. 4655-4657). However, Rev. Rul. 83-41 held that heirs liable under Code § 6901 as transferees may sign consents for their own liabilities.

4660 31 U.S.C. § 3713(b), as described in fn. 5446 in part III.B.5.d.iv.(e) Which Estates Are Affected by the Estate Tax Lien?.

4661 See part III.B.5.d.iv Federal Estate Tax Liens.

4662 Instead of a letter, one might file IRS Form 5495. However, the form has various requirements, and neither provision requires using the form.

reserve enough (a "refunding agreement");[4663] however, a refunding agreement is only as good as the executor's ability to seize assets from the beneficiaries.

See part III.B.2.j Tax Allocations upon Change of Interest in a Business, especially parts III.B.2.j.ii.(d) Death of a Shareholder and III.B.2.j.iii.(c) Death of a Partner — Treated Like a Transfer of a Partner's Entire Interest. Consider planning opportunities for allocations in the year of death or when funding bequests, such as measuring pre- and post-mortem income based on an accounting cut-off or pro-rata, per-share, per-day.

Planning for partnership interests also includes:

[4663] Letter Ruling 201745001 held that entering into a refunding agreement with a private foundation would not be a prohibited act of self-dealing under Code § 4941, and any repayments the foundation may make would not constitute taxable expenditures under Code § 4945. The IRS described the refunding agreement:

> You represent that Trust and Foundation are seeking to fulfill Grantor's intent that the Trust distribute the maximum value of Trust to the Foundation at the earliest opportunity. You further represent that the administration of Trust has not been completed and is ongoing. Pursuant to the provisions of Trust instrument, assets remaining to be distributed to the Foundation may be or become subject to expenses, losses or liabilities sustained in the administration of Trust. You state that under State law, Trustee 1 and Trustee 2 may be personally liable for expenses, losses and liabilities sustained in the administration of the Trust. Given the potential exposure to future claims and liabilities against Trust, Trustee 1 and Trustee 2 believe it would be prudent to retain until the completion of trust administration a sufficient reserve to satisfy any such claims. You represent that there is a risk that liabilities will likely extend well beyond the termination of Trust.
>
> The transfer of the remaining assets of Trust to the Foundation is within the powers of Trustee 1 and Trustee 2. Foundation has requested that Trustee 1 and Trustee 2 accelerate distributions of the assets of the Trust to Foundation before Trustee 1 and Trustee 2 know the full extent of potential claims and liabilities. In order to induce Trustee 1 and Trustee 2 to make substantial distributions to Foundation sooner than they otherwise would make them, Foundation has proposed to execute and deliver to Trustee 1 and Trustee 2 the Agreement.
>
> Under the Agreement, Foundation acknowledges that Trustee 1 and Trustee 2 would normally defer a substantial portion of the distributions to Foundation until a final resolution of all liabilities and claims. Trustee 1 and Trustee 2 would only make a final distribution of the remaining assets of the Trust when they are satisfied that all liabilities of the Trust have been determined and discharged. Trustee 1 and Trustee 2 are willing to consider accelerating the distribution of assets to the Foundation, provided that the Foundation obligates itself to indemnify Trustee 1 and Trustee 2. Further, under the Agreement, Foundation agrees to return any distribution required to be refunded under the Agreement to either Trustee 1 or Trustee 2 should claims and liabilities arise. Under the Agreement, the distribution of assets to the Foundation will include cash or in kind assets whether investment securities, real property or other assets. Pursuant to the Agreement, Trustee 1 and Trustee 2 can be assured that the Foundation will pay such amounts or return such portion of distributions that Trustee 1 and Trustee 2 determine in their sole and absolute discretion are needed or desirable to pay all such liabilities.
>
> In addition, under the Agreement, Foundation agrees to indemnify and hold harmless Trustee 1 and Trustee 2 from any and all liabilities and expenses sustained in the administration of the Trust. Further, nothing in the Agreement requires Trustee 1 or Trustee 2 to make any distributions to Foundation at any particular time and Trustee 1 and Trustee 2 shall determine the amounts of and whether to make distributions in their sole and absolute discretion.

- Obtaining an inside basis step-up on death. See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations. (Pre-mortem planning includes part II.H.2.i Avoiding a Basis Step-Down.) If the decedent owned all (perhaps most) of the stock of an S corporation than held only marketable securities or other nondepreciable property, consider whether liquidating the corporation (for example, converting it to an LLC taxed as a sole proprietorship or partnership) might facilitate an inside basis at little cost; see part II.H.8 Lack of Basis Step-Up for Depreciable or Ordinary Income Property in S Corporation; Possible Way to Attain Basis Step-Up.

- Distributing a partnership interest when funding bequests provides an opportunity to obtain an inside basis step-up (especially if the partnership did not make the requisite election on or before the partnership's taxable year that included date of death) and make new partnership elections, but it also might cause depreciation periods to start again (which could significantly defer depreciation for real estate). See parts II.Q.8.e.i Distribution of Partnership Interests and II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.

See also part III.B.2.e.ii Tax ID Issues When the Deemed Owner of a Grantor Trust Dies; Related Effect on Quarterly Payments of Estimated Income Tax.

III.B. Transfer Tax Issues

Transfer tax issues include transfers during life, estate tax issues, and special valuation issues.

III.B.1. Transfers During Life

Transfers during life include many ways of transferring equity to one's loved ones. The simplest way is shifting a business opportunity. Gifts without consideration can appear straightforward, but then valuation issues complicate matters, and designing trusts to hold stock in S corporations can be tricky. More advanced tactics include transfers to grantor retained annuity trusts and various sale techniques, including self-canceling installment notes and private annuities.

III.B.1.a. Business Opportunities

A business owner who plans to add new locations or new products or services may be able to use some basic techniques to let family members participate in the business' growth. These techniques involve shifting these business opportunities to the family members.

New businesses often have speculative value. Even a successful business may have difficulty expanding into new locations or adding products or services. When starting a new business, consider giving most of the ownership to family members through nonvoting ownership interests. For example, the client owns 1% of the company and all of the voting rights, and the client's children own 99% of the company without any voting rights. The 99% that the client gives his or her children has little value if the new business has an uncertain future. Because the client controls the business, the client can use the business techniques that the client has mastered to make sure it is managed correctly. However, the children own 99% of the profits that the client creates.

Examples of this might include investing in the following that might be leased or otherwise profitably provided to the existing business:

- New location.
- New line of business.
- New customer target group.
- New equipment.
- New business method.
- New patent.

A retailer used this concept to make his children rich. He would identify the location for a new store. Then his children or their spouses would buy the land, build a store, and lease it to the retailer. The lease payments enabled the children and their spouses to build equity in the real estate. This happened repeatedly, and the children and their spouse became multi-millionaires.

Another businessperson had special knowledge of a leasing business. He helped his family and close friends arrange financing to buy equipment. The financing is a combination of bank loans and loans from himself to them at the applicable federal rate (AFR – interest rates promulgated by the IRS monthly). He might make a gift to the family member or friend so that the recipient will be able to contribute equity to the project. However, no commitment is made to finance and buy the equipment until he finds someone willing to commit to lease the property for long enough for the buyer to use the lease payments to repay the loans. Although he was the moving force behind the transactions, his family and close friends owned most of the business from inception and therefore received most of the benefits of the equity.

Making long-term loans to a client's children at today's low interest rates is an easy way to help them acquire investments, whether a privately-owned business, real estate, or marketable securities.

Whatever form the gift may take, as it stands, the Code does not mention the term "gift of opportunity." This, naturally, has not stopped the IRS from pursuing these "gifts" as taxable transfers. The gift tax was initially devised as a backstop to the federal estate tax; however, this purpose was seemingly broadened by the decision in *Dickman v. Commissioner*.[4664] In *Dickman*, the Supreme Court established that the gratuitous gift of the use of property constituted a taxable gift.[4665] In holding such, the court stated that, "Congress intended the gift tax statute to reach all gratuitous transfers of any valuable interest in property."[4666] The court goes further by adding, "the gift tax was designed to encompass all transfers of property and property rights having significant value."[4667]

[4664] 465 U.S. 330 (1984).
[4665] Id. at 333.
[4666] Id. at 334.
[4667] Id.

Several past cases highlight the extensive grasp of the gift tax provisions. "Gift," as Congress intended the word, means all of the "protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech."[4668] The gift tax is "broad enough to include property, however conceptual or contingent,"[4669] and may "reach every kind and type of transfer by gift."[4670] Suffice it to say, the Supreme Court has supported a broad interpretation of what may fall under the purview of the gift tax statutes.

That being said, the IRS has encountered limited success in its efforts at reaching gifts of opportunity. The following discussion outlines some of these successes, and, likewise, some of its failures.

Loaning money to a child or other family member, under the holding in *Crown v. Commissioner*[4671] did not produce gift tax liability should the lending parent fail to charge or collect interest on the loans. The court stated that interest-free demand loans were not transfers of property within the meaning of the gift tax statutes, as the borrowing child had no legally protected right against the lending parent.[4672] Furthermore, the child's use of the money was not an interest with an exchangeable value.[4673]

In certain respects, *Dickman* changed this. The Supreme Court, as previously mentioned, held that the right to use the loaned money represented a valuable, taxable gift because it represents a transfer of property by gift.[4674] The Court softened this blow by recapping the merits of the gift tax exclusions available to individuals and families, such as the annual exclusion, gift splitting, exemptions, and the unified credit.[4675] However, *Crown* might apply in particular circumstances. For instance, a parent who allows his or her adult child to use the family vacation home rent-free might not make a gift tax liability if the child does not have a legally enforceable right, against the parent, to stay in the home.[4676] *Dickman* involved loans and other arrangement where the borrower had a legally protected interest to use loaned funds. It also reasoned:

> What was transferred here was the use of a substantial amount of cash for an indefinite period of time. An analogous interest in real property, the use under a tenancy at will, has long been recognized as a property right. E*. g., Restatement (Second) of Property* § 1.6 (1977); G. Thompson, *Commentaries on the Modern Law of Real Property* § 1020 (J. Grimes ed. 1980). For example, a parent who grants to a child the rent-free, indefinite use of commercial property having a reasonable rental value of $8000 a month has clearly transferred a valuable property right.

[4668] *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945).
[4669] *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943).
[4670] *Robinette v. Helvering*, 318 U.S. 184, 187 (1943).
[4671] 585 F.2d 234 (7th Cir. 1978).
[4672] Id. at 239.
[4673] Id.
[4674] *Dickman*, 465 U.S. at 333.
[4675] *Id.* at 341-42.
[4676] The *Dickman* Court expressly reserved for future cases adult children's use of cars or vacation cottages. *Id.* at 336.

Thus, although a short-term use of property might be free from gift tax, indefinite use of property is more problematic.[4677]

III.B.1.a.i. Loans

Interest-free or below-market loans are governed by Code § 7872, which generally requires imputation of interest of such loans.[4678] Each month, the IRS publishes a revenue ruling that prescribes interest rates to be used for federal tax purposes. These Applicable Federal Rates (AFRs) provide short-, mid-, and long-term government rates of interest.

Fundamental to using the AFR is that there is a reasonable expectation of repayment.[4679] One might consider documenting this expectation and the loan itself using the principles of Reg. § 1.385-2; I am not at all suggesting that such documentation is necessary but merely that a tax planner who is extraordinarily cautious might find some comfort there.[4680]

These loans break down into two categories: term loans and demand loans. A term loan, as the name implies, is a loan for a specific term, i.e. it has a defined start date and end date. A demand loan is a loan that is immediately callable at any time.

See also part II.G.3.a.i Loans to Businesses – Whether AFR Is Required, discussing whether Code § 7872 applies. If Code § 7872 does not apply, then one might consider whether to charge interest anyway to avoid a gift under common law principles;[4681] characterization of a transfer to a family controlled entity as a contribution to capital rather a loan can result in the IRS seeking to apply the draconian Code § 2701.[4682]

Code § 7872 provides certain exceptions to the general rule of imputing interest. For instance, gift loans between individuals may qualify for a de minimis exception. If the outstanding aggregate amount of loans between individuals is less than $10,000, then the general rules of Code § 7872 will not apply.[4683] The same rule holds true for compensation-related and corporate shareholder loans.[4684] Also, Code § 7872 provides

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[4677] See Letter Ruling 8104207.

[4678] *Dickman* has been superseded and codified as Code § 7872, which provides for short-term (under three years), mid-term (three to nine years), and long-term (over nine years) AFRs.

[4679] See the paragraph accompanying fn. 4707, found in part III.B.1.a.ii.(a) Gift Tax Issues. In the income tax arena, debt might be recharacterized as equity. See part II.G.19 Debt vs. Equity.

[4680] As part II.G.19 Debt vs. Equity discusses, generally Reg. § 1.385-2 targets C corporations engaged in international financial transactions and would not apply to intra-family loans for estate planning. However, if one can satisfy Reg. § 1.385-2, which was geared toward perceived abuses, presumably one would go a long way toward showing a loan's bona fides. Note that part II.G.19 Debt vs. Equity discusses various cases, so consider checking out what it says, even if you don't want to go the lengths of using the ideas of Reg. § 1.385-2.

[4681] Gift tax applies to not only direct but also indirect gifts. Code § 2511(a); Reg. § 25.2511-1(h)(1), which governs indirect gifts through business entities and is reproduced in fn. 4859 in part III.B.1.h Transfers in the Ordinary Course of Business– Reg. § 25.2512-8.

[4682] Code § 2701(e)(5). See III.B.7.b Code § 2701 Overview, and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

[4683] Code § 7872(c)(2)(A).

[4684] Code § 7872(c)(3)(A).

for an income tax (but not gift tax) exclusion of accrued interest where aggregate loans do not exceed $100,000.[4685]

For notes arising from a taxable sale, also see part II.G.14 Limitations on the Use of Installment Sales.

III.B.1.a.i.(a). Term Loans

Term loans with an interest rate below the AFR immediately result in a completed gift of the difference between the amount of proceeds and the value of the repayments using the AFR. For instance, the July 2005 mid-term monthly AFR was 3.79%. On a five-year loan of $100,000, the monthly payment would be $1,832. An interest-free loan, however, would generate a monthly payment of only $1,667. The monthly difference between the two payments is $165. The present value of five years' worth of $165 monthly payments is $9,006 (at the AFR), a figure which also represents the completed gift.

If an interest-free or below-market term loan is made, the lender is treated as having transferred an amount equal to the money loaned, less the present value of all payments due under the loan.[4686] The present value is calculated using a discount rate equal to the AFR for the term of the loan.[4687] If principal payments are fixed in total amount but uncertain as to time, for the term use the latest possible date on which a principal payment can be made.[4688] Although some have suggested that, for sales, one could use the AFR for the month of the sale or for either of the two preceding months, in an intra-family transaction I would always use the AFR for the month of sale.[4689]

The loan will be considered to have original issue discount ("OID") in an amount equal to the excess of the money loaned over the present value of the payments due on the loan.[4690] The lender will accrue interest income in each year of the loan. The borrower's tax treatment on the loan depends on whether he or she can deduct the interest. If deductible, it must be deducted in each year of the loan.

III.B.1.a.i.(b). Demand Loans

Demand loans, i.e. those immediately callable at any time, are valued annually for gift tax purposes. The short-term AFR is used, assuming that on the last day of the year, the amount of interest was paid to the lender, who in turn made a gift back to the borrower.[4691]

[4685] Code § 7872(d)(1).
[4686] Code §§ 7872(b)(1), 7872(d)(2).
[4687] Code § 7872(f)(1).
[4688] Reg. § 1.1274-4(c)(4).
[4689] See Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1447. I have additional commentary saved as document # 5278071, which even more strongly reinforces my view as applied to sales to irrevocable grantor trusts.
[4690] Code § 7872(b)(2)(A). Added to this OID amount is any OID that the loan would carry before considering the gift element. Code § 7872(b)(2)(B).
[4691] Code § 7872(a)(1); See generally Kathryn Henkel ¶ 28.02, Section 7872: Imputed Interest on Below-Market Loans, Estate Planning and Wealth Preservation (June 2005).

III.B.1.a.i.(c). Refinancing or Cancelling Loans

Regulations provide some flexibility in loan work-outs[4692] or other loan modifications.[4693] For a general discussion of the relevant issues, see *Hunt v. Commissioner*, T.C. Memo. 1989-335. Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the Code § 166 bad debt deduction.[4694]

For income and transfer tax consequences of cancellation by reason of gift or bequest and issues raised by discounting the value of a note on death, see part III.B.5.a Promissory Notes.

When refinancing, canceling or otherwise transferring notes arising from a taxable sale, also see part II.G.14 Limitations on the Use of Installment Sales.

III.B.1.a.ii. Loan Guarantees

Generally, a guarantee is a promise to pay another person's debt, and the borrower is required to repay the guarantor any funds the grantor pays on the borrower's behalf.[4695]

[4692] Prop. Reg. § 1.7872-11(a)(2), providing no income taxation in some situations when accrued interest is forgiven.

[4693] Reg. § 1.1001-3(c), discussing exceptions to the general rule that a significant modification of debt instrument is a taxable exchange.

[4694] Reg. § 1.166-2(b).

[4695] *Standard Oil Company of New Jersey v. Commissioner*, 7 T.C. 1310, 1321 (1946) (a reviewed decision supplemented 11 T.C. 843 (1948), *acq.* 1949-2 C.B. 3), held:

> Guaranty is defined in 38 C.J.S. 1129 as follows:
>
> > A guaranty or guarantee may be generally defined as a collateral promise or undertaking by one person to answer for the payment of some debt or the performance of some contract or duty in case of the default of another person, who in the first instance is liable for such payment or performance; a collateral promise or undertaking to pay a debt owing by a third person in case the latter does not pay.
>
> A guaranty may be one of various kinds, such as an absolute or conditional guaranty, a guaranty of payment or of collection, a general, special, continuing, or unlimited guaranty, or a letter of credit. 38 C.J.S. 1139. In the instant proceeding, as noted above, the agreement of November 6, 1929 states that the guaranty thereby given shall be deemed a continuing guaranty. In 38 C.J.S. 1142 A continuing guaranty is one which is not limited to a single transaction, but which contemplates a future course of dealing, covering a series of transactions, generally for an indefinite time or until revoked.
>
> In 38 C.J. S. 1130, it is stated:
>
> > A guaranty in its technical and legal sense has relation to some other contract or obligation with reference to which it is a collateral undertaking; it is a secondary and not a primary obligation.
>
> Numerous authorities are cited in the footnote for the above proposition, including *Howell v. Commissioner*, 69 Fed. (2d) 447. In that case the Circuit Court of Appeals, Eighth Circuit, among other things said:
>
> > That in the case of suretyship or guaranty there is an implied agreement on the part of the principal debtor to reimburse his surety or guarantor is unquestioned. See *Melletee Farmers' Elevator Co. v. H. Poehler Co.* (D.C.) 18 Fed. (2d) 430; *In*

Although it is often viewed as a payment when the borrower defaults, a lender may insist that the guarantor agree that the lender not be required to try to collect from the borrower or that the guarantor sign as a co-borrower.

Code § 7872 provides that lending money at no less than the applicable federal rate does not constitute a transfer,[4696] so long as there is a reasonable expectation of repayment.[4697] Consider including in any guarantee agreement that the borrower must repay the guarantor not only any funds the guarantor pays the lender but also interest at a rate no less than the AFR.

One CPA expressed concern to me that an S corporation guaranteeing a loan made to a shareholder might generate a second class of stock if "a principal purpose of the agreement is to circumvent" the single class of stock requirement.[4698] To address such a concern, consider providing that:

- Any payment on the guaranteed loan must be accompanied by a similar proportionate loan to each other shareholder, with the payment on the guaranteed loan and the similar proportionate loan payable with interest at a rate no less than the AFR.

- If there is no reasonable expectation of repayment at the time that the payment on the guaranteed loan is made, the payment on the guaranteed loan is instead a distribution and the other shareholders will receive similar distributions.

- If the borrower transfers the stock while the guaranteed loan continues in effect, any payments on behalf of the borrower will be treated as payments to the transferee, with the transferee's sole recourse being against the borrower.

III.B.1.a.ii.(a). Gift Tax Issues Involving Loan Guarantees

Under a prior version of the Code, the Tax Court found no taxable gift when the taxpayer helped refinance her husband's note (at a time before the unlimited marital deduction). For legitimate business reasons, the husband (J.C.) asked the taxpayer to become the primary named borrower, although the taxpayer clearly was not, in substance, the borrower. The Tax Court said:[4699]

> The facts and circumstances surrounding the transaction here involved do not convince us that petitioner intended to divest herself of any property or interest therein owned by her in 1938, or that any of the parties involved anticipated that any of her property would ever be used to satisfy the obligation to the bank. In

re Dailey et al. (D.C.) 19 Fed. (2d) 95; *United States Fidelity & Guaranty Co. v. Centropolis Bank of Kansas City, Mo.* (C.C.A. 8) 17 Fed. (2d) 913, 917, 53 A.L.R. 295; *National Surety Co. v. Salt Lake County* (C.C.A. 8) 5 Fed. (2d) 34; (compare *Jenkins v. National Surety Co.*, 277 U.S. 258, 48 S.Ct. 445, 72 L.Ed. 874); 28 C.J. 1037.

[4696] See part III.B.1.a.i Loans.

[4697] See the paragraph accompanying fn. 4707, found in part III.B.1.a.ii.(a) Gift Tax Issues.

[4698] See Reg. § 1.1361-1(*l*)(2)(i), reproduced in fn. 206, found in part II.A.2.j.ii Temporary Timing Differences; Other Varying Differences.

[4699] *Bradford v. Commissioner*, 34 T.C. 1059, 1064-65 (1960), *acq.* 1961-2 C.B. 4.

> the first place she did not own property in 1938 that would have come anywhere near satisfying the obligation to the bank, and she had no prospects of acquiring any except through her husband. Secondly, the entire transaction was arranged by J.C., his collateral was retained as security for petitioner's note, and he testified that it was understood that the bank would look first to his collateral for liquidation of the obligation, and he hoped and expected that the collateral would increase sufficiently in value to cover the entire obligation. J.C. paid the interest on the loan and it is reasonable to assume that all parties involved looked to J.C.'s assets and his earning power to liquidate the loan.
>
> This does not mean that petitioner was not obligated on the indebtedness evidenced by her note. We assume the bank could have taken judgment against her on the note had it not been paid, and levied on her property to help satisfy the judgment, and that it probably would have done so had that course of action become necessary. But unless and until such action was taken we do not believe petitioner parted with, or intended to part with, dominion and control of any property owned by her which would give rise to a gift tax.
>
> Granted that section 501 is comprehensive enough to "include property, however conceptual or contingent," *Smith v. Shaughnessy*, 318 U.S. 176, and to reach any passage of control over the economic benefits of property, *Estate of Sanford v. Commissioner*, 308 U.S. 39; nevertheless, no matter how intangible, the donor must own a property right or interest which is capable of being, and is, transferred. *Commissioner v. Mills*.[4700] Petitioner transferred no property or interest in property in 1938 but only made a promise to pay in the future if called upon to do so. *John D. Archbold*, 42 B.T.A. 453. The fact that J.C. may have derived some economic benefit in 1938 as a result of this promise is not controlling. Regs. 79, art. 1.

However, Letter Ruling 9113009 held that loan guarantees conferred "valuable economic benefits" to the grantee that constituted a gift. If the grantee, without the guarantees, would pay a higher interest rate on the loan, or otherwise be unable to obtain the loan altogether, then the grantee has received a valuable property interest. The grantor had assumed a legally enforceable obligation for less than full consideration. Thus, when a loan guarantee became binding, the grantor had made a completed gift.

At least one commentator, at the time, noted the "foolishness" with which loan guarantees were taxed.[4701] The folly came by way of comparison of the effects of a parent loaning a child funds (possibly using a "back-to-back" loan) versus a parent guaranteeing a child's loan. Code § 7872, which superseded *Dickman*, controls below-market demand loans. Thus, at the October 2010 short-term AFR,[4702] a parent could lend his or her child funds at 1.73% for almost nine years without incurring gift tax liability. If the parent has wonderful credit, he or she may be able to borrow funds for himself or herself at the prime lending rate, which, as of October 1, 2010, was 3.25%. Thus, using a back-to-back loan, a parent who could borrow at the prime lending rate

[4700] 183 F.2d 32 (C.A. 9, 1950), affirming 12 T.C. 468.
[4701] See Randall J. Gingiss, The Gift of Opportunity, 41 *DePaul L. Rev.* 395, 409 (1991-1992).
[4702] Rev. Rul. 2010-24.

can essentially gift 1.52% per year tax-free. However, if the parent simply chose to guarantee the child's loan, under Letter Ruling 9113009, this would incur gift tax liability.

The IRS withdrew Letter Ruling 9113009 in 1993.[4703] Thus, a parent should be able to make his or her credit standing available to his or her children without creating an income or gift tax event.[4704] What is essentially a loan of creditworthiness, though it may enable a child to obtain a loan at a more favorable interest rate or a loan that would have otherwise been unavailable to him or her, should not factor into gift of opportunity analysis. Thus, one of the more troublesome aspects of *Carriage Square* has been superseded. Furthermore, in Letter Ruling 200534014,[4705] the IRS did not appear to be troubled by a parent providing his creditworthiness to his child, pointing to some cases that seem to have been decided under state law where parents loaned collateral to their children. The Tax Court has referred to loan guarantees as "unmatured, potential claims."[4706]

Indirect support for the proposition that generally one can ignore credit risk comes from the fact that Code § 7872(e)(1) and (f)(2) refer to the applicable federal rate under Code § 1274(d). Generally, Code §§ 1271-1275 are read together as one coherent set of rules. In determining whether to give effect to a schedule of stated payments, these rules ignore "the possibility of nonpayment due to default, insolvency, or similar circumstances" unless "the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions."[4707]

One can glean from all of the above that, if the intent to repay is not genuine, then the arrangement is vulnerable to IRS attack.[4708] The converse is that, if the intent to repay is genuine, then no transfer occurs until the person who bears the credit risk not only makes a payment but also, on a gratuitous basis, forgoes commercially reasonable

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[4703] Letter Ruling 9409018.

[4704] William P. Streng, *Estate Planning*, 800-2d T.M. VII.D.2. See also Hatcher and Manigault, Using Beneficiary Guarantees in Defective Grantor Trusts, *Journal of Taxation* (March 2000) (beneficiary guarantees of loans to trusts). Some have suggested that the Tax Court's position is that a beneficiary does not make a gift by guaranteeing a loan to a trust from which (s)he benefits. Blattmachr and Zaritsky, Is the BDIT Ready for Primetime? *Probate Practice Reporter* (University of South Carolina School of Law, ISBN 1044-7423), Sept. 2012.

[4705] In addition to the fact that letter rulings are not precedent, this particular ruling dealt with the effect of a child conveying to the parent stock in the company that borrowed the money. Thus, the loan of credit-worthiness was not the true issue; rather, the parent was deemed to have held the stock in trust for the child. The author does not recommend intentionally creating the facts present in that ruling.

[4706] *Estate of Theis v. Commissioner*, 81 T.C. 741, 748 (reviewed decision 1983) (rejecting estate tax deduction for claim due to guarantees that were legally valid, but the underlying loan was not in default), *aff'd* 770 F.2d 981 (11th Cir. 1985); followed *Estate Of Charles P. Cafaro v. Commissioner*, T.C. Memo. 1989-348.

[4707] Reg. § 1.1273-1(c)(1)(ii).

[4708] Rev. Rul. 77-299 (IRS did not respect notes intended to be forgiven in the amount of the annual exclusion each year). If one wants to transfer property over time and use the annual exclusion, then, the IRS argues, one should simply give a small portion of the property each year. Rev. Rul. 83-180. The latter strategy would take longer if the property appreciates, but that might be the cost of obtaining the annual exclusion. In the income tax arena, debt might be recharacterized as equity. See part II.G.19 Debt vs. Equity.

remedies against the debtor to recover the right to be reimbursed for that payment.[4709] If a later forgiveness is gratuitous, then the forgiveness of principal should be treated as a gift rather than cancellation of indebtedness income.[4710] The forgiveness of interest will not constitute a deemed receipt of interest by the lender and a deemed payment by the borrower if the forgiveness includes in substantial part the loan principal.[4711]

If one is concerned that a loan guarantee is a gift, one should structure the loan as a back-to-back loan.[4712] If that is impractical, consider paying the parent a reasonable guarantee fee.

Notwithstanding the lack of gift tax consequences, consider additional documentation when a trust guarantees the obligations of another trust. The IRS might argue that, by entering into a transaction for the benefit of someone other than the beneficiaries, the fruits of that transaction belong to the guarantor trust.[4713] Steps to try to avoid such an argument might include:

- a provision in the trust agreement allowing extending credit to other trusts for the benefit of the trust's beneficiaries,

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[4709] An income tax analogy is Prop. Reg. § 1.465-6(d), providing that, in applying the at-risk rules:

> If a taxpayer guarantees repayment of an amount borrowed by another person (primary obligor) for use in an activity, the guarantee shall not increase the taxpayer's amount at risk. If the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk shall be increased at such time as the taxpayer has no remaining legal rights against the primary obligor.

[4710] Although it addressed a different situation, in analyzing the consequences of an employee's loan modification, Rev. Rul. 2004-37 stated:

> Not every indebtedness that is cancelled results in the debtor realizing gross income by reason of discharge of indebtedness within the meaning of §§ 61(a)(12) and 108(a). Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment, rather than under the debt discharge rules. S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980), 1980-2 C.B. 620, 624 n.6.

Code § 108(e)(6) confirms no cancellation of indebtedness income when a shareholder cancels a debt owed by the corporation to the shareholder.

[4711] Prop. Reg. § 1.7872-11(a)(2).

[4712] If the parent's will cancels the loan, the loan is included in the parent's gross estate, but the Code § 102 exclusion of bequests from income trumps Code § 61(a)(12). Letter Ruling 9240003.

[4713] *Harris Trust and Sav. Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238, 250 (2000), an ERISA case that looked to general trust law principles, noted:

> As petitioners and amicus curiae the United States observe, it has long been settled that when a trustee in breach of his fiduciary duty to the beneficiaries transfers trust property to a third person, the third person takes the property subject to the trust, unless he has purchased the property for value and without notice of the fiduciary's breach of duty. The trustee or beneficiaries may then maintain an action for restitution of the property (if not already disposed of) or disgorgement of proceeds (if already disposed of), and disgorgement of the third person's profits derived therefrom. *See, e.g., Restatement (Second) of Trusts* §§ 284, 291, 294, 295, 297 (1957); 4 A. Scott & W. Fratcher, *Law of Trusts* § 284, § 291.1, pp. 77–78, § 294.2, p. 101, § 297 (4th ed. 1989) (hereinafter *Law of Trusts*); 5 *id.*, § 470, at 363; 1 D. Dobbs, Law of Remedies § 4.7(1), pp. 660–661 (2d ed. 1993); G. Bogert, *Law of Trusts and Trustees* § 866, pp. 95–96 (rev. 2d ed. 1995).

- charging a fair market value guarantee fee would give a guarantee a business purpose, or

- obtaining the beneficiaries' consent.

III.B.1.a.ii.(b). Loan Guarantees Forbidden for IRAs

"Prohibited transaction" includes any direct or indirect "lending of money or other extension of credit" between a plan and a disqualified person.[4714]

If, during any taxable year of an IRA owner, that individual or his beneficiary engages in any prohibited transaction with respect to such account, such account ceases to be an IRA as of the first day of such taxable year.[4715]

III.B.1.a.ii.(c). Income Tax Consequences Involving Loan Guarantees

Generally, a guarantee is not considered to be a payment for income tax purposes. Instead, when the lender forces the guarantor to make a payment, the actual payment is a loan from the guarantor to the borrower.

Guarantees can play a role in certain C corporation debt-equity disputes: C corporation shareholders often prefer to treat advances to the corporation as debt, so that they can extract the money without the extraction constituting a dividend.[4716] This has prompted disputes over whether advances are debt or equity.[4717] Along these lines, a shareholder's guarantee of a corporation's loans may be characterized as a loan to the shareholder followed by the shareholder's contribution to capital if the corporation is thinly capitalized and the lender looks to the guarantor as the primary source for payment, in which case the corporation's repayment constitutes a distribution to the shareholder that might be taxable as a dividend.[4718] If a corporation is thinly capitalized,

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[4714] Code § 4975(c)(1)(B).

[4715] Code § 408(e)(2)(A). See part II.G.21 IRA as Business Owner, especially fn. 1251.

[4716] See part II.Q.7.h.ii Taxation of Shareholders When Corporation Distributes Cash or Other Property.

[4717] See part II.G.19 Debt vs. Equity.

[4718] *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972) (*cert. den.* 409 U.S. 1076 (1972)), *aff'g* T.C. Memo. 1970-182. See Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* (WG&L), ¶ 4.03[3][f][iii] Borrower identity: guarantees and back-to-back loans, stating in a footnote:

> The leading case on this issue is *Plantation Patterns, Inc. v. Comm'r*, 462 F2d 712 (5th Cir.), *cert. denied*, 409 US 1076 (1972) ; see also *Casco Bank & Trust Co. v. United States*, 544 F2d 528 (1st Cir. 1976), *cert. denied*, 430 US 907 (1977), and cases cited therein; *In re Lane*, 742 F2d 1311, 1320 (11th Cir. 1984) (guaranties used as substitutes for infusion of more capital). But, for cases treating the corporation as the true debtor, see *J. Paul Smyers*, 57 TC 189 (1971) (fact that bank loan would not have been made without guarantee of shareholder does not, per se, make bank loan equity when corporation is not otherwise thin); *Murphy Logging Co. v. United States*, 378 F2d 222 (9th Cir. 1967) (corporation was not thin in either case); *Falkoff v. Comm'r*, 604 F2d 1045 (7th Cir. 1979) (corporation held to be true borrower); *Intergraph Corp.*, 106 TC 312 (1996), *aff'd*, *121 F3d 723* (11th Cir. 1997) (form of loan was to subsidiary; substance followed form; not a guarantor parent). Compare *Joseph Creel*, 72 TC 1173 (1979), aff'd sub nom. *Martin v. Comm'r*, 649 F2d 1133 (5th Cir. 1981) (on facts at issue, where

the shareholder's payment of the corporation's bank loan pursuant to a guarantee is not deductible as a debt when the loan (really the shareholder's subrogation rights against an insolvent corporation) is more properly characterized as a contribution to capital.[4719]

> corporation borrowed funds and loaned proceeds to guarantor shareholders, transactions recast as loan by third party to shareholders). The same issue arises in connection with S corporations, as discussed at ¶ 6.06[4][b]; see, *e.g.*, *Bergman v. United States*, 174 F3d 928 (8th Cir. 1999) .

[4719] *Titmas v. Commissioner*, T.C. Memo. 1995-267; *Peterson v. Commissioner*, T.C. Memo. 1997-377. Bittker & Eustice, ¶ 4.03[3][f][iii] Borrower identity: guarantees and back-to-back loans, Federal Income Taxation of Corporations & Shareholders, explains (footnotes omitted, except for one):

> Use of shareholder-guaranteed corporate loans is sometimes suggested as a method of avoiding the thin capitalization problem. The theory is that if the corporation is organized with a minimum of equity capital and then borrows whatever funds it may need from a bank or other outside lender on notes endorsed by its shareholders, the interest paid by the debtor corporation to the lender should be deductible under § 163 and the repayment of the borrowed funds at maturity should not constitute a dividend to its shareholders. This recommendation of guaranteed loans as a solution to the problems of the thin corporation, however, underestimates the perspicacity of the courts. Just as a bond may not necessarily be a bond, a guarantor may not necessarily be a guarantor, and, for that matter, a lender may not necessarily be a lender. In form, the bank may have lent money to the corporation upon the shareholders' guarantee, but the substance of the transaction may be that the bank made the loan to the shareholders, who in turn passed the funds on to the corporation as—perish the thought—a capital contribution.[172]
>
> If a transaction is recast in this fashion, any payments by the corporation to the bank (whether labeled interest or repayment of loan) serve to discharge obligations of the shareholders to the bank and thus are disguised dividends. If the corporation becomes insolvent, however, the shareholders would suffer capital losses (long-term or short-term, as the case may be) under § 165(g), rather than short-term capital losses under § 166(d) as interpreted by the *Putnam* case.
>
> Similarly, where a loan is made by one party to an intermediary party who relends to a borrower that is related to the first lender (a so-called back-to-back loan), regulations may recast such transactions, under appropriate circumstances, in accordance with their true substance, namely, as a direct loan from the first lender to the related borrower.

Footnote 172:

> The leading case on this issue is *Plantation Patterns, Inc. v. Comm'r*, 462 F2d 712 (5th Cir.), *cert. denied*, 409 US 1076 (1972); see also *Casco Bank & Trust Co. v. United States*, 544 F2d 528 (1st Cir. 1976), *cert. denied*, 430 US 907 (1977), and cases cited therein; *In re Lane*, 742 F2d 1311, 1320 (11th Cir. 1984) (guaranties used as substitutes for infusion of more capital). But, for cases treating the corporation as the true debtor, see *J. Paul Smyers*, 57 TC 189 (1971) (fact that bank loan would not have been made without guarantee of shareholder does not, per se, make bank loan equity when corporation is not otherwise thin); *Murphy Logging Co. v. United States*, 378 F2d 222 (9th Cir. 1967) (corporation was not thin in either case); *Falkoff v. Comm'r*, 604 F2d 1045 (7th Cir. 1979) (corporation held to be true borrower); *Intergraph Corp.*, 106 TC 312 (1996), *aff'd*, 121 F3d 723 (11th Cir. 1997) (form of loan was to subsidiary; substance followed form; not a guarantor parent). Compare *Joseph Creel*, 72 TC 1173 (1979), *aff'd sub nom. Martin v. Comm'r*, 649 F2d 1133 (5th Cir. 1981) (on facts at issue, where corporation borrowed funds and loaned proceeds to guarantor shareholders, transactions recast as loan by third party to shareholders). The same issue arises in connection with S corporations, as discussed at ¶ 6.06[4][b]; see, *e.g.*, *Bergman v. United States*, 174 F3d 928 (8th Cir. 1999).

However, that loan treatment does not extend to the S corporation arena for the purpose of creating basis to absorb loss; for that specific purpose, an actual loan and not a mere guarantee is required.[4720] Only when the guarantor pays on the loan is the guarantor considered to have made a loan.[4721]

In the partnership arena, a guarantee does not constitute a liability,[4722] but it can affect how debt is allocated among the partners, because generally debt is allocated according to who bears the economic risk of loss.[4723] For more information, see part II.C.3 Allocating Liabilities (Including Debt), including Prop. Reg. § 1.752-2(j)(3) on when a guarantee may be disregarded in allocating liabilities.[4724]

When a taxpayer makes a payment to discharge part or all the taxpayer's agreement to act as a guarantor where the agreement provides for a right of subrogation or other similar right against the issuer, treatment as a worthless debt is not allowed until the taxable year in which the right of subrogation or other similar right becomes totally worthless (or partially worthless in the case of an agreement which arose in the course of the taxpayer's trade or business).[4725] Normally, a guarantor's payment on a debt will

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[4720] See part II.G.3.c.i.(a) Limitations on Using Debt to Deduct S Corporation Losses, fns. 822-823.

[4721] Reg. § 1.1366-2(a)(2)(ii), reproduced in fn. 822. Reg. § 1.1366-2(a)(2)(iii), Example (4) provides:

> *Guarantee*. A is a shareholder of S, an S corporation. In 2014, S received a loan from Bank. Bank required A's guarantee as a condition of making the loan to S. Beginning in 2015, S could no longer make payments on the loan and A made payments directly to Bank from A's personal funds until the loan obligation was satisfied. For each payment A made on the note, A obtains basis of indebtedness under paragraph (a)(2)(ii) of this section. Thus, A's basis of indebtedness is increased during 2015 under paragraph (a)(2)(ii) of this section to the extent of A's payments to Bank pursuant to the guarantee agreement.

[4722] Reg. § 1.752-1(a)(4)(i) provides:

> *In general*. An obligation is a liability for purposes of section 752 and the regulations thereunder (§ 1.752-1 liability), only if, when, and to the extent that incurring the obligation—
>
> (A) Creates or increases the basis of any of the obligor's assets (including cash);
>
> (B) Gives rise to an immediate deduction to the obligor; or
>
> (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

[4723] See also Reg. § 1.175-4(b)(2)(iv)(A).

[4724] See part II.C.3.c.ii.(b) Temporary Rules Allocating Economic Risk of Loss to Recourse Liabilities, especially fns. 367-372 and the accompanying text.

[4725] Reg. § 1.166-9(e)(2). *Intergraph Corp. v. Commissioner*, 106 T.C. 312, 324 (1996), held:

> Section 1.166-9(a), (d), and (e)(2), Income Tax Regs., properly read, stands for the proposition that where a guarantor does have rights of subrogation and reimbursement from the original debtor (regardless of whether or not these rights are expressly stated in the guaranty agreement), the provisions of section 1.166-9(e)(2), Income Tax Regs., apply, and the guarantor is not entitled to a bad debt deduction until the rights of subrogation and reimbursement are shown to be worthless. See *Howell v. Commissioner*, 69 F.2d 447, 451 (8th Cir. 1934), *affg.* 22 B.T.A. 140 (1931); *Martin v. Commissioner*, 52 T.C. 140, 143 (1969); *Rietzke v. Commissioner*, 40 T.C. 443, 451 (1963), *affd.* 424 F.2d 1368 (9th Cir. 1970); *Bradford v. Commissioner*, 22 T.C. 1057, 1069 (1954), *revd.* on other issues 233 F.2d 935 (6th Cir. 1956); *Standard Oil Co. v. Commissioner*, 7 T.C. 1310, 1323 (1946), *supplemented by* 11 T.C. 843 (1948).

be deductible,[4726] either as a business bad debt[4727] or non-business bad debt. Bad debt deductions apply only where the taxpayer received reasonable consideration for making the guarantee and provides that consideration received from a spouse or other defined family member must be direct consideration in the form of cash or property.[4728]

When a guarantor becomes primarily liable on a debt and that debt is later forgiven, the forgiveness does not constitute cancellation of indebtedness income.[4729] That's because merely providing the guarantee does not increase the guarantor's assets.[4730] If a

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[4726] See Blattmachr and Zaritsky, Is the BDIT Ready for Primetime? *Probate Practice Reporter* (University of South Carolina School of Law, ISBN 1044-7423), Sept. 2012.

[4727] For a debt to be a business bad debt, it needs to be incurred in connection with the taxpayer's trade or business; furthermore, to be engaged in a trade or business, an individual must be involved in an activity with continuity and regularity, and the primary purpose for engaging in the activity must be for income or profit. *Alpert v. Commissioner*, T.C. Memo. 2014-70 (sustaining accuracy-related penalties when taxpayer could not produce credible evidence of the above).

[4728] Reg. § 1.166-9(e); *Lair v. Commissioner*, 95 T.C. 35 (1990) (imposing penalties for deducting loss on guarantee of family member's obligation in light of that regulation).

[4729] *Mylander v. Commissioner*, T.C. Memo. 2014-191, reasoning:

> Under the guaranty petitioners were secondary obligors as to the Murray debt because they were obligated to pay the debt only if the Ledbetters—the primary obligors—defaulted. See *Restatement 3d*, Suretyship & Guaranty, sec. 1 (1996). When the Ledbetters defaulted, a cause of action against petitioners accrued to Mr. Murray which led to the State court judgment against petitioners and the subsequent covenant not to execute. Under the State court judgment, as well as the covenant not to execute, petitioners' secondary obligation became a primary obligation. See *Chevron Chem. Co. v. Mecham*, 536 F.Supp. 1036, 1043 (D. Utah 1982) (Default on the primary contract by the debtor ripens an unconditional guaranty into an actionable liability of the guarantor separate and apart from that of the principal debtor. The guarantor's obligation becomes absolute and is no longer secondary[.]).
>
> Petitioners argue that even if they had become primary obligors on the Murray debt, they did not realize any COD income when the remaining debt was forgiven because they did not receive the benefit of the non-taxable proceeds from the loan obligation. We agree with petitioners.

[4730] *Mylander v. Commissioner*, T.C. Memo. 2014-191, reasoning:

> Even though petitioners had become primary obligors under the guaranty, their situation remained similar to those of the taxpayers in *Hunt* and *Landreth*. We observed in *Landreth v. Commissioner*, 50 T.C. at 813, that where the guarantor is relieved of his contingent liability *** because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth. See also *Hunt v. Commissioner*, T.C. Memo. 1990-248, 59 T.C.M. (CCH) at 649-650 (quoting *Landreth v. Commissioner*, 50 T.C. at 813).
>
> We do not see any material difference between the situation in *Landreth* and one in which a guarantor's contingent liability has ripened into a primary liability. Unlike a debtor who borrows funds, a guarantor who assumes a contingent liability does not receive an untaxed accretion of assets which is accompanied by an offsetting obligation to pay. This remains the case even after the guarantor becomes a primary obligor because of the debtor's default. Regardless of whether the guarantor is a secondary obligor or has become a primary obligor, when the debt is discharged the guarantor's net worth is not increased over what it would have been if the original transaction had never occurred. *Landreth v. Commissioner*, 50 T.C. at 813.
>
> Petitioners did not receive any untaxed accretion of assets when they gave the guaranty. Nor did they receive any untaxed accretion of assets with respect to the guaranty when they later became primarily liable on the Murray debt as a result of the State court

taxpayer who intended to be a guarantor mistakenly signs loan documentation as the primary obligor and the taxpayer never received the loan proceeds, never made payments, and never was looked to for payments, the taxpayer is recognized as a mere guarantor and does not realize income when the loan is forgiven.[4731]

Factors determining whether a corporation may deduct guarantee fees paid to shareholders include: the fees must be reasonable,[4732] businesses of the same type and

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> judgment. Therefore, when the remaining debt was forgiven petitioners did not realize an untaxed increase in wealth any more than had they remained secondary obligors.[14]
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> [14] Respondent argues that, pursuant to our decision in *Hahn v. Commissioner*, T.C. Memo. 2007-75, petitioners received an accession to wealth upon the discharge of the remaining debt. We find that *Hahn* is distinguishable because in that case the taxpayer was a debtor, not a guarantor, and received untaxed loan proceeds. *Id.*, slip op. at 2.

The court concluded:

> Petitioners were initially secondary obligors on the Murray debt, under the terms of the guaranty. They did not receive any valuable consideration in exchange for the guaranty. Upon the Ledbetters' default, and the subsequent State court judgment and covenant not to execute, petitioners became primarily liable on the Murray debt. However, at no point did they receive an untaxed accretion of assets with respect to the guaranty. Accordingly, we find that, when the remaining debt was forgiven by Mr. Murray in 2010, petitioners did not have an accession to wealth and did not realize any COD income.

[4731] *Bullock v. Commissioner*, T.C. Memo. 2017-219, relying on the testimony of the taxpayer of her daughter-in-law (one of the intended borrowers), reasoned:

> When petitioner went to the car dealership, she did not intend to be the primary obligor on the loan. In fact, she did not realize until trial that she had signed paperwork stating otherwise. She did not intend to personally repay the loan, and she made no payments on the loan. See *Monon R.R. v. Commissioner*, 55 T.C. 345, 357 (1970) ("The intent of the parties, in turn, may be reflected by their subsequent acts[.]"). The credit union also understood that petitioner intended only to be a cosigner; it was aware that petitioner's son and daughter-in-law were responsible for the loan payments, and it never looked to petitioner for repayment. See *id* . Without an intention for petitioner to repay the debt, there was no bona fide primary obligation between petitioner and the credit union. See *PepsiCo P.R., Inc. v. Commissioner*, T.C. Memo. 2012-269, at *55, *88-*91 (emphasizing the lack of intent to create a repayable obligation as a factor in holding that no debt existed).
>
> Instead, petitioner, with the knowledge of the credit union, essentially operated as a guarantor for her son and daughter-in-law. Petitioner was merely promising to be responsible for her son and daughter-in-law in the event they failed to make the loan payments; she made no payments on the loan, and she never used the truck.
>
> Because petitioner was merely the secondary obligor, her net worth was not "increased over what it would have been if the original transaction had never occurred." See *Mylander v. Commissioner*, at *18, *22 (holding that the taxpayers did not receive COD income for a debt that they had become primary obligors on via a guaranty (citing *Landreth v. Commissioner*, 50 T.C. at 813)). When the truck loan was forgiven, petitioner did not realize an untaxed increase in wealth. See *id*. at *23. Therefore, petitioner did not receive $8,164 in cancellation of debt income...

PepsiCo P.R., Inc. v. Commissioner is quoted extensively in the text accompanying fn. 1219 in part II.G.19 Debt vs. Equity.

[4732] Bittker & Lokken, ¶ 79.4. Loans or Advances, *Federal Taxation of Income, Estates, and Gifts* (WG&L), when discussing Code § 482 implications of interest paid between related companies,

> A related issue, which has not been directly litigated in the United States, is arm's length pricing of fees for guaranteeing a related person's debt. See *General Elec. Capital Canada Inc. v. Queen*, 2009 TCC 563 (Tax Court of Canada 2009); Breen, Evaluating

size as the payor corporation must customarily pay guarantor fees to their shareholders, shareholders must demand compensation in exchange for signing on as guarantors, the payment of guarantor fees suggests a constructive dividend if the corporation's profitability enabled it to pay a dividend and yet no dividends were paid out during the relevant tax year, and the courts give consideration to the proportional relationship between the amount of the payments and the shareholders' stock ownership.[4733] In deciding the deductibility of guaranty fees paid to a shareholder employee, courts consider:[4734]

(1) Whether, given the financial risks, the fees are reasonable in amount;

(2) whether businesses of the same type and size as the payor must customarily pay guarantor fees to shareholders;

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the Arm's-Length Price of Financial Guarantees; A Review of the OECD Framework, 59 Tax Notes Int'l 869 (Sept. 13, 2010); Hales, Robinson, Axelsen & Ielceanu, Determining Arm's-Length Guarantee Fees, 39 Tax Mgmt. Int'l J. 445 (2010); Stewart, Officials Engage Practitioners on Pricing of Guarantee Fees, 127 Tax Notes 770 (May 17, 2010). See also Horst, How to Determine Tax-Deductible, Debt-Related Costs For a Subsidiary, 62 Tax Notes Int'l 589 (May 16, 2011); Miller, Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis, 48 Tax Law. 103 (1994).

[4733] *Seminole Thriftway, Inc. v. U.S.*, 42 Fed. Cl. 584 (1999), after discussing *Tulia Feedlot, Inc. v. U.S.*, 513 F.2d 800, 804 (5th Cir. 1975); *Olton Feed Yard, Inc. v. U.S.*, 592 F.2d 272 (5th Cir. 1979); *Tulia Feedlot, Inc. v. U.S.*, 3 Cl. Ct. 364 (1983); and *Fong v. Commissioner*, T.C. Memo. 1984-402. *A.A. and E.B. Jones Co. v. Commissioner*, T.C. Memo. 1960-284, approved fees for guaranteeing surety bonds that were required to do business when the taxpayers proved that the payments were usual and were comparable to others in somewhat similar circumstances.

[4734] *E.J. Harrison and Sons, Inc. v. Commissioner*, T.C. Memo. 2003-239, citing:

> See *Olton Feed Yard, Inc. v. United States*, 592 F.2d 272, 275-276 (5th Cir. 1979); *Tulia Feedlot, Inc. v. United States*, 513 F.2d 800, 803-806 (5th Cir. 1975); *Fong v. Commissioner*, T.C. Memo. 1984-402, *affd*. without published opinion 816 F.2d 684 (9th Cir. 1987); *Seminole Thriftway, Inc. v. United States*, 42 Fed. Cl. 584, 589-590 (1998) (the guaranty fee cases).

The court held:

> Mrs. Harrison's loan guaranties represented one of her principal contributions to petitioner. They did not, as in the no-fee cases, merely supplement her performance of substantial managerial activities on petitioner's behalf. Therefore, we find those cases to be inapposite. Rather, we find that the factors utilized in the guaranty fee cases are properly suited to the task of determining what amount, if any, may be considered reasonable compensation for Mrs. Harrison's personal guaranties. Because (1) Mrs. Harrison was willing to issue the guaranties without compensation, (2) there is no evidence that businesses of the same type and size as petitioner customarily paid guarantor fees to shareholders, (3) petitioner had sufficient profits to pay dividends, but failed to do so, and (4) the evidence does not establish what amount, if any, would constitute reasonable compensation for her guaranties, we find that Mrs. Harrison's guaranties do not support the characterization of any amount she received from petitioner as reasonable compensation. Instead, we view the shareholder guaranties in this case as a means of protecting the shareholders' ownership interests in petitioner, not as a function of their employment by petitioner. See *Olton Feed Yard, Inc. v. United States*, 592 F.2d at 275-276 (stating that employee-shareholders' willingness to guaranty, without charge, the corporate employer's debt is evidence that such individuals "signed the guaranties in order to protect and enhance their investment in the corporation").

(3) whether the shareholder demanded compensation for the guaranty;

(4) whether the payor had sufficient profits to pay a dividend, but failed to do so; and

(5) whether the purported guaranty fees were proportional to stock ownership.

When a savings and loan association engaged in the financing of residential mortgages, established a "pool" of mortgages, all of which are insured by the Federal Housing Administration, the Farmers Home Administration, or are insured or guaranteed by the Veterans Administration, those who bought an interest in the mortgages[4735] may deduct the servicing, custodian, and guarantee fees under Code § 162 or 212.[4736]

Code § 102 (no income on a gift) trumps Code § 61(a)(2) (discharge of indebtedness is income income).[4737]

III.B.1.a.iii. Gift of Services

The gift tax applies to gifts of property, not services. Before *Dickman*, the courts generally concluded that the gift tax only applied to transfers of title or interest in property. This is clearly no longer true, considering how the court chose to define "property": "[It] is more than just the physical thing – the land, the bricks, the mortar – it is also the sum of all the rights and powers incident to ownership of the physical thing. Property is composed of constituent elements and of these elements the right to *use* the physical thing to the exclusion of others is the most essential and beneficial."[4738]

A pre-*Dickman* case held that donating one's own services does not create gift tax liability relating to the value or profits derived from those services.[4739] "The taxpayer is not under any duty to cultivate the fruits of his capital (or labor) and will not be taxed as if

[4735] Rev. Rul. 84-10 treated the pools as multiple owner grantor trusts, presumably having in mind the rules discussed in part II.D.4.a Investment Trusts, which is part of part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes. Rev. Rul. 84-10 noted:

> The Service has discussed the federal income tax consequences of similar pooling arrangements in Rev. Rul. 71-399, 1971-2 C.B. 433, amplified by Rev. Rul. 81-203, 1981-2 C.B. 137, Rev. Rul. 80-96, 1980-1 C.B. 317, Rev. Rul. 74-300, 1974-1 C.B. 169, Rev. Rul. 74-221, 1974-1 C.B. 365, and Rev. Rul. 72-376, 1972-2 C.B. 647 (concerning mortgage pools established by the Federal Home Loan Mortgage Corporation); Rev. Rul. 70-544, 1970-2 C.B. 6, and Rev. Rul. 70-545, 1970-2 C.B. 7, both modified by Rev. Rul. 74-169, 1974-1 C.B. 147 (concerning mortgage pools guaranteed by the Government National Mortgage Association); and Rev. Rul. 77-349, 1977-2 C.B. 20 (concerning a mortgage pool created by a commercial bank).

[4736] Rev. Rul. 70-544.

[4737] *Helvering v. American Dental*, 318 U.S. 322 (1943) (interpreting predecessors to these statutes); *Bosse v. Commissioner*, T.C. Memo. 1970-355 (not citing *Helvering v. American Dental* but rather determining the gratuitous nature of the forgiveness).

[4738] *Dickman*, 465 U.S. at 336, quoting *Passailaigue v. U.S.*, 224 F.Supp 682, 686 (M.D. Ga. 1963).

[4739] *Hogle v. Commissioner*, 7 T.C. 986 (1946 reviewed decision), *aff'd* 165 F.2d 352 (10th Cir. 1947).

he had when he hasn't."[4740] Also, *Dickman* states that the gift tax is an excise tax on transfers of property.[4741] *Dickman* did not address gifts of services.

The IRS ruled that a timely waiver of fees for serving as executor was neither income to, nor a gift by, the executor, reasoning:[4742]

> The crucial test of whether the executor of an estate or any other fiduciary in a similar situation may waive his right to receive statutory commissions without thereby incurring any income or gift tax liability is whether the waiver involved will at least primarily constitute evidence of an intent to render a gratuitous service. If the timing, purpose, and effect of the waiver make it serve any other important objective, it may then be proper to conclude that the fiduciary has thereby enjoyed a realization of income by means of controlling the disposition thereof, and at the same time, has also effected a taxable gift by means of any resulting transfer to a third party of his contingent beneficial interest in a part of the assets under his fiduciary control. See [Revenue Rulings 56-472 and 225] and the authorities therein cited, as well as section 25.2511-1(c) of the Gift Tax Regulations.
>
> The requisite intention to serve on a gratuitous basis will ordinarily be deemed to have been adequately manifested if the executor or administrator of an estate supplies one or more of the decedent's principal legatees or devisees, or of those principally entitled to distribution of decedent's intestate estate, within six months after his initial appointment as such fiduciary, with a formal waiver of any right to compensation for his services. Such an intention to serve on a gratuitous basis may also be adequately manifested through an implied waiver, if the fiduciary fails to claim fees or commissions at the time of filing the usual accountings and if all the other attendant facts and circumstances are consistent with a fixed and continuing intention to serve gratuitously. If the executor or administrator of an estate claims his statutory fees or commissions as a deduction on one or more of the estate, inheritance, or income tax returns which are filed on behalf of the estate, such action will ordinarily be considered inconsistent with any fixed or definite intention to serve on a gratuitous basis. No such claim was made in the instant case.

Commentators generally agree that, if the service provider clearly establishes intent not to charge for services before the service provider earned compensation income, then gratuitously rendering services will not constitute a gift, because no property has been transferred.

4740 *Crown*, 585 F.2d at 236

4741 *Dickman*, 465 U.S. at 340.

4742 Rev. Rul. 66-167, followed *Breidert v. Commissioner*, 50 T.C. 844 (1968) (executor's commission was claimed on estate tax return but was still deemed not income when executor refused to pay himself), Rev. Rul. 70-237, and Letter Ruling 7846049. *Breidert v. Commissioner* was distinguished in *O'Connell v. Commissioner*, T.C. Memo. 1980-432.

III.B.1.a.iv. Family Partnerships

III.B.1.a.iv.(a). Gift/Estate Tax Uses and Issues Regarding Family Partnerships

Generally, my materials do not cover valuation disputes, annual exclusion issues, or Code § 2036 cases.

When a partner receives a capital account (or increases an existing capital account) by the fair market value of contributed assets (as is required by the regulations under Code § 704(b)),[4743] the contribution to the partnership is not a gift.[4744] However, if the partnership's income and loss are not proportionate to capital accounts, see parts III.B.7.b Code § 2701 Overview and III.B.7.c Code § 2701 Interaction with Income Tax Planning.

Any part of the discussion below that relates to preferred partnership is subject to part III.B.7.b Code § 2701 Overview when considering how to structure a preferred return so that the preferred return is given effect for gift tax purposes (including whether a sale is for adequate and full consideration).

One problem with sales to irrevocable grantor trusts[4745] is that neither the growth nor the value of the asset at the time of the sale receives a basis step-up at death; the same issue applies to gifts. Considerable growth is required for the estate tax savings to make up for the income tax benefits lost due to the lack of a basis step up.[4746] See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property). One way to obtain a basis step-up on the value of the gift or sold asset at the time of the transfer is to retain a preferred partnership interest and transfer the common interest.[4747]

III.B.1.a.iv.(b). Income Tax Aspects of Family Partnerships

Numerous provisions in part II Income Tax Flexibility discuss partnership income taxation generally. For an operating business, a robust structure is described in part II.E Recommended Structure for Entities.

Code § 704(e) was amended in 2015;[4748] now:

[4743] See part II.C.7 Maintaining Capital Accounts (And Be Wary of "Tax Basis" Capital Accounts), especially fn. 418.

[4744] *Estate of Jones v. Commissioner*, 116 T.C. 121, 128 (2001), holding:

> The contributions of property in the case at hand are similar to the contributions in *Estate of Strangi* and are distinguishable from the gifts in *Shepherd*. Decedent contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts.

[4745] See part III.B.2.a Tax Basis Issues within part III.B.2 Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust.

[4746] See Stacy Eastland's materials at the 2015 Heckerling Institute on Estate Planning.

[4747] See part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

[4748] RIA's history provides [some punctuation added]:

> In 2015, P.L. 114-74, Sec. 1102(b)(1), deleted para. (e)(1), and redes. paras. (e)(2) and (e)(3) as paras. (e)(1) and (e)(2), respectively. P.L. 114-74, Sec. 1102(b)(2),

- If a partnership interest is created by gift, the donee's distributive share is includible in the donee's gross income, except to the extent that the share is determined without allowance of reasonable compensation for services that the donor rendered to the partnership, and except to the extent that the portion of that share attributable to donated capital is proportionately greater than the donor's share attributable to the donor's capital.[4749] In applying this rule, "an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital."[4750]

- Regarding a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to that interest is determined without regard to whether such interest was derived by gift from any other person.[4751]

Before these amendments, the following analysis applied:

Suppose a parent real estate entrepreneur makes a capital contribution to become the general and managing partner of a family partnership. The children all make capital contributions, as limited partners, in amounts greater than or equal to the parent's. The lion's share of the capital necessary to finance the project is borrowed from banks, presumably on the basis of the parent's good credit and standing in the financial community. If the transaction succeeds, the banks are paid back and the children are rewarded in proportion to their capital contributions. If the transaction fails, however, the banks and the parent, as general partner, are left holding the bag. This scenario is similar in some respects to *Carriage Square, Inc. v. Commissioner*.[4752]

In *Carriage Square*, the father, through his corporation, Carriage Square, Inc., contributed funds to a partnership (10% of total funds), while five trusts, for the benefit of his wife and children, each contributed the remainder (90%). The father became the general partner, while the trusts became limited partners. The father would then purchase land with borrowed money and sell the land to the partnership, with the partnership borrowing the necessary capital from the same bank on a guarantee by the father. The partnership would also take out a construction loan, again guaranteed by the

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substituted this subsection for this section in para. (e)(2) (as redes. by Sec. 1102(b)(1)). P.L. 114-74, Sec. 1102(b)(3), substituted Partnership Interests Created by Gift for Family Partnerships the heading of subsec. (e), effective for partnership tax. yrs. begin. after 12/31/2015.

Prior to deletion, para. (e)(1) read as follows:

(1) Recognition of interest created by purchase or gift. A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

[4749] Code § 704(e)(1), which further provides, The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

[4750] Code § 704(e)(2), which further provides:

The family of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

[4751] Code § 761(b).

[4752] 69 T.C. 119 (1977).

father. Once the real estate development became successful, the five trusts received 90% of the profits.

The *Carriage Square* majority held that the borrowed capital was not a material income-producing factor.[4753] Code § 704(e)(1), a non-exclusive safe harbor, stated that a person shall be recognized as a partner for income tax purposes if he or she owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person. However, whether capital is a material income-producing factor in a partnership is for the fact finder to determine on a case-by-case basis. Essentially, the court believed the bank would not have loaned the money to capitalize the venture without the secured guarantees by the father.

The court held that the partnership was a sham designed to transfer tax-free income streams to the children. Because capital was not a material income producing factor, Code § 704(e)(1) did not apply. Also, the court held, the partners did not have a valid business purpose for forming the partnership, considering the 90% share of profits the trusts earned in light of their limited capital contributions and consequential limited risk (since they did not guarantee the loans). Because the partnership could borrow whatever amounts it needed based on the guarantees by the father, their capital contributions were not material. Further, because the father, through the general partner corporation, performed all the services necessary to operate the business, assumed all the risk of business failure, and used his contacts and community goodwill to secure the loans, the court held that the trusts were not partners.[4754] Judge Tannenwald, in his dissent, instead of discounting the partnership interests of the trusts, raised the specter of the trusts' partnership interests having been acquired by gift under Code § 704(e)(2).[4755]

A family partnership in which capital is not a material income-producing factor may still be recognized as a valid entity and the persons within it as valid partners under the *Culbertson* standard.[4756] Partners must show they had a good faith business motive for entering into the partnership. However, for income tax purposes, failure to satisfy Code § 704(e)(1) would preclude the partnership from passing the *Culbertson* hurdle.[4757]

Commentators have long questioned the *Carriage Square* holding.[4758] The case, as the Tax Court admitted, was an egregious example of tax avoidance.[4759]

[4753] The court believed that Reg. § 1.704-1(e)(1)(i) prohibited the borrowed capital from being considered as an income producing factor because it was not contributed by a partner. *Id*. at 127. The production of income by a partnership is attributable to the capital or services, or both, contributed by the partners. Reg. § 1.704-1(e)(1). Here, the capital was guaranteed by a non-partner, the father.

[4754] *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 128.

[4755] *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 140-41.

[4756] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

[4757] Howard Zaritsky, ¶ 10.09 The Family Partnership Rules, *Tax Planning for Family Wealth Transfers: Analysis With Forms*.

[4758] W. McKee, W. Nelson, R. Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 14.02 (3rd ed. 1997) (stating that establishing a recognizable capital interest is less onerous under Code § 704(e)(1) and Reg. § 1.704-1(e)(1)(iv) than *Carriage Square* believes).

III.B.1.a.v. Sending Business

In *Crowley v. Commissioner*,[4760] a father owned a savings and loan. In addition to the traditional sources of income, the business generated income by means of appraisal fees, insurance fees, and title commissions. He created a partnership for his four children to handle these ancillary income streams for the S&L. One son was trained as an appraiser and insurance agent, handling the S&L's appraisal and insurance needs. The profits from this work were shared between the S&L and the partnership. The Tax Court held that the income was all taxable to the partnership and not to the father.[4761] Having determined that no income was attributable to the father, the court held that there were no gift tax issues.

The son could not have obtained the amount of appraisal work he did without the aid of his father. This was a business opportunity that the son (and his siblings) had not earned on the basis of individual ability. One author suggested that such nepotism, however, would be extraordinarily difficult to tax, and the IRS does not regularly pursue it.[4762]

Bross Trucking, Inc.. v. Commissioner, T.C. Memo. 2014-107, held that:

- Lack of non-compete precluded corporate goodwill regarding owner-officer's relationships.
- Owner's sons developed relationships with owner's customers when owner shut down owner's business due to regulatory hassles and sons started new corporation.
- Workforce intangible not deemed transferred when only 50% of the employees of the old corporation worked for the new corporation.

For a detailed analysis of the *Bross Trucking* case, see part II.Q.7.h.v Taxpayer Win in *Bross Trucking* When IRS Asserted Corporation Distribution of Goodwill to Shareholder Followed by Gift to Shareholder of New Corporation (2014).

Also see *Estate of Adell v. Commissioner*, T.C. Memo. 2014-155 (lack of non-compete precluded corporate goodwill regarding owner-officer's relationships; customers did business with owner's son because they trusted the son personally; son was qualified to run the business), part of a line of cases discussed in part II.Q.1.c.iii Does Goodwill Belong to the Business or to Its Owners or Employees?

If a new entity is formed, make sure it has a business purpose and conducts business. For example, if one sets up a domestic international sales corporation (DISC), which does not require a business purpose or business activity when owned by the shareholders of the corporation that the DISC serves, the IRS might attack the

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[4759] *Carriage Square, Inc. v. Commissioner*, 69 T.C. 119, 131.
[4760] 34 T.C. 333 (1960).
[4761] *Crowley v. Commissioner*, 34 T.C. 333, 345-47.
[4762] Gingiss, The Gift of Opportunity, 41 *DePaul L. Rev* 395, 410 (1991-1992).

arrangement if the person owning the DISC differs from the person owning the exporter.[4763]

III.B.1.a.vi. Asset Transfers to Children or Their Businesses

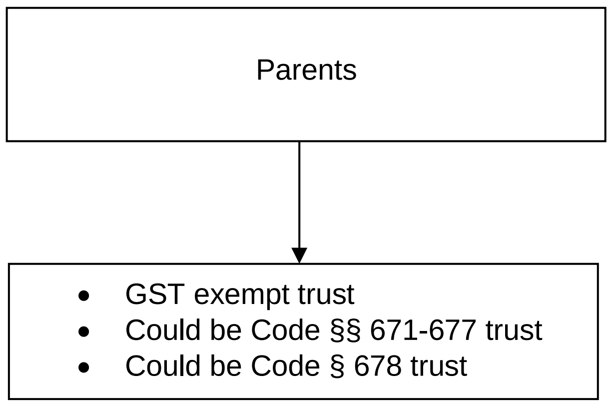
When transferring an asset with low current value from which the children could reap significant profits, be extra careful to make sure that the transfers are properly documented to ensure locking in the current value. Otherwise, the IRS might argue that the transferor still owns the asset or transferred it at a later time.[4764]

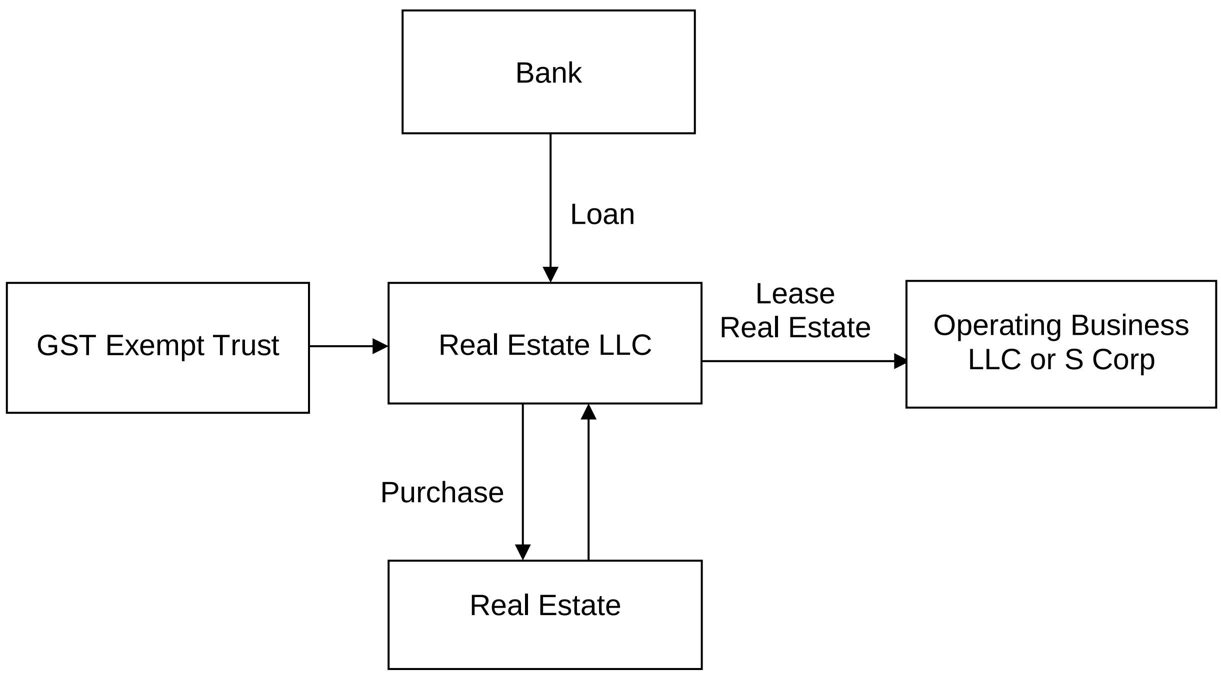
[4763] See *Summa Holdings, Inc. v. Commissioner*, T.C. Memo. 2015-119, described in part II.G.21 IRA as Business Owner, which also explains what DISCs are and why taxpayers might be lulled into a false sense of security in dealing with them.

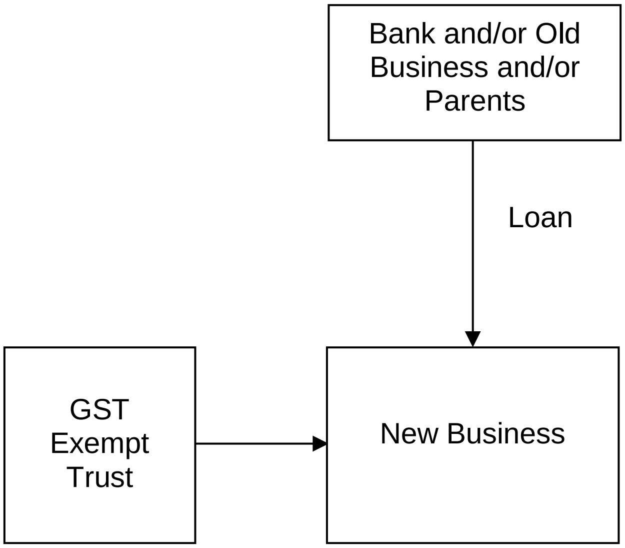
[4764] *Cavallaro v. Commissioner*, T.C. Memo. 2014-189 (supposed transfer was documented many years later; gift occurred at time of proper documentation), *rev'd* on other grounds 118 A.F.T.R.2d ¶2016-5517 (1st Cir. 11/18/2016).

III.B.1.a.vii. Business Expansion into New Location

Consider the following:







III.B.1.a.vii.(a). Estate Planning

A new business or real estate venture often has either minimal value or net asset value. This structure moves future growth outside of the estate tax system.

However, one might consider some mechanism to get the property back into the estate tax system, to get a basis step-up when a beneficiary dies; this concern applies particularly when a beneficiary's gross estate is below the beneficiary's available estate tax exemption, but planning strategies can provide a basis step-up with minimal estate tax even if the beneficiary has a taxable estate.[4765]

When used for real estate, growth in value, although desirable, is not necessary for this to be beneficial for estate tax planning. The property will gain equity simply by the real estate LLC using the rent to pay down the mortgage.

When used for real estate, this can facilitate equalizing bequests to family members not involved in the business. The outsiders get real estate rental income, and the insiders get business income.

When used for an operating business, this also facilitates siblings pursuing different lines of business or different locations so that they are not entangled with each other as long.

III.B.1.a.vii.(b). FICA Planning

Partnership income from a trade or business is generally subject to self-employment tax, unless the partner is a limited partner.

In recent income tax cases, the Service has tried to characterize a member of a limited liability company as a limited partner to disallow losses for income tax purposes under the Code § 469 passive loss rules. Courts have rejected this attempt.

[4765] See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property).

Real estate rental income is not subject to self-employment tax. Holding the real estate in a separate LLC would allow the business LLC to deduct rent payments for income and self-employment tax purposes and the real estate LLC owners to be subject to income but not self-employment tax. This self-employment tax savings is often small in initial years, because if the property were held in the business LLC then the business would deduct interest, depreciation, etc. However, as the mortgage gets paid down (thereby decreasing interest deductions) and rent increases, this savings can be significant.

See II.L.3 Self-Employment Tax: General Partner or Sole Proprietor, for a detailed discussion.

III.B.1.b. Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers

For smaller companies, consider gifts either outright or in trust. Gifts provide more favorable valuation rules than transfers by bequest. Suppose, for example, that Decedent bequeathed 100% of the stock of her business to her children. The bequest is of a single 100% block of stock, so valuation adjustments for lack of control would not apply. However, if while alive she gave a 20% block of stock to each of five children, so that she gave away 100% of all of stock all at once. Each 20% block is valued separately, with valuation adjustments for lack of control.[4766] Proposed regulations would eliminate these valuation adjustments if the gift is made within 3 years of death,[4767] as well as artificially increasing the value beyond customary valuation principles.[4768]

When a donor delivers a properly indorsed stock certificate, when the gift is complete depends on to whom the donor delivers the certificate:[4769]

- If delivered to the donee or the donee's agent, the gift is complete for gift tax purposes on the date of delivery.

- If delivered to the donor's bank or broker as the donor's agent, or to the issuing corporation or its transfer agent, for transfer into the name of the donee, the gift is complete on the date the stock is transferred on the corporation's books.

[4766] Rev. Rul. 93-12.

[4767] Prop. Reg. § 25.2704-1(f), Example (4), would be revised to end as follows:

> More than three years before D's death, D transfers one-half of D's stock in equal shares to D's three children (14 percent each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y because the voting rights with respect to the transferred shares are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death.

For further discussion, see part III.B.7.f.ii.(a) Prop. Reg. § 25.2704-1 Regarding .

[4768] See part III.B.7.f.ii.(b) Prop. Reg. §§ 25.2704-2 and 25.2704-3 Increasing Value.

[4769] Reg. § 25.2511-2(h). When in doubt as to whether the gift was complete, look at the parties' conduct and local law. *Estate of Davenport*, T.C. Memo. 1997-390, *aff'd* 184 F.3d 1176 (10th Cir. 1999) (completed gift when donor signed stock power).

A gift to a minor should probably be done using the Uniform Transfers to Minors Law unless the gift is in trust. Gifts to minors of partnership interests that are not done in that manner can be problematic, and a conservatorship would be advisable.[4770]

For corporations, the author frequently recommends that clients create nonvoting stock, doing a 19-for-1 nonvoting-for-voting stock dividend.[4771] The parent keeps the voting stock, which represents all of the voting rights, but only 5% of the distribution rights, the parent then transfers part or all of the nonvoting stock.[4772] This restructuring may also be a prelude to the more advanced techniques.

For an S corporation, a simple way to protect the principal from the donee's creditors (including the IRS through estate taxes) would be to use a qualified subchapter S trust (QSST).[4773] A QSST has only one beneficiary, and all of its income must be distributed to that individual. A QSST's income is taxed to its beneficiary,[4774] which means that the trust's fiduciary income tax returns simply report the trust's income on a statement, which the beneficiary then uses to prepare his or her own individual income tax returns. In part III.A.3 Trusts Holding Stock in S Corporations, especially part III.A.3.e.iii Comparing QSSTs to ESBTs, this article discusses the merits of QSSTs compared to other alternatives.

Whether a transfer qualifies for the gift tax annual exclusion depends on whether the property is transferable or income-producing and whether it is outright or in trust.[4775] If the interest transferred is not income-producing, consider giving the donee the right to sell it to the donor for its fair market value within 30 days after the transfer.

4770 Reg. § 1.704-1(e)(2)(viii) provides that, except where a minor child is shown to be competent to manage his own property and participate in the partnership activities in accordance with his or her interest in the property, a minor child generally will not be recognized as a member of a partnership unless control of the property is exercised by another person as fiduciary for the sole benefit of the child, and unless there is such judicial supervision of the conduct of the fiduciary as is required by law. Of course that is an income tax regulation and does not on its face apply for gift/estate/GST tax purposes. An income tax regulation can override the state law property rights that apply for gift/estate/GST tax purposes, and the *Pierre* case certainly drove home that point when it held that the check-the-box regulations did not apply to determine the gift tax effect of the transfer of an interest in a single-member LLC. See text accompanying fn 2943. On the other hand, gift/estate/GST tax rules governing partnerships are not well-defined, and courts and the IRS often look to income tax rules when figuring out matters involving partnerships, so a conservatorship would be recommended to avoid an argument, as well as to prove acceptance of the gift.

4771 See fn 198 for reporting requirements relating to this stock dividend.

4772 A transfer of nonvoting stock poses much less estate tax risk than a transfer of minority voting stock. See fns 194-196.

4773 Code § 1361(d)(3).

4774 Code § 1361(d)(1)(B).

4775 For qualification of withdrawal rights for the annual exclusion, see *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), and its progeny. For whether an interest in a business entity qualifies for the annual exclusion, see *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd* 335 F.3d 664 (7th Cir. 2003), and its progeny, including *Price v. Commissioner*, T.C. Memo. 2010-2; *Fisher v. U.S.*, 105 A.F.T.R.2d 2010-1347 (D. Ind 2010); *Estate of Wimmer v. Commissioner*, T.C. Memo. 2012-157; *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249 (annual exclusion upheld because LLC's assets produced income). For the amount of the annual exclusion, see Code § 2503(b).

Restructuring trusts might or might not have tax consequences.

Suppose a trust includes a power that would cause estate inclusion and a court modifies the trust (not a retroactive clarification,[4776] but rather a prospective modification). Although the modification itself might have transfer tax consequences, if the modification is legally binding then the IRS will respect its subsequent effect – even if inconsistent with what the highest court in the state would have done.[4777] However, the IRS sometimes conflates the two concepts, as it did in CCA 201747005.[4778]

Failing to enforce one's legal rights might constitute a gift.[4779] Thus, the trustee might want to consider providing accountings or other notices to the beneficiaries that would

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[4776] Letter Ruling 201652002 approved reforming a GRAT to include required language. Florida Trust Code § 736.0416, which corresponds to Uniform Trust Code § 416, authorized the action. The GRAT's savings clause probably helped a lot in terms of making the court action a retroactive reformation clarify the original intent rather than a prospective modification:

> In this case, each trust instrument provides that Grantor's retained interest is intended to constitute a qualified interest within the meaning of § 2702(b)(1). However, the attorney retained to draft each trust instrument failed to include in each instrument the prohibition required by § 25.2702-3(d)(6) thus causing the interest Grantor retained in each Trust to fail to constitute a qualified interest within the meaning of § 2702(b)(1). The trust instruments and State Statute permit the amendment of each Trust.
>
> Accordingly, based on the facts submitted and the representations made, we conclude that as a result of the judicial reformation of Trusts to correct scrivener's error, Grantor's interest in each Trust is a qualified interest under §§ 25.2702-2 and 25.2702-3, effective as of the date each Trust was created.

For comments from the ACTEC Fellow who obtained the ruling, see Thompson Coburn LLP document number 6488460.

[4777] Rev. Rul. 73-142 held:

> In this case the lower court had jurisdiction over the parties and over the subject matter of the proceeding. Thus, the time for appeal having elapsed, its judgment is final and conclusive as to those parties, regardless of how erroneous the court's application of the state law may have been. Consequently, after the time for appeal had expired, the grantor-decedent did not have the power to appoint himself as successor trustee. The aforesaid rights and powers which would otherwise have brought the value of the trust corpus within the provisions of sections 2036 and 2038 of the Code were thus effectively cut off before his death.
>
> Unlike the situation in *Bosch*, the decree in this case was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such date since the decree, in and of itself, effectively extinguished the power. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter.
>
> Accordingly, it is held that the value of the property transferred to the inter vivos trust is not includible in the grantor-decedent's gross estate under section 2036 or section 2038 of the Code.

[4778] See fn. 1789 in part II.J.4.c Charitable Distributions, looking at the requirement that the governing instrument must authorize a distribution to charity for the trust to take the Code § 642(c) charitable deduction.

[4779] Rev. Rul. 84-105 held that the surviving spouse made a gift by failing to object to underfunding of a general power of appointment marital deduction trust for her benefit over which she appeared to have an unlimited withdrawal right:

start running the statute of limitations for making a claim against the trustee so that the beneficiaries could not add up all of their alleged grievances and then pile them together, which procedure might help minimize any gift tax consequences to failing to make a claim.[4780]

If a beneficiary exercises his inter vivos limited power of appointment in a manner that moves all of the trust's assets elsewhere, the beneficiary has made a gift of the beneficiary's interest in the trust.[4781] Letter Ruling 200243026 asserted that this rule applies even though any distributions to the beneficiary were in the "sole discretion" of a

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> In the present case, S could have recovered the [shortfall] by routinely asserting in the local probate court the right as beneficiary under D's will to have the bequest adequately satisfied. The fact that some of the land would have had to be either sold or severed to satisfy fully the bequest to S would not have impaired S's claim for full satisfaction. The failure of S to raise an objection to the underfunding of the testamentary trust at some time before the expiration of S's right to appeal the final order of the local probate court in effect constituted an irrevocable transfer to C by S of the 40x dollar amount.
>
> S's acquiescence in the underfunding of the trust is not an assignment or surrender of a property interest in settlement of a controversy described in section 20.2056(e)-2(d)(1) of the regulations. Further, S's acquiescence is not a qualified disclaimer because S made no disclaimer of the 40x dollar amount within 9 months of D's death.
>
> For purposes of the estate and gift tax provisions of the Code, the amount of property that passed from D to S under D's will was [the full amount of the bequest shown on the estate tax return], notwithstanding the underfunding of S's trust. The [shortfall] that was diverted by D's executor from S to C is a gift by S to C on [the expiration date of S's right to appeal the probate court's approval of the estate settlement].

Rev. Rul. 81-264 held that D made a gift to A by failing to enforce A's note payable to D:

> Here, as in all such familial transactions, there is a presumption that the transfer of wealth from D to A without consideration is not entirely free of donative intent. *Estate of Lang v. Commissioner*, 64 T.C. 404 (1975), *aff'd*, 613 F.2d 770 (9th Cir. 1980). A had the resources to pay the debt, and, as D's child, was the natural object of D's bounty. On these facts, D's failing to enforce the debt obligation and permitting it to be barred by the statute has not been shown to be free of donative intent, and thus is not a transaction in the ordinary course of business within the meaning of section 25.2512-8 of the regulations.
>
> It does not matter that the running of the statute of limitations does not extinguish the debt but merely creates an affirmative defense in a collection suit. Control of the debt passes to the debtor when the statute of limitations runs. Thereafter, it is the debtor rather than the creditor who decides whether and under what terms loaned funds will be repaid. The essence of a gift is such relinquishment of control by the donor over the property. *Estate of Lang v. Commissioner*.

[4780] See part II.J.4.j Helping the Trustee Provide Annual Notices to Beneficiaries to Reduce Exposure.

[4781] Reg. § 25.2514-1(b)(2), which provides:

> The power of the owner of a property interest already possessed by him to dispose of his interest, and nothing more, is not a power of appointment, and the interest is includible in the amount of his gifts to the extent it would be includible under section 511 or other provisions of the Internal Revenue Code. For example, if a trust created by provides for payment of the income to A for life with power in A to appoint the entire trust property by deed during her lifetime to a class consisting of her children, and a further power to dispose of the entire corpus by will to anyone, including her estate, and A exercises the inter vivos power in favor of her children, she has necessarily made a transfer of her income interest which constitutes a taxable gift under section 2511(a), without regard to section 2514.

disinterested trustee.[4782] If and to the extent that the transfer is a gift, person exercising the power of appointment becomes the transferor with respect to the gifted portion and may allocate GST exemption to that portion.[4783]

[4782] Letter Ruling 200243026 reasoned:

> Pursuant to Trust, Spouse also has interests in the income and principal of Trust. Trust provides that the Disinterested Trustee, in his sole discretion, may distribute to Spouse income and/or principal as the Disinterested Trustee deems necessary or appropriate for the care, support, maintenance, education, advancement of life and comfortable living of Spouse. As a result of Spouse's exercise of his inter vivos special power appointing the Trust corpus to the Child 3 Trust, Grandchild 1 Trust, and Grandchild 2 Trust, Spouse will relinquish his income and corpus interests in Trust. Although Spouse's rights to receive income and principal distributions from Trust are subject to the sole discretion of the Disinterested Trustee, the relinquishment of these interests will be a taxable gift under § 2511(a). See *Estate of Regester*, *supra* and Rev. Rul. 79-327, *supra*. The value of the gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2002-1, 2002-1 I.R.B. 1, 20, and Rev. Rul. 75-550, 1975-2 C.B. 357 (illustrating the correct method of computing the value of a decedent's interest in a residuary trust subject to the discretionary power of the trustee to invade corpus for the benefit of others).

Further above, the ruling had mentioned:

> *Estate of Regester v. Commissioner*, 83 T.C. 1 (1984) (holding that a decedent made a taxable gift of her life interest in the income of a trust when she transferred the corpus of the trust through the exercise of a special power of appointment).

[4783] Letter Ruling 200243026 reasoned:

> Further, because Spouse will have made a taxable gift of his income and principal interests to the three trusts, Spouse will be considered the transferor of the value of the taxable gift for purposes of chapter 13. The beneficiaries of the Grandchild 1 Trust and Grandchild 2 Trust include Spouse's grandchildren, descendants of the grandchildren or charitable organizations. Therefore, the trust is a skip person. Accordingly, the transfer is a direct skip for purposes of chapter 13. Spouse's GST exemption will be deemed allocated to the property transferred by him to the two trusts, unless Spouse elects not to have § 2632(b) apply. The beneficiaries of the Child 3 Trust include Spouse's child, Child 3, Child 3's spouse, Child 3's issue, spouses of Child 3's issue, and descendants of Child 3. The trust could have a generation-skipping transfer with respect to the transferor, Spouse, and the trust does not come within any exceptions contained in § 2632(c)(3)(B)(i). Therefore, the Child 3 Trust is a GST trust. Accordingly, the transfer is an indirect skip for purposes of chapter 13. Spouse's GST exemption is deemed allocated to the property transferred by Spouse to the Child 3 Trust, unless Spouse elects not to have § 2632(c) apply. Each portion of the three trusts of which Spouse is the transferor will comprise the chapter 13 portion of each trust. The non-chapter 13 portions and the chapter 13 portions of each trust are treated as separate trusts for purposes of chapter 13. Section 26.2654-1(a)(2)(i).
>
> Accordingly, based upon the facts submitted and representations made, we rule as follows: The proposed exercise of the power of appointment by Spouse and the resulting transfer of the appointed assets of Trust to the two GSETs and the Child 3 Trust will not constitute constructive additions to the Trust under § 26.2601-1(b)(1)(v). The proposed exercise of the power of appointment by Spouse will result in a taxable gift of Spouse's income and principal interests under § 2511. For purposes of chapter 13, Spouse will be the transferor of the gifted property transferred by Spouse to the Child 3 Trust and the two GSETs. The gifted property in each trust will comprise the chapter 13 portion of the trusts. The balance of the corpus of each trust will constitute the non-chapter 13 portion of each trust. Spouse's GST exemption will be deemed allocated to the chapter 13

Another gift might be early termination of a trust. When a beneficiary may receive distributions under an ascertainable standard and has an annual right to withdraw from the trust, the beneficiary made a gift by renouncing distributions to her while living,[4784] caused her to become the transferor for GST purposes to the extent of the property she renounced,[4785] but did not blow GST grandfathering for the remaining property.[4786] Renouncing a testamentary nongeneral power of appointment did not have gift tax consequences or blow GST grandfathering.[4787]

On the other hand, if Mom creates a trust for the benefit of Daughter and Daughter's children, but Daughter doesn't need all of that money and would like her children to

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> portions of each trust, unless Spouse elects not to have § 2632(b) and (c) apply. The chapter 13 portion of each trust will have an inclusion ratio determined under § 2642. The non-chapter 13 portions of each trust will be exempt from GST tax under § 26.2601-1(b)(i).

[4784] Letter Ruling 200745015, reasoning:

> The value of the gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2007-1, 2007-1 I.R.B. 1, 14. However, since the gift is not an absolute right to distributions of income or principal, it cannot be valued by use of the tables contained in § 2512. See *Deal v. Commissioner*, 29 T.C. 730 (1958). Rather, the value of the gift should be determined in accordance with the general valuation principles contained in § 25.2512-1. Further, such an interest has more than a nominal value. See Rev. Rul. 67-370, 1967-1 C.B. 324.

[4785] Letter Ruling 200745015, further explaining (with "exemption" referring to grandfathering from GST tax):

> As stated above, under § 2652, for purposes of chapter 13, Daughter is the transferor of X shares that will be transferred to the three subtrusts. Accordingly, the three subtrusts are not exempt from chapter 13 by virtue of Trust's exemption. Daughter may allocate her GST exemption to the three subtrusts at the time of the transfer or GST exemption may be automatically allocated under § 2632(c)(1) depending on whether the subtrusts are GST Trusts as defined in that Code section. Based upon the facts provided and the representations made, we conclude that Daughter is the transferor of the X shares that will be transferred to the three subtrusts for purposes of chapter 13 and, accordingly, distributions and terminating distributions from the subtrusts to skip persons are subject to GST tax.

[4786] Letter Ruling 200745015, reasoning:

> Trust was executed prior to September 25, 1985, and it is represented that there have been no additions (actual or constructive) to Trust since that date. Accordingly, Trust is not subject to chapter 13. Daughter's renunciation of her entire beneficial interest in X shares is a taxable transfer for gift tax purposes. X shares will be transferred into three subtrusts in which Daughter will have no interest. The property remaining in Trust continues to be subject to the original Trust provisions, with no modifications to those provisions. Based upon the facts provided and the representations made, we conclude that Daughter's renunciation of her entire beneficial interest in X shares will not cause Trust to become subject to chapter 13.

[4787] Letter Ruling 200745015, reasoning:

> As discussed above, Daughter holds a testamentary nongeneral power of appointment over Trust. Daughter will release this power over X shares that are transferred to the three subtrusts. The power of appointment was created in Trust, an irrevocable Trust, that is not subject to chapter 13. Therefore, the release of the power of appointment over X shares will not be treated as a constructive addition to Trust. Accordingly, based upon the facts provided and the representations made, we conclude that the release of Daughter's testamentary nongeneral power of appointment over X shares will not cause Trust to become subject to chapter 13.

benefit currently and cooperates in the trustee's obtaining a court order directing early partial termination of the trust. That action:[4788]

- Is not subject to income tax,[4789]
- Will not blow the trust's grandfathering from generation-skipping transfer tax,[4790] and
- Will constitute a gift by Daughter, albeit perhaps a nominal gift.[4791]

[4788] Per Letter Ruling 201122007, parts of which are quoted in the footnotes below.

[4789] Letter Ruling 201122007, which did not appear to involve any debt, concluded Ruling 1 by reasoning:

> In general, a gift or other transfer without reciprocal consideration is not treated as a sale or exchange or as a distribution of property that results in a realization of income by the donor. *See, e.g.*, § 1.1001-1(e) (illustrating that the gift portion of a transfer is not treated as gain realized). The same would be true of a transfer from a trust as provided in the terms of the trust agreement or by court order modifying the trust agreement. Such a transaction is not a realization event in which property differing in kind or extent is being exchanged. In addition, gross income does not include the value of property acquired by gift, bequest, devise or inheritance. See § 102.
>
> Based on the information submitted, Taxpayer, the remainder beneficiaries, and Trust will not recognize gain as a result of the early distribution of a portion of the trust principal to the remainder beneficiaries because the distribution will not constitute a sale, exchange, or other realization event. Also, there is no accession of wealth to Taxpayer or Trust. In addition, to the extent that any portion of the early distribution of the trust principal and accumulated income (previously taxed to the trust) constitutes a gift, bequest, devise or inheritance to the remainder beneficiaries, it will not constitute includable income to the remainder beneficiaries for federal income tax purposes because of the exclusion provided under § 102.

[4790] Letter Ruling 201122007 concluded Ruling 2 by reasoning:

> State Statue provides that a noncharitable irrevocable trust may be modified on consent of all the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust.
>
> Based on the facts presented and representations made, we conclude that if State court issues an order approving the early distribution of a portion of the trust principal to the remainder beneficiaries, as discussed above, this distribution will not shift any beneficial interest in Trust to a beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification. In addition, the early distribution of a portion of the trust principal to the remainder beneficiaries will not extend the time for vesting of any beneficial interest in Trust beyond the period provided for in the original trust. Accordingly, based on the facts submitted and the representations made, we conclude that if, under a State court order, the trustees of Trust make an early distribution of the trust principal to the remainder beneficiaries, such a distribution will not cause Trust to be subject to the generation-skipping transfer tax imposed by chapter 13.

[4791] Letter Ruling 201122007 concluded Ruling 3 by reasoning:

> Taxpayer attests that Taxpayer has never received a distribution from Trust and that her income and resources are sufficient to maintain her current standard of living for the remainder of her lifetime. However, that does not negate the fact that under Section 6(a) of Trust, Taxpayer has an income interest entitling her to distributions of income in the case of emergency and at the discretion of the trustee. The interest may be nominal, however, the value of the gifted interest is a factual determination, not a determination of whether or not Taxpayer has made a gift of the interest.

However, Letter Ruling 201647001 held that the children did not make a gift when a trust was modified to add a clause authorizing an independent trustee to reimburse the grantors' income tax, because the reimbursement clause was "administrative in nature" and did not "result in a change in beneficial interests" in the trust.[4792] Neither that change nor any other change done at the same time had any income, gift, estate, or GST tax consequences.

Many of the gifts raised in this part III.B.1.b involve complex gift tax issues, which may spill over into the GST arena. See part III.B.1.d Generation-Skipping Transfer (GST) Issues.

III.B.1.c. Gifts With Consideration – Bargain Sales

Where a transfer of property is in part a sale and in part a gift (a "bargain sale"), the donor has gain to the extent that the amount realized by the donor exceeds the donor's adjusted basis in the property.[4793] However, a donor may not deduct a loss in a bargain sale.[4794]

A bargain sale includes transferring property subject to a debt.[4795]

Examples of computing gain or gift when property is transferred in bargain sale:[4796]

> *Example (1)*. A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A's gain is $30,000, the excess of $*60*,000, the amount realized, over the adjusted basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

> *Example (2)*. A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

> Based upon the facts submitted and representations made, we conclude that Taxpayer will make a gift of her interest in the portion of the early distribution of the trust principal to the remainder beneficiaries. The value of this gift is a question of fact and the Service does not rule on such factual determinations. See Rev. Proc. 2011-1, 20011-1 I.R.B. 1, 13.

Note that the IRS might argue that the value of Taxpayer's gift in Letter Ruling 201122007 is the value of Taxpayer's entire interest in the trust. See part Code § 2702 Overview, especially the text accompanying fns. 5635-5642.

[4792] To place this in context, see part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner, which discusses this ruling in fn 5286. Note that a gratuitous payment of another person's obligation constitutes a (possibly excludible) gift by the payor, followed by a (possibly deductible) payment by the obligor. *Lang v. Commissioner*, T.C. Memo. 2010-286 (donor's gifts were not taxable; obligor could deduct medical and tax payments).

[4793] Reg. § 1.1001-1(e)(1).

[4794] Reg. § 1.1001-1(e)(1).

[4795] See fn. 4974, found in part III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System.

[4796] Reg. § 1.1001-1(e)(2).

Example (3). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Example (4). A transfers property to his son for $30,000. Such property in A's hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Examples of computing basis in property transferred in bargain sale include:[4797]

Example (1). If A transfers property to his son for $30,000, and such property at the time of the transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $30,000.

Example (2). If A transfers property to his son for $60,000, and such property at the time of transfer has an adjusted basis of $30,000 in A's hands (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (3). If A transfers property to his son for $30,000, and such property at the time of transfer has an adjusted basis in A's hands of $60,000 (and a fair market value of $90,000), the unadjusted basis of such property in the hands of the son is $60,000.

Example (4). If A transfers property to his son for $30,000 and such property at the time of transfer has an adjusted basis of $90,000 in A's hands (and a fair market value of $60,000), the unadjusted basis of the property in the hands of the son is $90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its unadjusted basis in his hands is $60,000.

For gift tax purposes, Code § 7872 applies when valuing notes the buyer issues in a bargain sale.[4798]

III.B.1.d. Generation-Skipping Transfer (GST) Issues

These materials do not attempt to cover GST issues generally but rather cover selected matters that I feel like documenting.

An addition to a grandfathered trust causes the trust to lose its exclusion from the GST system to the extent of the addition.[4799]

[4797] Reg. § 1.1015-4(b).

[4798] See fn. 5355 in part III.B.5.a Promissory Notes.

[4799] Reg. § 26.2601-1(b)(1)(iv) provides:

A constructive addition is treated as an addition.[4800] Constructive additions include certain powers of appointment[4801] (if and to the extent the regulation is valid) to the extent not excluded[4802] and the relief of certain liabilities.[4803] Except to the extent that

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In general. If an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of paragraph (b)(1) of this section, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a portion not subject to chapter 13 (the non-chapter 13 portion) and a portion subject to chapter 13 (the chapter 13 portion), each with a separate inclusion ratio (as defined in section 2642(a)). The non-chapter 13 portion represents the value of the assets of the trust as it existed on September 25, 1985. The applicable fraction (as defined in section 2642(a)(2)) for the non-chapter 13 portion is deemed to be 1 and the inclusion ratio for such portion is 0. The chapter 13 portion of the trust represents the value of all additions made to the trust after September 25, 1985. The inclusion ratio for the chapter 13 portion is determined under section 2642. This paragraph (b)(1)(iv)(A) requires separate portions of one trust only for purposes of determining inclusion ratios. For purposes of chapter 13, a constructive addition under paragraph (b)(1)(v) of this section is treated as an addition. See paragraph (b)(4) of this section for exceptions to the additions rule of this paragraph (b)(1)(iv). See § 26.2654-1(a)(2) for rules treating additions to a trust by an individual other than the initial transferor as a separate trust for purposes of chapter 13.

4800 See the highlighted portion of Reg. § 26.2601-1(b)(1)(iv) in fn. 4799.

4801 Reg. § 26.2601-1(b)(1)(v)(A) provides:

Powers of appointment. Except as provided in paragraph (b)(1)(v)(B) of this section, where any portion of a trust remains in the trust after the post-September 25, 1985, release, exercise, or lapse of a power of appointment over that portion of the trust, and the release, exercise, or lapse is treated to any extent as a taxable transfer under chapter 11 or chapter 12, the value of the entire portion of the trust subject to the power that was released, exercised, or lapsed is treated as if that portion had been withdrawn and immediately retransferred to the trust at the time of the release, exercise, or lapse. The creator of the power will be considered the transferor of the addition except to the extent that the release, exercise, or lapse of the power is treated as a taxable transfer under chapter 11 or chapter 12. See section 26.2652-1 for rules for determining the identity of the transferor of property for purposes of chapter 13.

4802 Reg. § 26.2601-1(b)(1)(v)(B) provides:

Special rule for certain powers of appointment. The release, exercise, or lapse of a power of appointment (other than a general power of appointment as defined in section 2041(b)) is not treated as an addition to a trust if—

(1) Such power of appointment was created in an irrevocable trust that is not subject to chapter 13 under paragraph (b)(1) of this section; and

(2) In the case of an exercise, the power of appointment is not exercised in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of the trust, extending beyond any life in being at the date of creation of the trust plus a period of 21 years plus, if necessary, a reasonable period of gestation (the perpetuities period). For purposes of this paragraph (b)(1)(v)(B)(2), the exercise of a power of appointment that validly postpones or suspends the vesting, absolute ownership or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date of creation of the trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership or the power of alienation beyond the perpetuities period. If a power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

the above rules allocate subsequent appreciation and accumulated income between the original trust and additions thereto, appreciation the trust's value and accumulated income are not considered an addition to the principal of a trust.[4804]

Reg. § 26.2601-1(b)(4) sets forth safe harbors for when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust will not cause the trust to lose its grandfathered status. These safe harbors apply to certain discretionary powers,[4805] settlements,[4806] judicial constructions,[4807] or certain modifications.[4808] Reg. § 26.2601-1(b)(4)(i)(E) provides examples of these safe harbors.

[4803] Reg. § 26.2601-1(b)(1)(v)(C) provides:

> *Constructive addition if liability is not paid out of trust principal*. Where a trust described in paragraph (b)(1) of this section is relieved of any liability properly payable out of the assets of such trust, the person or entity who actually satisfies the liability is considered to have made a constructive addition to the trust in an amount equal to the liability. The constructive addition occurs when the trust is relieved of liability (*e.g.*, when the right of recovery is no longer enforceable). But see section 26.2652-1(a)(3) for rules involving the application of section 2207A in the case of an election under section 2652(a)(3).

[4804] Reg. § 26.2601-1(b)(1)(vi).

[4805] Reg. § 26.2601-1(b)(4)(i)(A) provides:

> The distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the provisions of chapter 13, if—
>
> (1) Either—
>
> (i) The terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or
>
> (ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and
>
> (2) The terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. For purposes of this paragraph (b)(4)(i)(A), the exercise of a trustee's distributive power that validly postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term of years that will not exceed 90 years (measured from the date the original trust became irrevocable) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power of alienation beyond the perpetuities period. If a distributive power is exercised by creating another power, it is deemed to be exercised to whatever extent the second power may be exercised.

[4806] Reg. § 26.2601-1(b)(4)(i)(B) provides:

> A court-approved settlement of a bona fide issue regarding the administration of the trust or the construction of terms of the governing instrument will not cause the new or continuing trust to be subject to the provisions of chapter 13, if—
>
> (1) The settlement is the product of arm's length negotiations; and
>
> (2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating

Not satisfying the safe harbors means only that one must test for actual or constructive additions. When a court or trustee takes action (or a trustee fails to act), that action might affect beneficial interests. One may be concerned that failure to act vigorously in court or to make a claim against the trustee may constitute an actual or constructive addition. The beneficiaries who failed to act may need to allocate GST exemption to provide a zero inclusion ratio to the extent that they are transferors. These issues become much more complex when a beneficiary has a retained interest in the trust, because the ETIP rules may prevent allocating GST exemption in a manner that sets the inclusion ratio until the beneficiary's interest terminates. Thus, satisfying the safe harbors avoids addressing these issues to the extent that one is concerned about GST issues; however, the safe harbors do not address gift or estate tax issues that might apply to such a failure to act. Regarding the latter, see part III.B.1.b Gifts Without

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parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

[4807] Reg. § 26.2601-1(b)(4)(i)(C) provides:

judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause the new or continuing trust to be subject to the provisions of chapter 13, if—

(1) The judicial action involves a bona fide issue; and

(2) The construction is consistent with applicable state law that would be applied by the highest court of the state.

[4808] Reg. § 26.2601-1(b)(4)(i)(D) provides:

(1) A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

(2) For purposes of this section, a modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer. To determine whether a modification of an irrevocable trust will shift a beneficial interest in a trust to a beneficiary who occupies a lower generation, the effect of the instrument on the date of the modification is measured against the effect of the instrument in existence immediately before the modification. If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification. A modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust. In addition, administration of a trust in conformance with applicable local law that defines the term income as a unitrust amount (or permits a right to income to be satisfied by such an amount) or that permits the trustee to adjust between principal and income to fulfill the trustee's duty of impartiality between income and principal beneficiaries will not be considered to shift a beneficial interest in the trust, if applicable local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and meets the requirements of § 1.643(b)-1 of this chapter.

Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers.

III.B.1.e. Valuation Issues

Business that are not publicly traded are inherently difficult to value.

Corporations that engage in a Code § 162 trade or business are likely to be valued based on their projected net cash flow, with earlier years' results being used to determine whether projected earnings are reasonable.

See part III.C Fairness Within Families; Valuation, for a further discussion of valuation.

Among IRS resources is http://www.irs.gov/Businesses/Valuation-of-Assets, which includes separate papers on discounts for lack of marketability and S corporations.

III.B.1.f. Self-Canceling Installment Notes

A self-canceling installment note (SCIN) involves a sale of property to a buyer in exchange for an installment note that expires upon a certain cancellation event.[4809] Typically, an older family member sells to a younger family member and the cancellation event is the seller's death.[4810] When the obligation to make payments on the SCIN ceases upon the seller's death, nothing of value exists to be included in the seller's gross estate. Thus, the unpaid purchase price and future appreciation in the property are excluded from the gross estate.[4811]

Other advantages of a properly structured SCIN include: the avoidance of gift tax, possible increased liquidity for the seller, the ability to completely secure the property, the ability to use capital losses and possibly give the buyers an increased basis in the transferred property (compared with a gift), and the seller's ability to spread income out over time.

Disadvantages of using a SCIN include: questions regarding stepped-up basis at death, a finite term of payments, restrictions on alienability of the sold property for two years,[4812] and potential income from discharge of indebtedness.

For the arrangement to be characterized as a SCIN, buyers and sellers have to maintain the form and substance of a SCIN. Since SCINs are transactions between family members, strict scrutiny applies and the transactions are presumed to be gifts. To rebut this presumption, taxpayers must show a genuine intent and expectation that payment be made.[4813] To avoid inclusion of the value of the property in the gross estate under

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[4809] For a comprehensive discussion, see Akers, SCINs and Private Annuities: Disappearing Value or Disappearing Strategies? *Heckerling Institute on Estate Planning* 2015. That would be a more helpful starting point than my materials.

[4810] The cancellation event could also be the buyer's death, the first to die of the buyer and seller, or the death of a third party.

[4811] However, any delinquent payments will be included in the gross estate.

[4812] Code §453(e) (accelerates income if the buyer sells the property within two years after an installment sale).

[4813] *Estate of Costanza v. Commissioner*, 320 F.3d 595, 597 (6th Cir. 2003).

Code § 2036, the seller cannot retain an interest in the property.[4814] Also, the loan's terms must cancel the note at death; a bequest of a note is not a SCIN.[4815] Although the SCIN term need not be the seller's life, the chosen term cannot exceed the seller's life expectancy; if it does, the SCIN might be re-characterized as a private annuity.[4816]

Most importantly, the buyer has to pay a premium to the seller as compensation for the chance that the seller may die before full payment is received.[4817] If this risk premium is too low, the IRS might re-characterize the transaction as a bargain sale or part gift.[4818] Traditionally, estate planners use Code § 7520 interest and mortality rates to set this premium; however, CCA 201330033 asserted:[4819]

> We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

GCM 39503 had commented on SCINs:

> …unlike the private annuity, there is no requirement that the actuarial tables are to be used in determining the gift taxation of installment sale. Thus, the taxpayer's particular health status may be considered, and there is more room to establish that the terms of the sale are reasonable. See S. Banoff and M. Hartz, "Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities

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4814 See *Cain v. Commissioner*, 37 T.C. 185, 187-188 (1961) (stock not included in gross estate where the seller divested herself of all title to and control over the stock), *acq*. 1962-2 C.B. 4.

4815 *Estate of Buckwalter v. Commissioner*, 46 T.C. 805, 816-817 (1966).

4816 GCM 39503 (1986).

4817 See *Estate of Moss v. Commissioner*, 74 T.C. 1239, 1246-47 (1980) (full consideration for SCIN includes consideration for the cancellation provision; court held no inclusion in estate but did not discuss how to value the cancellation provision), *acq. in result*, 1981-2 C.B. 2 (acquiesce that notes were excluded from gross estate without necessarily agreeing with the court's reasoning). Although the IRS has not provided guidance on how to calculate this premium, it is usually calculated using the actuarial likelihood that the seller will die during the term of the trust using IRS life expectancy tables as indicated in Reg. § 20.2031-7.

4818 See *Estate of Berkman v. Commissioner*, 38 T.C. Memo 1979-46 ([T]he difference between the amount of each transfer and the fair market value of each promissory note given in exchange constitutes a taxable gift.).

4819 CCA 201330033 involved Brad Poston, indicating that the IRS had its top people involved in this ruling. My understanding is that this case involved a $2.6 billion deficiency and was docketed in the Tax Court: *Estate of William M. Davidson v. Commissioner*, Docket No. 013748-13, https://www.ustaxcourt.gov/UstcDockInq/DocketDisplay.aspx?DocketNo=13013748, that each of the taxpayer and IRS retained two medical experts, and that all four experts concluded that, at the time of the transactions, the transferor had a greater than 50% chance of living for more than 12 months. On July 6, 2015, the court entered a stipulated judgment, increasing the transfer tax assessed from the $168.5 million shown on the return to $320.5 million – a substantial increase but the $152 million stipulated deficiency was only a small fraction of the asserted deficiency.

Obsolete?," 59 *Taxes* 499 (1981); E. Schnee, "Cancelling a Debt Correctly Can Give Rise to Estate and Gift Tax Advantages," 8 *Est. Plan.* 276 (1981).

At least one noted commentator has vigorously asserted that the CCA is wrong. He points out that it is inconsistent with the position that the IRS has taken in valuing lottery winnings. Note that Code § 7520 was enacted after GCM 39503 was issued, so the GCM and its related Revenue Ruling did not address Code § 7520. Nevertheless, if one is concerned about the CCA's and GCM's position, one might consider using a private annuity, which is discussed in part III.B.1.g Private Annuities.

A properly structured SCIN will pre-empt inclusion of the property in the seller's gross estate. Gift tax will also be averted if the SCIN's value - including the premium for self-cancellation - equals the value of the property transferred.[4820] Also, Chapter 14 should not apply to a properly structured SCIN.[4821]

For the buyer's income tax purposes, since a SCIN is an installment sale, the buyer should be able to deduct whatever part of each payment represents deductible interest, if the property purchased is an investment or a trade or business. The buyer's basis should be the property's full stated price.[4822] A more complicated issue is whether buyers recognize gain based on cancellation of indebtedness[4823] when the seller dies. Although it seems unfair to tax both the buyer and seller (as discussed below) on this gain, to date there has been no decision on this issue; however, the better view is that the buyer does not recognize income. In addressing the issue of the buyer's basis, courts and the IRS assumed that the buyer's basis would increase without a corresponding income recognition unless the seller or seller's estate recognizes income.

The seller of property for a SCIN pays income tax on the receipt of payments according to the installment method (unless the seller opts out of it).[4824] In *Estate of Frane v. Commissioner*,[4825] the Tax Court in a reviewed case held (and the Eighth Circuit affirmed) that cancellation upon death caused the estate to pay income tax on the amount of the installment obligation cancelled.[4826] The dissent in the Tax Court claimed

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[4820] See *Wilson v. Commissioner*, T.C. Memo. 1992-480 (1992). The premium for the cancellation feature is based on § 7520 rules and IRS actuarial tables if the seller is not terminally ill. See note 4838.

[4821] See Letter Ruling 9436006 (1994) (neither §2701 nor § 2702 applied to a note because debt is not a retained interest in a trust).

[4822] GCM 39503 (1986). See *Frane v. Commissioner*, cited at fn. 4825, at 570-71. It has been suggested that regulations on contingent payments indicate that basis in a SCIN builds as payments come due because one cannot rely on the scheduled payments (Regs. §§ 1.483-4(b), 1.1275-4(c)(5)(iii)). However, under Reg. § 1.1272-1(c)(2), an alternative payment schedule applies only if, based on all the facts and circumstances as of the issue date the alternative payment schedule is significantly more likely than not to occur. Because a properly structured SCIN has a term that is less than life expectancy, it would be practically impossible for an alternate payment schedule to be significantly more likely than not to occur.

[4823] Code § 61(a)(12).

[4824] Code § 453. Interest on deferred tax may apply to transactions aggregating over $5 million. Code § 453A(c). The seller's gain is accelerated if the buyer is a related party and re-sells the property within two years. Code § 453(e). For more special rules, see part II.G.14 Limitations on the Use of Installment Sales.

[4825] 998 F.2d 567 (8th Cir. 1993), *accord* Rev. Rul. 86-72.

[4826] Code § §691(a)(2). See part II.G.14 Limitations on the Use of Installment Sales.

that income should not be realized because no payments are due after death that can be cancelled.[4827] The dissent further suggested a way around the holding by phrasing the exchange as a contingent sale,[4828] but that technique has not been tested in court.[4829]

Because increasing the principal adds to the potential income tax issues at death described above, charging a higher interest rate seems preferable. Although intra-family loans tend to pay interest annually, note that, in a SCIN, the seller might die before receiving an interest payment. Consider making the interest payments monthly, as was done in *Costanza*, so that the seller actually receives the benefit of the interest payment.[4830]

A SCIN is a good planning technique when the seller wants security, the buyer has means to make payments, the buyer wants an interest deduction, the buyer plans to hold the property for at least two years, the seller's income tax bracket is relatively low, and estate tax bracket is relatively high. Although having the means to repay a promissory note is always important, consider that the mortality premium increases the cash flow paid to seller and that the IRS would argue for testing the cash flow assuming that the seller lived to the life expectancy used in determining the mortality premium;[4831] therefore, consider making sure that the buyer has outside funds to be able to pay the mortality premium.

III.B.1.g. Private Annuities

III.B.1.g.i. Private Annuities: Estate Planning Implications

Generally, a private annuity is a transfer of property for the transferee's unsecured promise to make specific, periodic payments to the transferor for the rest of the transferor's life.[4832] In distinguishing private annuities from installment sales (and therefore also SCINs), IRS has stated:[4833]

[4827] *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992) (reviewed decision), *aff'd* in part and *rev'd* in part, 998 F.2d 567 (8th Cir. 1993).

[4828] THE PARTIES INTEND THIS TO BE A CONTINGENT PAYMENT SALE. The purchase price of the stock is variable, and will be somewhere between $0 and $141,050, depending upon how long seller lives. A condition precedent to each contingent payment is that seller be alive on the scheduled potential payment date. Consequently, if seller dies before any scheduled potential payment, the obligation to such payment does not come into existence.

[4829] Another possible route to avoid *Frane* is to use an irrevocable grantor trust as the transferee and argue that death cannot be a cancellation event since no realization event occurs during life. This proposition is controversial.

[4830] CCA 201330033.

[4831] CCA 201330033.

[4832] For a comprehensive discussion, see Akers, SCINs and Private Annuities: Disappearing Value or Disappearing Strategies? *Heckerling Institute on Estate Planning* 2015. That would be a more helpful starting point than my materials.

[4833] GCM 39503 (1986), the basis for Rev. Rul. 86-72. Additional language from the GCM follows:

> ISSUES
>
> (1) Where property is conveyed in return for a contractual obligation to make payments until a specified principal sum has been paid, or until the conveyor's death, whichever

occurs first, is the obligation to make the payments treated as an annuity under section 72 of the Code, or as an installment obligation under section 453?

…..

CONCLUSION

(1) (A) We believe that when property is transferred in exchange for a transferee's promise to make periodic payments to the transferor until his death, the transaction should be considered a private annuity.

(B) When property is transferred in exchange for a transferee's promise to make periodic payments until a stated monetary amount is reached, or until the transferor's death, whichever occurs first, the transaction should be considered a private annuity, except as stated below.

….

ANALYSIS

….

ISSUE (1) Clearly, a private annuity can fit literally within this definition of an installment sale. The Committee Reports, however, state that the Act 'does not deal directly' with private annuities. S. Rep. No. 96-1000, 1980-2 CB at 500, n. 12; H.R. Rep. No. 96-1042, 96th Cong., 2d Sess. 10, n. 12 (1980). In our view, this language does not mean that private annuities are not installment sales; rather, it was meant to leave room for the Service to determine what constitutes an installment sale and what constitutes a private annuity. In other words, the Committee meant that the Act does not deal with private annuities as such, but does effectively deal with them to the extent that they are determined to be installment sales.

This brings us to the question of whether the installment sales rules of section 453 of the Code or the annuity rules of section 72 govern the treatment of periodic payments received by a taxpayer who has conveyed property in return for a contractual right to receive payments for a period not longer than the remainder of his life. We start with the premise that the substance of the transaction rather than the parties' characterization of it should control the question. We believe that where the conveyor of property receives a right to periodic payments for the remainder of his life, with no monetary limit provided, as in situation 1, the payments represent an annuity and should be governed by section 72. A stream of payments for life is squarely within the accepted concept of an annuity in our opinion, so the annuity rules in the Code, at section 72, are logically applicable. The Service already appears to have so recognized in Rev. Rul. 69-74, 1969-1 CB 43, which applies section 72 where appreciated property is exchanged for a right to periodic payments for life.

We do not think the 1980 amendment to the installment sales rules requires a different conclusion. While the amendment makes installment sale reporting available where a sale price is contingent, we infer that at least the primary intent of the legislation was to cover cases where the contingency relates to the profitability of the property to the purchaser. [fn: Neither the legislative history nor Temp. Treas. Reg. section 15A.453-1(c) provide specific guidance as to the type of contingencies that are contemplated.] As we have already explained, we believe the statement in the committee reports referring specifically to private annuities confirms our belief that the legislation was not intended to subject private annuity transactions to the installment reporting rules.

Where the stream of payments to which a conveyor of property is entitled will cease upon reaching a monetary limit, or upon his earlier death, as in situations 2 and 3, the question of whether the transaction is an annuity or an installment sale is somewhat closer in our view. While the life-limiting feature of the contractual right to receive payments still militates for annuity treatment, the monetary limit tends to dilute the annuity nature of the transaction and to make it more like the typical installment sale for a fixed consideration. Further, if we treat as annuities all situations in which the payments terminate at the death of the recipient, we would be transforming what are in substance installment sales into annuities in some instances.

> A private annuity is generally an arrangement whereby an individual transfers property, usually real estate, to a transferee who promises to make periodic payments to the transferor for the remaining life of the transferor. A private annuity may also include a transaction whereby the transferee agrees to make periodic payments until a specific monetary amount is reached or until the transferor's death, whichever occurs first. Private annuity arrangements are often used for intra-family transfers whereby an older family member transfers appreciated property to a younger family member in order to gain tax advantages, e.g., removal of the property from the transferor's gross estate….
>
> When the terms of a property transaction are structured so that there is a stated maximum payout that will be achieved in a period less than the life expectancy of the transferor (as determined at the time of the transaction in accordance with Table I, Treas. Reg. section 1.72-9), then the transaction will be characterized as an installment sale with a contingent sales price, and will be treated in accordance with the installment sale rules.

Private annuities offer many of the same advantages as SCINs. The property and its future appreciation are excluded from the gross estate,[4834] probate is avoided, gift tax is avoided, the transferor acquires increased liquidity, wealth is kept in the family, and capital losses can be utilized. Unlike SCINs, the transferor is paid for life, though the payments will be lower since no risk premium is included.

Private annuities also have disadvantages. Private annuities do not allow a step-up in basis at death. Unlike SCINs, the transferee cannot deduct interest payments, and private annuities also have a default risk since they are unsecured. Moreover, private annuities bear the risk that the transferor could outlive actuarial life expectancy, though it

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> Suppose for example that property is transferred in return for the transferee's promise to pay the transferor $1,000x annually, until $10,000x has been paid or until the transferor's death, whichever occurs first. Assume further that the transferor's life expectancy at the time of the sales agreement, determined by reference to Table I.-Ordinary Life Annuities-One Life Expected Return Multiples, Treas. Reg. section 1.72-9, is 30.4 years. Under these facts it is relatively unlikely that an amount less than the agreed maximum price will be paid. Therefore, if we treated this as an annuity, we would be allowing taxpayers to determine the characterization of their transaction by a provision that may have been added only to produce annuity treatment, with small chance of the provision ever coming into play.
>
> In order to avert this problem, we believe that the following approach should be used in determining whether annuity treatment or installment sale treatment is appropriate where there is a monetary limit upon the total amount that will be paid. When the terms of a property transaction are structured so that there is a stated maximum payout that will be achieved in a period less than the life expectancy of the transferor (as determined at the time of the transaction in accordance with Table I, Treas. Reg. section 1.72-9), then the transaction will be characterized as an installment sale with a contingent sales price, and will be treated in accordance with the installment sale rules. Hence, in situation 3, supra at page 2, where the seller's life expectancy at the time of the sales agreement is 11 years, and the maximum stated sales price will be reached in 10 years, the transaction will be termed an installment sale rather than an annuity.

[4834] *Hirsh v. United States*, 35 F.2d 982 (Ct. Cl. 1929), excluded from the decedent's estate private annuities payable by his children to him as part of a bargain sale, where the sold property did not secure the annuity.

may be drafted to cap payments so that they do not extend for more than a short time after life expectancy. Regulations provide:[4835]

> In the case of an annuity payable from a trust or other limited fund, the annuity is not considered payable for the entire defined period if, considering the applicable section 7520 interest rate at the valuation date of the transfer, the annuity is expected to exhaust the fund before the last possible annuity payment is made in full. For this purpose, it must be assumed that it is possible for each measuring life to survive until age 110.

If a trust is the obligor, consider structuring the payment stream so that it is for the lesser of the annuitant's life or a term of years (to avoid using age 110 for the exhaustion test), with the term of years being at least the annuitant's life expectancy, with the life expectancy measure using the longer of the Code § 72 tables and the Code § 7520 tables (to qualify the payment stream as an annuity rather than a SCIN).

Like a SCIN, certain rules have to be followed to have an exchange properly characterized as a private annuity. Because the exchange is between family members, strict scrutiny applies. In order to have the transfer characterized as a private annuity and not as a gift or part gift, the annuity's actuarial value should equal the fair market value of the property.[4836] The annuity's actuarial value is based on the Code § 7520 rate of interest and the transferor's life expectancy.[4837] To determine life expectancy, the actuarial tables should be used unless the transferor is terminally ill. An individual known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50% probability that the individual will die within 1 year; however, if the individual survives for 18 months or longer after the date of the decedent's death, that individual shall be presumed to have not been terminally ill at the date of death unless the contrary is established by clear and convincing evidence.[4838]

To avoid re-characterization of the private annuity as a transfer with a retained life interest, which would be included in the transferor's gross estate under Code § 2036(a), the transferor cannot retain an interest in the property.[4839] When a trust buys from its grantor in an exchange for a private annuity, the Tax Court held that it will look at several

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[4835] Reg. §§ 25.7520-3(b)(2)(i), 1.7520-3(b)(2)(i) and 20.7520-3(b)(2)(i).

[4836] *Estate of Cullison v. Commissioner*, T.C. Memo. 1998-216 (1998), *aff'd* 221 F.3d 1347 (9th Cir. 2000) (unpublished decision). See also *212 Corp. v. Commissioner*, 70 T.C. 788, 798 (1978) (reviewed decision).

[4837] *Cullison*, fn. 4836 (holding that the transitional rules of Reg. § 25.7520-4 required the use of §7520 actuarial rules). Section 7520 regulations require the use of Code § 72 tables for annuities.

[4838] Regs. §§1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3).

[4839] See *Greene v. U.S.*, 237 F.2d 848, 852-853 (7th Cir. 1956) (transferred securities included in gross estate where transferor retained the right to all income generated by the securities); *Estate of Holland v. Commissioner*, 47 B.T.A. 807 (1942) (transferred stock included in life estate where transferors retained voting rights, transferees could not divest the stock, and the annuity payments were tied to stock value), *acq*. 1942-2 C.B. 9. Rev. Rul. 68-183 (an income tax ruling regarding Code § 677) held that, when annuity payments equaled the current income yield of the entire property held in trust, in substance the sale constituted a contribution of the sold property to the trust with a reservation by the grantor of annual payments of a fixed amount for life. Rev. Rul. 79-94 applied Code § 2036 to a more complicated set of facts with a similar theme.

factors to determinate whether the transaction might be characterized for income tax purposes as a gift to a trust instead of a sale, including: (1) the relationship between the creation of the trust and the transfer of property to the trust; (2) the relationship between the income generated by the transferred property and the amount of the annuity payments; (3) the degree of control over the transferred properties exercisable by the transferor; (4) the nature and extent of the transferor's continuing interest in the transferred properties; (5) the source of the annuity payment; and (6) the arm's-length nature of the annuity/sale arrangement.[4840] A treatise suggested the following have caused Code § 2036 inclusion:[4841] the transferor retained an interest in the transferred property, the transferee is not personally liable for the annuity payments, the annuity payments have been secured, the transferee has no independent financial means from which to make annuity payments, the transferee's annuity payments are identical or substantially similar to the income generated from the transferred assets, and the possibility that the transferee would ever be called upon to make annuity payments from the transferee's own funds is remote. The 2008 regulation change determining estate inclusion for GRATs, T.D. 9414, included the following explanation in the preamble:

> With regard to the position of certain taxpayers that the full and adequate consideration exception under section 2036 is satisfied when the present value of the remainder interest is zero, the IRS and Treasury Department believe that this exception to section 2036 does not apply. There is a significant difference between the bona fide sale of property to a third party in exchange for an annuity, and the retention of an annuity interest in property transferred to a third party. In the bona fide sale, there is a negotiation and agreement between two parties, each of whom is the owner of a property interest before the sale; each uses his or her own property to provide consideration to the other in exchange for the property interest to be received from the other in the sale. When the transferor retains an annuity or similar interest in the transferred property (as in the case of a GRAT or GRUT), the transferor is not selling the transferred property to a third party in exchange for an annuity because there is no other owner of property negotiating or engaging in a sale transaction with the transferor. The transferor, instead, is transferring the property subject to a retained possession and enjoyment of, or right to, the income from the property. If the grantor retains the interest for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death, the property is subject to inclusion in the grantor's gross estate under section 2036.

[4840] *Weigl v. Commissioner*, 84 T.C. 1192, 1225-26 (1985) (reviewed decision) (income tax case holding that a transfer to trust does not create an annuity where the transferor effectively controls the trust). An attempt to dispose of a family limited partnership interest using a private annuity was ignored when the children who promised to pay the annuity were not expected to use their own funds to make the payments. *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278; the resulting estate tax inclusion provided a basis step to the partnership that held the partnership at death (without using a Code § 754 election – see part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000) – as described in fn. 1016, found in part II.G.6 Abandoning an Asset to Obtain Ordinary Loss Instead of Capital Loss; Code § 1234A. Sloppy documentation using foreign trusts lost the day for the taxpayer in *Melnik v. Commissioner*, T.C. Memo. 2006-25, responding to a taxpayer's attempt to rely on *Fabric* and *Stern*, cited in fn. 4842.

[4841] 805 *T.M.* V.A.3.c.

Courts (primarily the Ninth Circuit and cases appealable to it, as well as the Seventh Circuit) have upheld properly structured annuity sales to trusts.[4842] A trust should have significant seed money before buying from its grantor in exchange for a private annuity.[4843] The IRS has attacked a sale where all of the trust's income was required to pay interest on promissory notes issued to the decedent.[4844]

[4842] *Estate of Fabric v. Commissioner*, 83 T.C. 932 (1984); *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984), *rev'g* 77 T.C. 614 (1981). In *Fabric*, the corporate trustee personally guaranteed payment of the annuity, worth $1,215,000, by a trust with $750 of initial funding; because the case was appealable to the Ninth Circuit, which had reversed the Tax Court in *Stern* and *LaFargue* (income tax case in fn. 5076), the Tax Court held that the guarantee and other issues sufficed to require it to respect the annuity agreement, despite sloppiness in execution of the plan. In an income tax case (also appealable to the Ninth Circuit) that had followed *LaFargue*, *Benson v. Commissioner*, 80 T.C. 789 (1983) respected an annuity with a present value of over $177,500 when the trust was funded with only $5. Careful documentation can convince the court that the obligors had the ability to pay and that the seller wanted to receive the payments. *Kite v. Commissioner*, T.C. Memo. 2013-43.

[4843] Gans and Blattmachr, Private Annuities and Installment Sales: *Trombetta* and Section 2036, 120 *Journal of Taxation* 227 (May 2014), focusing on *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), and trying to distinguish *Trombetta* (fn. 4846) from *Ray v. U.S.*, 762 F.2d 1361 (9th Cir. 1985).

Fidelity-Philadelphia is often cited for the proposition that providing another source for paying an annuity, such as a personal guarantee, causes the annuity to be respected as not constituting a retained interest in the trust. Here are the facts (footnotes omitted):

> The question before the Court is whether the proceeds of certain insurance policies on the life of the decedent, payable to named beneficiaries and irrevocably assigned by the insured, should be included in the estate of the decedent for the purposes of the federal estate tax. The facts are not in dispute. In 1934 decedent, then aged 76, purchased a series of annuity-life insurance policy combinations. Three single-premium life insurance policies, at face value of $200,000, $100,000, and $50,000, respectively, were obtained without the requirement of a medical examination. As a condition to selling decedent each life insurance policy, the companies involved required decedent also to purchase a separate, single-premium, nonrefundable life annuity policy. The premiums for each life insurance policy and for each annuity policy were fixed at regular rates. The size of each annuity, however, was calculated so that in the event the annuitant-insured died prematurely the annuity premium, less the amount allocated to annuity payments already made, would combine with the companion life insurance premium, plus interest, to equal the amount of insurance proceeds to be paid. Each annuity policy could have been purchased without the insurance policy for the same premium charged for it under the annuity-life insurance combination.
>
> The decedent's children were primary beneficiaries of the insurance policies; the Fidelity-Philadelphia Trust Company, as trustee of a trust established by decedent, was named beneficiary of the interests of any of decedent's children who predeceased her. In the year of purchase, decedent assigned all rights and benefits under two of the life insurance policies to her children and under the other to the Fidelity-Philadelphia Trust Company as trustee. These rights and benefits included the rights to receive dividends, to change the beneficiaries, to surrender the policies, and to assign them. Dividends were received, but, as far as the record discloses, none of the other rights was exercised. A gift tax on these transfers was paid by the decedent in 1935. In 1938 decedent amended the above-mentioned trust so that it became irrevocable. As the Government concedes, the decedent retained no beneficial or reversionary interest in the trust.
>
> The insured died in 1946. The proceeds of the three insurance policies were not included in her estate in the estate tax return.

Here's the Court's analysis; evaluate for yourself what the case stands for (footnotes and citations omitted, except for one pivotal footnote):

> Prior to death, the decedent had divested herself of all interests in the insurance policies, including the possibility that the funds would return to her or her estate if the beneficiaries predeceased her. The assignees became the owners of the policies before her death; they had received the right to the immediate and unlimited use of the policies to the full extent of their worth. The immediate value of the policies was always substantial. In the year of assignment their total cash surrender value was over $289,000; in the year of death it was over $326,000. Under the assignment, the decedent had not become a life tenant who postpones the possession and enjoyment of the property by the remaindermen until her death…. On the contrary, the assignees held the bundle of rights, the incidents of ownership, over property from which the decedent had totally divorced herself….
>
> …. Instead of the provision taxing transfers intending to take effect in possession or enjoyment at or after the transferor's death, the provision… the Government relies on the provision taxing transfers in which the transferor has retained until death the right to income from the transferred property. However, the Government's position that the annuities were income from property which the insured transferred to her children under the life insurance policies is not well taken.
>
> To establish its contention, the Government must aggregate the premiums of the annuity policies with those of the life insurance policies and establish that the annuity payments were derived as income from the entire investment. This proposition cannot be established. Admittedly, when the policies were purchased, each life insurance-annuity combination was the product of a single, integrated transaction. However, the parties neither intended that, nor acted as if, any of the transactions would have a quality of indivisibility. Regardless of the considerations prompting the insurance companies to hedge their life insurance contracts with annuities, each time an annuity-life insurance combination was written, two items of property, an annuity policy and an insurance policy, were transferred to the purchaser. The annuity policy could have been acquired separately, and the life insurance policy could have been, and was, conveyed separately. The annuities arose from personal obligations of the insurance companies which were in no way conditioned on the continued existence of the life insurance contracts. These periodic payments would have continued unimpaired and without diminution in size throughout the life of the insured even if the life insurance policies had been extinguished.[8] Quite clearly the annuity payments arose solely from the annuity policies. The use and enjoyment of the annuity policies were entirely independent of the life insurance policies. Because of this independence, the Commissioner may not, by aggregating the two types of policies into one investment, conclude that by receiving the annuities, the decedent had retained income from the life insurance contracts.
>
> [8] Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. *E.g.*, *Estate of Sarah A. Bergan*, 1 T.C. 543, *acq.*, 1943 Cum Bull. 2; *Security Trust & Savings Bank, Trustee*, 11 B.T.A. 833; *Seymour Johnson*, 10 B.T.A. 411; *Hirsh v. United States*, 35 F.2d 982 (Ct. Cl. 1929); *cf*. *Welch v. Hall*, 134 F.2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.

In *Bergan*, a 1943 case, one sister transferred assets to another in exchange for the latter's promise to support the former for the rest of her life; the Tax Court held that the sister who transferred made a gift to the extent that the value of the transferred assets exceeded the value of the support obligation, and none of the transferred assets were included in the transferor's estate.

Footnote 8 was pivotal when the Seventh Circuit reversed the Tax Court in *Estate of Becklenberg v. Commissioner*, 273 F2d 297 (7th Cir. 1959).

> We agree that decedent (under the interpretation made by the Superior Court of Cook County) retained a right to receive $10,000 annually, by way of annuity or by distribution from the Trust. Although this sum was, in fact, paid to decedent out of the income of the Trust for most years, it does not appear that the payments were restricted to income. In 1942, in settling decedent's claim for deficiencies in payments previously made to her, a portion of the corpus was distributed to decedent with approval of the Superior Court. Under the 1938 Trust, payments might be made from principal. Under the construction of the Superior Court, decedent would have had to be paid $10,000 annually, even though the Trust produced an income of less than $10,000, and it had been necessary to invade corpus. Unlike the Tax Court, we believe that the Trust had an obligation to pay decedent $10,000 annually, and that her right to receive it was not limited to the property transferred by her or the income therefrom.
>
> The Tax Court has computed the amount of the Trust assets to be includible in decedent's gross estate as though the Trust here required decedent to be paid $10,000 out of taxable income, whereas decedent could have been paid out of principal. She retained the right to receive $10,000 annually for life; she did receive $10,000 annually for life. Thus at her death, there was nothing left to be included in her gross estate.

The court then said that the case was more like *Fidelity-Philadelphia* than any case in which the decedent had retained income, citing footnote 8 from that case, concluding:

> Because of the basis on which this case has been determined, we do not reach various other questions respecting such matters as, for example, valuation of assets which decedent transferred to the Trust, or computation of the amount of corpus which would have been needed to produce an income of $10,000 annually, had decedent retained the right to receive payments of $10,000 annually, limited to income of the Trust.

[4844] TAM 9251004 involved the following facts:

> In 1980, the Donor became the income beneficiary (with general power of appointment) of a marital trust created by her spouse (the marital trust).
>
> On December 29, 1989, the Donor directed the trustee of the marital trust to distribute 480,000 shares of closely-held stock to a new trust for the benefit of her grandchildren (the trust) in exchange for 15-year interest-only notes having a face value of approximately $1.5 million. The notes were to pay 11 percent interest per year with principal payable on December 15, 2004. Based on a returned value of $12 per share, the entire block of stock represented a transfer of $5,760,000. The value of the stock was based on the assumption that the stock would yield approximately 6.25 percent, the current dividend being paid at the time of the gift. Donor's representative characterized the Donor's action as a direction to make a sale/gift.
>
> Pursuant to the terms of the trust and the Donor's instructions, the trustee immediately allocated the stock and assigned the debt to separate trust shares for each of the Donor's 12 grandchildren as follows:
>
> (1) Approximately 23 percent of the stock (and approximately 32 percent of the debt) equally to two shares for the benefit of the two children of the Donor's Child A;
> (2) approximately 33 percent of the stock (and approximately 33 percent of the debt) equally to four shares for the benefit of the four children of the Donor's Child B; and
> (3) approximately 44 percent of the stock (and approximately 35 percent of the debt) equally to six shares for the benefit of the six children of Donor's Child C.
>
> Prior to the sale/gift, if the corporation were to continue paying a dividend of $0.75 per share with respect to the 480,000 shares of stock, the Donor would receive $360,000 in dividend income. Immediately after the sale/gift, the Donor, by reason of her income interest, became entitled to receive annual payments of $165,000.
>
> ….
>
> The entire trust corpus consists of shares of stock of Corporation. Immediately after the gift/sale, Child A held (individually or as a trustee of this and other trusts) 63.3 percent of

Furthermore, the seller should not retain too much control over the trust. In *Bixby v. Commissioner*, 58 T.C 757 (1972), the named settlor gave $1,000 to each trust, and the parent of the named beneficiaries sold $129,000 of closely-held stock to the trust in exchange for a private annuity with a present value equal to the value of the sold stock. The court held that each seller retained so much control that they really just made a transfer in trust, with annuity payments recast as trust distributions, and was taxed under Code § 677 as the grantor:[4845]

> the voting power of Corporation. Thus, Child A not only has the ability to control the dividend stream flowing to the various trust shares but is also directed to vote the stock, enter into agreements, etc., in a manner that is consistent with his own best interests (as an individual family owner) and with the best interest of the beneficiaries of the other trusts (representing family ownership of Corporation).
>
> On January 4, 1990, six days after the stock transfer, the notes were transferred to the Donor's three children in the same proportion that the debt was allocated among their children; *i.e.*, 32 percent of the notes were transferred to Child A, 33 percent of the notes were transferred to Child B, and 35 percent of the notes were transferred to Child C. Thus, each child became entitled to receive approximately one-third of the $165,000 previously payable to the surviving spouse (by way of the marital trust).
>
> Donor died in 1992, less than three years after the notes were transferred to Donor's children.

The IRS invoked Code § 2035 inclusion, claiming that the decedent transferred her alleged Code § 2036 retained interest within 3 years of death, conveniently omitting any reference to the *Becklenberg* case and other authority cited in fn. 4843:

> For purposes of section 2036 it is immaterial that a retained right is stated in terms of a contractual right or limited to a specific dollar amount so long as the retained right is a preferential right to a significant portion of the income. *Estate of C. B. Swartz*, 9 T.C. 229 (1947); *Estate of Fry*, 9 T.C. 503 (1947).
>
> As noted above, under the circumstances of this case the Donor's transfer of the closely-held stock into the trust with a retention of a priority right to a major share (if not all) of the trust income in the form of note interest payments must be considered a retention of the right to receive trust income. Because section 2036 of the Code includes the value of all property to the extent the Donor has retained an income interest therein, and because the Donor retained, at the time of the sale/gift, the right to receive the first $165,000 of trust income the value of the transferred stock would have been includible in the Donor's gross estate under section 2036 of the Code.

[4845] The court relied heavily on *Samuel v. Commissioner*, 306 F.2d 682, 687 (1st Cir. 1962) (a grantor trust income tax case). Before reciting the control in the text quoted above, *Bixby* reasoned:

> The test of control that can be drawn from *Samuel* is an eminently practical one. Did the purported annuitant transfer so many incidents of ownership that it can be said that he or she no longer has effective control over the property? We believe that this test should be applied in a strict fashion in order to curb abuses in the area of private annuities. The outcome in each case will depend upon the attendant facts as viewed, we hope, in the light of reality. The fact that annuity agreements were executed is, of course, not controlling. *Harold W. Smith*, 56 T.C. 263 (1971); *Estate of Cornelia B. Schwartz*, 9 T.C. 229 (1947). Also, it should be noted that the *Samuel* test need not coincide with similar-sounding tests in other areas of the tax law where other considerations may be at work, for example, the test carefully constructed by Congress in sections 671 through 678, the test appearing under the family partnership provisions (see *Adolph K. Krause*, 57 T.C. 890 (1972), and the legislative history, regulations, and cases cited therein), and the specific tests of section 2036 (see *United States v. Byrum*, 408 U.S. 125 (1972), petition for rehearing pending; *Estate of Pamelia D. Holland*, 47 B.T.A. 807

In this case it is plain that the petitioner-"annuitants" deliberately avoided relinquishing control over the stock and its proceeds. Through the advisory committees they could continue to deal with the property as before—with a free hand. They could direct its investment; they could borrow it without payment of interest or providing security; they could use it to purchase life insurance; they could have themselves appointed as "Voting Trustees" and vote stock. It cannot be said that the advisory committees were not susceptible to the petitioners' directions because we find that they were, based on the closeness of family relations, the tendency of the trusts to act in tandem, and the solidarity of the trusts as demonstrated during the Tyer purchase transaction. Nor can petitioners rely on the fact that title to the property was technically in the name of the trustee. *Corliss v. Bowers*, 281 U.S. 376 (1930). And any suggestion that the committees and the Bermuda trustee must act perforce to benefit the named beneficiaries is undercut by the fact that the trustee is absolved of any liability and the trust

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(1942), and Supplemental Opinion, 1 T.C. 564 (1943); *Estate of William F. Hofford*, 4 T.C. 542 (1945), and Supplemental Opinion, 4 T.C. 790 (1945)).

After the text quoted in the main body of this paper, the court concluded:

Some analogous cases in the section 2036 area are instructive. In *Estate of Pamelia D. Holland*, *supra*, the decedent and her husband sold to their children all the stock of a corporation for a nominal amount of money. At the same time it was agreed that the father was to be paid a salary of $25,000 per year for as long as he lived and if he predeceased his wife, she was to be paid the same salary for as long as she lived. The father did predecease the mother, and upon her death the Commissioner determined that the value of the stock should be included in her estate. We agreed with the Commissioner's determination. Although the payments were labeled as salary payments, were not specified as company profits or dividends on stock, and were paid pursuant to a valid contract, in essence they represented a retained income interest. In the recent case of *United States v. Byrum*, *supra*, the Supreme Court discussed *Holland* and concluded that The settlor in Holland retained a considerably greater interest than Byrum retained, including an income interest. *Holland* was also discussed, at length, in *Estate of William F. Hofford*, *supra* , a case involving very similar facts. In *Hofford* we found that the salary payments were in fact just that—salary payments. We noted, among other things, that when the recipient of the payments attempted to exercise control over the transferred property by attempting to oust his cotrustees, he failed. Suffice it to say that if the present case were a section 2036 case, we would treat it as having more in common with *Holland* than with *Byrum* or *Hofford*. Not only have petitioners retained a greater interest than did the petitioner in *Byrum*, but in contrast to the petitioner in *Hofford*, the petitioners in this case have succeeded on at least one occasion in directing the trusts.

In view of our conclusion that the annual payments were not annuity payments, we find that the individual petitioners were the settlors of the Bermuda trusts. They furnished the consideration for the creation of the trusts. The named settlor was settlor in form only. *Cf. Harold W. Smith*, *supra*; *Estate of Cornelia B. Schwartz*, *supra*; *George H. Whiteley, Jr.*, 42 B.T.A. 402, *affd.* 120 F.2d 782 (C.A. 3, 1941), certiorari denied 314 U.S. 657 (1941); *Buhl v. Kavanagh*, 118 F.2d 315 (C.A. 6, 1941). Furthermore, we hold that the annual payments represent amounts distributable without the consent or approval of an adverse party under section 677(a)(1).[36] The purported annuity agreements amounted to little more than prearranged distributions. The petitioners are therefore taxable on the income of the trusts during 1961 as owners of those trusts under section 671.

[36] the rule is well established that a deficiency may be approved on the basis of reasons other than those relied upon by the Commissioner or even where his reason may be incorrect. [citations omitted]

income, while subject in some instances to a limited right of withdrawal, is not distributable until after the death of the petitioner for whom the trust was named. *Cf. Estate of Willard V. King*, 37 T.C. 973 (1962), an estate tax case.

A properly structured private annuity should not implicate chapter 14, with the exception of annuities paid by a trust, which may involve Code § 2702 issues.[4846] Code § 2702 applies to gifts in trust where the transferor or an applicable family member retains a qualified interest.[4847] Thus, Code § 2702 can be avoided where no gift exists (the fair market value of the property equals the actuarial value of the annuity)[4848] or where neither the transferor retains an interest in the trust after the transfer nor the transferee had an interest before the transfer.[4849]

III.B.1.g.ii. Private Annuities: Income Tax Implications

For income tax purposes, ***<u>on or before October 18, 2006</u>***, if the annuity is unsecured,[4850] then the transferor is treated as though the property were sold in a deferred recognition event for a term equal to the transferor's life expectancy.[4851] Each annuity payment consists of a capital component (including return of basis and capital gain) and an annuity component. An exclusion ratio determines how much of each payment is excluded from income as recovery of capital. The exclusion ratio is the transferor's investment in the contract (adjusted basis in the property) divided by the expected return from the annuity (life expectancy multiplied by annuity payments).[4852] The capital gain portion is the difference between the seller's basis in the property and the seller's expected return. The remaining amount is the annuity portion, which is taxed as ordinary income.[4853] Regulations govern how an annuity contract can avoid the original issue discount rules that impute interest on uneven payments; careful attention must be paid if the annuity is not a flat payment for life.[4854]

[4846] *Estate of Trombetta v. Commissioner*, T.C. Memo. 2013-234.
[4847] Code § 2702(a), (b).
[4848] For a sale to work as a practical matter, the trust needs to have significant other assets. Otherwise, the sale might be subject to Code § 2036 attack, because of failing the exhaustion test (fn. 4835 and accompanying text) or using all of the trust's income to pay the annuity (fn. 4839 and accompanying text).
[4849] See Letter Ruling 9253031 (1992) (Code § 2702 applied to an annuity where the taxpayer sold marketable securities to a preexisting trust in exchange for an unsecured private annuity).
[4850] If the annuity is fully secured, gain is recognized immediately (although the interest portion is deferred). GCM 39503 (1986); *Bell v. Commissioner*, 60 T.C. 472 (1973) (reviewed decision, *aff'd* per curiam 668 F.2d 448 (8th Cir. 1982)), followed by *212 Corp. v. Commissioner*, 70 T.C. 788, 802 (1978) (reviewed decision).
[4851] An installment sale has limitations on deferral, which limitations do not apply to annuities. See fn. 4824 and part III.B.1.g.ii Private Annuities: Income Tax Implications for how that appears to be changing.
[4852] Code § 72(b); Rev. Rul. 69-74.
[4853] Rev. Rul. 69-74.
[4854] Reg. § 1.1275-1(j). Reg. § 1.1275-1(j)(2) generally excludes an annuity from OID treatment if the contract provides for periodic distributions made not less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals) and does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

The transferee in a private annuity transaction is treated like the purchaser of an annuity, with the distinction that amounts paid in excess of the purchase price are non-deductible annuity payments, not deductible interest.[4855] The transferee's basis varies for different circumstances.[4856] For depreciation purposes during the transferor's life, the unadjusted basis is the present value of the annuity promise on the date of the agreement. For calculating tax on a disposition of the annuity property for a gain during the transferor's life, the transferee's unadjusted basis is the sum of annuity payments made plus the prospective payments owed at the date of disposition. If the sale is for a loss during the transferor's life, the transferee's unadjusted basis is the sum of the annuity payments made to the date of disposition. If the transferor outlives life expectancy—causing the transferee to pay more than the original present value of the annuity—the transferee's unadjusted basis increases accordingly. Upon the transferor's death, the transferee's unadjusted basis – for future disposition and depreciation purposes – becomes the sum of annuity payments made.

For income tax purposes, ***after October 18, 2006***, proposed regulations[4857] provide that the gain from the sale of property in exchange for a private annuity cannot be deferred, except as described below. First, the effective date is delayed six months if all three of the following conditions are satisfied:

(i) the issuer of the annuity contract is an individual;

(ii) the obligations under the annuity contract are not secured, either directly or indirectly; and

(iii) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

Second, the IRS has requested suggestions on the following topics:

(i) the clarity of the proposed regulations and how they can be made easier to understand;

(ii) what guidance, if any, is needed in addition to Rev. Rul. 55–119, 1955–1 CB 352, see § 601.601(d)(2), on the treatment of the issuer of an annuity contract that is not taxed under the provisions of subchapter L of the Code;

(iii) whether any changes to § 1.1011-2 (concerning a bargain sale to a charitable organization in exchange for an annuity contract), conforming those regulations to the proposed regulations, would be appropriate;

(iv) circumstances (and corresponding changes to the regulations under section 453, if any) in which it might be appropriate to treat an exchange of property for an annuity contract as an installment sale;

[4855] Rev. Rul. 55-119.
[4856] Rev. Rul. 55-119.
[4857] REG-141901-05, Exchanges of Property for an Annuity, Fed. Reg. Vol. 71, No. 201, p. 61441, proposing changes to Reg. §§ 1.72-6(e), 1.1001-1(j).

(v) circumstances, if any, in which the fair market value of an annuity contract for purposes of § 1.1001-1(j) should be determined other than by tables promulgated under the authority of section 7520; and

(vi) additional transactions, if any, for which the six month delayed effective date would be appropriate.

Note that the IRS still has not finalized the proposed regulations. Arguably, a taxpayer can rely on Rev. Rul. 69-74, which has not been revoked, for tax deferral. However, doing so risks retroactive application of the proposed regulations if they are ever finalized.

In a pre-2006 transaction, one taxpayer made a private annuity sale to a nongrantor trust to trigger gain, then later made the trust a grantor trust to try to avoid gain on the remaining annuity payments; the IRS said this transaction was abusive but rejected certain attacks its examiner made and asked the examiner to try to find other attacks.[4858]

III.B.1.g.iii. Private Annuities: Planning Observations

A private annuity is a good planning technique when the transferor has a shorter actual than actuarial life expectancy (yet will live beyond 18 months), the borrower has means to make payments, and the lender wants a source of retirement income. If one is concerned that the lender will live too long, the lender might contribute the SCIN to a GRAT, so that excess value goes to the lender's beneficiaries. One might consider waiting for a while before gift the SCIN to a GRAT, because such a gift might undermine the argument that the SCIN was done for investment purposes.

The trade-off is that the basis of the purchased property will be relatively small. If one is using high basis property and would like to avoid a basis step–down, then one might consider placing the asset in an entity so that the asset's basis is preserved and only the basis in the entity itself is decreased.

See parts III.B.1.g Private Annuities and III.B.1.f Self-Canceling Installment Notes.

III.B.1.h. Transfers in the Ordinary Course of Business– Reg. § 25.2512-8

In *Estate of Edward S. Redstone v. Commissioner*, 145 T.C. 259 (2015), in which the IRS claimed that a son's transfer of stock to his children to settle a dispute with his father, the court explained:

> A transfer of property will be regarded as occurring "in the ordinary course of business" and thus will be considered to have been made "for an adequate and full consideration in money or money's worth" only if it satisfies the three elements specified in section 25.2512-8, Gift Tax Regs. To meet this standard, the transfer must have been bona fide, transacted at arm's length, and free of donative intent. In applying this regulation to settlements of family disputes, we have identified certain subsidiary factors that may also be relevant. We have

[4858] CCA 200923024. An excerpt from CCA 200923024 is in fn. 4921 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation.

> considered, for example: whether a genuine controversy existed between the parties; whether the parties were represented by and acted upon the advice of counsel; whether the parties engaged in adversarial negotiations; whether the value of the property involved was substantial; whether the settlement was motivated by the parties' desire to avoid the uncertainty and expense of litigation; and whether the settlement was finalized under judicial supervision and incorporated in a judicial decree. See, *e.g.*, *Estate of Natkanski*, 64 T.C.M. (CCH) at 59; *Estate of Noland*, 47 T.C.M. (CCH) at 1644-1645.

In determining whether a dispute is bona fide, the court said:

> The requirement that the transfer be "bona fide" considers whether the parties were settling a genuine dispute as opposed to engaging in a collusive attempt to make the transaction appear to be something it was not. See *Black's Law Dictionary* 199 (9th ed. 2009) (defining "bona fide" as "[m]ade in good faith; without fraud or deceit").

For the next prong, the court held:

> The requirement that the transfer be "arm's length" is satisfied so long as the taxpayer acts "as one would act in the settlement of differences with a stranger."

Regarding being free from donative intent, the court said:

> The evidence clearly established that Edward transferred stock to his children, not because he wished to do it, but because Mickey demanded that he do it…. The transfer of stock in trust for Michael and Ruth Ann was prompted by Mickey's twin desires to ensure his grandchildren's financial security and to keep the Redstone family business within the Redstone family. At the time of the settlement, Edward had no desire to transfer stock to his children. He was forced to accept this transfer in order to placate Mickey, settle the family dispute, and obtain a $5 million payment for the remaining 66 2/3 shares.
>
> ….
>
> We find that Edward acquiesced in the notion of an "oral trust" because he had no other alternative; this was a "deal breaker" for Mickey. There is no evidence that Edward, in making this transfer, was motivated by love and affection or other feelings that normally prompt the making of a gift.

The IRS argued that the fact that neither the donee trust nor the beneficiaries provided any consideration for the transfer meant that a gift was made to them. The court rejected that argument:

> Respondent's argument derives no support from the text of the governing regulations. Section 25.2511-1(g)(1), Gift Tax Regs., provides unequivocally that "[t]he gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth." Section 25.2512-8, Gift Tax Regs., provides that a "transfer of property made in the ordinary course of business *** will be considered as made for an adequate and full consideration in money or money's worth." Section 25.2512-8, Gift Tax Regs., specifies three elements that an

> ordinary business transaction must meet, and we have found that Edward's transfer met all three elements. The consequence of that determination is that "[t]he gift tax is not applicable to *** [the] transfer." Sec. 25.2511-1(g)(1), Gift Tax Regs.

That taxpayer's brother established similar trusts pursuant to the same general goal, only he established these trusts voluntarily, rather than being compelled to do so by litigation. In finding for the IRS, *Sumner Redstone v. Commissioner*, T.C. Memo. 2015-237 held:

> Petitioner's transfer of stock to his children was undoubtedly prompted by the Settlement Agreement, both as to its timing and its terms, and this transfer surely pleased Mickey [the taxpayer's father] by ensuring the financial security of his four grandchildren on equal terms. But this is not enough to make it a transaction "in the ordinary course of business." Pleasing parents, like pleasing children, is presumptively a family motivation, and we discern no evidence tending to rebut that presumption here. There was no claim against Sumner; there were no arm's-length negotiations; and he received no consideration from anyone in exchange for his transfer.
>
> In transferring stock to the Brent and Shari Trusts, Sumner was essentially motivated by the kinship that he had with his father and his children. Sumner was the sole trustee of both his children's Trusts; there is no evidence that he was reluctant to effect this transfer or that it disadvantaged him from a business perspective.[6] The transfer thus bears all the indicia of donative intent toward the natural objects of his affection.
>
> [6] By contrast, Edward was clearly reluctant to transfer stock to his own children's Trusts; for one thing, Sumner, rather than he, was the sole trustee of those Trusts. Both economic and family reasons motivated Edward to insist on securing outright ownership of (or payment for) all 100 shares that were originally registered in his name. See *Estate of Redstone*, 145 T.C. at __ (slip op. at 25 & n.5).

Intra-family sales are scrutinized, and the IRS argues that the ordinary course of business exception does not apply. This can include indirect transfers involving entities, in that an entity's owners are considered the transferors or transferees, as the case may be.[4859]

[4859] Reg § 25.2511-1(h)(1) provides:

> A transfer of property by a corporation to B is a gift to B from the stockholders of the corporation. If B himself is a stockholder, the transfer is a gift to him from the other stockholders but only to the extent it exceeds B's own interest in such amount as a shareholder. A transfer of property by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation. However, there may be an exception to this rule, such as a transfer made by an individual to a charitable, public, political or similar organization which may constitute a gift to the organization as a single entity, depending upon the facts and circumstances in the particular case.

III.B.1.i. Transfers with Contingencies Based on Acts of Independent Significance

Sometimes an action has important nontax consequences that are considered to dwarf their tax consequences to such an extent that the action's effect on property rights do not have transfer tax consequences.

Such an act of independent significance includes:

- Adoption. A trust provision automatically including the settlor's after-born and after-adopted children as beneficiaries is not equivalent to the settlor's retention of a power to designate or change beneficial interests within the meaning of Code § §2036(a) and 2038.[4860]

- Divorce. "The act of divorcing one's spouse is an act of independent significance, the incidental and collateral consequences of which is to terminate the spouse's interest in the trust. Thus, we do not believe the decedent possessed an "incident of ownership" in the insurance policy as a result of the trust provision which would terminate the interest of the decedent's spouse in the event of a divorce."[4861] If B has a power to terminate a trust and receive all of the trust assets if A and B divorce or are legally separated and they never do, B's termination power will not constitute a general power of appointment in the existence of decedent's death that would cause the value of the Spousal Trust to be included in B's gross estate.[4862]

- Termination of Employment. "An insured's power to cancel his insurance coverage by terminating his employment is a collateral consequence of the power that every employee has to terminate his employment" that does not constitute an incident of ownership under Code § 2042.[4863] "If a decedent transferred all the incidents of ownership in a noncontributory group-term life insurance policy on the decedent's life, but retained the right to convert the policy to an individual policy should the decedent's employment be terminated, the proceeds are not includible in the

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As applied to partnerships, *see*, *e.g.*, *Shepherd v. Commissioner*, 115 T.C. 376 (reviewed decision 2000), *aff'd* 283 F.3d 1258 (11th Cir. 2002); *Senda v. Commissioner*, T.C. Memo 2004-160, *aff'd* 433 F.3d 1044 (8th Cir. 2006). *Estate of Magus v. Commissioner*, T.C. Memo. 2000-129, held that a corporate redemption in excess of the fair market value (including valuation adjustments relating to control and marketability) was a gift.

[4860] Rev. Rul. 80-255.

[4861] Letter Ruling 8819001.

[4862] Letter Ruling 9141027, viewing the contingency of divorce or separation as an act of independent significance and citing *Estate of Tully v. United States*, 528 F.2d 1401 (Ct. Cl. 1976) (see fn. 3112 in part II.Q.4.a Funding the Buy-Sell), and Rev. Rul. 80-255, the latter cited in fn. 4860.

[4863] Rev. Rul. 72-307.

decedent's gross estate" under Code § 2042(2).[4864] Various buy-sell provisions may also constitute acts of independent significance.[4865]

- Death Benefits Decedent Did Not Control. Survivors' loss benefits, payable under a no-fault automobile insurance policy, are not includible in the decedent's gross estate.[4866]

- Terminate Enrollment in College. The contingency that a person terminate enrollment in college is an act of independent significance for certain gift tax purposes.[4867]

[4864] Rev. Rul. 84-130, 1984-2 C.B. 194, stating:

The Service acquiesces in the result in the decision in *Estate of Smead v. Commissioner*, 78 T.C. 43 (1982), which held that a retained conversion privilege exercisable only on termination of employment was not an incident of ownership. See page 2, this Bulletin.

[4865] See fn. 3112 in part II.Q.4.a Funding the Buy-Sell.

[4866] Rev. Rul. 82-5, reasoning:

The decedent was required to obtain the coverage by the state's no-fault automobile insurance statute and had no choice as to the persons entitled to receive survivors' loss benefits or the amount of the benefits. The right to survivors' loss benefits was created by statute for the benefit of a decedent's dependents and is designed to compensate for amounts that they would have received from the decedent had the decedent lived. Since the loss for which the benefits are designed to compensate for did not accrue until after the decedent died, the right of the decedent's spouse to the benefits also did not arise until after the decedent died. Thus, the decedent had no interest in the survivors' loss benefits at the date of death and the benefits are not includible under section 2033 of the Code. See Rev. Rul. 56-637, 1956-2 C.B. 600, which holds that workmen's compensation benefits payable to the dependents of a deceased employee are not includible in the deceased's gross estate for federal estate tax purposes; Rev. Rul. 67-277, 1967-2 C.B. 322, which holds that the lump sum payable under section 402(i) of title 42 of the United States Code (the Social Security Act) to the widow or widower of the deceased is not includible in the decedent's gross estate for federal estate tax purposes; and Rev. Rul. 54-19, 1954-1 C.B. 179, which holds that amounts receivable in settlement of claims under the New Jersey "Death of Wrongful Act" statute are not includible in the decedent's gross estate.

Furthermore, the Service does not consider the survivor's loss benefits to be includible in the decedent's gross estate under section 2042 of the Code. While the Service takes no position on whether the survivor's loss benefits are classifiable as life insurance proceeds, nonetheless, the proceeds would not be includible in the decedent's gross estate because the decedent did not possess any incidents of ownership. Neither the power to cancel the policy and relinquish the motor vehicle registration nor the power to substitute a policy with identical survivor's benefits constitutes an incident of ownership within the meaning of section 2042. See Rev. Rul. 72-307, 1972-1 C.B. 307; *Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq.* 1977-1 C.B. 1.

[4867] Rev. Rul. 75-415 reasoned:

The only way C can immediately obtain the use, possession, or enjoyment of a proportionate share of the income interest is to terminate enrollment as a full-time student in an institution of higher learning. Although C's action will result in the enjoyment of the income interest, such action is merely a collateral consequence of a power that every student has to drop out of school. C's termination of enrollment does not directly affect the trust and, therefore, is a barrier to the present enjoyment of the income interest.

Accordingly, the gift tax exclusion authorized by section 2503(b) of the Code for gifts of present interests is not allowable with respect to a donee's right to receive one-third of

The "event or contingency must not be illusory and must have some significant non-tax consequence independent of the decedent's ability to exercise the power."[4868]

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the income from property for a term of years if enjoyment is to commence at the earlier of the expiration of three years from the date of gift or termination of enrollment as a full-time student in an institution of higher learning.

[4868] Holding that the ministerial requirement that one actually withdrawal right in a particular sequence was not enough to prevent it from constituting a general power of appointment under Code § 2041, *Kurz v. Commissioner*, 101 T.C. 44, 59-61 (1993), *aff'd* 68 F3d 1027 (7th Cir. 1995), made the statement quoted in the text above and further reasoned:

> The legislative history, however, clearly indicates that all property of which the decedent on the date of his death had practical, if not technical, ownership is to be included in his estate. We think any illusory or sham restriction placed on a power of appointment should be ignored. An event or condition that has no significant non-tax consequence independent of a decedent's power to appoint the property for his own benefit is illusory. For example, for purposes of section 2038, a power is disregarded if it becomes operational as a mere by-product of an event, the non-tax consequences of which greatly overshadow its significance for tax purposes. See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, par. 126.5.4, at 126-64 (2d ed. 1984). If the power involves acts of "independent significance", whose effect on the trust is "incidental and collateral", such acts are also deemed to be beyond the decedent's control. See Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of "independent significance", whose effect on a trust that included after-born and after-adopted children was "incidental and collateral"); see also *Estate of Tully v. United States*, 208 Ct. Cl. 596, 528 F.2d 1401, 1406 (1976) ("In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."). Thus, if a power is contingent upon an event of substantial independent consequence that the decedent could, but did not, bring about, the event is deemed to be beyond the decedent's control for purposes of section 2038.
>
> We do not think that, where the general power of appointment is the right to withdraw principal from a trust, Congress intended that application of section 2041(a)(2) could be avoided by stacking or ordering the withdrawal powers; *i.e.*, exercising the power to withdraw a certain number of dollars before the power to withdraw the next portion comes into operation. A condition that has no significant non-tax consequence independent of a decedent's power to appoint the property for her own benefit does not prevent practical ownership; it is illusory and should be ignored. We conclude that for purposes of section 2041, although the condition does not have to be beyond the decedent's control, it must have some significant non-tax consequence independent of the decedent's power to appoint the property. Petitioner has not demonstrated that withdrawing principal from the Marital Trust Fund has any significant non-tax consequence independent of decedent's power to withdraw principal from the Family Trust Fund. Such condition is illusory and, thus, is not an event or a contingency contemplated by the section 20.2041-3(b), Estate Tax Regs.
>
> We hold that, if by its terms a general power of appointment is exercisable only upon the occurrence during the decedent's lifetime of an event or contingency that has no significant non-tax consequence independent of the decedent's ability to exercise the power, the power exists on the date of decedent's death, regardless of whether the event or contingency did in fact occur during such time. Because petitioner has failed to demonstrate any significant non-tax consequence independent of decedent's right to withdraw principal from the Family Trust Fund, we hold that, on the date of her death, decedent had a general power of appointment over 5 percent of the Family Trust Fund that causes that portion to be includable in her estate under section 2041.

III.B.2. Grantor Trust Planning, Including GRAT vs. Sale to Irrevocable Grantor Trust

III.B.2.a. Tax Basis Issues When Using Irrevocable Grantor Trusts

Whenever using irrevocable grantor trusts, consider that the assets the trust holds will not get a basis step-up at death. Consider recommending that clients or their income tax preparers monitor the relationship between value and basis. If value becomes significantly larger than basis for one or more assets, consider having the trust sell those to the grantor in exchange for cash or another high basis asset.

See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property).

If grantor trust status terminates, generally the grantor is deemed to have sold to the trust the assets the grantor had been deemed to own immediately before the sale in exchange for whatever the principal balance is of any notes payable to the grantor and any liabilities of which the grantor has been deemed relieved.[4869]

The trust's basis in the assets is the sum of:[4870]

(1) Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor's adjusted basis for the property at the time of the transfer, and

(2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see § 1.1015-5).

III.B.2.b. General Description of GRAT vs. Sale to Irrevocable Grantor Trust

For a company whose value is so high that its stock cannot be transferred merely by annual exclusion gifting, we often transfer S stock to irrevocable grantor trusts – trusts whose assets are, or will be later, excluded from the grantor's estate, but whose income is currently taxable to the grantor. Two types of transfers most commonly used are:

- Gift to Grantor Retained Annuity Trust (GRAT).[4871] The grantor gives property (nonvoting stock)[4872] to the trust and receives an annuity for a fixed term of years in exchange for the transfer of property. Usually, the annuity is expressed as a specific

Decedent's power of appointment over 5 percent of the Family Trust Fund was in existence on the date of her death regardless of the fact that the principal of the Marital Trust Fund had not been completely exhausted by that date. Hence, 5 percent of the Family Trust Fund was includable in her gross estate.

[4869] See fn. 4974.

[4870] Reg. § 1.1015-4(a), which applies to noncharitable bargain sales.

[4871] This is just a summary of certain features of a GRAT that help determine its financial success. The technical requirements are beyond this article's scope. If a GRAT fails to meet the terms required by the statute or regulations, consider a reformation, as occurred in fn. 4776.

[4872] See part II.A.2.j.i.(b) Why Nonvoting Shares Are Needed for Estate Planning.

percentage of the initial value of the trust's assets.[4873] This initial value is the value determined for federal tax purposes,[4874] and adjustments to payments are required if the initial value is incorrectly determined.[4875] The amount of the gift is the excess of the gifted property's value over the present value of the retained annuity, determined using Code § 7520 interest rates.[4876] If the IRS increases the initial value, the annuity also increases, allowing the grantor to report a gift that is either zero or close to zero. GRATs have become more popular since a 2000 court decision on valuing retained annuities.[4877]

- Sale to Irrevocable Grantor Trust. The grantor establishes an irrevocable trust that is excluded from the grantor's estate for estate tax purposes but treated as owned by the grantor for income tax purposes.[4878] The grantor makes a gift[4879] equal to at least one-ninth of the value of the property the grantor is going to sell.[4880] The grantor sells property (nonvoting stock) to the trust and receives a promissory note.[4881] While the trust is a grantor trust, income tax does not apply to the sale.[4882]

The gift to a GRAT is safer than a sale to an irrevocable grantor trust, in that the grantor can ensure that the gift is close to zero, even if the IRS tries to adjust the property's value; I often use formula sales to mitigate the risk of a sale to an irrevocable grantor trust, but formula sales remain a point of contention.[4883] A sale to an irrevocable grantor

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[4873] Code § 2702(b)(2).
[4874] Reg. § 25.2702-3(b)(1)(ii)(B).
[4875] Reg. § 25.2702-3(b)(2).
[4876] Code § 2702(a)(2)(B).
[4877] Reg. § 25.2702-2(a)(5), giving credit for an annuity payable to an estate, amended in response to *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq*. IRS Notice 2003-72.
[4878] A power commonly used to make a trust be a grantor trust is under Code § 675(4)(C): a power, exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.
[4879] Arguably the trust should not grant withdrawal rights (*Crummey* rights) to the beneficiaries. The argument is that Code § 678(b) provides that a grantor's rights to income supersede a beneficiary's right to income for grantor trust purposes, but do a grantor's rights to income supersede a beneficiary's right to principal for grantor trust purposes? Letter Rulings 200603040 and 200606006 and numerous rulings before and after those rulings have read Code § 678(b) in the context of taxable income, rather than fiduciary accounting income, so including *Crummey* rights should be OK.
[4880] *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, approved a gift of LLC interests followed by a sale for promissory notes three days later using this structure.
[4881] If somehow the IRS successfully recharacterizes the note described below as equity, then the Code § 2701 rules come into play. Code § 2701 assigns at least a 10% minimum value to the junior equity, which would be represented by the initial gift to the trust. For example, if the property to be sold is worth $9M, then the gift would be $1M, so that the junior equity would be worth 10% ($1M divided by the $10M total in the trust). This 1/9 funding also provides more substance to the trust. Finally, the trust should make all interest payments on time, and the 1/9 funding provides funding in case corporate cash flow to the shareholders is insufficient (due to a temporary downturn in business, for example).
[4882] Rev. Rul. 85-13.
[4883] Formula sales are described in part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

trust triggers income tax if the grantor trust powers are turned off;[4884] to the extent that the note's principal exceeds the basis of the trust's assets, a bargain sale is likely to have occurred.[4885] It also does not require an up-front gift, which can cause complexity when the grantor tries to sell stock to an irrevocable grantor trust and does not have enough gift tax exemption available to provide sufficient funding.[4886] Finally, GRATs have a 105-day grace period in the event of a late payment.[4887]

A word about zero gifts: don't do them. To avoid income tax on the annuity payment (GRAT) or on the sale and note payments (sale to irrevocable trust), the taxpayer needs to establish that the trust is a grantor trust. See part III.B.2.h.i Who Is the Grantor. Having even a small gift should satisfy that requirement. In the grand scheme of things, having a $100 or $1,000 taxable gift isn't going to make a material difference in the taxpayer's estate/gift tax exclusion amount. For a sale to an irrevocable grantor trust, if the taxpayer has not opened a bank account before the sale, see whether the trust might have provided for nominal consideration and whether the trustee might have that cash in hand without having opened a bank account. I prefer, however, that, for a sale to an irrevocable grantor trust, the funding be more substantial than that, if possible, as mentioned above.

A sale to an irrevocable grantor trust has several advantages over GRATs, if one is willing to take gift tax audit risks:

- Payments back to the grantor are lower and more flexible than in a GRAT.[4888]

4884 The sale might qualify for installment sale treatment; see Code §§ 453, 453A. Note that the transfer of an installment obligation upon termination of a trust accelerates remaining gain. See part II.G.14 Limitations on the Use of Installment Sales.
Letter Ruling 200722027 asserted that:

- A partnership interest does not qualify for installment sale treatment to the extent that it represents income attributable to Code § 751(c)(2) unrealized receivables for payment for services rendered.
- The seller may report the balance of the income realized from the sale of the partnership interest using the installment method of reporting.

4885 See fn. 4974, found in part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

4886 Loan guarantees are commonly used to shore up trusts that are thinly funded; see fn. 4889 regarding thinly funded trusts. For tax consequences of loan guarantees, see part III.B.1.a.ii Loan Guarantees. Although I believe that paying a reasonable guarantee fee is not required to avoid a gift (with which not everyone agrees), it may be helpful to provide a nontax reason why the guarantor provided the guarantee. See part III.B.2.i.v Funding the Trust with Small Gifts. The guarantee fee would be income to the guarantor but not deductible, the latter result because the sale does not exist for income tax purposes. As a practical matter, the appraiser valuing the business should also be able to recommend a guarantee fee.

4887 Reg. § 25.2702-3(b)(4).

4888 A sale uses the applicable federal rate (§ 1274), and a GRAT uses the § 7520 rate, which is 120% of the annual mid-term rate (rounded to the nearest 0.2%). A sale can have interest-only payments with a balloon payment upon maturity, with optional principal prepayments. A GRAT must have relatively even payments, with any year's payment no greater than 120% of the prior year's payment. Reg. § 25.2702-3(b)(1)(ii). Thus, a GRAT requires higher payments up-front, which leaves less in the trust to grow.

- If the grantor dies during the term, the assets in the trust should not be brought back into the grantor's estate[4889] (unlike a GRAT).[4890] On the other hand, if one is using low basis assets and the grantor dies before significant estate tax savings are realized, the tax benefit of the basis step-up from the GRAT's includability might very well exceed the tax detriment of estate tax on the growth. Life insurance might help take some of the sting out of this lack of basis step-up. Also, having a business interest included in one's estate may generate estate tax deferral under Code § 6166, whereas a promissory note is not eligible for that deferral.[4891]

- The grantor can apply GST exemption up front on a highly leveraged basis (in other words, using a small amount of GST exemption relative to the property transferred to the trust); whereas, to make a GRAT exempt the grantor would apply GST exemption at the end of its term, based on the trust's asset's values at that time:[4892]

[4889] If the promissory note is considered an interest in the trust and is worth less than the stock sold, the IRS might argue that the sale was not for adequate and full consideration and attempt to include the trust in the grantor's estate under Code § 2036(a)(1). The IRS' argument would be that the only source of payment was the transferred property and that the grantor retained an interest in the trust. This has been a point of contention in sales for private annuities, as described in fn. 4843, found in part III.B.1.g.i Private Annuities: Estate Planning Implications. This issue generally does not arise when selling to an individual, as shown by Rev. Rul. 77-193 (but in a more complex set of facts):

> In addition, since B's promise to pay for the timber rights is a personal obligation of B as transferee, the obligation is not chargeable to the transferred property, and the payments are wholly independent of whether or not the transferred property produces income for the transferee. Thus, no part of the transferred property is includible in the transferor's gross estate under section 2036(a)(1) of the Code. See the following footnote in *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U. S. 274, 280 (1958), 1958-1 C.B. 557, 559:
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> > Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his life-time, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. *E.g.*, *Estate of Sarah A. Bergan*, 1 T.C. 543, *Acq.*, 1943 Cum. Bull. 2; *Security Trust & Savings Bank, Trustee*, 11 B.T.A. 833; *Seymour Johnson*, 10 B.T.A. 411; *Hirsh v. United States*, 1929, 35 F.2d 982, 68 Ct. Cl. 508; *cf. Welch v. Hall*, 1 Cir. 134 F.2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.
>
> Accordingly, it is held that section 2036 of the Code does not apply to the transaction under which A conveyed timber rights to B for a term of years in exchange for a cash payment and promissory notes, not all of which had reached maturity at the time of A's death, and A subsequently conveyed all of his interest and estate in the land to C.

[4890] If the grantor dies while receiving payments from a GRAT, then all or part of the GRAT will be included in the grantor's estate under Code 2036(a)(1). In FSA 200036012, the IRS took the position that all of a GRAT is included under Code § 2039, but the better view is that Code § 2039 should not apply, the latter which is now confirmed by Regs. §§ 20.2036-1(c)(2), 20.2039-1(e).

[4891] See part III.B.5.d.ii Code § 6166 Deferral.

[4892] Code § 2642(f). One should opt out of automatic allocation of GST exemption to a GRAT upon inception. Although Reg. § 26.2632-1(c)(1)(i) provides, A direct skip or an indirect skip that is subject to an estate tax inclusion period (ETIP) is deemed to have been made only at the close of the ETIP, Reg. § 26.2632-1(c)(2)(ii)(A) provides that the value of transferred property is not

- If the grantor and spouse split gifts, then each may allocate GST exemption at the back end.[4893] Generally, gifts that may be included in the donor's estate should not be split, because the consenting spouse's gift tax exemption is not restored if the asset is included in the donor's estate. However, splitting GRATs that are nearly zeroed out would make any loss of gift tax exemption be nominal.

- One might consider the remaindermen selling their interest in the GRAT to a GST-exempt trust when the GRAT is created, so that the GRAT remainder becomes GST-exempt, an approach implicitly rejected by Letter Ruling 200107015 (charitable lead annuity trust, not a GRAT). Commentators have questioned Letter Ruling 200107015, some rejecting and some accepting its result as applied to GRATs;[4894] note that the trustee can make a distribution to a skip person, file the appropriate forms to run the statute of limitations (SOL) on the inclusion ratio, and resolve the issue of inclusion ratio when the SOL runs.[4895] However, also consider whether such a sale might result in the IRS arguing that the purchaser trust is included in the seller's estate if the seller is a beneficiary.[4896]

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considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate. A counter-argument to this is that the proceeds from annuity payments will be part of the grantor's gross estate no matter when the grantor dies; given that Reg. § 26.2632-1(c)(1)(iii) provides that an ETIP applies to the entire trust if any part of it is subject to an ETIP suggests that the less than 5% so remote as to be negligible exception will not apply to a GRAT until all of the annuity payments have been paid. Rather than choosing which argument is right, I take the easy route and opt out. Letter Ruling 201705002 allowed a donor to opt out late when she instructed the gift tax return preparer to opt out and the preparer inadvertently failed to elect out of the automatic allocation of GST exemption.

[4893] Code § 2652(a)(2); Reg. § 26.2652-1(a)(4), the latter which provides:

> *Split-gift transfers*. In the case of a transfer with respect to which the donor's spouse makes an election under section 2513 to treat the gift as made one-half by the spouse, the electing spouse is treated as the transferor of one-half of the entire value of the property transferred by the donor, regardless of the interest the electing spouse is actually deemed to have transferred under section 2513. The donor is treated as the transferor of one-half of the value of the entire property. See § 26.2632-1(c)(5) Example 3, regarding allocation of GST exemption with respect to split-gift transfers subject to an ETIP.

See also Reg. § 26.2632-1(c)(2), applying ETIP regarding the life of a spouse even if no gift splitting occurred.

[4894] See Harrington, Plaine & Zaritsky, ¶ 9.12[5] Assignments of Remainder Interests—Uncharted Waters (found within ¶9.12. Examples of Deferring or Minimizing the Application of the Generation-Skipping Transfer Tax), *Generation-Skipping Transfer Tax* (WG&L). But see Bramwell and Weissbart, The Dueling Transferors Problem in Generation-Skipping Transfer Taxation, *ACTEC Law Journal*, Vol. 41, No. 1 (Spring 2015) (concluding that the sale strategy does not work because the sale does not change the transferor).

[4895] See part III.B.3.a.ii Sale from One Trust to Another, especially the text accompanying fn. 5307.

[4896] See *Estate of Magnin v. Commissioner*, 184 F.3d 1074 (9th Cir. 1999) (not included in seller's estate), *rev'g* T.C. Memo. 1996-25; *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997) (not

S corporation stock can work very well for a GRAT or sale to an irrevocable grantor trust over a 5-10 year period. Frequently, S corporation stock is valued at 4-5 times earnings, so it is easy to pay for the sale. For example, suppose an S corporation generates $200,000 of net cash flow per-year and distributes $90,000 each year to the shareholders so that they can pay their taxes. The corporation is worth $1 million (5 times earnings). In the first year, the promissory note payments from the trust to the grantor are $90,000, which the grantor uses to pay taxes as usual. The $90,000 payments are $60,000 interest (using a 6% AFR) and $30,000 principal. If the corporation distributes all of its earnings to get estate tax matters taken care of, then it distributes $200,000 in the first year, which the trust could use to pay $60,000 interest and $140,000 principal. In the second year, the trust could use the $200,000 distribution to pay $51,600 interest and $148,400 principal. The note could easily be paid off in 5-10 years, even if the corporation's earnings do not increase.

For hard-to-value assets, a GRAT that does not have a lot of cash flow might require payments be made in kind. The IRS might argue that the payments back to the grantor were overvalued, so that the grantor really did not receive a large enough annuity payment. To reduce this possibility, consider using do an increasing annuity with enough liquid assets to be sure to pay the first three years of payments, the GRAT borrowing from a bank to make the distributions, or using a formula distribution equal to the annuity payment.

For a sale to an irrevocable grantor trust involving an asset that does not generate much cash flow, consider how the note will be repaid; if one cannot develop a solid plan for repaying the note consider alternative strategies. Consider instead using a GRAT or sale to an irrevocable grantor trust to generate cash flow, which then might be used to buy that non-cash-flowing asset. GRATs and sales to irrevocable grantor trusts can also be used to roll out of a split-dollar arrangement, which generally require an exit strategy.[4897]

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included in seller's estate), *rev'g* 77 A.F.T.R.2d 96-1411 (W.D. Tex. 1996); *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3rd Cir. 1996) (not included in seller's estate), *rev'g* 105 TC 252 (1995), *cert. denied* 1997 WL 134397 (5/19/1997). *D'Ambrosio* distinguished *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd* 897 F.2d 516 (Fed. Cir. 1990), and *Pittman v. United States*, 878 F.Supp. 833 (E.D. N.C. 1994), with the Fifth Circuit stating:

> In support of its equilibrium rule, the *Gradow* court cited precedent in the adequate and full consideration area, most notably *United States v. Allen*, 293 F.2d 916 (10th Cir.), *cert. denied*, 82 S.Ct. 378 (1961).
>
> ….
>
> The problem with the *Gradow* dicta is that, in its effort to escape the hypothetical posed by the taxpayer, it lost sight of the very principle the court was trying to apply; namely, the notion that adequate and full consideration under the exception to section 2036(a) requires only that the sale not deplete the gross estate. *Gradow* was correct in observing that it is not unreasonable to require that, at a minimum, the sale accomplish an equilibrium for estate tax purposes. *Gradow*, 11 Cl. Ct. at 813-14. Indeed, *United States v. Allen*, 293 F.2d 916, when properly construed, stands simply for that proposition.

CCM 201745012 listed other reasons why it believes that that a deathbed purchase by the grantor of a GRAT of the remainder interest for its actuarial value did not work.

[4897] See part II.Q.4.f Split-Dollar Arrangements.

For marketable securities, consider using a rolling, asset-splitting GRAT strategy, which is as follows:[4898] The grantor divides the grantor's marketable securities portfolio into baskets that move in different directions. For the sake of developing an example, consider using four different baskets and starting with four separate two-year GRATs.[4899] Each GRAT distributes roughly half of the initial value of its assets on its first anniversary and a slightly larger one on the second anniversary on its second anniversary. If anything is left at the GRAT's termination, it might continue in an irrevocable grantor trust for the grantor's children or might be distributed to them.[4900] If a GRAT does well, the children get the excess growth; if it does not do well, the grantor absorbs the loss. If an asset hits a peak during the GRAT's term, the grantor might swap it out for a stable asset to lock in the gain. Each year, when the grantor receives roughly one-half of the initial value of the assets, the grantor places them in another GRAT. Thus, the grantor starts with four GRATs, but after the first year creates another set of four two-year GRATs. Thus, generally the grantor would have eight GRATs. Because each GRAT's funding should occur on a single day, consider using an LLC to hold a basket, so that asset transfers can be done using assignments of LLC interests instead of moving assets. Each LLC will be disregarded for income tax purposes so long as all of the owners are GRATs or other revocable or irrevocable grantor trusts owned by the same person.[4901]

With either technique, if the grantor's spouse is also the parent of the grantor's descendants who are beneficiaries of the trust, the grantor might consider including the spouse as a beneficiary (sometimes known as a SLAT – spousal limited access trust). A disadvantage of this approach would be the inability to turn off the grantor trust status, in whole or in part; authorizing an independent trustee to make distributions for the spouse's welfare might ease the pain of unrelenting grantor trust status.

Finally, if the asset being transferred is an interest in a closely-held business, consider liquidity to pay estate tax. If the grantor dies during the initial GRAT term, any business interest that is included in the grantor's estate is potentially eligible for long-term estate tax deferral.[4902] If the grantor dies holding a note from a sale to an irrevocable grantor trust, the note is a passive asset for which deferral is not available. The grantor might consider term life insurance to fund any estate tax incurred on the note. The parties might also prepare in advance documents to effectuate a sale of the business asset from the irrevocable grantor trust back to the grantor in exchange for the remaining balance on the note, so that the sale back to the grantor could be effectuated on short notice if the grantor is about to die.[4903] The sale back to the grantor might not only provide a

[4898] I first heard of this strategy listening to Carlyn McCaffrey lecture at Heckerling in 2001.

[4899] Ideally, one would have separate GRAT for each asset. However, the strategy needs to be practical to work. Whether one should have more or fewer baskets depends on the client's situation.

[4900] Generally my preference would be an irrevocable grantor trust, but consider GST complexity in doing this. Many permutations of back-end strategies might constitute reasonable approaches.

[4901] See fn. 272.

[4902] See part III.B.5.d.ii Code § 6166 Deferral.

[4903] The sale might be a formula sale, buying back the portion of business assets having a value equal to the remaining value of the note, as finally determined for federal gift tax purposes. See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

chance of estate tax deferral but also might generate a basis step-up in the reacquired assets.[4904]

III.B.2.c. GRIT Instead of GRAT for Divorced or Otherwise Unrelated Parties

If Code § 2702 does not apply, one can use a retained income interest instead of a GRAT.

Reg. § 25.2702-1(c)(7) excludes from Code § 2702:

> *Certain property settlements*. A transfer in trust if the transfer of an interest to a spouse is deemed to be for full and adequate consideration by reason of section 2516 (relating to certain property settlements) and the remaining interests in the trust are retained by the other spouse.

Reg. § 25.2702-4(d) explains:

> *Example (5)*. H and W enter into a written agreement relative to their marital and property rights that requires W to transfer property to an irrevocable trust, the terms of which provide that the income of the trust will be paid to H for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to W. H and W divorce within two years after the agreement is entered into. Pursuant to section 2516, the transfer to H would otherwise be deemed to be for full and adequate consideration. Section 2702 does not apply to the acquisition of the term interest by H because no member of H's family acquired an interest in the property in the same transaction or series of transactions. The result would not be the same if, on the termination of H's interest in the trust, the trust corpus were distributable to the children of H and W rather than W.

The last sentence of the above example point out an important issue: When a divorce decree benefits children beyond the support owed to them, then either the obligor has made a gift to the children or the spouse who gave up rights to create the obligation to the children is making a gift.[4905] Letter Ruling 9235032 would treat the whole transfer in the above Example as a gift if the children are included as beneficiaries and the spouse did not have a qualified retained interest.

However, suppose spouse A creates a trust to pay income to spouse B for life, remainder to spouse A. If the two divorce within two years after entering a separation agreement that requires the creation of this trust, this transaction will not be subject to Code § 2702; and, if spouse A predeceases spouse B, then the trust will be included in spouse A's estate. Minus the value of spouse B's income interest.[4906] If, after the

[4904] For the latter, consider whether Code § 1014(e) might apply and whether the assets should therefore be bequeathed to persons other than the irrevocable grantor trust.
[4905] Rev. Ruls. 68-379, 79-363.
[4906] Letter Ruling 201707007.

divorce, A gives the remainder interest in the trust to A's and B's children, Code § 2702 will not apply, because B will no longer be married to A.[4907]

Note also that, when former spouses re-arranging their obligations of alimony and child support settled with a lump sum payment, that change was not subject to gift tax.[4908]

III.B.2.d. Income Tax Effect of Irrevocable Grantor Trust Treatment

III.B.2.d.i. Federal Income Tax and Irrevocable Grantor Trust Treatment

III.B.2.d.i.(a). General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation

Both a GRAT and a sale to an irrevocable grantor trust rely on grantor trust treatment.[4909] If a GRAT were not a grantor trust, using property other than cash to satisfy the annuity would constitute a taxable sale.[4910]

If the grantor or another person is treated as the owner of any portion of a trust under the grantor trust rules, that person's taxable income and credits includes those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.[4911] Such an item of income, deduction, or credit is treated as if it had been received or paid directly by the grantor or other person.[4912]

CCA 201343021, issued by policy maker Bradford R. Poston, Senior Counsel, Branch 2, Passthroughs & Special Industries, commented:

> We believe that Rev. Rul. 85-13 should be read broadly, requiring that a grantor trust not be recognized as a separate taxable entity for federal income tax purposes if someone has such dominion and control over it as to create a single identity of interest between the trust and the owner. As Rev. Rul. 85-13 states, it would be anomalous for the existence of a grantor trust would be ignored for purposes of attribution of income, deduction, and credit, and yet retain its identity as a separate entity capable of entering into a sales transaction with the owner. When a grantor or other person exercises dominion and control over a trust, either by retaining a power over or an interest in the trust by dealing with the trust property for the owner's benefit, the owner has treated the trust property as though it were the owner's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is consistent with and

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[4907] Except for the part about estate inclusion, the example and analysis were by C. McCaffrey & J. McCaffrey, "*Obergefell* and the Authority of the IRS to Challenge Valid Marriages and Divorces," *Steve Leimberg's Estate Planning Email Newsletter*, No. 2345 (9/21/2015).
[4908] Letter Ruling 201206005.
[4909] Key rulings include Rev. Ruls. 81-6, 85-13, 2004-64, 2007-13, 2008-22, and 2011-28, as well as Rev. Procs. 2008-45 and 2008-46. Other pronouncements touching upon these rules include Notice 90-1 and Rev. Ruls. 88-103, 90-7 and 2004-86. For more on Rev. Rul. 2004-64, see fns. 5273-5291, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner.
[4910] Reg. § 1.661(a)-2(f).
[4911] Code § 671.
[4912] Reg. § 1.671-2(c)

supported by the rationale for attributing items of income, deduction, and credit to the owner. Accordingly, we conclude that a trust that is treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes, including §§ 267 and 707(b)(1)(A).

The CCA continued:

[I]t should be noted that there have been a very limited set of circumstances after the publication of Rev. Rul. 85-13 where the Service or the courts have treated a grantor trust and its owner as separate entities for a federal income tax purpose:

(1) *Rothstein* itself has never been overturned, and theoretically is still good law in the Second Circuit. We have found only one case which, in dicta, follows the reasoning in *Rothstein*. In *Zand v. Comm'r*, T.C. Memo 1996-19, the Tax Court found that a grantor was not the owner of a trust under § 675(3), relating to grantor borrowings from the trust, because the loan met the exceptions provided in § 675(3) for borrowings with adequate interest and security made by an independent trustee. The Court continued, however, that even had the grantor been properly treated as the owner, he still would have been able to deduct interest paid to the trust because the grantor trust provisions only relate to income attribution.

(2) Rev. Rul. 85-13 never explicitly revoked or modified Rev. Rul. 74-243, 1974-1 C.B. 106. Rev. Rul. 85-13 cites numerous cases and rulings for its conclusion, but also mentions Rev. Rul. 74-243 as one counter-example. In Rev. Rul. 74-243, a corporate executive accepted a government appointment and transferred property, including a qualified stock option, to a "blind trust" which would have been a grantor trust under §677, although the ruling does not explicitly describe it as a grantor trust. The ruling concludes that the transfer of the option to the trust was a taxable disposition under § 425. Rev. Rul. 74-243 has not been applied or cited approvingly by the Service or a court after 1985, although it arguably still technically reflects the Service's position under the narrow facts of the ruling. Moreover, at least two PLRs (9124019, 9309027) (both issued by CC:TEGE apparently without coordinating with CC:PSI) have allowed similar transfers to grantor trusts without triggering a taxable disposition.

(3) *Textron v. Comm'r*, 117 T.C. 67 (2001) was arguably inconsistent with Rev. Rul. 85-13. In *Textron*, a domestic corporation owned substantially all the stock of a foreign corporation, which it was ordered (initially by the Federal Trade Commission, and later confirmed by a federal district court injunction) to transfer to a voting trust with a court-appointed trustee. It was uncontested that the voting trust was a grantor trust to Textron under § 677. The issue before the Tax Court was whether Textron was taxable on the foreign corporation's subpart F income during the existence of the voting trust; the Court found that the trust, not Textron, was the shareholder for purposes of §§ 951(a) and 958(a), but then ruled in favor of the government on the alternative ground that the trust was taxable as the subsidiary's U.S. shareholder, with the subpart F income then flowing through to Textron. The decision was criticized for its inconsistency with Rev. Rul. 85-13 and other grantor trust authority in Stevens, Matthew A., "A Grantor Trust Visits

Subpart F: Ruminations on *Textron v. Commissioner* and other Anomalies", 21 *Va. Tax Rev. 507* (2002).

(4) PLRs 201117042 and 201129045 appear to conflict with Rev. Rul. 85-13. PLRs 201117042 and 201129045 were issued by IRS Employee Plans, and state that an individual retirement account (IRA) cannot be transferred to a grantor trust of the IRA owner.[4913] The conflict between these rulings and Rev. Rul. 85-13 was noted in Beers, Deborah M., "IRS Issues Two Seemingly Contradictory Rulings on Effects of Transfer of IRA to Special Needs Grantor Trust," 36 *Tax Mgmt. Est. & Tr. J* 230 (2011) and Jones, Michael J., "The Economy and other Retirement Mysteries," *Trusts & Estates*, January 2012, at 35. Both articles mention prior PLRs issued by the same office appearing to accept that the owner of a grantor trust is the owner of its assets, which may include an IRA. See PLRs 200620025, 200826008, and 201116005.

The deemed owner of a portion of the trust is also deemed to directly own that portion of the trust's property.[4914] Thus, when a person who is deemed to own all of a trust sells assets to that trust, no transaction is deemed to have occurred.[4915] Furthermore, when the grantor trust status is turned off, the sale does not spring into existence merely because a sale had occurred.[4916] When the deemed owner of a trust sells its interest in the trust, the seller is deemed to sell the trust's assets to the buyer, and the buyer becomes the trust's deemed owner.[4917]

[4913] [This is my footnote and not from the CCA:] Reg. § 1.408-4(a)(2) prohibits an individual from assigning the IRA. How does this interact with the fact that grantor trusts generally are disregarded? Choate, ¶ 6.1.06, *Life and Death Planning for Retirement Benefits* (Digital Edition, viewed 6/28/2016), suggests that a transfer to a grantor trust that permitted distributions to anyone other than the individual IRA owner during that individual's life would be a transfer triggering Reg. § 1.408-4(a)(2). Given that Letter Rulings 200620025, 200826008, and 201116005 approved transfers of inherited IRAs to special needs trusts for the benefit of the beneficiary, that suggestion appears consistent with the IRS' approach.

[4914] Notice 90-1 stated, If the grantor is treated as the owner of all the trust under sections 671 through 677, the grantor is considered to be the owner of the trust assets for federal income tax purposes. Rev. Rul. 2004-86 followed that idea. Rev. Rul. 87-61 points that, under Rev. Rul. 85-13, a grantor who is treated as the owner of a portion of a trust represented by specific trust property is considered to be the owner of that property, and Rev. Rul. 88-103 makes a similar statement. Rev. Rul. 90-7 applied that concept to an exchange of closely-held business stock. Rev. Rul. 2007-13 reaffirmed this principle; see fn. 3131.

[4915] Rev. Rul. 85-13, reasoning, A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. See *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925).

[4916] See Letter Rulings 201436006 and 201436007 in fn. 4516.

[4917] A specialized application of this idea involving multiple grantors is in part II.D.4.a Investment Trusts. For the proposition cited in the text, TAM 200814026 reasoned:

> The transaction is properly characterized as follows: (1) prior to Date 8, X, the seller and grantor, was treated as the owner of Trust 1 under § 677; (2) if a grantor is treated as the owner of the entire trust, the grant or is treated as the owner of the trust's assets for federal income tax purposes, and X's sale of the beneficial ownership interest in Trust 1 to Taxpayer is treated as a sale of X's assets; (3) Taxpayer therefore is treated as purchasing the assets of Trust 1; (4) Taxpayer is treated as forming a new trust; and (5) Taxpayer is treated as contributing the Trust 1 assets to the new trust. Taxpayer thus is treated as a grantor with respect to Trust 1 pursuant to § 1.671-2(e)(1), which provides

Rev. Rul. 85-13 ignored the existence of a note that its deemed owner owed a trust. This seems analogous to disregarding a debt that one division of a corporation owes another division.[4918]

A gift to a trust occurs for income tax purposes not when the gift is made but rather when the grantor trust powers are turned off.[4919]

Code § 1015(d) provides a basis increase when gift tax is paid on a gift. However, because a transfer to a grantor trust does not exist for income tax purposes, is it a gift under Code § 1015(d), or does Code § 1015(d) merely look to whether a gift was made for gift tax purposes? The latter appears to be the rule.[4920] However, to avoid doubt on the consequence of any gift tax paid when a transfer is made to a trust, consider having the grantor trust status with respect to such a gift arise, through an automatic trigger, at some point after the tax-triggering gift is made.

Generally, converting from a nongrantor trust to a grantor trust is not a realization event,[4921] and the IRS has taken the position that the conversion is not even considered

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> that the term "grantor" includes a person who makes a non-gratuitous transfer of property to a trust, and as an owner under § 677. As a result, Taxpayer may not properly claim a bad debt deduction to discharge its obligation on the Notes through the redemptions on Dates 11 through 17 because transactions between Taxpayer and Trust 1 are disregarded for federal income tax purposes.

[4918] Rev. Rul. 80-228 involved the following facts:

> X corporation operated its business in two entirely separate divisions ("Division 1" and "Division 2"), keeping a separate bank account and a separate set of books for each division. Each division also maintained an intracompany account in their respective books of account and transactions between the two divisions were recorded therein. For valid business reasons X organized a new corporation, Y. All the assets of Division 2 were transferred by X to Y at net book value in exchange for all of the stock of Y. At the time of the transfer, the intracompany account payable due to Division 1 from Division 2 was 100x dollars. On its opening balance sheet Y listed an account payable to X of 100x dollars and X, conversely, listed an account receivable from Y of 100x dollars. Within one year after the transfer the account payable of Y was paid in full to X.

Disagreeing with the Code § 351(b) analysis of *Wham Construction Company, Inc. v. United States*, Civil No. 72-689 (D.S.C., Feb. 16, 1976), *aff'd* Civil No. 76-2047 (4th Cir. 1979), Rev. Rul. 80-228 held:

> In the instant case the account receivable to X from Y was a note or other evidence of indebtedness received by X in a section 351 transaction and it constituted "other property" for purposes of section 351(b) of the Code. This is due to the fact that the preincorporation intracompany accounts could not have given rise to a debtor-creditor relationship between X and Y because X could not, prior to incorporation of Y, have been liable for a debt to itself. The intracompany accounts were mere bookkeeping entries by X, a single corporation, to show the activities of separate divisions for internal accounting purposes.

[4919] Reg. § 1.671-2(e)(2)(i) provides, "A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes."

[4920] Without mentioning why this might be a concern, Letter Ruling 9109027 ruled that gift tax paid on a GRIT that was a wholly owned grantor trust caused a basis increase. For some factual background on the ruling, see fn. 2600 in part II.M.4.c.i When a Gift to an Employee Is Compensation and Not a Gift.

[4921] CCA 200923024 made a strong statement to this effect:

to be a distribution to the grantor.[4922] However, one might exercise caution where the nongrantor trust has debt in excess of basis, in case a rule similar to the converse situation arises: when a trust converts from a grantor trust to a nongrantor trust during the grantor's life, the grantor being relieved of debt in excess of the basis of the trust's assets causes income to be recognized.[4923] See also part III.B.2.j Tax Allocations upon Change of Interest, given that a change in grantor trust status is a change in ownership for income tax purposes.

An irrevocable grantor trust's assets that are not included in the grantor's estate generally would not receive a new basis at the grantor's death.[4924] See part II.H.5 Irrevocable Trust Planning and Basis Issues.

> Assuming the transaction in the present case is abusive, asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations. A nongrantor trust may become a grantor trust in several situations: examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§ 674); a borrowing of the trust corpus under § 675(3) (discussed below in ISSUE 2 with regard to the application of Rev. Rul. 85-13); or the payment of the grantor's legal support obligations under § 677(b). No prior guidance dealing with these events has indicated that they result in taxable income to the deemed transferee (the owner of the grantor trust). Rev. Rul. 85-13 concluded that the grantor became the owner of the trust corpus which he had indirectly borrowed and thus was taxable on the trust's income and, as the deemed owner of the trust assets, could not engage in a transaction with the trust that would be respected for income tax purposes. It did not conclude that the grantor realized the amount of the indirect borrowing or any portion of that amount as income under § 61 or any other section. Therefore, while we agree that this appears to be an abusive transaction, the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor.

The CCA suggesting attacking a transaction that potentially abused the grantor trust rules instead by considering applying the step transaction, the economic substance doctrine or other judicial doctrines. I have been told that Brad Poston wrote the CCA.

[4922] Letter Rulings 201730012, 201730017 and 201730018, all under Brad Poston's name, held:

> Rev. Rul. 77-402 concludes that the lapse of grantor trust status during the grantor-owner's life may have income tax consequences, but does not impose such consequences on a non-grantor trust that becomes a grantor trust. Rev. Rul. 85-13 describes the income tax effects of a non-grantor trust becoming a grantor trust, which effects did not include the realization or recognition of any income by the grantor-owner by reason of the conversion. Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision.

The grantor had created a nongrantor charitable lead trust, and want a ruling that the conversion to a grantor charitable lead trust would constitute a distribution to the grantor, followed by a deductible charitable contribution; see Code § 170(f)(2)(B). The IRS may have simply been trying to prevent toggling on grantor trust status from generating a deduction.

[4923] See parts III.B.2.j.i Changing Grantor Trust Status and III.B.2.g Income Tax Concerns When Removing Property from the Estate Tax System, fn. 4974.

[4924] At the May 2017 meeting of the Fiduciary Income Tax Committee of the American Bar Association's Section on Taxation, Brad Poston informally stated that he viewed an irrevocable trust's termination of grantor trust status at death as not being the kind of passing from a decedent contemplated by Code § 1014.

Reg. § 1.108-9, dealing with excluding cancellation of indebtedness income under the insolvency and bankruptcy provisions of Code § 108, would not disregard a grantor trust in all cases.

III.B.2.d.i.(b). Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation

A person may be the deemed owner of none, part, or all of a trust. The deemed owner includes "those items of income, deduction, and credit against tax attributable to or included in that portion."[4925] For example:

(1) A person who is treated as the owner of an entire trust (corpus as well as ordinary income) takes into account all items of income, deduction, and credit (including capital gains and losses) to which that person would have been entitled had the trust not been in existence during the period that person is treated as owner.[4926]

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion, items directly related to trust property not included in the portion treated as owned by the person are taxed under the nongrantor trust rules, and items that relate to both portions "must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent."[4927]

(3) If the portion of a trust treated as owned by a person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item is normally allocated to the portion.[4928] If a slice of the entire trust is involved, see part III.B.2.i.vi Portion Owned When a Gift Over $5,000 is Made. Regarding rights to corpus or income, regulations provide:

> … where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion.[4929]
>
> If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust.[4930]

4925 Reg. § 1.671-3(a).
4926 Reg. § 1.671-3(a)(1).
4927 Reg. § 1.671-3(a)(2).
4928 Reg. § 1.671-3(a)(3).
4929 Reg. § 1.671-3(a)(3).
4930 Reg. § 1.671-3(c), incorporated by reference into Reg. § 1.671-3(a)(3).

If a person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus.[4931] For example:

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone.[4932]

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included.[4933]

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph.[4934]

If only income allocable to corpus is included in computing a deemed owner's tax liability, the deemed owner will take into account in that computation only those items that would not be included under the nongrantor trust rules when computing the current

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[4931] Reg. § 1.671-3(b).

[4932] Reg. § 1.671-3(b)(1), which further provides:

> Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674-678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

[4933] Reg. § 1.671-3(b)(2), which further provides:

> For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676(a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

[4934] Reg. § 1.671-3(b)(3), which further provides:

> For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

income beneficiaries' tax liability if all distributable net income had actually been distributed to those beneficiaries.[4935]

On the other hand, if a person is treated as an owner solely because of the person's interest in or power over ordinary income alone, the person will take into account in computing the person's tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income.[4936]

See Reg. § 1.677(a)-1(g) for examples when a grantor has a current or reversionary right to income.

In addition to determining the types of items attributed deemed ownership, one needs to know for what part of the year the grantor is deemed to own those items. Under Code § 675(3),[4937] a grantor-trustee who has both borrowed the entire[4938] trust corpus and repaid the borrowed funds plus interest in the same year is treated for federal income tax purposes as the owner of the entire trust for that year, notwithstanding full payment.[4939] Except for that power, turning off the grantor trust features generally is effective for the rest of the year.[4940] See also part III.B.2.j.i Changing Grantor Trust Status, which is part of part III.B.2.j Tax Allocations upon Change of Interest in a Business, which explores how such changes affect allocations of K-1 income from partnerships and S corporations. Within the latter discussion, fn. 5172 supports the following surprising result:

[4935] Reg. § 1.671-3(c).

[4936] Reg. § 1.671-3(c).

[4937] See part III.B.2.h.iii Borrow Power, especially fns. 5010-5012.

[4938] For borrowing less than all of the income, see *Bennett v. Commissioner*, 79 T.C. 470 (1982). For borrowing all of the income, see *Benson v. Commissioner*, 76 T.C. 1040 (1981).

[4939] Rev. Rul. 86-82, reasoning:

> In *Mau v. United States*, 355 F.Supp. 909 (D. Hawaii 1973), the taxpayer established five separate trusts, with the taxpayer designated trustee of each. In 1965, the taxpayer borrowed money from each of the trusts. These amounts were not repaid until 1969. The taxpayer argued that section 675(3) of the Code did not cause the taxpayer-grantor to be liable for federal income tax on the trusts' 1965 income because the loans were not outstanding at the beginning of the year. The court rejected this interpretation of the statute, reasoning that section 675(3) was enacted to prevent the shifting of taxable income in situations where a grantor retained control and use of trust properties through borrowing. Therefore, the court held that the borrowing of trust corpus or income by a grantor at any time during a taxable year would result in the grantor being taxed on trust income for that entire year under section 675(3). The court concluded that the taxpayer was taxable on income of the trusts in 1965, the year the borrowing occurred, even though the loans were made after the beginning of the year. If section 675(3) otherwise applies for a given year, its effect is not avoided by making repayment before the year closes. *Mau* therefore stands for the principle that section 675(3) applies for any year during any part of which a loan by a trust to the grantor-trustee is outstanding.

[4940] Reg. § 1.1001-2(c), Example (5) would deem this transfer to occur on the day the grantor trust powers are turned off; this was followed by *Madorin v. Commissioner*, 84 T.C. 667 (1985). See Zaritsky, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms*, ¶ 3.02[3][j][iii] Turning off grantor trust status, for a complete analysis of this topic.

> Irrevocable trust holds stock in S corporation. Grantor turns off grantor trust status, effective the end of December 30. The S corporation sells its assets December 31 (or is deemed to do so when the trust sells its stock and elects to treat the stock sale as an asset sale).[4941] Because the grantor owned the stock for almost all of the year, the grantor is taxed on almost all of the gain, notwithstanding the fact that the trust was not a grantor trust when the stock was sold. If the stock were not sold until the following January 1, the grantor would not be taxed at all.

III.B.2.d.i.(c). Federal Fiduciary Income Tax Reporting of Irrevocable Grantor Trust Treatment

Generally, items of income, deduction, and credit attributable to any portion of a trust that the grantor trust rules treat as owned by the grantor or another person, are not reported by the trust on Form 1041, "U.S. Income Tax Return for Estates and Trusts," but are shown on a separate statement to be attached to that form.[4942] Exceptions apply to certain trusts deemed owned all by one person, widely held fixed investment trusts, and environmental remediation trusts.[4943]

Eligible trusts may report differently. Ineligible trusts include a common trust fund under Code § 584(a), a trust that has its situs or any of its assets located outside the United States, a QSST,[4944] a trust all of which is treated as owned by one grantor or one other person whose taxable year is a fiscal year, a trust all of which is treated as owned by one grantor or one other person who is not a United States person, and a trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.[4945] Ineligible trusts also include a trust the deemed owner of which is an exempt recipient for information reporting purposes and a trust treated as owned by two or more persons, the latter trust if one or more deemed owners are exempt recipients for information reporting purposes unless not only at least one deemed owner of the trust is a person who is not an exempt recipient for information reporting purposes but also the trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients for information reporting purposes.[4946]

An eligible trust, all of which is treated as owned by one person, may furnish the deemed owner's name and taxpayer identification number (TIN) and the trust's address to all payors during the taxable year, and comply with certain additional requirements,[4947] and the trustee is not required to file any type of return with the IRS.[4948] The deemed owner must provide to the trustee a complete Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury.[4949] Unless the deemed owner is the trustee or a co-

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[4941] The election is described in part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[4942] Reg. § 1.671-4(a).
[4943] Reg. § 1.671-4(a).
[4944] See part III.A.3.e.i QSSTs, found in part III.A.3.e QSSTs and ESBTs.
[4945] Reg. § 1.671-4(b)(6).
[4946] Reg. § 1.671-4(b)(7).
[4947] Reg. § 1.671-4(b)(2)(i)(A).
[4948] Reg. § 1.671-4(b)(2)(ii)(B).
[4949] Reg. § 1.671-4(b)(7).

trustee of the trust, the trustee must furnish the deemed owner of the trust with a statement that:[4950]

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

(2) Identifies the payor of each item of income;

(3) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(4) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

Another alternative method an eligible trust may use is to furnish the trust's name, TIN, and address to all payors during the taxable year.[4951] In that case, the trustee must file with the IRS the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the deemed owner of the trust as the payee.[4952]

Unless the deemed owner of the trust is the trustee or a co-trustee of the trust, the trustee must also furnish to the deemed owner of the trust a statement that:[4953]

(i) Shows all items of income, deduction, and credit of the trust for the taxable year;

(ii) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(iii) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

[4950] Reg. § 1.671-4(b)(2)(ii)(A).

[4951] Reg. § 1.671-4(b)(2)(i)(B).

[4952] Reg. § 1.671-4(b)(2)(iii)(A), which also provides:

> The trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. See paragraph (b)(5) of this section regarding the amounts required to be included on any Forms 1099 filed by the trustee.

[4953] Reg. § 1.671-4(b)(2)(iii)(B)(1). This statement satisfies the trustee's obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee. Reg. § 1.671-4(b)(2)(iii)(B)(2).

For purposes of all of the above rules in this part III.B.2.d.i.(c), a trust all of which is treated as owned by a married couple filing jointly under Code § 6013 is considered to be owned by one grantor.[4954]

A grantor trust owned by a business in a large multinational enterprise might be required to file Form 8975.[4955]

III.B.2.d.i.(d). S Corporation Issues Regarding Irrevocable Grantor Trust Treatment

See parts III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures, III.A.3.b.i A Trust All Of Which Is Treated Under The Grantor Trust Rules As Owned By An Individual Who Is A Citizen Or Resident of the United States, and III.A.3.b.ii A Trust That Was A Grantor Trust With Respect To All Of Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death.

If S corporation stock is reported under the first alternative method (using the deemed owner's TIN) and the deemed owner actually owns or is deemed to own (using the deemed owner's TIN) stock in the same S corporation, may the S corporation issue one K-1 to the deemed owner instead of a separate K-1 to each actual owner? If the S corporation takes that position, the K-1 should break out each actual owner's portion of the items, not only to respect each trust's separateness but also to facilitate any additional reporting required if the grantor is not the trustee or a co-trustee.[4956] Second, the S corporation must furnish to each person who is a shareholder at any time during such taxable year a copy of such information shown on such return as may be required by regulations.[4957] Reg. § 1.6037-1(a) requires Form 1120S to set forth:

(1) The names and addresses of all persons owning stock in the corporation at any time during the taxable year;

(2) The number of shares of stock owned by each shareholder at all times during the taxable year;

(3) The amount of money and other property distributed by the corporation during the taxable year to each shareholder;

(4) The date of each distribution of money and other property; and

(5) Such other information as is required by the form or by the instructions issued with respect to such form.

[4954] Reg. § 1.671-4(b)(1).
[4955] See text accompanying fn. 530 in part II.D.2 Business Entity as Grantor of Trust.
[4956] Reg. § 1.671-4(b)(2)(iii)(B)(1). This statement satisfies the trustee's obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee. Reg. § 1.671-4(b)(2)(iii)(B)(2).
[4957] Code § 6037(b).

Pages 21-22 were the only place in the Instructions for Form 1120S (2016) that I noticed a reference to shareholder identifying information. Although they do not discuss grantor trusts, they refer to a situation that might be analogous:

> If a single-member limited liability company (LLC) owns stock in the corporation, and the LLC is treated as a disregarded entity for federal income tax purposes, enter the owner's identifying number in item D and the owner's name and address in item E.

See also part II.A.2.f.ii Procedure for Making the S Election; Verifying the S Election; Relief for Certain Defects in Making the Election, especially fn. 118.

III.B.2.d.ii. State Income Tax Effect of Irrevocable Grantor Trust Treatment

Not all states recognize grantor trust status.[4958]

Thus, a transaction that might be ignored for federal income tax purposes might be subjected to state income tax.

III.B.2.d.iii. Effect of State Tax on Logistics Involving S Corporations and Partnerships Held in Grantor Trusts

Often states require withholding or similar payments regarding an owner's share of state tax liabilities.

When an irrevocable grantor trust owns an interest in an S corporation or partnership, the business entity might be required to make payments on behalf of the deemed owner. This can be awkward, in that the deemed owner is not the actual owner, and the business entity might not have a legal relationship with the deemed owner.

Consider how the business entity, trust, and deemed owner might contract regarding this flow of cash, so that the deemed owner is not treated as receiving a distribution from the business entity or the trust. When the deemed owner has sold assets to the trust and holds a note from the trust, these arrangements might be made in the form of deemed distributions from the entity to the trust, followed by note payments. When the note is fully repaid or the ownership structure is more complex, one might need to spend more time carefully planning any necessary arrangements and documenting them as burdens on the business entity under by state tax law and not something that is voluntarily arranged for the deemed owner's benefit.

III.B.2.e. Grantor Trust Tax Identification Number During Life and Upon Death

III.B.2.e.i. Grantor Trust Treatment During the Grantor's Life

Subject to certain exceptions,[4959] a grantor trust may use the taxpayer identification number (TIN) of the deemed owner rather than obtaining its own TIN.[4960] The deemed

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[4958] See part II.J.3.e.ii Whether a State Recognizes Grantor Trust Status; Effect of Grantor Trust Status on a Trust's Residence, especially fn. 1743.

[4959] Reg. § 1.671-4(b)(6) lists various exceptions, including requiring that a qualified subchapter S trust not use its beneficiary's social security number.

owner is required to give the trustee a Form W-9 reporting the deemed owner's TIN.[4961] Unless the deemed owner is the trustee or a co-trustee of the trust, the trustee must furnish the deemed owner of the trust with a statement that:[4962]

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

(2) Identifies the payor of each item of income;

(3) Provides the deemed owner with the information necessary to take the items into account in computing the deemed owner's taxable income; and

(4) Informs the deemed owner that the items of income, deduction and credit and other information shown on the statement must be included in computing the deemed owner's taxable income and credits on the deemed owner's income tax return.

As a practical matter, usually the trustee simply forwards to the deemed owner all information reporting forms the trustee receives.

If the trust does not use this reporting, then the trustee files fiduciary income tax returns (IRS Form 1041) and attaches a grantor information statement reporting the trust's income, etc. to be included on the deemed owner's return.[4963]

The trustee might want to consider the latter if:

- The grantor trust treatment is uncertain, so that the statute of limitations on the issue of grantor trust status can start running.

- The deemed owner has creditor issues. Although grantor trust status does not change a trust's asset protection features, a financial institution might use the deemed owner's TIN to determine which accounts to turn over to a creditor garnishing accounts held at the financial institution. The deemed owner then expends time and money to correct the financial institution's mistake. I have seen this happen.

If a trust has more than one owner, then generally the trust must report on Form 1041 using the latter procedure.[4964] However, if all of the trust is treated as owned by spouses who file a joint return, the spouses are treated as one owner.[4965] Whose social security number should be used presumably is a moot point for federal income tax purposes; if contributions are unequal, one might use the number of the spouse who contributed more than the other. However, in Missouri (and perhaps some other states), spouses have separate run-ups through the brackets, so one should consider what might be least likely to cause the state income tax return preparer to incorrectly allocate income.

[4960] Reg. § 1.671-4(b)(2)(i)(A).
[4961] Reg. § 1.671-4(b)(1).
[4962] Reg. § 1.671-4(b)(2)(ii)(A).
[4963] See Reg. § 1.671-4(b)(2)(B).
[4964] Reg. § 1.671-4(b)(3).
[4965] Reg. § 1.671-4(b)(8).

III.B.2.e.ii. Tax ID Issues When the Deemed Owner of a Grantor Trust Dies; Related Effect on Quarterly Payments of Estimated Income Tax

The trust (or portion of a trust) that ceases to be a grantor trust by reason of the deemed owner's death may no longer report under the grantor trust rules.[4966] If all of the trust was treated as owned by the decedent, the trust must obtain a new TIN upon deemed owner's death, if the trust will continue after the deemed owner's death.[4967] See the IRS links provided at part II.G.1.c How and When to Obtain or Change an Employer Identification Number (EIN).

Because the trust income tax return from after the date of death until December 31 will not be a taxable year of 12 months, the trust cannot use the prior year exception for calculating payments of estimated income tax.[4968]

However, payments of estimated income tax are not required, with respect to "any taxable year ending before the date 2 years after the date of the decedent's death," if the taxpayer is either the decedent's estate or a grantor trust wholly owned by the decedent before death, which trust is one "to which the residue of the decedent's estate will pass under his will (or, if no will is admitted to probate, which is the trust primarily responsible for paying debts, taxes, and expenses of administration)."[4969] Although the decedent's (previously) revocable trust generally would qualify, if one has any doubts then one might consider electing to treat the trust as part of the decedent's estate.[4970]

III.B.2.f. Triggering the Statute of Limitations for Grantor Trusts

The tax return for the deemed owner is what determines the statute of limitations for any grantor trust items.[4971]

When the trust turns into a nongrantor trust, the trust's return is the proper one to audit, even if it distributes income to the beneficiary.[4972]

III.B.2.g. Income Tax Concerns When Removing Property from the Estate Tax System

Note that gifts of properties subject to liabilities in excess of basis (sometimes referred to as "negative basis" assets,[4973] which is a technically incorrect description that gets the

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[4966] Reg. § 1.671-4(h)(2). Reg. § 1.671-4(h)(3) explains how to report the trust's income for that year.

[4967] Reg. § 1.671-4(h)(2), which also cross-references Reg. § 301.6109-1(a)(3)(i) for rules regarding obtaining a TIN upon the deemed owner's death.

[4968] The last sentence of Code § 6654(d)(1)(B) provides that the prior year exception "shall not apply if the preceding taxable year was not a taxable year of 12 months or if the individual did not file a return for such preceding taxable year."

[4969] Code § 6654(*l*)(2).

[4970] See part II.J.7 Election to Treat a Revocable Trust as an Estate.

[4971] *Lardas v. Commissioner*, 99 T.C. 490 (1992) (reviewed decision, with only one judge dissenting). For a quote from *Lardas*, see fn. 1133, found in part II.G.18 IRS Audits.

[4972] *Fendell v. Commissioner*, 906 F.2d 362 (8th Cir. 1990), *rev'g* 92 T.C. 708 (1989).

[4973] There is no such thing as a negative basis. Negative basis asset is just a shorthand description for a certain situation:

1. The basis of the partnership interest is zero, before considering liabilities.

point across) will trigger gain recognition. Even if one uses an irrevocable grantor trust as the donee, one must consider any income tax consequences when grantor trust status terminates.[4974] One might consider the grantor retaining an interest in the

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2. The partner's basis in liabilities allocated to the partner is less than the face amount of those liabilities.

Under Code § 752, the allocation of liabilities is considered a contribution that creates basis and a reduction in liabilities is considered a distribution that, under Code § 731, reduces basis or creates gain.

A so-called negative basis asset occurs when a partner has used not only the basis in item 1 but also has taken losses against his item 2 share of liabilities. The partner's basis in liabilities is zero or a positive number; it's just that the deemed distribution when liabilities are relieved exceeds the partner's basis in the liabilities that are relieved.

For example, ignoring all other partners: a partner contributes $100 to a partnership that borrows $50 and buys equipment for $150. The partnership writes off the full value of the equipment through depreciation deductions over time. The partner's capital account is negative $50 ($100 contribution minus $150 depreciation deductions). The partner's basis is zero: $100 actual contribution, plus $50 liabilities that constitute a deemed contribution, minus $150 in losses. If the partner were suddenly relieved of the $100 of liabilities, he would have no basis to absorb the $50 deemed distribution and would have to recognize income. The transfer of the partnership interest would cause that deemed distribution to occur. Having gain without receiving any cash is phantom income by reason of disposing of a negative basis asset, that really has a zero basis; this result is fair, because the partner already deducted $50 more than the cash he contributed ($150 deductions minus $100 cash contribution).

For the basis of the property that the trust is deemed to have received, see part III.B.2.a Tax Basis Issues, including fn. 4870.

[4974] If a grantor trust terminates during life in a manner that results in the grantor being relieved of liabilities, gain is recognized under Rev. Rul. 77-402 (reduction in allocation of liabilities with respect to a partnership interest); Reg. § 1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); see also fn. 4884 for installment sale issues. Regarding dispositions of partnership interests to which liabilities had been allocated, see Rev. Rul. 74-40, quoted in full in fn. 3859, found in part II.Q.8.b.i.(a) Code § 731: General Rule for Distributions, and Rev. Rul. 75-194 (deemed bargain sale of partnership interest contributed to charity), discussed in fn. 3313, found in part II.Q.6.b Possible Deemed Sale or Reduced Deduction When Contributing Partnership Interest to Charity. For grantor trust status generally and the effect of turning on grantor trust status, see part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, especially part III.B.2.d.i Federal Income Tax and Irrevocable Grantor Trust Treatment, especially fn. 4921. See also part III.B.1.c Gifts With Consideration – Bargain Sales.

Blattmachr, Gans & Jacobson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, 96 *J. of Taxation* 149 (Sept. 2002), asserts that gain is not recognized at death. CCA 200923024 appears to have accepted their arguments; relying on Rev. Rul. 85-13, the IRS lawyer said that turning on grantor trust status was not a taxable event. An excerpt from CCA 200923024 is in fn. 4921 in part III.B.2.d.i.(a) General Concepts of the Effect of Irrevocable Grantor Trust Treatment on Federal Income Taxation. Because no case has addressed this issue squarely, notwithstanding emphatic comments made by one of the co-authors of the cited article, the reader might consider advising clients that this tax treatment is a risk. I believe that this risk might also be a benefit – if gain is recognized, then the trust has a higher basis; since the trust is typically a GST-exempt entity and the income tax on the sale will likely be paid with assets that are not GST-exempt (as well as the income tax perhaps being a debt of the estate that reduces the amount subject to estate tax), paying the tax might be beneficial in the long run. Furthermore, if and to the extent that one is able to secure capital gain treatment on the sale and then depreciate the stepped-up basis, one might find this tax risk to be quite beneficial. See part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property). Some take the position that, even without this sale treatment, the assets receive a partnership and assuming liabilities in a side agreement,[4975] so that the grantor's estate and not the irrevocable grantor trust is allocated the liabilities in excess of basis, which would then be cleansed.[4976] This shifting should have no income tax consequences during life, since the client and the irrevocable grantor trust are deemed to be the same person. This shifting might or might be available, depending on the nature of the loan and the partners' respective legal liabilities, in which case other shifting opportunities might be available at the partnership level; one should coordinate carefully with the partnership's income tax return preparer.

Rev. Rul. 72-406 provides that the basis for the property deemed sold is based on the grantor's original basis.

For why one might not want to move low basis assets outside of the estate tax system and how to cleanse a "negative basis" situation, see part II.H Income Tax vs. Estate and Gift Tax (Particularly for Depreciable Property), especially part II.H.5 Irrevocable Trust Planning and Basis Issues.

If one does recognize gain on the termination of a grantor trust,[4977] generally the gain would be the extent that the amount realized by the grantor exceeds the grantor's adjusted basis in the property as described in part III.B.1.c Gifts With Consideration – Bargain Sales:

- Beware of any nonrecourse debt, because the basis against which the nonrecourse debt is allocated would be limited to the property securing the nonrecourse debt. One might consider placing that that property in a partnership that has more assets against which the debt can be allocated.[4978]

- However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis.[4979] For the basis of the property that the trust is deemed to have received, see part III.B.2.a Tax Basis Issues, including fn. 4870.

For example, suppose one sold property with a fair market value of $1 million to an irrevocable grantor trust in exchange for a $1 million note, and the grantor trust powers are turned off when the note has a $500,000 face amount:

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basis adjustment when the grantor dies, because the assets were deemed owned by the grantor immediately before death; CCA 200937028 (which should have little weight because it was a rather cursory discussion of the issue and was not approved using IRS National Office procedures) disputes that position.

4975 For opportunities and limitations on this idea, see part II.C.3 Allocating Liabilities (Including Debt). Code § 752 analysis can interact with the Code § 465 at-risk rules; see part II.G.3.g At Risk Rules, especially CCA 201606027, including key excerpts in fns. 876-879.

4976 See fn. 1325, found in part II.H.2 Basis Step-Up Issues.

4977 See fn. 4974.

4978 ACTEC Fellow George P. Mair noticed this issue and planning opportunity. See fn. 4975 regarding the grantor expressly assuming the liability when contributing the property to the partnership.

4979 Reg. §§ 1.1001-1(e)(1), 1.1011-2.

- Assuming the note had interest of at least the AFR, the note's remaining principal of $500,000 is the sale price when the grantor trust power is turned off. The $500,000 needs to be compared to the basis of the trust's assets.

- If the trust's assets have an aggregate basis of at least $500,000, then the basis does not change,[4980] and there is no gain or loss on sale under the bargain sale rules.

- If and to the extent that $500,000 exceeds the aggregate basis of the trust's assets, that excess is gain, to be recognized under the installment method unless the grantor reports the whole gain. As a result of the gain, the trust's assets have a new basis of $500,000.[4981]

The Code § 453 installment sale rules apply to any gain recognized.[4982]

III.B.2.h. How to Make a Trust a Grantor Trust

To protect one's clients from depleting their estates to the point of jeopardizing their standard of living, the ideal power is one that the grantor can turn off completely. Powers may treat the grantor as deemed owner of only a portion of the trust; for details, see part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation.

When considering the powers described in various portions of this part III.B.2.h, consider Reg. § 1.675-1(c):

> *Authority of trustee*. The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

III.B.2.h.i. Who Is the Grantor

A grantor includes any person to the extent such person either creates a trust, or directly or indirectly[4983] makes a gratuitous transfer of property to a trust.[4984] If more than one person makes a gratuitous transfer, each is a grantor.[4985]

[4980] See Reg. § 1.1015-4(b), Example (1).

[4981] See Reg. § 1.1015-4(b), Example (2).

[4982] Reg. § 1.1001-1(d); Code § 453(a). See part II.G.14 Limitations on the Use of Installment Sales.

[4983] Reg. § 1.671-2(e)(6), Example (3), provides:

> A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers $100 to FT out of A's funds. A is reimbursed by B for the $100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B and B's children. Both A and B are treated as grantors of FT under paragraph (e)(1) of this section. In addition, B is treated as the owner of the entire trust under section 677.

A gratuitous transfer is any transfer other than a transfer for fair market value, without regard to whether the transfer is treated as a gift for gift tax purposes.[4986] For that purpose, a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust;[4987] thus, buying property from a trust for more than its value is a gratuitous transfer

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> Because A is reimbursed for the $100 transferred to FT on behalf of B, A is not treated as transferring any property to FT. Therefore, A is not an owner of any portion of FT under sections 671 through 677 regardless of whether A retained any power over or interest in FT described in sections 673 through 677. Furthermore, A is not treated as an owner of any portion of FT under section 679. Both A and B are responsible parties for purposes of the requirements in section 6048.

[4984] Reg. § 1.671-2(e)(1) provides:

> For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. For purposes of this section, the term property includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also § 1.672(f)-5(a).

[4985] Reg. § 1.671-2(e)(6), Example (1).

[4986] Reg. § 1.671-2(e)(2)(i).

[4987] Reg. § 1.671-2(e)(2)(ii), which further provides:

> For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

As to the payment of interest on a loan, Reg. § 1.671-2(e)(6), Example (6) provides:

> A borrows cash from T, a trust. A has not made any gratuitous transfers to T. Arm's length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(2)(ii) of this section. Therefore, under paragraph (e)(1) of this section, A is not a grantor of T with respect to the interest payments.

Reg. § 1.671-2(e)(2)(iii) provides:

> For purposes of this paragraph (e), a gratuitous transfer does not include a distribution to a trust with respect to an interest held by such trust in either a trust described in paragraph (e)(3) of this section or an entity other than a trust. For example, a distribution to a trust by a corporation with respect to its stock described in section 301 is not a gratuitous transfer.

Regarding the latter, see parts II.D.2 Business Entity as Grantor of Trust and II.Q.7.a.iv Dividends; Avoiding Dividend Treatment Using Redemptions under Code §§ 302 and 303 (discussing Code § 301).

Reg. § 1.671-2(e)(3) provides:

> A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in

to the trust.[4988] Receiving an interest in the trust is not considered receiving fair market value under this test.[4989]

"If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust."[4990]

Exercising - not merely holding[4991] - a general power of appointment makes the person exercising the power the grantor to the extent of the exercise,[4992] even if the trust was a grantor trust deemed owned by the settlor before the exercise.[4993]

> § 301.7701-4(c) of this chapter, liquidating trusts described in § 301.7701-4(d) of this chapter, or environmental remediation trusts described in § 301.7701-4(e) of this chapter.

See part II.D.4 Disregarding Multiple Owner Trust for Income Tax Purposes, which discusses each of these trusts.

4988 Reg. § 1.671-2(e)(6), Example (7) provides:

> A, B's brother, creates a trust, T, for B's benefit and transfers $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair market value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of $100,000. Under paragraph (e)(2)(ii) of this section, the $900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

4989 Reg. § 1.671-2(e)(6), Example (5) provides:

> A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under paragraph (e)(2)(ii) of this section. Therefore, A has made a gratuitous transfer to T, and, under paragraph (e)(1) of this section, A is a grantor of T.

4990 Reg. § 1.671-2(e)(5). See part II.D.3 Trust as Grantor of a Trust.

4991 Reg. § 1.671-2(e)(6), Example (4) provides:

> A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

See generally part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

4992 Reg. § 1.671-2(e)(6), Example (9) provides:

> G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

See generally part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts.

4993 Reg. § 1.671-2(e)(5).

III.B.2.h.ii. Swap Power

Code § 675(4), a provision commonly relied upon in drafting irrevocable grantor trusts, treats a grantor of a trust as the owner if:

> A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers… (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

The trust agreement should specify that the grantor does not hold this power in a fiduciary capacity and preferably that, if the grantor is a trustee, some other trustee (preferably one who is not a related or subordinate party as described in Code § 672(c)) has the fiduciary power to review the grantor's exercise. These principles come from two sources:

1. The income tax statute quoted above requires the power to be exercisable in a nonfiduciary capacity.[4994] Reg. § 1.675-1(b)(4)(iii) provides:

   > If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.

2. From an estate tax perspective Rev. Rul. 2008-22 provides:

   > [T]he trustee [must have] a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

[4994] Letter Ruling 9037011 included the following caveat with the trust agreement expressly stated that the trustee's exercise of the power would be in a nonfiduciary capacity: "Provided that the circumstances surrounding the administration of the power held by [the nongrantor trustee] to substitute property of equal value for the trust corpus do not indicate that the power is held in a fiduciary capacity…." In that Letter Ruling, a co-trustee was available to review the exercise.

Rev. Rul. 2008-22 held that, if it complies with the estate tax standard above,[4995] "a grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038." Rev. Rul. 2011-28 extends Rev. Rul. 2008-22 to Code § 2042, so that this swap power can apply to life insurance as well.

A clause I tend to use (which may be used only by a qualified lawyer using his or her independent judgment) is:

> POWER TO EXCHANGE ASSETS. I, acting alone in my individual capacity and not in any fiduciary capacity, shall have the power, with respect to any trust created under this Agreement, to reacquire the trust corpus by substituting other property of an equivalent value.[4996] The power described in this Section may be exercised by me or by an agent of mine appointed under a durable power of attorney or through any other means, whose actions shall be conclusive and binding.[4997] Neither the consent of the trustee nor the consent of any other person shall be required. Upon exercise of this power, the person exercising it (the "Exchanger") shall notify the trustee; if the Exchanger is the trustee, the Exchanger shall notify the person designated in [the provision designating trustees] to succeed the Exchanger as trustee, ignoring any exercise by the Exchanger of powers under [the provision for changing the designation of trustees], and such designated successor shall serve as special trustee for purposes of this Section; and, if there is a total vacancy, then the Exchanger shall appoint a special trustee.[4998] The trustee or this special trustee, as the case may be, shall comply with Rev. Rul. 2008-22 or Rev. Rul. 2011-28, as applicable, including satisfying himself, herself, or itself that the properties acquired and substituted pursuant to this Section are in fact of equivalent value and that the that the proposed substitution will not have the effect of shifting beneficial interests among trust beneficiaries.[4999] The power described in this Section may be released by a written statement executed by me or by an agent appointed under a durable power of attorney or through any other means (whose actions shall be conclusive and binding), and delivered to the trustee.[5000]

I also tend to fund irrevocable grantor trusts with *nonvoting* stock when closely-held businesses are involved. The "Law and Analysis" portion of Rev. Rul. 2008-22 that discussed Code § 2036 cited Code § 2036(a), and the provision regarding closely-held businesses is in Code § 2036(b). Because the literal holding of Rev. Rul. 2008-22

[4995] Most practitioners do not believe that prior documents need to be fixed.
[4996] This language is intended to track the statute. The grantor is not required to hold this power; the grantor is listed to provide flexibility as described below in the annotation to this clause.
[4997] To leave no doubt that the grantor's incapacity does not extinguish the power.
[4998] The swap power cannot be subjected to fiduciary constraints, so the person holding the power should not be acting as a fiduciary with respect to the swap power. See Reg. § 1.675-1(b)(4)(iii) above.
[4999] This tracks standards within Rev. Rul. 2008-22. I include this language to be very clear about tracking the ruling; however, a trustee's fiduciary duties generally would include these standards, so that trusts that do not have such a clause tend to be likely to comply with the ruling anyway.
[5000] I tend to rely on swap powers to give the grantor control over grantor trust status. This sentence is intended to clearly authorize turning off that status.

addressed all of Code § 2036, a swap power itself probably will not trigger Code § 2036 inclusion of closely-held business stock. However, if the grantor is capable of providing input to the trustee on how to vote stock, concerns other than the swap power also strongly suggest not initially funding the trust with voting stock.[5001] It's possible that other concerns[5002] might suggest later exchanging the nonvoting stock for voting stock[5003] after the trust is no longer a grantor trust, but to avoid a step-transaction argument I do not discuss this idea with clients until the grantor trust status is about to be turned off.

Although the trustee cannot resist the swap if the swap is for equivalent value, at least one court has held that the trustee can refuse the swap if the trustee determines that the value the grantor offers to pay is insufficient.[5004]

Guidance on the use of this power can also be found in the charitable area. Rev. Proc. 2008-45[5005] contains annotated sample declarations of trust and alternate provisions that meet the requirements for an inter vivos charitable lead unitrust (CLUT) providing for unitrust payments payable to one or more charitable beneficiaries for the unitrust period followed by the distribution of trust assets to one or more noncharitable remaindermen. Of particular interest is Section 8.09:[5006]

> (1) *Power to substitute trust assets*. The donor to a CLUT may claim an income tax charitable deduction under § 170(a) if the donor is treated as the owner of the entire CLUT under the provisions of subpart E, part I, subchapter J, chapter 1,

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[5001] See II.A.2.j.i.(b) Why Nonvoting Shares Are Needed for Estate Planning through II.A.2.j.i.(d) Reallocations between Voting and Nonvoting Stock.

[5002] See part II.K.2.b Participation by an Estate or Nongrantor Trust.

[5003] Such a swap would not be an income taxable event. Code § 1036. One might want to use a formula swap, such as the number of nonvoting shares of value equal to the traded voting shares, to try to protect the swap from being considered a gift. See part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

[5004] *In re Dino Rigoni Intentional Grantor Trust for Benefit of Rajzer*, 2015 WL 4255417 (Court of Appeals of Michigan 7/14/2015), held:

> Once Rigoni has tendered property of equivalent value, the trustee lacks the discretion to deny the substitution. The trustee, however, still possessed the power and duty to determine whether the attempted substitution complied with the requirements of the substitution clause. See 3 *Restatement Trusts, 3d* (2007), p. 55, comment d (The primary duty of the trustee in regard to such a power is to ascertain whether an attempted exercise is within the terms of the power and to refuse to comply if it is not.). The trial court did not err in giving effect to every word of the substitution clause. *Kostin*, 278 Mich. App at 53. In fact, Rigoni's argument would substantially rewrite the substitution clause by essentially causing it to read, I may substitute any property for trust assets; if the trustee determines that the value of the property substituted was not equivalent, it may seek additional value afterwards. We decline to rewrite the unambiguous language of the substitution clause in such a fashion. See *Ourlian v. Major*, 333 Mich. 491, 496; 53 NW2d 346 (1952).

[5005] Its companion pronouncement, Rev. Proc. 2008-46, issued forms for testamentary CLUTs.

[5006] Note that the statute does not say who must hold the swap power to make it a grantor trust. Is it a big leap to treat the trust as a grantor trust when a person **other than** the grantor holds the swap power, as Section 8.09 does? No, since Reg. § 1.675-1(b)(4) (emphasis added) provides, The existence of certain powers of administration exercisable in a nonfiduciary capacity by **any nonadverse party** without the approval or consent of any person in a fiduciary capacity will cause the grantor to be treated as the owner. For more details on Code § 675(4)(C), see 819 T.M. XII.C.

subtitle A of the Code. Paragraph 11, Retained Powers and Interests, of the sample trust in section 7 creates a grantor CLUT through the use of a power to substitute trust assets under § 675(4) that is held by a person other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1), and is exercisable only in a nonfiduciary capacity. The circumstances surrounding the administration of a CLUT will determine whether a § 675(4) substitution power is exercised in a fiduciary or nonfiduciary capacity. This is a question of fact. Note, that the exercise of a § 675(4) power may result in an act of self-dealing under § 4941.

> (2) *Other powers or provisions to create a grantor trust*. As noted above, the sample trust in section 7 includes a § 675(4) power that is held by someone other than donor, the trustee, or a disqualified person as defined in § 4946(a)(1), and that may be exercised only in a nonfiduciary capacity. The CLUT instrument may instead incorporate a power or provision, other than the one provided in the sample trust in section 7, that will cause the donor to be treated as the owner of the entire CLUT under the provisions of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. See § 671 et seq. However, practitioners should exercise caution when choosing a particular power or provision because certain methods of creating a grantor trust may have unforeseen tax consequences.

Letter Ruling 200944002 ruled that a transfer to a self-settled spendthrift trust was a completed gift. It also ruled that the trust's assets would not be included in the grantor's estate, but "We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." Letter Ruling 200944002 provides a good roadmap for obtaining a private letter ruling when creating such a trust in light of Rev. Rul. 2008-22, which requires certain procedural safeguards when a grantor exercises a swap power (the right to substitute assets of equivalent value).[5007]

If a grantor turns off this power but would like to reactivate it, consider forming an identical trust with a swap power and then the trustee of the nongrantor trust merges the nongrantor trust into the grantor trust.

III.B.2.h.iii. Borrow Power

Another way to make a trust a grantor trust is:[5008]

> A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the

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[5007] Conversations with the IRS seem to indicate that the IRS will tend to avoid issuing private letter rulings on sales to irrevocable grantor trusts, so be sure to have an informal pre-submission conference before putting together a formal ruling request.

[5008] Code § 675(2).

> grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

Because the IRS would probably attack the use of inadequate interest as beneficial enjoyment, when using this power I tend to require that the loan must be one that will not make the loan be characterized as a "below-market loan" under Code § 7872(e)(1) and that, instead, the loan may have inadequate security. The framework of Code § 7872 and related regulations governing the use of the AFR to determine the interest rate do not take creditworthiness into account so long as the loan is reasonably expected to be repaid; see part III.B.1.a.ii.(a) Gift Tax Issues Involving Loan Guarantees, especially fn. 4707.

Although I am not concerned whether such a power has Code § 2036 implications, to be extra careful one might give a nonadverse party the authority to give the right to borrow, rather than simply giving the grantor the right to borrow.[5009]

An actual borrowing by the grantor or the grantor's spouse also makes the grantor taxable on the trust's income in part or in whole of the loan is not adequately secured or the trustee is not independent,[5010] and borrowing for any part of the year makes the grantor taxable for the whole year.[5011] If the trust loans to a business entity owned by the grantor, does that count as a loan to the grantor? Yes if it's a partnership; no if it's a C corporation.[5012]

III.B.2.h.iv. Life Insurance

Subject to certain exceptions, Code § 677(a)(3) taxes to the grantor income that is or may be applied to the payment of premiums on policies insuring the grantor's or grantor's spouse's life.

[5009] From Interactive Legal Solutions, which Jonathan Blattmachr kindly shared with me:

> During the Grantor's lifetime, the Loan Director shall have the power, exercisable at any time and from time to time in a non-fiduciary capacity (within the meaning of Code Sec. 675) without the approval or consent of any person in a fiduciary capacity within the meaning of that section, to compel the Trustee to loan some or all of the trust property to the Grantor without adequate security within the meaning of Code Sec. 675(2) although with adequate interest within the meaning of that section.

[5010] Code § 675(3); Reg. § 1.675-1(a)(3); Rev. Rul. 85-13 (grantor borrowed all assets so 100% grantor trust). For more details, see Zaritsky, Lane & Danforth, *Federal Income Taxation of Estates and Trusts* (WG&L), ¶11.04. Actual Borrowing from the Trust. Code § 675(3) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which:

> The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

[5011] See part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation, fn. 4939.

[5012] *Bennett v. Commissioner*, 79 T.C. 470 (1982).

The "better" view is that the grantor is taxed only to the extent that the trust actually pays premiums, but the answer is uncertain.[5013]

The transfer of life insurance might trigger immediate income tax, might make the death benefit partly or wholly taxable, or both.[5014] To avoid those consequences and the uncertainty of Code § 677(a)(3), I generally use a swap power in my trusts holding life insurance.[5015] A swap power over a trust holding life insurance does not trigger Code § 2042 incidents of ownership in the grantor-insured.[5016]

Suppose one has a nongrantor trust that wishes to hold insurance on the grantor's life. If the grantor wishes to limit taxation on the trust's income and is not comfortable with the uncertainty of the "better" view, consider dividing the trust so that only what is needed to pay premiums is in the portion that hold life insurance. That portion might invest in tax-exempt bonds, annuities (which would generate income tax on distributions from the annuities to pay premiums),[5017] or cash-value-rich life insurance. If the trustee of one trust pays premiums on life insurance on the grantor's life owned by another trust, then the grantor is the Code § 677(a) deemed owner "of the amount of the trust income which is used to pay the premiums on these policies of insurance on her life."[5018]

III.B.2.h.v. Protecting the Grantor

The grantor's payment of income tax under the grantor trust rules is not a gift.[5019]

When using one or both of the swap or borrow powers to establish grantor trust powers, I generally provide that the powers may be exercised or released by the grantor's agent.

One might protect the grantor simply by encouraging the grantor not to transfer all of the grantor's interest in the entity being transferred. For example, if the grantor transfers half and keeps half, then the grantor might be able to use the half the grantor retained to pay tax on the taxable income generated by both halves. For the reasons described in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner, I hesitate to use income tax reimbursement clauses, but I tend to include in GRATs the option or requirement to make a distribution to the grantor to the extent that income tax on the GRAT's income exceeds the annuity payment.[5020]

[5013] Zaritsky & Aucutt, ¶ 12.02[5][c][v] Power to pay life insurance premiums, *Structuring Estate Freezes: Analysis With Forms* (WG&L). Internal doc. no. 6207986 is a thorough analysis of the issue espousing the better view, but the author asked me not to share it with anyone, so I would need to spend several hours going through the materials to provide a fully researched analysis or would merely refer the person asking to contact the author. See also *Corning v. Commissioner*, 104 F.2d 329 (6th Cir. 1939), and *Weil v. Commissioner*, 3 T.C. 579 (1944), acq. 1944 C.B. 29.

[5014] See part II.Q.4.a Funding the Buy-Sell, especially fns. 3128-3134.

[5015] See part III.B.2.h.i Who Is the Grantor.

[5016] Rev. Rul. 2011-28.

[5017] Although Code § 72(u) states that a taxpayer that is not a natural person cannot defer tax on annuities, various private letters ruling, citing favorable legislative history, do not apply this prohibition to most trusts.

[5018] Rev. Rul. 66-313.

[5019] Rev. Rul. 2004-64, which is discussed further in fns. 5273-5291, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the Deemed Owner.

[5020] See part III.B.2.h.vii.(b) GRATs as Grantor Trusts.

The end of part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation discusses whether the release of grantor trust powers changes deemed ownership for the taxable year prospectively - or perhaps not at all! For an example of how bad timing could be disastrous when an S corporation is involved, see the indented text accompanying fn. 4941 in that part III.B.2.d.i.(b).

One might be concerned whether a power of appointment, a power to decant, a power to merge, or some other power might cause the grantor to be taxed as the owner after the grantor turns off those powers. If one is concerned about this, consider including a savings clause that says that, under no event may the trustee's actions or any such power cause the trust to be a grantor trust, determined as if the swap or borrow power (that is being used to make the trust a grantor trust) does not exist. If the grantor's spouse is a beneficiary, one would generally need to make this savings clause apply only after the spouse's death[5021] or divorce.[5022]

III.B.2.h.vi. Distribution Provisions Might Prevent Turning Off Grantor Trust Status

III.B.2.h.vi.(a). Distribution Provisions Resulting from Control Causing Grantor Trust Treatment

If the grantor (or current to former spouse)[5023] or a nonadverse party, or both, can make distributions without the approval or consent of any adverse party, the trust might be a grantor trust under Code § 674(a). "Adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by making or not making the distribution.[5024] Because a beneficiary's interest might not be totally adverse to distributions being made,[5025] I hesitate to rely on a person being an adverse party.

Below are some situations in which Code § 674(a) does not apply to the power to make distributions, so long as no person, other than a person substituting other beneficiaries to succeed to his or her interest in the trust, has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries (other than providing for after-born or after-adopted children) to whom distributions may be made:[5026]

5021 See Code §§ 677, 672(e).

5022 See fn. 4470.

5023 Code § 672(e)(1) provides that a grantor shall be treated as holding any power or interest held by any individual who either was the spouse of the grantor at the time of the creation of such power or interest or became the spouse of the grantor after the creation of such power or interest; the latter applies only with respect to periods after such individual became the spouse of the grantor.

5024 Code § 672(a).

5025 Reg. § 1.672(a)-1 provides various limitations. However, Letter Ruling 201310002 viewed as adverse to the grantor a distribution committee consisting of the grantor and four sons, when all of the grantor's descendants were eligible to receive discretionary distributions.

5026 Reg. § 1.674(d)-2(b) provides:

> *Power to add beneficiaries*. The exceptions described in section 674(b)(5), (6), and (7), (c), and (d) are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus,

- A power over income is solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or a current or former spouse of the grantor,[5027] and is limited by an ascertainable standard.[5028]

- A power over income, principal, or both, is solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or a current or former spouse of the grantor,[5029] and no more than half of whom are related or subordinate parties [5030] who are subservient to the wishes of the grantor.[5031] Note that an ascertainable standard is not required to qualify for this exclusion. Note also that the power must be exercisable by a trustee or trustees, so the exception would not apply to the holder of a power of appointment.

- A power to distribute principal under an ascertainable standard.[5032]

- A power to distribute income to any current income beneficiary (or accumulate that income), if any accumulated income must ultimately be payable to the beneficiary, the beneficiary's estate, or the beneficiary's appointees under the broadest possible nongeneral power of appointment.[5033] Note that an ascertainable standard is not required to qualify for this exclusion.

> except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the limitation apply to a power held by any person which would qualify as an exception under section 674(b)(3) (relating to testamentary powers).

Neither the regulation nor the relevant statutes provide whether "after-born or after-adopted children" refer to children of the grantor or of anyone. For some context, see fn. 4860 in part III.B.1.i Transfers with Contingencies Based on Acts of Independent Significance.

[5027] Code § 674(d) says, spouse living with the grantor. However, see fn. 5023 regarding spousal attribution under Code § 672(e), which, when Congress enacted it, Congress did not appear to try to reconcile with the living with the grantor condition of Code § 674(d). To avoid any argument, one might exclude any current or former spouse from being a trustee if one wants to rely on this exception.

[5028] Code § 674(d).

[5029] For the reference to current or former spouse, see fn. 5023.

[5030] Code § 672(c) provides that:

> the term related or subordinate party means any nonadverse party who is-
> (1) the grantor's spouse if living with the grantor;
> (2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.
>
> For purposes of [Code § 674], a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

[5031] Code § 674(c).

[5032] Code § 674(b)(5)(A).

[5033] Code § 674(b)(6)(A); see fn. 5038 for the relevant regulation and the paragraph accompanying it for related issues. When relying on this exclusion, I tend to override the usual

These exceptions are not intended to be exhaustive; they are simply the ones to which I most frequently look.

The grantor being the trustee prevents one from looking to Code § 674(c) or (d) for relief and might risk estate inclusion. Using ascertainable standards should avoid estate inclusion[5034] and would suffice for avoiding grantor trust status as to principal,[5035] but further steps would be required as to income.[5036]

Suppose the grantor is not a beneficiary of a trust, but someone holding a testamentary power of appointment can make the grantor a beneficiary. Does that trigger Code § 677, if the power holder does not have a beneficial interest adverse to its exercise? Yes, if the power may be exercised only to benefit the grantor.[5037] No, for the broadest possible nongeneral power of appointment where the power holder is the sole beneficiary to whom distributions may be made currently.[5038] Consider whether the latter should be

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conversion of accumulated income to principal, provide that any distributions to that beneficiary come first from current or accumulated income and then from principal, and (if necessary) expand the beneficiary's power of appointment with respect to this accumulated income on trust termination.

[5034] See Rev. Rul. 73-143 re Code § 2038 and Reg. § 20.2036-1(b)(3) re looking to Code § 2038 when applying Code § 2036.

[5035] See fn. 5032.

[5036] See text accompanying fn. 5033.

[5037] Reg. § 1.672(a)-1(c) provides:

> The interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus. Thus, if the income of a trust is payable to A for life, with a power (which is not a general power of appointment) in A to appoint the corpus to the grantor either during his life or by will, A's interest is adverse to the return of the corpus to the grantor during A's life, but is not adverse to a return of the corpus after A's death. In other words, A's interest is adverse as to ordinary income but is not adverse as to income allocable to corpus. Therefore, assuming no other relevant facts exist, the grantor would not be taxable on the ordinary income of the trust under section 674, 676, or 677, but would be taxable under section 677 on income allocable to corpus (such as capital gains), since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor. Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of his interest but not to a return of corpus after the termination of his interest.

[5038] Reg. § 1.674(b)-1(b)(6)(i). First, some context, elaborating on fn. 5033: Reg. § 1.674(b)-1(b)(6)(i) provides:

> Section 674(b)(6) excepts a power which, in general, enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary. Specifically, there is excepted a power to distribute or apply ordinary income to or for a current income beneficiary or to accumulate the income, if the accumulated income must ultimately be payable either:
>
> (a) To the beneficiary from whom it was withheld, his estate, or his appointees (or persons designated by name, as a class, or otherwise as alternate takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate (section 674(b)(6)(A))…

Reg. § 1.674(b)-1(b)(6)(i)(c) includes the following in parentheses:

> [I]f a trust otherwise qualifies for the exception in (a) of this subdivision the trust income will not be considered to be taxable to the grantor under section 677 by reason of the existence of the power of appointment referred to in (a) of this subdivision.

narrowly construed, in light of Code § 676[5039] or one case decided before the regulations cited in fn. 5038 were promulgated.[5040] In any event, consider whether allowing a power

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Thus, even though the beneficiary might appoint to the grantor under Reg. § 1.674(b)-1(b)(6)(i)(a), Code § 677(a) does not apply. Note that the parenthetical applies to when the trust has only one income beneficiary. Was the parenthetical merely an aside, or did it intend to create an exception to applying Code § 677? I view it as the former but leave it up to the reader to decide for himself or herself.

[5039] Code § 676(a) treats the grantor as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both. However, Code § 676(b) provides:

> Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.

Generally, I do not believe that Code § 676 is intended to apply to the broadest possible testamentary power of appointment that might be exercised in favor of the grantor, given that the Code § 674(b)(6)(A) safe harbor for grantor trust treatment, which is described more fully in fns. 5033 and 5038 and was enacted at the same time as Code §676, would be rendered meaningless by that reading.

Note also that Code § 676 was not listed among the grounds for treating the grantor as owner of corpus under Reg. § 1.672(a)-1(c) – see fn. 5037. However, it was among the provisions listed as not causing grantor trust treatment regarding income in that regulation.

[5040] A very prolific and knowledgeable lawyer said that, when grantor trust status is being prevented, he has always prohibited any power of appointment from being exercised in favor of the grantor, the grantor's spouse, any creditor of either, or the estate or the creditor of the estate of either. That lawyer cited broad language *Kaplan v. Commissioner*, 66 F.2d 401 (1st Cir. 1933):

> We think the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the grantor such portion of the income is taxable to him.

However, *Kaplan* involved a reversion, not merely a possibility that a beneficiary might exercise a power of appointment to the grantor:

> Kaplan made a written declaration of trust and transferred to himself as trustee under it certain personal property. By the terms of the instrument, the income of the trust property was to be paid to Kaplan's wife for her life, with a reversion of the beneficial interest to him if he outlived her, and if he did not, then on her death to his children. The declaration also permitted the trustee to accumulate a reasonable portion of the income, the accumulation to be payable at the discretion of the trustee to the person or persons who at the time of payment were entitled to the income of the trust.

The broad language should be read in context of the whole paragraph, under which he served as trustee in this pre-1954 Code case:

> The first point made for the petitioner is that the Kaplan trust is not within the terms of the statute. This depends on whether the expression in the statute may, in the discretion of the grantor of the trust *** be held or accumulated for future distribution to him refers to the accumulation of income which, under certain contingencies, may in the future be paid to the grantor, or to the accumulation of income which must in the future come to the grantor. This provision was intended, as its legislative history clearly shows, as a protection to the government against evasion of income taxes, especially surtaxes, by means of trusts whereby the grantor, although parting with the legal control of the trust property, reserved a practical control over the income of it which could, in point of fact, be exercised for his own benefit. As Kaplan named himself trustee, the large discretion given in the trust instrument to the trustee as to the accumulation and payment of income

of appointment to be exercised in a way that might benefit the grantor is important enough to risk not being able to turn off grantor trust status. For some trusts, the point might be moot; for example, a trust for the benefit of the grantor's spouse might always be a grantor trust so long as they are married, although one would then need to consider what if they are no longer married.

Relying on a beneficiary being adverse is not as easy as it might appear:

- A beneficiary is adverse to the extent that the beneficiary has "a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust."[5041] Merely being a trustee does not constitute a beneficial interest, but holding a general power of appointment does.[5042] A beneficial interest is substantial "if its value in relation to the total value of the property subject to the power is not insignificant."[5043]

- Even if a beneficiary is an adverse party, the beneficiary may be an adverse party only as to part of the income or principal, depending on the beneficial interest.[5044] Thus, if A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent, the grantor is treated as the owner of three-fourths of the trust.[5045] Similarly, a beneficiary with only a mandatory income interest is not adverse as to principal passing at his or her death.[5046] Furthermore, a remainderman's interest is adverse to the exercise of any power over the trust's corpus, but not to the exercise of a power over any income interest preceding the remainder.[5047]

III.B.2.h.vi.(b). Distribution Provisions Benefitting Grantor Causing Grantor Trust Treatment

Generally, the grantor is treated as the owner of any portion of a trust, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, held or accumulated for future distribution to the grantor or the grantor's spouse,

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> is attributable to him personally. By the terms of the trust that discretion can be exercised for his own possible benefit, within wide limits. We see no occasion for refinement of construction against the government. We think the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the grantor such portion of the income is taxable to him.

When reading the broad language in the context of the whole paragraph, I do not see that holding as extending to the possibility that a beneficiary might one day make the grantor a beneficiary. Rather, that case involved a grantor who was a remainderman. Ultimately, however, you the reader need to decide yourself whether the broad language troubles you.

[5041] Reg. § 1.672(a)-1(a).
[5042] Reg. § 1.672(a)-1(a).
[5043] Reg. § 1.672(a)-1(a).
[5044] Reg. § 1.672(a)-1(b).
[5045] Reg. § 1.672(a)-1(b).
[5046] See fn. 5037.
[5047] Reg. § 1.672(a)-1(d). The last sentence of the regulation should be read in light of a 5% interest in Code § 673 replacing the 10-year period referenced in that sentence.

or applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (with certain exceptions regarding charitable life insurance).[5048]

Income is not be considered taxable to the grantor merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed.[5049] That rule applies even though it might have been applied or distributed for other purposes.[5050]

If amounts so applied or distributed toward support obligations are paid out of corpus or out of other than income for the taxable year, such amounts are considered to be distributions to the grantor in the same way as distributions to any other beneficiary.[5051]

For a custodial account that may be used to discharge the grantor's legal obligation of support, the amount of such income includible in the gross income of a person obligated to support or maintain a minor is limited by the extent of his legal obligations under local law.[5052] To the extent that the account's income is not so includible in the gross income of the person obligated to support or maintain the minor (donee), that income is taxable to the minor.[5053]

III.B.2.h.vii. Code § 677(a) and GRATs

III.B.2.h.vii.(a). Code § 677(a) Generally

Code § 677(a) provides

> The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
>
> (1) distributed to the grantor or the grantor's spouse;
>
> (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or
>
> (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

5048 Code § 677(a). See part III.B.2.h.vii.(a) Code § 677(a) Generally.
5049 Code § 677(b).
5050 Reg. § 1.677(b)-1(a).
5051 Code § 677(b).
5052 Rev. Rul. 56-484. For possible estate tax issues, see *Exchange Bank & Trust Co. of Fla. v. United States*, 694 F2d 1261 (Fed. Cir. 1982) (which I've been told applied the reciprocal trust doctrine).
5053 Rev. Rul. 56-484.

> This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

For more on Code § 677(a)(3), see part III.B.2.h.iv Life Insurance.

For the effect on Code § 677 when a spouse becomes separated or divorced, see part III.B.2.h.viii Code § 682 Limitations on Grantor Trust Treatment.

III.B.2.h.vii.(b). GRATs as Grantor Trusts

GRATs are described in parts III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust and III.B.7.d Code § 2702 Overview.

The very significant annuity payments the grantor receives makes a GRAT a grantor trust under Code § 677(a)(1) in whole or in part, depending on how the payments relate to the GRAT's taxable income. To try to nail down grantor trust treatment, I tend to use the powers described in one or both of parts III.B.2.h.ii Swap Power or III.B.2.h.iii Borrow Power. Nailing down grantor trust treatment also eliminates any uncertainty as to whether satisfying the annuity in kind, during the grace period after the date for final payment, is a taxable event. It also helps protect the GRAT's eligibility to hold stock in an S corporation, although I prefer also making an ESBT election, all as described in part III.A.3.a Wholly Owned Grantor Trusts – How to Qualify, Risks, and Protective Measures.

Because the grantor cannot turn off grantor trust treatment during the annuity term, consider whether the grantor should be a mandatory or discretionary distributee of income in excess of the annuity amount.[5054]

Letter Ruling 9449013[5055] recognized as a grantor trust seven GRATs without any back-up grantor trust clauses. The only clause upon which it relied provided that "the payment of the annuity installment shall be made from the income and, to the extent that income is not sufficient, the principal of the trust" and directed the trustee to "accumulate any net income not so paid and add it to the principal of the trust." (Contrary to the latter, I prefer to direct the trustee not to accumulated any unpaid income and not to add it to principal until after the final annuity payment has been satisfied.) It concluded:

> The grantor is the owner of the trust under section 677(a) because article I(B) provides that the annuity installment is to be paid from income and, to the extent income is not sufficient, from principal. Therefore, the grantor will be considered the owner of the entire trust for purposes of section 671 until the earlier of the grantor's death or the termination of the trust….

[5054] See part III.B.2.h.v Protecting the Grantor, especially fn. 5020.

[5055] Letter Rulings 9449012 and 9448018 contained similar terms, the latter also ruling that the trust qualified as an S corporation shareholder as a wholly-owned grantor trust.

> In accordance with the principle set forth in Rev. Rul. 85-13, we conclude that neither the grantors nor the trusts will recognize any gain or loss as a result of the grantor's transfer of shares of Company stock to fund the trusts, or as the result of the transfer from a trust to a grantor in payment of an annuity, or as the result of the substitution by the grantor of cash or other property for shares of stock.

Letter Ruling 9504021 also recognized as a grantor trust a GRAT without any back-up grantor trust clauses.

Letter Ruling 9451056 treated a GRAT as a grantor trust under Code § 677 "because the income of each trust may be distributed to the respective trust grantor during the annuity period." However, in addition to annuity payments:[5056]

> For any year in which the grantor is considered the owner of the trust for federal income tax purposes, the trustees shall distribute to the grantor, in addition to the annuity amount, an amount equal to the excess of the grantor's personal income tax liability (as owner of the trust) over the grantor's personal income tax liability computed as if the grantor were not treated as the owner of the trust.

Letter Rulings 200001013 and 200001015 treated the following GRAT as grantor trusts:

> Under the terms of the Trust, Taxpayer will receive an annuity payable first from income, and to the extent accumulated income is insufficient, from principal. In addition, during the Trust term, the trustee (a nonadverse party) will have the sole discretion to pay the Taxpayer all of the Trust's net income (if there is any remaining after payment of the annuity). Therefore, under section 677, Taxpayer will be treated as the owner of the income portion of the Trust during the Trust term. Additionally, capital gains are accumulated and added to corpus and Taxpayer has a general testamentary power exercisable only by will to appoint the accumulated amounts. Therefore, under section 674(a), Taxpayer will be treated as the owner of the corpus portion of the Trust during the Trust term. Accordingly, Taxpayer will be treated as the owner of the Trust for purposes of section 671 during the Trust term.

III.B.2.h.viii. Code § 682 Limitations on Grantor Trust Treatment

Code § 682 overrides grantor trust treatment to the extent that distributions are made or are required to be made to a divorced or legally separated spouse and treats that recipient as a beneficiary. Except to the extent that distributions constitute Code § 71 alimony, distributions are taxed under the usual rules governing distributions to beneficiaries under part II.J.1 Trust's Income Less Deductions and Exemptions Is Split Between Trust and Beneficiaries.[5057]

[5056] The trust also included a swap power, but the ruling did not mention that when concluding that the trust was a grantor trust.

[5057] Reg. § 1.682(a)-1(a)(2) provides:

> If section 71 applies, it requires inclusion in the wife's income of the full amount of periodic payments received attributable to property in trust (whether or not out of trust income), while, if section 71 does not apply, section 682(a) requires amounts paid,

Its interaction with Code § 677 is somewhat complex. Reg. § 1.677(a)-1(b)(2) concludes with:

> With respect to the treatment of a grantor as the owner of a portion of a trust solely because its income is, or may be, distributed or held or accumulated for future distributions to a beneficiary who is his spouse or applied to the payment of premiums for insurance on the spouse's life, section 677(a) applies to the income of a trust solely during the period of the marriage of the grantor to a beneficiary. In the case of divorce or separation, see sections 71 and 682 and the regulations thereunder.

Reg. § 1.682(a)-1(a)(1)(i) is quite clear that Code § 682 shifts only so much of the income as is paid, credited, or required to be distributed to the ex-spouse beneficiary. Therefore, the cross-reference to Code § 682 might lead one to believe that Code § 677(a) would apply to the extent that distributions are not made to the ex-spouse, consistent with certain legislation history to the Tax Reform Act of 1969:

> Both versions of the bill provide that in the case of a trust created by a taxpayer for the benefit of his spouse, the trust income which may be used for the benefit of the spouse is to be taxed to the creator of the trust as it is earned. However, this provision is not to apply where another provision of the Code requires the wife to include in her gross income the income from a trust.

However, Reg. § 1.1361-1(k)(1), Example (10), paragraph (ii), indicates that the more expansive reading of the next-to-the last-sentence of Reg. § 1.677(a)-1(b)(2) applies, so that Code § 677(a) will never tax the grantor on distributions that are accumulated for possible future distribution to the ex-spouse. Note, however, that the next-to-the last-sentence of Reg. § 1.677(a)-1(b)(2) does not apply to a spouse who is separated, so the more limited rules of Reg. § 1.682(a)-1(a)(1)(i) would apply.

Code § 672(e) does not seem to coordinate with Code § 682. However, Reg. § 1.1361-1(k) was promulgated after Code § 672(e) was enacted, so Reg. § 1.1361-1(k)(1), Example (10), would appear to clarify somewhat the scope of Code § 672(e).

> credited, or required to be distributed to her to be included only to the extent they are includible in the taxable income of a trust beneficiary under subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code.

Letter Ruling 9235032 applies these rules to determining whether the recipient is taxed on capital gains, pointing to the rules described in part II.J.8 Allocating Capital Gain to Distributable Net Income (DNI):

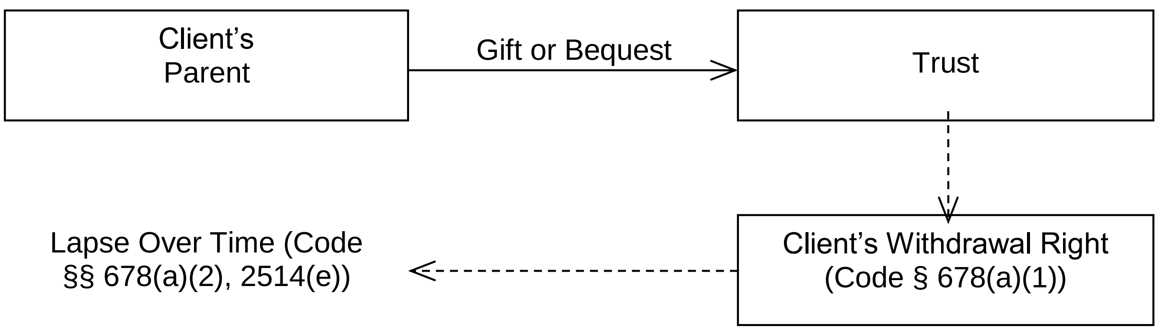
> In this case, the trustee is required under the governing instrument to allocate net capital gains to income when paying the annual annuity amount to A. That allocation is permitted under local law….
>
> The taxable income of the trust and of A will be determined in accordance with subchapter J of the Code, including, in particular, sections 682 and 662 of the Code, relating to amounts includible in the gross income of A and of the trust, and section 661, relating to the trust's deduction of amounts distributed to A as an annuity interest, limited by the trust's distributable net income. For purposes of section 661, the trust's distributable net income, determined under section 643, will include net capital gains to the extent required to be distributed to satisfy the annuity amount.

Note, however, that grantor trust provisions other than Code § 677 may trigger grantor trust treatment; see Letter Ruling 200408015 (swap power caused grantor trust treatment regarding capital gains that were not distributed to the ex-spouse).[5058]

III.B.2.i. Code § 678 (Beneficiary Grantor) Trusts

Beneficiary grantor trusts can be helpful tools; one proponent calls his version a Beneficiary Defective Inheritor's Trust (BDIT).[5059] This article describes what a beneficiary grantor trust is, when it is useful, sales to the trust, and the structures used in recent rulings. For the effect of the trust being deemed owned by a beneficiary, see part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment, which includes the fact that not all states recognize federal grantor trust rules.

Fund Trust



Structure recommended in this article:

Client's powers:

- Trustee – may distribute for own support and support of descendants; may invest in any manner that does not trigger estate tax issues; may totally re-write who serves as trustee. However, if the client lives in (or might move to) a creditor-friendly state, then the client should not serve as trustee or have the right to remove and replace the trustee.[5060]

[5058] Letter Ruling 200408015 is discussed further in fn. 5650, found in part III.B.7.d Code § 2702 Overview.

[5059] "The Beneficiary Defective Inheritor's Trust (BDIT): Finessing the Pipe Dream," www.oshins.com/images/BDIT_article.pdf. See Blattmachr and Zaritsky, "Is the BDIT Ready for Primetime?" *Probate Practice Reporter* (University of South Carolina School of Law, ISBN 1044-7423), Sept. 2012.

[5060] Part III.B.2.i.viii Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed, points out that not all states clearly protect from creditors a beneficiary who allowed a withdrawal right to lapse. Conflict of laws issues might arise if the trust is established in a state that provides such protection and the trustee or trust's assets are in a state that does not. If a court in a creditor-friendly state cannot obtain jurisdiction over the trustee or over the trust's assets, then the rules of the protective state would tend to prevail. *Hanson v. Denckla*, 357 U.S. 235 (1958); see fn. 5138 in part III.B.2.i.ixLetter Ruling 200949012 in part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts. Suppose, however, that a court in a creditor-friendly state obtains jurisdiction over the trustee or trust's assets and wants to apply that

- Power to restructure who serves as independent trustee should a vacancy in that position occur;[5061] may not name a person who is a related or subordinate party with respect to the independent trustee.[5062]

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state's laws. New York has done so in a conflict-of-laws situation and allowed the creditor to reach the assets. See note 5137.

[5061] Consider the possibility that a court might order a beneficiary to remove the independent trustee and replace it with one that would be likely to distribute assets or that is subject to the court's jurisdiction. The latter might threaten the trust's spendthrift status. See note 5060. Limiting the beneficiary's power to one of replacement rather than removal-and-replacement might avoid that problem. Another feature might be to grant the power to remove the independent trustee to a person who lives (and will always live) in a protective state who can remove the independent trustee, triggering the beneficiary's right to replace the independent trustee; if a court in a creditor-friendly state never obtains jurisdiction over this person, this power should not be problematic.

[5062] Reg. § 20.2041-1(b)(1) provides:

> A power in a donee to remove or discharge a trustee and appoint himself may be a power of appointment. For example, if under the terms of a trust instrument, the trustee or his successor has the power to appoint the principal of the trust for the benefit of individuals including himself, and the decedent has the unrestricted power to remove or discharge the trustee at any time and appoint any other person including himself, the decedent is considered as having a power of appointment. However, the decedent is not considered to have a power of appointment if he only had the power to appoint a successor, including himself, under limited conditions which did not exist at the time of his death, without an accompanying unrestricted power of removal.

Do the restrictions of Rev. Rul. 95-58 suffice to prevent the power to appoint a trustee from being a general power of appointment under the above regulation? The following Letter Rulings applied Rev. Rul. 95-58 and held that certain rights did not cause inclusion as a general power of appointment under Code § 2041: 9607008 (right to remove a corporate trustee and replace it with a corporate trustee that was not a related or subordinate party), 200229013 (beneficiaries were not imputed powers of family trust company where beneficiaries renounced their right, directly or indirectly, to participate as a trustee, or in any other capacity, in any decisions regarding discretionary distribution and members of distributions committee could not include any related or subordinate party), 200533008 (right to remove a corporate trustee and replace it with a corporate trustee that was not a related or subordinate party), 200734010 (right to replace a resigned corporate trustee with a corporate trustee that was not a related or subordinate party), 201207001 (power to remove distribution trustee and replace with a party that is not a related or subordinate party), 201209003 (power to fill vacancy with beneficiary's spouse's business partners who were not related or subordinate to beneficiary), 201345004 (power to remove distribution trustee and replace with a person that is not a related or subordinate party did not implicate Code § 2041 or 2514), the apparently related 201345026, 201345027, 201345028, 201432005, and 201433006 (same), 201434004 (same), 201434005, 201436003 (same), 201634016, 201634017, 201641020 (power to fill vacancy with a person that is not a related or subordinate party is not the equivalent of the power referred to in the examples in Reg. §§ 20.2041-1(b)(1) and 25.2514-1(b)(1) where an individual may remove a trustee and appoint himself), 201647001 (power to remove and replace the trustee with person that is not a related or subordinate party did not implicate Code § 2036, 2038, 2041 or 2514), and 201702016, 201702017 and 201702018 (power to remove and replace the trustee with person that is not a related or subordinate party did not implicate Code § 2041 or 2514 or have any GST implications). I have been told (but have not verified) that Letter Rulings 9735023, 9746007, 200031008, and 200533010 had a similar result.

However, an asset protection case, *SEC v. Wyly*, 2014 WL 4792229 (S.D.N.Y. 9/25/2014), held that the grantors' control over the independent trustees was so powerful that they essentially held

- Broad inter vivos limited power of appointment.

- Broad testamentary limited power of appointment.

Independent Trustee:

- May distribute for welfare.[5063]

- Holds any other tax-sensitive powers.

In a typical BDIT, the independent trustee effectuates the purchase of any assets that are difficult to value, holds any insurance on the beneficiary's life if life insurance is purchased, and has sole authority over any tax-sensitive powers. Furthermore, the beneficiary has the power to remove the independent trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the beneficiary (within the meaning of section Code § 672(c)). I do not necessarily grant the power to remove the independent trustee, because the authority upon which this is based does not expressly extend to general powers of appointment and holding life insurance; however, one might very well be able to obtain a private letter ruling that extends to general powers of appointment and holding life insurance.[5064]

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the distribution powers themselves, undermining Code § 674(c) (and perhaps the estate tax premise of these Letter Rulings).

In *First National Bank of Denver v. United States*, 648 F.2d 1286 (10th Cir. 1981), the parties assumed that the beneficiary's right to remove and replace a corporate trustee, that could make distributions beyond an ascertainable standard, with another corporate trustee did not constitute a general power of appointment. The only argument was whether the beneficiary was required to appoint another corporate trustee, which the taxpayer proved to be the case. *Estate of Wilson v. Commissioner*, T.C. Memo. 1992-479, citing the above case favorably, found that a surviving spouse had a general power of appointment when she was authorized to appoint herself as sole trustee and terminate the trust, thereby qualifying the trust as a general power of appointment marital deduction trust.

[5063] Because the beneficiary will <u>always</u> be the deemed owner with no possibility of turning off that deemed ownership, authorizing distributions to reimburse taxes (or using a broader standard) is quite important. See Rev. Rul. 2004-64, which is discussed further in fns. 5273-5291, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the .

[5064] The right to remove and replace a trustee with such a trustee was discussed in Rev. Rul. 95-58. The Ruling starts with a broad statement, The Internal Revenue Service has reconsidered whether a grantor's reservation of an unqualified power to remove a trustee and appoint a new trustee (other than the grantor) is tantamount to a reservation by the grantor of the trustee's discretionary powers of distribution. Reg. § 20.2036-1(b)(3), which it cited, states, "…if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee." Reg. § 20.2038-1(a), which it cited, repeats that almost verbatim, but adds, "However, this result would not follow if he only had the power to appoint himself trustee under limited conditions which did not exist at the time of his death," referring to a contingency beyond the decedent's control which did not occur before his death. The Ruling then revokes some anti-taxpayer Revenue Rulings dealing with Code § 2036 or 2038, holding that the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of Code § 672(c) – see fn. 1751) is not deemed the retention of a trustee's discretionary control over trust income. Thus, despite the introductory broad language, the Ruling does not by its terms extend outside of Code § 2036 or 2038. However, Letter Rulings

III.B.2.i.i. Trusts Intended to Be Beneficiary Grantor Trusts from Inception

A beneficiary grantor trust – an irrevocable trust treated as owned by the beneficiary for income tax purposes but not for estate tax purposes – can be a very useful tool. For example, your client owns a business that is expanding. Her mother creates a beneficiary grantor trust, making a $5,000 gift. The trust forms a limited liability company (LLC). The LLC makes a deal with the business – the LLC builds the building, and the business will rent the building from the LLC. The LLC takes the lease to a lender and obtains financing for the purchase of land and construction of the building. Over time, the LLC uses the rental income to pay down the mortgage, acquiring equity in the building. When the mortgage is retired, the trust continues receiving rental income and gaining equity. The annual income taxes the beneficiary pays reduces the beneficiary's estate. Eventually the beneficiary might get to the point where her other assets are depleted, so that her estate is reduced to the estate tax applicable exclusion amount. She can then live off the trust comfortably, without having a conflict between having plenty of retirement income and avoiding estate tax, because her primary source of income – the trust – is outside of the estate tax system.

Generally, beneficiary grantor trusts are formed as follows: the grantor establishes an irrevocable trust for the benefit of one of the grantor's children ("the beneficiary"). The grantor is the client's parent or another person who is not in a business relationship with the beneficiary[5065] sets up a beneficiary grantor trust. The beneficiary has a withdrawal right over gifts to the trust, which withdrawal right lapses to the greatest extent allowable without the lapse constituting a gift.[5066] The trust is irrevocable and is structured so that the only assets included in the beneficiary's estate are unlapsed withdrawal rights. The grantor allocates GST exemption to the trust. The trust can then pass from generation to generation outside of the estate tax system.

The beneficiary is taxed as the owner[5067] of the portion that beneficiary can withdraw.[5068] The trust is drafted so that the grantor is not taxed as the owner for income tax

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suggest that its spirit carries into other areas, as discussed in notes 3269 (Code § 2042 life insurance) and 5062 (Code § 2041 general power of appointment).

[5065] If a business associate of the beneficiary sets up the trust, the transfer to trust might be deemed a payment to the beneficiary, followed by a gift from the beneficiary to the trust. See, *e.g.*, Reg. §§ 1.61-22(c)(2)(ii), 1.83-6(d)(1).

[5066] Code § 2514(e) provides that the lapse of a withdrawal right does not constitute a gift to the extent that the lapse does not exceed the greater of $5,000 or 5% of the trust's assets. Because the $5,000 limit applies to all lapses during the year with respect to the holder of the withdrawal right, and coordination between irrevocable trusts often is cumbersome or impractical, when drafting it's usually best when describing the lapse to refer either to Code § 2514 or a lapse of 5% without mentioning the $5,000 amount.

[5067] However, Beneficiary is not treated as the grantor for income tax purposes. Reg. § 1.671-2(e)(6), Example (4). This rule is necessary for Code § 678(b) work.

[5068] Code § 678(a)(1) provides, A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself. This includes an unlimited withdrawal rights, Rev. Rul. 85-45 (Code § 121 exclusion for gain on sale of residence applied to beneficiary), and applies even to a beneficiary who lacks legal capacity to exercise the power, Rev. Rul. 81-6.

purposes[5069] and so that, if the beneficiary had been the settlor, the beneficiary would have been taxed as the owner for income tax purposes.[5070] Thus, the beneficiary is treated as the owner of the trust for income tax purposes - many private letter rulings have held that Code § 678(a)(2) taxes the beneficiary after a withdrawal right lapses, even though the statute requires that the beneficiary "partially released or otherwise modified" the withdrawal right.[5071] The deemed owner is treated as the owner of the

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[5069] If the grantor is taxed as the owner under other provisions of the grantor trust rules, then the beneficiary is not taxed as the owner to the extent provided in Code § 678(b). Even if the beneficiary is the deemed owner of the trust under Code § 678, the settlor continues to be the grantor for income tax purposes until the beneficiary exercises the beneficiary's withdrawal right. See Reg. §§ 1.672-1(e)(5) and 1.672-1(e)(6), Ex. (4). Among possible grantor trust rules that might apply, one would consider at least avoiding the grantor being treated as owner under part III.B.2.h.vi Distribution Provisions Might Prevent Turning Off Grantor Trust Status.

Although Code § 678(b) appears limited in scope, most commentators believe, and numerous recent Letter Rulings hold, that any conflict in whether the grantor or a beneficiary of the trust is treated as the owner for income purposes is resolved in favor of the grantor being treated as such an owner. Thus, for example, a swap power under Code § 675(4)(C) might not work, if both Grantor and Beneficiary would be deemed owners, and Code § 678(b) would make Grantor the trust's deemed owner. However, when the beneficiary was the holder of the swap power, Letter Rulings 9311021 and 201216034 held that the trust was deemed owned by only the beneficiary, not by the grantor; the law behind this is questioned by several top lawyers I know, so I remain very reluctant to include a swap power during the settlor's life. The rulings might be focused on the fact that the beneficiary is an adverse party as to the grantor; see Reg. § 1.675-1(b)(4), which is discussed in fn. 5006, found in part III.B.2.h.i Who Is the Grantor.

Furthermore, suppose a trust would be a beneficiary grantor trust, but for Code § 678(b) causing the settlor's grantor trust powers to trump the beneficiary's. Suppose further that the settlor dies or otherwise turns off his or her grantor trust powers. Does the beneficiary become the deemed owner, since the Code § 678(b) suppression of the beneficiary's grantor trust powers no longer applies? No, said the IRS in Letter Ruling 9321050, inexplicably reversing its position in Letter Ruling 9026036. The beneficiary would need a new withdrawal right over all of the trust's assets once the settlor's powers are turned off, and then have those new withdrawal rights lapse over time. Blattmachr, Gans and Lo, A Beneficiary as Trust Owner: Decoding Section 678, *ACTEC Journal* (Fall 2009), found this change in position puzzling (as do I). Given that the IRS did not explain why it changed its position, either position would appear to have substantial authority; however, when planning, one would consider that presumably on audit the IRS would assert its most recent position.

[5070] Code § 678(a)(2) provides, A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which… person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

[5071] In The Year in Review: An Estate Planner's Perspective on Recent Tax Developments, *TM Estates, Gifts and Trusts Journal* (BNA) (1/13/2011), Howard Zaritsky commented [dates of PLRs excised below]:

> The IRS never explains this, but always treats the lapse of the withdrawal right as a modification or partial release. See PLRs 201039010; 200747002; 200147044; 200104005; 200022035; 200011058, 200011054–200011056; 199942037; 199935046–199935047; 9812006; 9810006–9810008; 9810004; 9809005–9809008; 9745010; 9739026; 9625031; 9535047; 9504024; 9450014; 9448018; 9320018; 9311021; 9226037; 9140047; 9034004; 9009010; 8936031; 8827023; 8805032; 8701007; 8613054; 8521060; 8342088. See also Blattmachr, Gans & Lo, A Beneficiary as Trust Owner: Decoding § 678, 35 *ACTEC J.* 106, 114–117 (Fall 2009).

income for tax purposes, whether that income is allocated to trust accounting income or principal (such as capital gain).[5072]

This withdrawal right must apply to all property transferred to the trust. Otherwise, only the portion subject to the initial withdrawal right will be taxed to the beneficiary.[5073] Partial withdrawal rights generate partial deemed ownership,[5074] so that any future sale

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[5072] Reg. § 1.671-3(b)(3).

[5073] Reg. § 1.671-3(a)(3).

[5074] Letter Ruling 9034004 involved a trust in which the beneficiary, A, received mandatory income distributions and had the noncumulative annual right to withdraw the greater of $5,000 or 5% of the trust's principal at the end of the year. For 11 years, A never exercised her withdrawal right, but the trustee did exercise his discretionary power to the trust corpus. The trustee made substantial discretionary distributions of corpus to A over the years, depleting the trust to the point that only a single piece of real estate remained. That asset was sold at a gain, and the trustee requested a ruling concerning the portion of any gain that A must report as a result of a series of lapses of her withdrawal right. Based on Reg. § 1.671-3(a)(3) and Rev. Rul. 67-241, the IRS ruled that, when A failed to exercise her withdrawal right, she would be treated as if she partially released a power to withdraw a portion of the trust corpus under Code § 678(a)(2). Because the income of that portion will be paid to A, she would be treated as the owner of that portion of the trust under Code §§ 677 and 678. During each succeeding year in which A failed to exercise her power, A was treated as the owner of an increasing portion of corpus of T. Each year, she was treated as owning an additional portion of corpus, multiplying the amount which she could withdraw by a fraction, the numerator of which is the portion of trust corpus which she is not already treated as owning, and the denominator of which is the total of trust corpus from which the withdrawal could be made. Discretionary distributions made by the trustee from corpus would be treated as coming from both the portion of corpus which A is treated as owning and from the portion which she is not treated as owning, in the same ratio as the fraction mentioned above.
Letter Rulings 200022035 and 200104005 had similar facts and the same result.
Letter Rulings 8035067, 8308033 and 8326074 mentioned Reg. § 1.671-3(a)(3) and Rev. Rul. 67-241 in connection with withdrawal rights but not say how to apply them.
Letter Ruling 8142061 involved a trust in which the beneficiary, N, had the right to withdraw the first $6,000 of gifts made to a trust each year. N would eventually receive all of the trust's assets by the time he attained age 35. Using language similar to (but mote explicit than) Letter Ruling 7852042, the IRS said (emphasis added), Therefore, until his power is exercised, released or allowed to lapse, N will be treated as the owner of **each item of income**, deduction and credit (including ordinary income items and items allocable to corpus, such as capital gains) **which is attributable to any new property which is transferred by gift to the trust** (subject to the $6,000 limitation contained in the trust agreement). Furthermore, the IRS pointed out that, if N fails to his withdrawal right over a gift to the trust, it will become a permanent part of the corpus of the trust. Because the income of that portion may be distributed to N or accumulated for future distribution to N, N will be treated as the owner of that portion of the trust (subject to the $6,000 limitation contained in the trust agreement), citing Code § 677.
LaFargue, notes 5076-5077, applied Reg. § 1.671-3(a)(3) to tax a grantor (who the trust did not designate as a beneficiary) on the trust's income to the extent that the grantor received annuity payments, so that case does not shed any light.
In *Scheft v. Commissioner*, 59 T.C. 428 (1972), the grantor was deemed to own all of the trust but tried to use a fiscal year vs. calendar year argument to say that Reg. § 1.671-3(a)(3) caused some ambiguity in calculations, but the court held that this argument did not change the fact that all of the trust's income and principal could be accumulated for the grantor's benefit. *Garvey v. Commissioner*, T.C. Memo. 1986-200, rejected the need for Reg. § 1.671-3(a)(3) for similar reasons and taxed the whole trust to the grantor.
Letter Ruling 201038004 is one of the most recent rulings about trusts deemed partially owned by beneficiaries. Thus, it does not help in the area of sales to irrevocable grantor trusts, although it

to the trust will be recognized to the extent of the part that is not deemed to be owned by the beneficiary. At least one commentator is concerned that, under the literal language of certain regulations, a lapse of the entire withdrawal right might not suffice and that those who do not obtain a private letter ruling on this issue do so at their own risk.[5075]

As mentioned above, the trust is drafted so that, if the beneficiary had been the settlor, the beneficiary would have been taxed as the owner for income tax purposes. The primary approach I use relies on Code § 678(a)(2) with Code § 677(a); combined, these sections provide that the beneficiary shall be treated as the owner of any portion of a trust, whose income without the approval or consent of any adverse party is, or, in the discretion of the beneficiary or a nonadverse party, or both, may be distributed to the beneficiary or held or accumulated for future distribution to the beneficiary. It has been suggested that a line of cases limits the application of Code § 677.[5076] I disagree with this suggestion[5077] but recommend that those who plan sales to beneficiary grantor trusts

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helps focus on some issues. The IRS ruled that a beneficiary with the right to withdraw income would be taxable on the income under Code § 678. Any undistributed income, which was not yet added to principal, would be includible in the beneficiary's estate as a general power of appointment. Any income that had been added to principal and constituted a lapse in excess of the greater of $5,000 or 5% of the trust's assets would be includible in the beneficiary's estate under Code § 2036, since the beneficiary was deemed to have transferred that part of the accumulated income and also retained the right to the income in that transferred property. The ruling did not address whether any capital gains later realized on the principal that constituted accumulated income would be taxable to the beneficiary under Code § 678(a)(2). The ruling did not address the gift tax consequences of the lapse, which presumably would be an incomplete gift because of the beneficiary's retained general power of appointment.

Consider instead giving the beneficiary a hanging power so that the power can lapse in a way that does not make any of the lapsed income includible in the beneficiary's estate. That might help not only for estate tax purposes but also for protection from future creditors. This structure has the advantage of allowing the trust's income to be accumulated income tax-free (to the trust, since the beneficiary is taxable personally on the income), with only the excess income, if any, being included in the beneficiary's estate. Given that income yields tend to be significantly lower than 5%, perhaps none of the accumulated income will ever be included in the beneficiary's estate. On the other hand, significant income tax benefits might be lost to the family as a whole. Trustee fees would be fully deductible if this were a nongrantor trust. Trustee fees attributable to the grantor trust portion would be deductible, if at all, as miscellaneous itemized deductions subject to the 2% floor and also disallowed for purposes of the alternative minimum tax.

[5075] See Zaritsky, ¶ 4.08[3][l][i] Beneficiary ownership of the trust, *Tax Planning for Family Wealth Transfers: Analysis With Forms* (WG&L).

[5076] *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq*. 1973-2 C.B. 1, *aff'd*, 513 F.2d 824 (9th Cir. 1975); *LaFargue v. Commissioner*, 73 T.C. 40 (1979), *aff'd in part, rev'd and rem'd in part*, 689 F.2d 845 (9th Cir. 1982), *on remand*, T.C. Memo. 1985-90, *aff'd*, 800 F.2d 936 (9th Cir. 1986); and *Stern v. Commissioner*, 77 T.C. 614 (1981), *rev'd and rem'd*, 747 F.2d 555 (9th Cir. 1984).

[5077] In *Lazarus* and *LaFargue*, fn. 5076, the grantor was not a named beneficiary of the trust. The Tax Court taxed the grantor on the income of retained annuities because it treated the grantor as the settlor and the annuity payments were all that the grantor could receive. The court expected that the grantor would be fully taxed on all of the income as the grantor received it from the trust; presumably the court thought it was fairer to tax the grantor each year when the grantor received the annuity to better match cash received with income reported. I don't view those cases as limiting the application of Code § 677. In *Stern*, however, the person who sold property to the trust in exchange for an annuity was a beneficiary of the trust. The Tax Court held that he was the settlor (because the sale for the annuity was really a transfer with a retained interest) and that consider these cases not only for that issue but also to get a flavor for how courts might respond to such sales. Also consider granting the beneficiary the power to borrow from the trust at the AFR but without adequate security, which will make the beneficiary and not the grantor the owner under a combination of Code § 678(a)(2) and 675(2).

The beneficiary can be the only beneficiary of the trust, which provides more financial security (but perhaps more risk if a creditor with a claim sympathetic to a judge brings a case against the trust), but it also precludes using the trust to help the beneficiary's descendants, so whether to authorize distributions to the beneficiary's descendants depends on the circumstances. Making the beneficiary the sole person to whom distributions can be made simplifies testing under the grantor trust rules, particularly when the beneficiary has an inter vivos power of appointment.[5078]

Many letter rulings requested that the beneficiary be treated as the sole owner of the trust under the grantor trust rules so that the trust could qualify as a shareholder in an S corporation.[5079]

III.B.2.i.ii. Can a Trust without a Withdrawal Right Be a Code § 678 Trust?

A direct, clear approach that can be very effective but has significant limitations on practicality in the long run is in part III.B.2.i.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.

A trust without a withdrawal right might be converted to a partial beneficiary grantor trust over time if the trustee credits distributions to the beneficiary and then the beneficiary lets his or her right to take those distributions lapse.[5080]

A more fundamental question is what is the threshold for beneficiary control over a trust to activate Code § 678(a)(1), which requires that the beneficiary have "a power exercisable solely by himself to vest the corpus or the income therefrom in himself."[5081]

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the income was fully taxable to him under Code § 677. The Ninth Circuit reversed, respecting the sale for the annuity. The settlor of each trust involved was either a business associate (who received no benefit other than the prospect of future business) or a family member; the seller was not the settlor (except allegedly with respect to the annuity sale, which the Ninth Circuit rejected). Implicitly, Code § 677 could not apply because the seller, who was also the beneficiary, was not the grantor.

[5078] A power to add beneficiaries can cause Code § 674 to apply – by preventing the exceptions to Code § 674(a) from applying. However, when the sole beneficiary can add beneficiaries, that power does not prevent the exceptions to Code § 674(a) from applying. Reg. § 1.674(d)-2(b).

[5079] Code § 1361(c)(2)(A)(i) authorizes as a shareholder of an S corporation a trust all of which is treated under the grantor trust rules as owned by an individual who is a United States citizen or resident. Code § 1361(c)(2)(A)(ii) authorizes such a trust to continue to hold S corporation stock for the 2-year period beginning on the day of the deemed owner's death. For a discussion of rulings treating trusts as grantor trusts so that they can hold S corporation stock, see Christian & Grant, ¶ 8.02[2] Grantor Trusts, *Subchapter S Taxation* (WG&L).

[5080] See fns. 1565-1570, found in part II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles.

[5081] *Trust No. 3 v. Commissioner*, 33 T.C. 734 (1960) held as follows when a trust tried to invoke Code § 678 to avoid taxation:

> An examination of the legislative history of section 678 discloses that it was the intention of Congress to incorporate the rule of *Edward Mallinckrodt, Jr.*, 2 T.C. 1128, *affd*. (C.A. 8)

Certainly a withdrawal right will do the trick.[5082] On the other hand, subjecting the withdrawal right to an ascertainable standard does not work.[5083] However, when a trust

146 F. 2d 1, *certiorari denied* 324 U.S. 871, which had been set forth in section 39.22(a)-22 of Regulations 118. See H. Rept. No. 1337, 83d Cong., 2d Sess., p. 63, and S. Rept. No. 1622, 83d Cong., 2d Sess., p. 87. In the latter committee report it is stated that a person other than a grantor may be treated as the substantial owner of the trust if he has an unrestricted power to take the trust principal or income. The *Mallinckrodt* case involved an adult beneficiary who had the right to terminate the trust. It was held that currently and without any restriction whatever the taxpayer could take as his own the income of the trust. In the *Mallinckrodt* case, we relied in part upon *Corliss v. Bowers*, 281 U.S. 376, in which the Supreme Court stated, But taxation is not so much concerned with the refinement of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid. *** The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

> Read in the light of the legislative history of the section, we think section 678 should not be held to apply in the situation here presented. It cannot be said that these beneficiaries were currently entitled to the income of the trust or that their command over the corpus or income was unfettered. Indeed, the trust provisions in question would seem to have been intended by the grantors of the trust to restrict, in accordance with the law of Illinois, the command hereof the minor beneficiaries over the property and income of the trust, particularly since the grantors did not proceed to have guardians appointed. Otherwise, the grantors would have made provision for themselves or others to exercise the power for the beneficiaries or would have proceeded to have guardians appointed for the beneficiaries. We conclude that the income in question was that of the petitioner under section 641.

The Seventh Circuit reversed, 285 F.2d 102 (1960), holding that a guardian need not be appointed to give effect to a withdrawal right, which result the IRS reached in fn. 5082. This case is mentioned above simply because of the Tax Court's view of the legislative history, which the appellate court did not controvert when it held that a minor's withdrawal right is not really encumbered by the need to appoint a guardian:

> We believe that, for several reasons, the Commissioner's argument lacks substance. It is not denied by him that the beneficiaries were given a right to terminate the trust and to take possession of the trust property, but he considers that their minority bars them because (he says) they could not assert that right except through a guardian duly appointed. This distinction is unconvincing in view of the fact that the appointment of a guardian for a minor under a state law is a matter of routine in which the federal government has no concern. To effectuate a termination of the trust as to any child and a delivery of its share of the accumulated income or corpus to the child, customarily there would be delivered to the trustees a properly authenticated copy of letters of guardianship and a receipt for the assets and monies delivered. However, we think the necessity of such routine steps would have no bearing upon the fundamental question of the legal right of the beneficiaries to terminate the trust. We should not deny an undisputed right because the conventional methods of exercising it have not been described in the instrument creating the right.

[5082] Rev. Rul. 67-241 (power to require distribution on request caused Code § 678(a)(1) to apply); Rev. Rul. 81-6, which applied even though the beneficiary was a minor and could not actually exercise the withdrawal right until a court appointed a representative.

[5083] *Funk v. Commissioner*, 185 F.2d 127 (3rd Cir. 1950), decided under pre-Code § 678 case law, involved a beneficiary who as trustee was authorized in her discretion to pay all or a part of the net income annually … to herself, in accordance with [her] needs, of which she shall be the sole judge. In distinguishing it from other cases:

authorized "the trustees to invade corpus, at their sole discretion, to provide for [the beneficiary's] support, welfare and maintenance, so long as the total net income and corpus paid to [the beneficiary] do not exceed $100,000 in any accounting year," the first $100,000 of annual income was taxable to the beneficiary while serving as sole trustee;[5084] on the other hand, "support, maintenance, comfort and enjoyment" was sufficiently ascertainable to avoid taxation in a pre-1954 case,[5085] as was "needs, maintenance and comfort" in a Code § 678 case[5086] or "support and maintenance" in Letter Ruling 8939012. Granting a beneficiary "the right to use so much thereof, either of the corpus or the income or both, as may be required by her for her personal support and maintenance, the reasonableness thereof to be determined by her" was enough to make her the deemed owner when it was a bequest in addition to her life estate;[5087] this case affirmed the trial court's finding that the beneficiary was taxable, but for context note that the trial court had gone further and stated that a trust was never intended to be created at all and that instead the beneficiary was the true owner, so one needs to place this case in the context of a very broad interpretation of the language that was used.[5088]

> Here, the trustee had no a fortiori right to the income, nor did the absence of any needs on the part of either her co-beneficiary or herself confer such right upon her. What was not needed was directed by the settlor to be accumulated and added to principal, and the trustee's discretionary power to distribute conclusively terminated. She did not even have the authority to invade the principal in the event the income proved inadequate.

Letter Ruling 9227037 (trustee shall also pay … for the proper health, support and maintenance of Spouse, after considering any income or resources of Spouse outside the trust and reasonably available for such purposes).

[5084] Letter Ruling 8211057. Compare that to *Townsend v. Commissioner*, 5 T.C. 1380 (1945), in which a state court had ruled that the beneficiary was entitled to $30,000 per year for maintenance and support unless the parties returned to court to determine a different amount; the Tax Court held that the beneficiary was taxable on the $30,000 each year whether or not she withdrew it. Blattmachr, Gans and Lo, A Beneficiary as Trust Owner: Decoding Section 678, *ACTEC Journal* (Fall 2009), argues that *Townsend* should not be relied upon and that the Letter Ruling used welfare and therefore was not an ascertainable standard.

[5085] *Smither v. U.S.*, 108 F.Supp 772 (S.D. Tex. 1952), *aff'd* 205 F.2d 518 (5th Cir. 1953) (adopting by reference the trial court's opinion). See also *Stavroudis v. Commissioner*, 27 T.C. 583 (1956), in which the beneficiary was not trustee and the court rejected the suggestion that she could control distributions:

> Respondent appears to contend that since under paragraph Fifth of the trust instrument, the trustees are given power, in their sole discretion, to invade the corpus of the trust in the event of financial need, they, in effect, have unlimited discretion to distribute trust corpus to petitioner in accordance with her desires. Petitioner, however, is not a trustee of the trust in question and possessed no power, under the terms of the trust instrument, arbitrarily to direct the trustees to make disbursements to her from either principal or income, beyond the amounts specified as her guaranteed annual income.... The trust instrument therefore creates a standard limiting the power of the trustees to invade the corpus of the trust on behalf of petitioner, thus restricting the rights of petitioner in the trust principal to the extent that she cannot be held to be the substantial owner thereof. *Eva V. Townsend*, 5 T.C. 1380; *Lewis Hunt Mills*, 39 B.T.A. 798; *Funk v. Commissioner*, *supra*.

[5086] *U.S. v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960). Similarly, support, comfort, health and service were sufficiently ascertainable to avoid taxation of capital gain to the life tenant in the pre-Code § 678 case of *Security-First Nat. Bank v. U.S.*, 181 F.Supp 911 (S.D. Ca. 1960).

[5087] *Koffman v. U.S.*, 300 F.2d 176 (6th Cir. 1962).

[5088] *Koffman v. U.S.*, 193 F.Supp 946 (E.D. Mich. 1961), held:

Construing the language of the above quoted paragraph SECOND, plaintiff, Fannie Koffman, simply received a life estate in all her deceased husband's estate together with the right to do as she saw fit with the corpus or income or both. Therefore, any income accruing to this life interest belonged to plaintiff and was taxable to her.

I am convinced that a trust was *not* intended, *nor* one created in fact. The instrument did not provide for separation of any legal or equitable titles to the property. The executor here did not hold the legal title to the property. There was no trustee. The executor was merely given limited managerial rights for a specific period (which period in truth, had expired under the partnership arrangement apparently.) But even liberally viewing the over-all language of the instrument's provisions as trust provisions, the plaintiff would still have sufficient power over the property as a beneficiary to be considered the owner of all the distributable income for tax purposes. Section 678, 1954 Internal Revenue Code, deals with such situations. It provides in pertinent part:

> (a) General Rule.—A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself ***

In the instant case, plaintiff was solely able to determine what would actually be distributed to her from the available income, but fact remains that all such property was distributable to her. The amount that she would consider reasonable was her business and hers alone. There was no one with the available right to check her discretion in this matter.

See *Emery v. Commissioner of Internal Revenue*, 156 F.2d 728—quoting from *Corliss v. Bowers*, 281 U.S. 376, at 378—

> The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

The *Emery* case likened the principles and logic of the Corliss case where it was the settlor of the trust who had broad powers to a situation where a beneficiary receives and retains such powers (as could be said here about plaintiff beneficiary's powers.) The fact that plaintiff beneficiary did not exercise these powers in her own favor during taxable years does not make the income any less taxable to her. It is not necessary to collect income which is attributable to person for purposes of income taxation. *Helvering v. Stuart*, 317 U.S. 154. A beneficiary is not taxed on what he receives, but his share of the distributable net income. See Sections 652(a) and 662(a), Internal Revenue Code of 1954. Plaintiff in this case was entitled to the whole share.

While we were impressed by plaintiff's theory that the widow beneficiary would be bound by reasonableness in the amount she needed for expenses and costs of living, nevertheless the words the reasonableness thereof to be determined by her made an impression upon this court and we sought to learn how those words or words of similar import had been interpreted by the Federal Court and the Supreme Court of the State of Michigan. In this connection we found that when the contract provides that something be done to the satisfaction of the purchasing party the courts have held time and time again that while the product or work might be satisfactory to everybody else, and the refusal of the purchasing party to accept the work or the product might even be very frivolous, yet if not done to his satisfaction he or she was not obliged to accept or pay for it. *Silsby Manuf'g Co. v. Town of Chico*, 24 F. 893, 894; *Patterson v. Alabama Vermiculite Corp.*, 149 F.Supp. 548. Michigan takes a very serious view of this provision. *Wood Machine Co. v. Smith*, 50 Mich. 565; *Schmand v. Jandorf*, 175 Mich. 88, 140 N.W. 996; *Graham v. City of Grand Rapids*, 141 Mich. 612, 104 N.W. 983; *Plano Manuf'g Co. v. Ellis*, 68 Mich. 101, 35 N.W. 841; *Gibson v. Cranage*, 39 Mich. 49, 50.

In the case at bar the last word was given to the widow to decide how much she wanted. Some of her expenses might be frivolous; might be considered absolute waste by some

In light of this uncertainty, if the settlor wants to make a trust a grantor trust as to the beneficiary while placing restrictions on the beneficiary's withdrawal rights then the settlor might consider providing only a temporary unrestricted withdrawal right and then lapsing it or subjecting it to restrictions after the lapse. Note that, to avoid a gift, the lapsed power to withdraw, to the extent that the lapse exceeds the 5-and-5 amount provided in Code § 2514(e), could be retained and subjected to the consent of a nonadverse party, allowing the withdrawal right to retain its status as a general power of appointment[5089] while providing some assurance of a check on its exercise; alternatively, if the power of appointment is no longer a general power of appointment, holding a present beneficial interest and a testamentary power of appointment should cause the gift to be incomplete.[5090]

III.B.2.i.iii. Benefits of Beneficiary Grantor Trusts Other Than Leveraged Transactions or Estate Reduction

Some grantor trusts are created with the thought of the income tax liability reducing the grantor's estate or engaging in leveraged transactions.

However, beneficiary grantor trusts can be very important in planning for the family without a taxable estate, which comprises 99.9% of the population when the estate tax exemption is over $5 million. Trusts are taxed at the highest income tax rates after reaching a relatively low taxable income threshold.[5091] Once informed of this issue, families who wish to use trusts to meet nontax objectives would like to avoid those high rates.

This part III.B.2.i Code § 678 (Beneficiary Grantor) Trusts describes how to make a trust a beneficiary grantor trust and discusses various issues in doing so.

In addition to those tools, one might build in some simple ideas into trusts that one commonly uses, which might make the trust a beneficiary grantor trust with respect to a part. For example, one might grant the beneficiary an annually exercisable 5% withdrawal right. If one is concerned about the beneficiary's creditors using this withdrawal right to obtain funds, one might appoint an independent trustee who could temporarily grant or suspend this withdrawal right. If a trust does not include a withdrawal right, consider the trustee determining that a particular amount (up to 5% if the trust) is appropriate to distribute and, instead of distributing it, makes it available to the beneficiary to draw upon.[5092]

When Trust 1 distributed assets to Trust 2, retaining the right to withdraw all of Trust 2's income, which right lapsed at the end of each year, Letter Ruling 201633021 held that Code § 678 would tax Trust 1 on all of Trust 2's income and capital gain. The trusts had identical terms regarding current distributions. It is unclear what the point was. Query

but it was up to her to decide and because of that power placed in her we believe puts an entirely different aspect upon the taxing power of the United States.

[5089] Code § 2514(c)(3)(B).

[5090] Letter Ruling 201525002 describes various nuances to making an incomplete gift, including dealing with the beneficiary's incapacity.

[5091] For a general discussion of trust income tax issues, see part II.J Fiduciary Income Taxation.

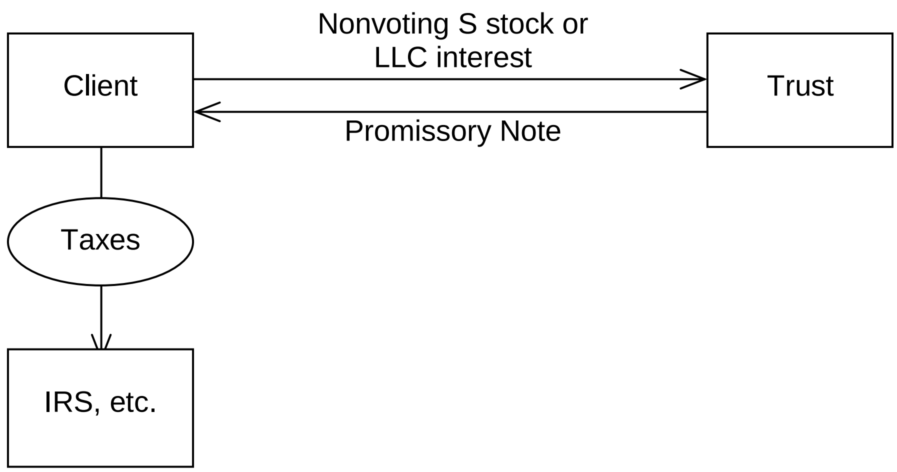
[5092] See text accompanying fn. 1569.

whether decanting with a similar withdrawal right might allow the decanted trust to grow if, unlike this ruling, one would like to benefit one subset of beneficiaries.

For more information, see parts II.I.7 Interaction of NII Tax with Fiduciary Income Tax Principles and III.B.2.i.vi Portion Owned When a Gift Over $5,000 is Made.

III.B.2.i.iv. Sale to a Beneficiary Grantor Trust – When a Traditional Sale to an Irrevocable Grantor Trust Does Not Meet the Client's Objectives

A sale to a beneficiary grantor trust can be a useful alternative to a traditional sale to an irrevocable grantor trust. In a typical sale to an irrevocable grantor trust, the senior family member sells an interest in a partnership or S corporation to a trust for the benefit of descendants or other family members. The sale is structured to be effective for transfer tax purposes but ignored for income tax purposes.



The sale is not subject to income tax, because for income tax purposes all the beneficiary has done is sold assets to himself or herself.[5093] Now, the business interest is outside of the estate tax system, yet the beneficiary has access to the trust's assets, so the beneficiary is more comfortable with the transfer than with selling to a traditional irrevocable grantor trust.

Furthermore, if the beneficiary has a power of appointment[5094] and the IRS asserts that the sale price was inadequate, any resulting gift is an incomplete gift[5095] and therefore is not subject to gift tax.[5096] This might be less susceptible to IRS attack than a defined value clause.

5093 See Rev. Rul. 85-13.

5094 That is not a general power of appointment under Code § 2041(b)(1), since the goal is avoiding inclusion in Beneficiary's estate.

5095 Reg. § 25.2511-2(b).

5096 In Letter Ruling 200949012, the Distribution Trustee could distribute the entire trust to Beneficiary. Thus, after an IRS audit, the incomplete gift portion could be transferred back to Beneficiary to engage in future sales to the trust.

Why might the senior family member not want to do a traditional sale to an irrevocable grantor trust?

- The client is concerned about preserving income for retirement or emergencies. The client might not feel comfortable reducing his or her estate to the amount of estate tax exemption.
- The client might not want to give that amount of wealth to his or her children too soon, as doing so might destroy work ethic.
- The client might want to control where the assets pass on the client's death.
- As an entrepreneur, the client likes to feel that he or she has a stake in the business' success. If the assets belong to a trust for the children, the client might feel as if he or she lost this emotional investment in the business.

A sale to a beneficiary grantor trust might be a palatable alternative that the client would do, rather than doing nothing.

III.B.2.i.v. Funding the Trust with Small Gifts

III.B.2.i.v.(a). General Concept of Funding with Small Gifts

In the BDIT structure, the trust is funded with a gift of up to $5,000, which the beneficiary has the right to withdraw. When a withdrawal right lapses, the beneficiary is deemed to have made a gift to the trust only if and to the extent the lapse exceeds the greater of $5,000 or 5% of the trust's assets (a "5&5 power").[5097] If and to the extent that a lapse exceeds a 5&5 power, and the beneficiary holds some power over the lapsed property, then a portion of the trust will be included in the beneficiary's estate, either because of strings under Code § 2036 or 2038 or because the lapse constitutes an incomplete gift. To avoid these issues, a BDIT is funded with an amount that does not exceed $5,000. The beneficiary should not hold withdrawal rights over any other trust that lapse before the lapse of the withdrawal right over the beneficiary grantor trust; otherwise, the lapse might exceed the limits of a 5&5 power.

However, $5,000 is rather thin capitalization to support the trust's purchase of the beneficiary's partnership (LLC) interest or S corporation stock. Therefore, the trustee will find someone other than the beneficiary to guarantee a portion of the sale. The trustee will compensate that person for the risk by paying a guarantee fee.[5098] The

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[5097] Code § 2514(e). This statement oversimplifies the rule, in that these provisions might need to be coordinated with other lapses with respect to other trusts.

[5098] The guarantee fee is not a tax law requirement, but it might be advisable – see part III.B.1.a.ii Loan Guarantees, especially part III.B.1.a.ii.(a) Gift Tax Issues and fn. 4713. Because the sale is a transaction between related parties, it receives a higher level of scrutiny. Thus, it is advisable to show the IRS and the courts the business motivation of each party to the transaction, including the guarantor, which a guarantee fee might do. One might consider using a formula to determine the fee –a market rate that is the greater of the rate needed to avoid a gift for gift tax purposes or the rate needed to avoid treatment as grantor under Reg. §1.671-2(e). If the guarantee fee is more money than the trust currently has, finding another motivation other guarantee fee will constitute income to the recipient but might not be deductible by the trust.[5099]

A more conservative strategy involves a trust that was set up to take advantage of business opportunities,[5100] without its only future significant activity being a sale to the beneficiary grantor trust. For example, the client asks his or her parent to fund a beneficiary grantor trust for one of the following situations:

- The client's business is expanding and needs another facility in which to operate. The trust forms an LLC to hold the real estate. The operating company agrees to a long-term lease with LLC. The lender might allow the LLC to be relatively thinly capitalized if it views the lease obligation to be solid. The use of beneficiary grantor trusts to hold real estate and later participate in an S corporation buy-sell agreement was the subject matter of the trusts used in my Life Insurance LLC private letter ruling;[5101] Be careful to make sure that the rent paid to the LLC is not excessive, lest the IRS argue that the owners of the tenant made a gift to the owners of the LLC; and a gift to the trust that owns the LLC might change the trust's income tax posture. Alternatively, consider the beneficiary setting up the highly leveraged LLC with the lease in place and then selling it to the trust, which would avoid issues with the initial lease; although this issue might pop up when it's time to renew the lease, the trust might be very well capitalized by then (due to success during the intervening period), minimizing the risk associated with this idea.

- The client is establishing a new line of business that does not require much in the way of start-up costs. This is especially an issue if the existing business is inside of a corporation, which is not as flexible or income tax-advantageous when the business is later sold,[5102] splits up,[5103] or passes to beneficiaries.[5104]

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than the guarantee fee might be advisable. For example, a trust with similar beneficiaries might guarantee a loan to a trust that benefits those beneficiaries.

5099 See, *e.g., A. A. and E. B. Jones Co. v. Commissioner*, T.C. Memo 1960-284 (approving deduction for fees for personal guarantees charged to obtain surety bonds); *Olton Feed Yard, Inc. v. U.S.*, 592 F.2d 272 (5th Cir. 1979) (guarantee fees were a nondeductible disguised dividend); *Tulia Feedlot, Inc. v U.S.*, 52 A.F.T.R.2d 83-5702, 3 Cl. Ct. 364 (1983) (approving a corporation's deduction of 3% guarantee fees paid to shareholders); *Fong v. Commissioner*, T.C. Memo 1984-402 (guarantee fees were not an ordinary and necessary business expense); *Seminole Thriftway Inc. v. U.S.*, 82 A.F.T.R.2d 98-7497, 42 Fed. Cl. 584 (1999) (guarantee fees were a nondeductible disguised dividend); *Container Corporation v. Commissioner*, 134 T.C. 122 (2010) (addressing withholding rules in international transactions; did not address deductibility). It's difficult to glean much from these cases, because generally the argument was really about disguised dividends to avoid C corporation double taxation.

5100 See generally part III.B.1.a Business Opportunities.

5101 See text after footnote 3282, including the chart shown as Appendix C to that portion of these materials. I had not informed the clients of the sale to beneficiary grantor trust concept when we established the trusts – I simply told them that it would be nice for the real estate trusts to be able to hold S corporation stock for future flexibility since the operating business is an S corporation.

5102 See part II.Q.1.a Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis.

5103 See part II.Q.7.f Corporate Division.

5104 See part II.H.2 Basis Step-Up Issues.

One does not need to use a thinly funded to make this structure work. Here are some examples of other ways to do it:

- Instead of setting up one trust for all descendants to receive annual exclusion gifts, do one trust for each child. Don't do it with the idea of doing a sale soon – do it with the idea of building a war chest over time that eventually can be used to invest in business assets. As with any *Crummey* trust, withdrawal rights tend to accumulate in the early years and lapse as the trust's investments grow. There are drawbacks to this idea. First, a *Crummey* trust for all descendants has a larger corpus from which a 5% withdrawal right can be satisfied, so the separate trust for each child has the disadvantage of much, much slower lapses. Second, a *Crummey* trust for all descendants is a simpler vehicle for the grantor to use for planning, such as holding a policy on the grantor's life or buying assets for the grantor. Finally, the beneficiary grantor trust is not a grantor trust as to the grantor, so it loses the tremendous power of depleting the grantor's estate.[5105] One might recommend that a client use some of each strategy. For example, the parent contributes $5,000 per year to a separate trust for each child and uses the balance of his or her annual exclusion for children and grandchildren for a gift to a trust for all descendants. The $5,000 gift should be done as early as possible in the year, so that other lapses during the year do not eat into the $5,000 amount.

- Perhaps the client with the business interests has parents who don't feel that they can afford to give the client money because they need it for their own retirement. They can bequeath the child's share to a trust over which the child has an unlimited withdrawal right. See the example below.

- In contrast to the bullet point above, suppose the parents have lots of money and would like to use part or all of the $5M+ lifetime gift/estate tax exemption. They can make a large gift to a beneficiary grantor trust, and 5% lapses would give the trust equity that can support a sale from the beneficiary to the trust. Again, see the example below.

III.B.2.i.v.(b). Contingency Plan for Trust Funded with Small Gifts

What if a transaction that the trust directly or indirectly enters into winds up being recharacterized as a bargain sale or similar transaction? Especially given the trust's initial small trust funding, this indirect gift might be very significant and might change the trust's income tax characteristics.

Consider providing that, after the initial funding, any future direct or indirect gift will be accounted for as a separate share, which share the beneficiary may withdraw at any time. For this share, one might then use the planning described in part III.B.2.i.vii Funding the Trust with a Large Initial Gift or Bequest. For example, the

[5105] See n. 5069 for why a beneficiary grantor trust should not be structured as deemed owned by the settlor at any time. Presumably, this problem could be cured if, after the settlor's grantor trust powers are turned off, the beneficiary is given the right to withdraw the entire trust, but I am unaware of any rulings on point.

portion of the withdrawal right of the separate share that annually lapsed might be added back to the main trust, using the principles of Letter Ruling 9009010.[5106]

III.B.2.i.vi. Portion Owned When a Gift Over $5,000 is Made

III.B.2.i.vi.(a). Determining Portion Owned When a Withdrawal Right Does Not Lapse in Full Before Any Income Is Earned

Reg. § 1.671-3(a)(3) provides:[5107]

> If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is [taxed ignoring the grantor trust rules].

Concern has been expressed about calculating this fraction in the example above. If this regulation were interpreted narrowly in cases when the withdrawal right extends over a particular dollar amount rather than a fractional share determined with reference to the gift creating the withdrawal right, then when calculating the fraction above one would mechanically calculate a lower portion owned by the beneficiary each year.

Let's apply this concern to the example in part III.B.2.i.vii.(a) Large Gift for One Beneficiary. After seven years, withdrawal rights are only $650K, with a trust value of $1.4M, so that only 46% ($650K divided by $1.4M) is deemed owned by the beneficiary. Thus, the second sale to the trust could generate substantial income tax.

This approach does not give the beneficiary credit for the fruits of the portion deemed owned by the beneficiary. Logically, when the trust is created, the beneficiary owns 100%. All income earned in the first year would be taxable to the beneficiary. However, those who would narrowly construe this Regulation would compute the fraction the next

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5106 Letter Ruling 9009010 is described in depth in part III.B.2.i.vii.(b) Large Gift for Multiple Beneficiaries. The strategy proposed here is different from the Letter Ruling's facts, but the principle is similar. A disadvantage of the idea of moving the lapsed portion from the separate share to the main trust is that the amount out of which the withdrawal right could be satisfied might be considered smaller, resulting in smaller annual lapses.

5107 Letter Ruling 5809125370A elaborated on this:

> Where the portion of a trust owned by a grantor consists of an interest in or a right to an amount of corpus only, a fraction of each item of income is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor and the denominator is normally the value of the trust corpus at the beginning of the taxable year in question. See section 1.671-3(a)(3) of the regulations. Accordingly, you would be taxed also on the fraction of each item of ordinary income of the trust attributable to the portion of trust corpus which ... you would be treated as owning.

year ignoring the fact that, by allowing the income to be reinvested, the beneficiary has, in effect, contributed this deemed income to the trust. With that view, they certainly would not view any unrealized gains or other gain in equity as contributed by the beneficiary, either.

The IRS has issued numerous letter rulings without expressing this view.[5108] Thus, I would feel confident in submitting a ruling request (if available). Nevertheless, if one

[5108] The following Letter Rulings held that a trust was eligible to hold stock in an S corporation because the beneficiary who had withdrawal rights was deemed to own all of the trust when the withdrawal rights applied to all gifts to the trust and the power lapsed in full, rather than hanging and lapsing over time: Letter Rulings 200147044, 200011058, 200011054, 200011055, 200011056, 199942037, 199935046, 199935047, 9812006, 9810006, 9810007, 9810008, 9810004, 9810006, 9809005, 9809006, 9809007, 9809008, 9745010, 9739026, 9625031, 9535047, 9504024, 9448018, 9320018, 9226037, 9140047 (included passing reference to, but no analysis of, Reg. § 1.671-3), 9009010, 8936031, 8827023 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8805032 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8701007 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8809043 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8613054 (included passing reference to, but no analysis of, Reg. § 1.671-3), 8521060, and 8342088 (included passing reference to, but no analysis of, Reg. § 1.671-3). A typical ruling in the late 1990s or later held:

> Because contributions to Trust will be subject to D's withdrawal power, D will be treated as having a power to vest each corpus contribution in D within the meaning of section 678(a)(1). For purposes of sections 678(a)(2) and 677(a), if D fails to exercise the withdrawal power, D will be treated as having released the power while retaining a right to have all trust income distributed to D or accumulated for later distribution. Therefore D will be treated as the owner of Trust under section 678(a).

However, Letter Ruling 9311021 included hanging powers. Without citing Reg § 1.671-3(a)(3) or mentioning any issues along those lines, the IRS ruled:

> The primary beneficiary is treated as the owner of that portion of the trust in which his withdraw right has not yet lapsed under section 678(a)(1) of the Code, because of his ability to withdraw any additions to the trust. in addition, upon the lapse of the withdrawal power the primary beneficiary still has a section 675(4)(C) power over the trust property because he may, at his option, exercisable in a non-fiduciary capacity, acquire all or any part of the property of the trust by exchanging for it property of equal value. Thus, under section 678(a)(2), the primary beneficiary is also treated as the owner of the trust property for which his withdrawal power has lapsed.

Similarly, Letter Ruling 201216034 ignored this issue with the following:

> Under the Trust instrument of Trust, Grantor may contribute, at any time and from time to time, to the principal of the Trust corpus. Primary Beneficiary has the power, following any such contribution to Trust by Grantor during Grantor's life, to withdraw the entire value of the contribution. Primary Beneficiary's power of withdrawal is cumulative. On D2 of each year, the total amount Primary Beneficiary may withdraw with respect to all preceding calendar years is reduced by the amount of $5,000.00, or 5 percent of the value of the Trust principal on D2 of that year, whichever is the greater amount and to that extent Primary Beneficiary's power of withdrawal shall lapse.

Perhaps contrary to the above rulings are Letter Rulings 7943152 and 7943153. The surviving spouse had an unlimited withdrawal right in a marital trust. Her release prevented her from being taxed on the trust's corpus - because she no longer had any interest in the trust's principal, her release was a **complete** release, not **a partial release or modification**. This can be distinguished from the rulings above in that those rulings still included a power to distribute principal for the beneficiary after the lapse.

does not obtain his or her own private letter ruling, one risks the IRS changing its approach, so one might consider an alternative approach.

If one is concerned about the IRS suddenly taking a narrow view of Reg. § 1.671-3(a)(3), one might design a trust with respect to which the beneficiary can withdraw all of the trust's assets - not just an amount equal to the initial gift. The withdrawal right lapses each year to the extent of 5&5.

What does one do with the lapsed portion? Perhaps one might require the trustee to transfer it to a separate trust, somewhat along the lines of the single trust in Letter Ruling 9009010, described in part III.B.2.i.vii.(b) Large Gift for Multiple Beneficiaries. That separate trust invests in any new business opportunity or buys business interests from the beneficiary. That way, none of these leveraged uses of the lapsed amounts are included in the beneficiary's estate.

III.B.2.i.vi.(b). Determining Portion Owned When Trust Is Only a Partial Grantor Trust

For each year a beneficiary fails to exercise a withdrawal right, the beneficiary will be treated as the owner of an increasing portion of the corpus of the trust. The annual increase of the portion of the corpus of the trust that the beneficiary will be treated as the owner is the product of the amount which the beneficiary could withdraw multiplied by a fraction, the numerator of which is the portion of the trust corpus that he is not already treated as owning, and the denominator of which is the total trust corpus from which the withdrawal could be made.[5109]

III.B.2.i.vi.(c). Reporting Portion Owned When Only a Partial Grantor Trust

The partial owner is treated as owning those items of income, deduction, and credit against tax attributable to or included in that portion. These items are shown on a separate statement to be attached to IRS Form 1041. The portions of trust corpus considered so owned are not subject to the provisions of Code §§ 661(a)(2) and 662(a)(2) when distributed to the deemed owner.[5110]

III.B.2.i.vii. Funding the Trust with a Large Initial Gift or Bequest

Below are two examples of way to make large gifts. In either case, consider having any lapsed withdrawal right transferred to a separate trust deemed owned 100% by the beneficiary before it acquires any S corporation stock.

An alternative to these methods is part III.B.2.i.xiii QSST as an Alternative Form of Beneficiary Grantor Trust.

[5109] Letter Rulings 9034004, 200022035, 200104005.

[5110] Rev. Rul. 67-241; for the grantor trust effect, see parts III.B.2.i.i Trusts Intended to Be Beneficiary Grantor Trusts from Inception, especially fn. 5074, and III.B.2.i.ii Can a Trust without a Withdrawal Right Be a Code § 678 Trust?, especially fn. 5082

III.B.2.i.vii.(a). Large Gift for One Beneficiary

Suppose the settlor gives or bequeaths $1M to a beneficiary grantor trust, allocates GST exemption to the gift or bequest, and provides that the beneficiary can withdraw the entire amount of the initial gift. Each year, 5% of the withdrawal rights lapse, subject to coordination with other trusts with respect to which the beneficiary has withdrawal rights.[5111]

With $1M funding, many more investment opportunities are available than with $5K initial funding, and the trust would be useful and significant, even if no sale ever occurred.

Let's ignore investment return for a moment and suppose two years pass. Each year, $50K (5% of $1M) has lapsed, so that a total of $100K of withdrawal rights have lapsed ($50K times two). The trust's assets consist of $900K, over which the beneficiary has withdrawal rights, and $100K, over which the beneficiary does not have a withdrawal right.

The beneficiary then sells $400K of nonvoting S corporation stock to the trust, in exchange for a promissory note of $400K. My target would be 20% equity in the deal, calculated by dividing $100K unlapsed withdrawal rights by $500K assets ($100K unlapsed withdrawal rights plus $400K nonvoting S corporation stock) subject to the deal. I did not count the assets subject to withdrawal rights as part of the deal, because they are reserved for any future exercise of the beneficiary's withdrawal rights. The trust uses the S corporation's earnings and earnings on the trust's other investments to repay the note over the next five years.[5112]

So, after seven years, the withdrawal right has lapsed at least $50K per year, for a total lapse in excess of $350K.[5113] The trust now consists of $650K of the original gift over which the beneficiary has withdrawal rights, $350K of the original gift in which the beneficiary no longer has withdrawal rights, and $400K of nonvoting S corporation stock.[5114]

[5111] For example, The total amount that may be withdrawn by the Primary Beneficiary under this Section after December 31 of a calendar year with respect to Transfers that occurred at any time (including in a prior year) before December of such calendar year shall be reduced by the maximum amount that the Primary Beneficiary could fail to withdraw on such date without such failure constituting a release of a general power of appointment under Code section 2514. This provides a lapse of 31 days and makes sure that other lapses that occur during the year are taken into account, without ruining what the other trusts were trying to accomplish.

[5112] I would tend to use a note with annual payments of only interest required, with principal payable in just under nine years to allow use of the mid-term applicable federal rate. The trust would prepay the note as investment earnings become available. Five years is just a realistic assumption; the actual time might vary significant. However, based on traditional valuation principles, it should easily be repaid within nine years.

[5113] For simplicity sake, this example ignores lapses to the extent of 5% of the increasing equity in the stock (through growth and principal repayments of the note) and any investment earnings.

[5114] Assuming no change in the stock's value.

With $750K of equity ($350K original gift in which the beneficiary no longer has withdrawal rights plus $400K of nonvoting S corporation stock), the beneficiary sells another $3M of nonvoting S corporation stock, using the same ideas as the first sale.

Let's further suppose that the second note is repaid in another five years:

- Lapses have occurred at a rate of $70K per year,[5115] for a total lapse of $350K during this five-year period. Add that to $350K of prior lapses, and total lapses equal $700K.
- The trust is now worth $4.4M, which consists of $300K ($1M minus $700K of lapses) of the original gift over which the beneficiary has withdrawal rights, $700K of the original gift in which the beneficiary no longer has withdrawal rights, and $3.4M of nonvoting S corporation stock.
- Note that future lapses will be at the rate of $220K per year.[5116] Thus, in two more years, the $300K remaining withdrawal rights will be gone.

Thus, after 14 years, all of the withdrawal rights have lapsed, and the trust has a net worth of $4.4M.

Future leveraged sales can be done, each time increasing the trust's equity significantly, just like traditional sales to irrevocable grantor trusts, but the beneficiary has access to the assets he or she sold to the trust.

This approach is slower than the traditional sale to a BDIT, but it has more substance and does not rely on finding a third party guarantor to whom to pay possibly nondeductible guarantee fees.

III.B.2.i.vii.(b). Large Gift for Multiple Beneficiaries

Letter Ruling 9009010 is an example of using one large trust to fund gifts to many beneficiaries:

- The grantor established seven trusts (trusts A-H), each for the primary benefit of a different child), each of which was funded by two annual gifts of less than $5K with respect to which the primary beneficiary had a withdrawal right that lapsed on December 31 of the year in which the gift was made. The IRS ruled that the primary beneficiary was deemed the owner of the entire trust.[5117]

- Later, the grantor established a single trust (Trust Q), with a gift of under $20K per beneficiary, with each beneficiary having a pro-rata withdrawal right. When the withdrawal rights lapsed in 20 days, the trustee was required to distribute the shares attributable to a beneficiary's separate trust (one of trusts A-H). The IRS ruled that each of the original trusts retained its character as being deemed owned solely by its

[5115] $1M initial gift plus $400K nonvoting stock equals $1.4M. 5% of $1.4M is $70K. Again, this example ignores lapses to the extent of 5% of the increasing equity in the stock (through growth and principal repayments of the note) and any investment earnings.
[5116] $1M original gift plus $3.4M nonvoting stock equals $4.4M. 5% of $4.4M is $220K. Again, this example ignores lapses to the extent of 5% of the increasing equity in the stock (through growth and principal repayments of the note) and any investment earnings.
[5117] Citing Code § 678 and Reg. § 1.671-3 (without any analysis of the latter).

primary beneficiary. Transferring the lapsed portion to the separate should help avoid confusion over which part of the trust the beneficiary owns.[5118]

- These gifts were of S corporation stock. In ruling that the beneficiaries were deemed to own all trust Q's assets,[5119] the IRS did not mention the fact that each grantor trust holding S corporation stock must have a sole owner.[5120] I would not risk transferring S corporation stock to such a trust, absent a ruling that each beneficiary had a separate share,[5121] unless an electing small business trust election were in place.[5122]

III.B.2.i.vii.(c). Comparison

Having a combined trust that then divides as in Letter Ruling 9009010 can provide a bigger pot that will create greater lapses. On the other hand, if only one beneficiary is to receive a trust in this arrangement, then this splitting-off of the withdrawal right can be detrimental. Any lapses in the trust that received the initial gift will be limited to what remains in that trust; the lapse would not consider the assets of the recipient trust. In the example above with one large trust in which only one beneficiary had withdrawal rights, I posited that the last two years of lapses would be $220K each because the trust had $4.4M equity; if we had split-off the withdrawal portion and sold the nonvoting stock to a recipient trust, none of the recipient trust's assets would be considered in calculating the lapse, and the lapse would have been $50K or less (5% of $1M, increased by investment earnings but depleted by assets transferred to the recipient trust).

III.B.2.i.viii. Creditor and Gift/Estate Tax Issues Regarding Withdrawal Rights, Whether Currently Exercisable or Lapsed

When a beneficiary holds a withdrawal right, in many states the beneficiary's creditors can force that beneficiary to exercise the withdrawal right.[5123] If all of the withdrawal rights lapse within a short amount of time after they are created, this should not be a significant problem, since the duration of exposure is small. So a gift that is solely within the 5-and-5 power is not very concerning. If, however, a trust is funded with a large gift or bequest that lapses only gradually over time, then more is put at risk to the beneficiary's creditors and estate tax inclusion. Also, an allocation of the grantor's GST exemption might turn out to be wasted to a certain extent.

From an estate tax viewpoint, a withdrawal right is itself a general power of appointment that is includible in the beneficiary's estate, whether or not it is subject to the

[5118] *Goldsby, Jr. v. Commissioner*, T.C. Memo. 2006-274, held that the taxpayer was not the deemed owner of certain property because he was owner of a different portion.
[5119] Citing Rev. Rul. 85-13.
[5120] Code § 1361(c)(2)(A)(i).
[5121] See fns. 4361-4362 in part III.A.3.a.i Qualifying as a Wholly Owned Grantor Trust.
[5122] See part III.A.3.a.iii Steps an S Corporation Might Take to Avoid a Trust Falling Short of Being a Wholly-Owned Grantor Trust.
[5123] See, *e.g.*, Uniform Trust Code § 505(b)(1) and Uniform Powers of Appointment Act § 502(a)(1), which are RSMo §§ 456.505.6(1) and 456.985.2(6). However, some states do not subject the beneficiary's withdrawal right to creditors. See, *e.g.*, 12 Del. C. § 3536(d)(2) (Delaware); NRS § 163.417.1(a) (Nevada) (in addition, it has been suggested that NRS §§ 163.4157 and 21.090(1)(cc)(3) exempt withdrawal rights from execution, because withdrawal rights are powers of appointment), North Carolina General Statutes § 36c-5-505(b)(1).

beneficiary's creditors.[5124] This is not troublesome while the withdrawal right is exercisable, because we expect that result. However, as described below, the beneficiary's creditors might be able to reach part or all of the trust's assets after a lapse, in which case the beneficiary's interest in that portion of the trust's assets are included in the beneficiary's estate, making the beneficiary grantor trust strategy not work.

If the trust has a typical spendthrift clause in it, one might think that the beneficiary's creditors cannot reach the trust's assets. However, the spendthrift clause will not be valid if and to the extent the beneficiary is considered to be the settlor of the trust and either applicable state law does not respect self-settled spendthrift trusts or the trust does not comply with any limitations applicable state law places upon self-settled spendthrift trusts. Would state creditor law consider a beneficiary whose withdrawal rights lapsed to have, in substance, made a gift to the trust, so that it becomes a self-settled trust for creditor protection purposes?

The drafters of the Uniform Trust Code ("UTC")[5125] recognized and fixed this issue by providing that that, "upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or Section 2503(b) of the Internal Revenue Code of 1986…."[5126] Section 503(b) of the Uniform Powers of Appointment Act follows the UTC's lead.[5127]

Thus, any state that has adopted UTC § 505(b)(2) or a similar statute or has case law along those lines should be a safe jurisdiction (regarding protecting the beneficiary's interest from creditors) for a beneficiary grantor trust. These states include Alabama, Alaska, Arizona, Arkansas, Colorado, Delaware, D.C., Florida, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, North Carolina, Ohio, Oregon, Pennsylvania, Tennessee, Texas, Utah, Vermont, Virginia, Washington and Wisconsin.[5128] This is just a partial

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5124 Code § 2041(b)(1).

5125 http://www.uniformlaws.org/Act.aspx?title=Trust Code.

5126 Uniform Trust Code § 505(b)(1). The Comments to that section expressly recognize that issue and decided to follow the lead of Arizona and Texas in fixing it.

5127 http://www.uniformlaws.org/Act.aspx?title=Powers of Appointment.

5128 See, e.g., **Alabama** Code § 19-3B-505(c)(2) (follows UTC); ARS § 14-10505(B)(2) (**Arizona** - protection applies to lapsed withdrawal rights, without any limitations whatsoever); [ULA cites **Arkansas** as having no variation in this language]; **D.C.** Code § 19-1305.05(b)(2) (protection applies to lapses to the extent of the greater of annual exclusion or 5&5); **Florida** Statutes section 736.0505(2) (protection applies to the greater of 5&5 or the annual exclusion (double if the donor is married)); 12 Del. C. § 3536(c)(1) (**Delaware** - protection applies to lapsed annual exclusion gift, even if above 5&5); **Idaho** Statutes § 15-7-502(5)(b) (protection applies to the greater of 5&5 or the annual exclusion and in certain other situations); 760 ILCS 5/16.2 (**Illinois** - protection applies to lapsed annual exclusion gift, even if above 5&5); KSA § 58a-505(b)(2) (**Kansas** - protection applies to lapsed annual exclusion gift, even if above 5&5); KRS § 386B.5-040(2)(b) (**Kentucky** protection applies without regard to the lapse's size); **Louisiana** Revised Statutes Title 9, Section 2004(2) (protecting any lapsed withdrawal right, without limit); **Maryland** Trust Code §§ 14.5-103(p) (defining power of withdrawal to be the greater of 5&5 or the annual exclusion – the latter doubled if the donor is married), 14.502 (a)(2), (e)(2), and 14.5-508(b); MCL § 700.7506 (**Michigan** – protection provided without limit); RSMo § 456.5-505.6 (**Missouri** - protection applies to lapses to the extent of the greater of annual exclusion or 5&5); [ULA reproduces **Nebraska** language referring to the greater of amounts in Code § 2041(b)(2), 2514(e) or 2503(b)]; NRS § 163.5559 (**Nevada** - protection applies to lapsed annual exclusion gift, even if above 5&5); [ULA cites **New Hampshire** as having no variation in this language]; NJS.3B:31-39.b(2) (effective 180 days after 1/19/2016) (**New Jersey** - protection applies to lapses to the extent of the greater of annual exclusion or 5&5); **North Carolina General Statutes** § 36c-5-505(b)(2) (protection provided even in excess of 5&5); **Ohio** Trust Code § 5805.06(B)(2) (protection applies to lapsed annual exclusion gift, even if above 5&5); [ULA reproduces **Oregon** language referring to the greater of amounts in Code § 2041(b)(2), 2514(e) or 2503(b)]; 20 **Pa.** C.S.A. §§ 7703 (defining withdraw power of withdrawal as excess over the greater of amounts in Code § 2041(b)(2), 2503(b) or 2514(e); presumably may in definition is same as shall), 7748 (power of withdrawal reachable by creditor whether or not lapsed; potentially problematic for hanging withdrawal rights above the annual exclusion that lapse within 5&5); **Tenn.** Code § 35-15-505(b) (protection applies to lapsed annual exclusion gift, even if above 5&5); **Texas** Property Code section 112.035(e); [ULA seems to cite **Utah** and **Vermont** as having no variation in this language]; **Va.** Code § 64.2-747(B) (protection applies to the greater of 5&5 or the annual exclusion (double if the donor is married)); RCW § 11.95.160 (**Washington** lapse protected without limits); **Wisconsin** statutes section 701.06(6)(b) (protection applies to lapsed annual exclusion gift, even if above 5&5). Some states apply double the annual exclusion amount if the donor is married at the time of the gift.

One Alaska lawyer stated to me that **Alaska** law infers that the lapse does not deem the beneficiary to be a settlor. The lawyer pointed to AS 34.40.115, which allows a beneficiary to hold an inter vivos (or testamentary) general power of appointment exercisable to the beneficiary, without the creditor being able to execute on an unexercised power.

University National Bank v. Rhoadarmer, 827 P.2d 561 (**Colo.** App. 1991), *cert. den.* (3/3/1992), prevented a creditor from requiring the current exercise of an annual 5&5 withdrawal right and from attaching trust property with respect to which the withdrawal power had lapsed.

Irwin Union Bank & Trust Co. v. Long, 312 N.E.2d 908 (**Ind.** App. 1st Dist. 1974) protected a lapsed gift, but its holding did not provide protection when the beneficiary had an ongoing withdrawal right over the entire trust, *Lincoln Nat. Bank and Trust Co. v. Figel*, 427 N.E.2d 5 (Ind. App. 4th Dist. 1981).

In New York, EPTL sections 10-7.1 and 10-7.2 provide that creditors can reach a general but not a limited inter vivos power of appointment; see *EM Ltd. v. Republic of Argentina*, cited in fn. 5137, regarding self-spendthrift trusts (citing *Vanderbilt Credit Corp. v. Chase Manhattan Bank, NA*, 100 A.D.2d 544, 546 (2d Dep't 1984); *Vanderbilt* has been suggested to me as commentators' favored reading of New York law). Section 5205(c)(1) of the New York Civil Practice Law and Rules authorizes spendthrift protection for beneficiaries if the trust was not created by and has not proceeded from the beneficiary. Whether a lapse of a general power of appointment makes the trust created by or proceeded from the beneficiary is an issue that does not appear to have been addressed.

The California Probate Code subjects an unlimited withdrawal right to the claims of the holder's creditors. Probate Code §§ 611(a)(generally referring to a withdrawal right as a general power of appointment), 682(a). If and to the extent that the withdrawal right lapses upon the holder's death, it is subject to the creditors of the holder's estate. Probate Code § 682(b). California's statutes do not appear to address the effect of a lapse during life. If and to the extent that the lapse made the beneficiary treated as the settlor, the beneficiary's creditors of the settlor may reach the maximum amount that the trustee could pay to or for the benefit of the beneficiary, not exceeding the amount of the beneficiary's deemed proportionate contribution to the trust. Probate Code § 15304.

In his blog, professor Charles E. Rounds, Jr. made the following comment about **Massachusetts**:

> Section §505(b)(2) (or a provision comparable) is lacking in the version of the UTC that was enacted in Massachusetts. The commentary that accompanies the MUTC, specifically that accompanies Mass. Gen, Laws ch. 190B, § 505(a), confirms that the omission was intentional, but does little else: The Committee deleted subsection (b), which would have changed current Massachusetts law relating to creditor rights against

listing received from a list-serve inquiry and additional citations I have come across; I have not reviewed Uniform Trust Code states not listed above and have not researched the law of any other state.[5129]

If the trust's governing law and the law of the state in which the beneficiary resides do not both affirmatively protect the beneficiary's interest in the trust from the beneficiary's creditors, then one must consider whether the trust might be includible in the beneficiary's estate and determine whether other techniques might be more appropriate.

III.B.2.i.ix. Letter Ruling 200949012

The ruling describes the subject trust, where the beneficiary was deemed the owner under the grantor trust rules, as follows:[5130]

> …Grantor proposes to create a trust ("Trust") for the benefit of Beneficiary. Under the terms of Trust, Beneficiary will serve as the Investment Trustee of Trust, A will serve as the Distribution Trustee of Trust and Company will serve as the Administrative Trustee of Trust (collectively, "Trustees"). A will have no beneficial interest in Trust. The Distribution Trustee will be authorized, but not required, to distribute income or corpus of Trust to Beneficiary. Beneficiary will have the power, during his lifetime, to direct the net income and/or principal of the Trust to be paid over or applied for Beneficiary's benefit, but only to the extent necessary for Beneficiary's health, education, maintenance or support. This power will not lapse.
>
> Additionally, Beneficiary will have the power to withdraw any property assigned, transferred or delivered, to the extent constituting a direct or indirect transfer for federal gift tax purposes, by Grantor to the Trustees. This power will lapse each calendar year in an amount equal to the greater of $z or y% of the value of the corpus of the Trust.
>
> Upon Beneficiary's death, all of the income and principal of Trust will be distributed either outright or in trust to such person or persons (other than Beneficiary, Grantor, their estates, their creditors and the creditors or their estates) and/or qualified charitable organizations as Beneficiary may appoint by Beneficiary's will. If Beneficiary does not exercise this power, the Distribution Trustee shall select one or more qualified charitable organizations for the distribution of the income and principal of Trust.

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property subject to powers of withdrawal and with respect to lapsing [sic], released or waived powers of withdrawal. No explanation of what that current law might be and how that law might have been changed by the enactment of UTC § 505(b) is supplied.

[5129] For a complete list, see Morrow, "Creditor Protection for Assets Subject to Presently Exercisable General Powers of Appointment (Including Crummey or Other Withdrawal Powers) Pre and Post Lapse in Trust," published in Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2577, "Ed Morrow: IRC Section 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)" (9/25/2017) and saved as Thompson Coburn doc. no. 6619581.

[5130] Even though a BDIT has many of the same features that were included in this letter ruling, the lawyer who obtained the ruling stated that it was not a BDIT.

Grantor is not a beneficiary under the Trust, and has no interest under the Trust. Trust provides that no income or principal of Trust may be paid or appointed for the benefit of Grantor or Grantor's spouse, or to pay premiums on insurance policies on the life of Grantor and/or Grantor's spouse. Trust further provides that neither Grantor nor Grantor's spouse may act as a Trustee of Trust and that no more than one-half of Trustees of Trust may be related or subordinate parties to Grantor, within the meaning of § 672(c).

Trust further provides that Grantor does not intend to be treated under subpart E of Part I of subchapter J as the owner of Trust. Trust further provides that neither *Grantor* nor any other "nonadverse party" as that term is defined in § 672(b) shall have the power to (1) purchase, exchange or otherwise deal with or dispose of Trust's principal or income for less than adequate consideration or (2) borrow any of Trust's principal or income without adequate interest or security.

Trust further provides that no person, other than a United States person, shall have the authority to control any substantial decision (within the meaning of § 7701(a)(30)(E) of any trust created and held under Trust. No court, other than a court *within* the United States, shall exercise primary supervision over the administration of any trust created and held under Trust. Grantor and Beneficiary represent that Trust will be a domestic trust within the meaning of § 301.7701-7 of the Procedure and Administration Regulations.

The IRS ruled that Beneficiary, not Grantor, would be treated as owning the trust for income tax purposes.

Some of the trust's key features are noteworthy:

1. Beneficiary had the right to withdraw whatever Beneficiary decided (s)he needed for living expenses. Beneficiary's right to withdraw the entire initial gift to the trust had partially lapsed into a right to withdraw for living expenses.[5131]

2. The Distribution Trustee could distribute part or all of the trust to Beneficiary. This might also facilitate decanting (distributing to a new trust created by the trustee) if administrative provisions need to be changed in the future.

3. The references at the end to various foreign trust provisions are to avoid the grantor trust treatment that would have been imposed on Grantor if the trust had been a foreign trust.[5132]

The state's spendthrift statute:

prevents a creditor existing when the trust is created or a person who subsequently becomes a creditor, from satisfying a claim out of the beneficiary's interest in the trust unless, (1) the trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely

[5131] This feature is more fully discussed in III.B.2.i.xi Dealing with Code § 678(a)(2) Uncertainty.
[5132] Code § 679.

> affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; (2) the settlor intends to defraud a creditor by transferring the assets to the trust; (3) the settlor is currently in default of a child support obligation by more than 30 days; or (4) the trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor.

The IRS ruled that the gift was a completed gift and that the trust would not be included in the settlor's estate for estate tax purposes. However, the IRS declined to rule "whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036." This caveat is not surprising, given the parameters of Rev. Rul. 2004-64.[5133] Generally, the trustee should avoid making distributions to the settlor to the extent possible to minimize the possibility that the IRS would raise Code § 2036 on audit. Taxpayers probably will not be able to replicate this ruling.[5134]

Readers might want to consider integrating into their planning beneficiary grantor trusts with some or all of the features set forth in Letter Ruling 200949012. However, I personally would not grant the beneficiary the continuing right to withdraw under ascertainable standards unless we could be sure that such a right to withdraw could not be reached by the beneficiary's creditors. Most states do not provide protection over the portion that a beneficiary could withdraw at the time the creditor attacks the trust and therefore would not be suitable for the structure of Letter Ruling 200949012; the trust in that ruling was formed under Alaska law, which does provide such protection. Several states protect a beneficiary's limited power of appointment from creditors, but the very logic that underlies Letter Ruling 200949012 might also be fodder for creditors: if the ongoing limited power of appointment is merely a partial continuation of the absolute withdrawal right, then might creditors also say that the statutes that protect limited powers do so only when they are not a mere partial continuation of a general power?[5135]

III.B.2.i.x. My Suggestion for Distribution Trustee – A Variation of Letter Ruling 201039010

The structure provided in Letter Ruling 200949012 is very sound from a Code § 678(a)(2) perspective, but it presents some challenges. For example, suppose someone established an Alaska trust that had those provisions, but the beneficiary lived in a state that did not provide the same level of protection as Alaska at the time the creditor makes the attack. Would that state be required under the Full Faith and Credit clause of the U.S. Constitution to defer to Alaska law, or would that state's public policy be so compelling as to override that deference?[5136] If the assets are subject to the

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[5133] See fns. 5273-5291, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the .

[5134] See Rev. Proc. 2013-3 § 4.01(48), (52), (55), and (63).

[5135] For example, New York protects limited powers, but only if the trust was not created by and has not proceeded from the beneficiary. See fn 5128.

[5136] In Rev. Rul. 76-103, a trust was established in a state that subjected the trust to the grantor's creditors. The IRS ruled that, because the grantor's creditors could reach the trust, the transfer in trust did not constitute a completed gift for Federal gift tax purposes. It also ruled that, [i]f and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's jurisdiction of a state that does not provide that level of protection, they might very well be subject to creditors.[5137] However, if a court in a creditor-friendly state cannot obtain

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decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete. Some might read that as holding that the IRS will look only to the law of the state in which the trust has situs. However, Rev. Rul. 2004-64, Situation 3, refers to whether applicable local law subjects the trust's assets to the grantor's creditors. Note also that *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986) held that trust assets that the settlor's creditors could reach were includible in the settlor's estate, pointing out that 1 *Restatement of Trusts. 2d*, § 156(2) (1959), provides, Where a person creates for his own benefit a trust for support or a discretionary trust, his transferee or creditors can reach the maximum amount which the trustee under the terms of the trust could pay to him or apply for his benefit, further citing 2 Scott, *Trusts*, § 156.2 (3d ed. 1967) and Bogert, *Trusts and Trustees*, § 223, at 438-439 (2d rev. ed. 1979). See also *Outwin v. Commissioner*, 76 T.C. 153 (1981) (local law allowed the creditors of the grantor of each trust to reach the trust assets for satisfaction of claims, so the grantors failed to relinquish dominion and control over the property and the transfers were incomplete for gift tax purposes); see, e.g., *Uhl v. United States*, 241 F.2d 867 (7th Cir. 1957) (no estate inclusion beyond that attributable to what the grantor had absolute right to receive at the time of death); *Estate of German v. Commissioner*, 7 Cl. Ct. 641 (1985) (IRS had not established that, under state law, creditors of the settlor could have reached the trust income or principal of her discretionary trusts up to the time of her death). Letter Ruling 8037116 failed to address the issue of creditor attack, concluding that the ability of this decedent to receive income and principal under the terms of the trust he created is not sufficient to require inclusion of the property under Code § 2036(a)(1). Letter Ruling 200944002 ruled that transfers to a self-settled spendthrift trust was a completed gift and that the trust's assets would not be included in the grantor's estate, but We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036. For more discussion, see Rothschild, D. Blattmachr, Gans, and J. Blattmachr, IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate, *Estate Planning Journal* (WG&L) (1/2010).

[5137] Argentina set up a trust under its own law, but its assets were held by a New York person, allowing a New York creditor to reach the assets. *EM Ltd. v. Republic of Argentina*, 2009 WL 2568433 (S.D.N.Y. 2009), *aff'd* 389 Fed. Appx. 38 (2nd Cir. 2010), *cert. den. Republic of Argentina v. EM Ltd.*, 131 S.Ct. 1474, 179 L.Ed.2d 301 (U.S. 2011).

In *Weitz v. Weitz*, 2012 N.Y. Slip. Op. 30767(U), N.Y. Sup. Ct. No. 016811-08 (3/22/2012), a New York trial court held that, when assets that were subject to a divorce judgment were transferred to a Cook Islands trustee, the receipt of a fraudulent conveyance subjected the trustee to New York's jurisdiction, even though the trustee:

> 1) does not own, lease or have any other interest in any real property located in New York; 2) does not have an office in New York; 3) does not have a bank account in New York; 4) does not have any officers or employees in New York; 5) does not have a telephone number in New York; 6) has never filed a lawsuit in New York; 7) has no investments in any business located in New York; 8) is not licensed to do business in New York; 9) has never warehoused or stored inventory or supplies in New York; and 10) does not advertise in New York.

An Illinois resident set up a Cook Islands trust, but the Illinois Supreme Court held that the trust was void as against the creditors of the settlor/beneficiary. *Rush University Medical Center v. Sessions*, 980 N.E.2d 45 (Ill. 2012), Illinois Supreme Court upheld the trial court and reversed the appellate court:

> This rule has a 500–year lineage (see Erwin N. Griswold, *Spendthrift Trusts Created in Whole or in Part for the Benefit of the Settlor*, 44 Harv. L. Rev. 203, 204 (1930) (citing 3 Hen. VII, c. 4)), has been consistently applied as the law in Illinois for over 140 years

(see, *e.g.*, *Guffin v. First National Bank of Morrison*, 74 Ill. 259 (1874); *Crane*, 238 Ill. App. 257 (1925); *In re Morris*, 151 B.R. 900 (C.D. Ill. 1993); *In re Marriage of Chapman*, 297 Ill.App.3d 611, 231 Ill. Dec. 811, 697 N.E.2d 365 (1998); *Dexia Credit Local v. Rogan*, 624 F.Supp.2d 970, 976 (N.D. Ill. 2009)), at least until the instant appellate court's decision, and remains the law in the vast majority of states throughout the nation (see Helene S. Shapo et al., *Bogert's Trusts and Trustees* § 223 (3d ed. 2007); *Restatement (Third) of Trusts* § 58 cmt. e (2003)).

The court's broad statement, "void as to existing and future creditors," sounds like the whole trust is void. However, the following excerpt (downloaded 3/3/2017) from the above citation to *Bogert's* clarifies that the scope as limited to the settlor's interest:

> The entire spendthrift clause, both as to voluntary and involuntary alienation, is void. The creditors can reach the settlor-beneficiary's interest,[11] and the settlor-beneficiary can transfer her interest.[12] The trust itself is not void, however, and the settlor cannot have it set aside on the ground of attempted fraud on creditors.[13] If the settlor is the sole beneficiary, she will be able to revoke the trust or ask for its termination.[14] If she is not the sole beneficiary she may not revoke in the absence of statutory authority.[15]
>
> [11] A spendthrift trust provision is invalid as to a contingent interest provided for the settlor in a trust. *Hughes v. Commissioner of Internal Revenue*, 104 F.2d 144, 39-2 U.S. Tax Cas. (CCH) ¶9538, 23 A.F.T.R. (P-H) ¶24 (C.C.A. 9th Cir. 1939), citing text, § 224.
>
> Where a settlor is the sole beneficiary of a spendthrift trust, his creditors can reach principal and income for the satisfaction of their claims on the ground that "it is against public policy to permit a man to tie up his property in such a way that he can enjoy it but prevent his creditors from reaching it." *Nelson v. California Trust Co.*, 33 Cal. 2d 501, 202 P.2d 1021 (1949).
>
> *Abrahams v. New York State Tax Com'n*, 131 Misc.2d 594, 500 N.Y.S.2d 965 (Sup 1986).
>
> A spendthrift clause in a trust for the settlor is void as to his interests. *Pilkington v. West*, 246 N.C. 575, 99 S.E.2d 798 (1957), citing text.
>
> [12] [various citations omitted]
>
> Where a settlor creates a spendthrift trust for himself, he may nevertheless assign the income of it…
>
> A settlor who made herself a life beneficiary of a spendthrift trust and accepted the interest can later destroy the trust as to herself by an instrument renouncing her interest and conveying it to the remaindermen beneficiaries, whose interests are then accelerated…. The spendthrift clause is not effective as to the settlor.
>
> Where a statute validates spendthrift trusts and declares that attempted assignments of the interests of beneficiaries thereunder are void, there is an implied exception of the case where the settlor is the beneficiary and an assignment by such beneficiary is valid. ….
>
> A spendthrift clause is not binding on a settlor-beneficiary and he may transfer his interest….
>
> The spendthrift clause did not prevent a settlor-life beneficiary from assigning his right to receive income from the trust, but a right to receive principal on demand, which was vested in him personally, was not transferable....
>
> The settlor created a trust to give his wife an annuity of $5,000 a year, and provided that any excess income should be paid to him, and that the principal should go to him at the death of the life tenant, or if he died before his wife that the principal should be disposed of as he appointed or to his heirs and next of kin if no appointment was made. Spendthrift provisions were inserted in the trust instrument as to both beneficiaries. The court held the clause as to the settlor was invalid; he could assign his interest under the trust to creditors and give them security, there being no proof that he was insolvent at the time he made the assignments. The power of appointment was destroyed by the assignments. On the death of both husband and wife the assignees of the husband are entitled to the capital of the trust….

Notwithstanding a spendthrift clause, a settlor-beneficiary can transfer his interest…. Where a settlor creates a spendthrift trust for herself for life, and later consents to taking less than the amount provided by the trust instrument, she is in effect giving a part of her interest to the remainder beneficiaries, which she may do, since the spendthrift provisions for the settlor are invalid….

[13] A spendthrift trust provision as to a settlor's life interest is invalid, but this does not invalidate the trust or make the trust subject to attack by the settlor. It merely results in the striking of the spendthrift clause. *Liberty Nat. Bank v. Hicks*, 173 F.2d 631, 9 A.L.R.2d 1355 (D.C. Cir. 1948). Noted in 37 Geo. L.J. 648 (1949); 17 U. Chi. L. Rev. 516 (1950).

[14] See § 1004, post.

[15] *Reidy v. Small*, 154 Pa. 505, 26 A. 602 (1893); *Rynd v. Baker*, 193 Pa. 486, 44 A. 551 (1899); *Willard v. Integrity Trust Co.*, 273 Pa. 24, 116 A. 513 (1922). But see *Stephens v. Moore*, 298 Mo. 215, 249 S.W. 601 (1923).

For cases where the settlor-beneficiary sought to revoke with the collusion of a creditor, see *First Nat. Bank v. Parker*, 87 N.J. Eq. 595, 101 A. 276 (Ct. Err. & App. 1917); *Kutz v. Nolan*, 224 Pa. 262, 73 A. 555 (1909).

The settlor-beneficiary of an irrevocable trust containing spendthrift provisions could not terminate the trust. The trust provided that the trustees in their discretion could pay principal to one or more of the settlor's descendants during the settlor's lifetime. The spendthrift provisions could not apply to settlor's interest but were severable, and the trust could not be terminated on the grounds that its purposes had been accomplished since the support and education of settlor's descendants remained a continuing purpose. *Fewell v. Republic Nat. Bank of Dallas*, 513 S.W.2d 596 (Tex. Civ. App. Eastland 1974), *writ refused n.r.e.*, (Feb. 12, 1975), citing text, § 223.

Dexia applied the law to all of the settlor's possible discretionary distributions and refused to apply the law of the jurisdiction in which the trust was created:

Under Illinois law, spendthrift trusts are valid except when they have been created or funded by a judgment debtor. See 735 ILCS 5/2–1403. A self-settled spendthrift trust is "void as to existing or future creditors, and they can reach his or her interest under the trust." *In re Marriage of Chapman*, 297 Ill.App.3d 611, 620, 231 Ill. Dec. 811, 697 N.E.2d 365, 371 (1998); see also *Barash v. Morris (In re Morris)*, 151 B.R. 900, 906–07 (C.D. Ill. 1993). This rule reflects the law in most U.S. jurisdictions. *E.g.*, *Restatement (Third) of Trusts* § 58(2); *Restatement (Second) of Trusts* § 156(2). Bahamian law to the contrary would violate Illinois' public policy. Accordingly, this Court will not apply Bahamian law to the construction and operation of the PGR trust. See, *e.g.*, *Scentura Creations, Inc. v. Long*, 325 Ill.App.3d 62, 69, 258 Ill. Dec. 469, 756 N.E.2d 451, 457 (2001) ("a party cannot rely on the protections of foreign law to enforce a contract that is illegal in the forum of the local government.").[2]

[2] Dexia has also cited persuasive authority that under Illinois law it is not bound by the PGR trust's choice of law provision as a third party and that application of the "most significant relationship test" would result in the application of Illinois rather than Bahamian law. See generally Dexia Mot. for Summ. J. at 18–22.

Illinois law permits Dexia to reach Peter Rogan's interest in the PGR trust. Under the terms of that trust, the trustees can provide Peter Rogan with the entire corpus of the trust, as well as all of the trust's income. Indeed, Dexia has submitted evidence, uncontested by the Rogan children, that Peter Rogan has received millions of dollars of distributions from the PGR trust. Because the PGR trust is self-settled and its settlor, Peter Rogan, can receive all of the trust's income as well as its entire corpus, Dexia, as his creditor, is entitled to execute on the assets of the Trust. Accordingly, the Court grants Dexia's motion for summary judgment with respect to its request for turnover of the Rogan children's interests in the PGR trust.[3]

[3] Under the authority cited above, there is no requirement that a creditor prove a trustee never refused to honor a request for a distribution by a settlor in order to execute on the

jurisdiction over the trustee or over the trust's assets, then the rules of the protective state would tend to prevail.[5138]

I suggest a middle ground. For example, in Letter Ruling 200747002 (which I obtained), the grantor set up an irrevocable trust for Child. Child was trustee and could make distributions under an ascertainable standard to Child and Child's descendants. Child also had the power to appoint at Brother's death to anyone except to Child, Child's creditors, Child's estate or the creditors of Child's estate. The IRS ruled that the trust was taxable to Child (and will qualify to hold stock in an S corporation).

Alternatively, in Letter Ruling 201039010, the beneficiary had the power to withdraw each gift, but the amount that can be withdrawn by the primary beneficiary in any one calendar year is limited to the maximum amount as to which the power of withdrawal can lapse without the lapse constituting the release of a general power of appointment under Code §§ 2041(b)(2) and 2514(e). The independent trustee had absolute discretion to distribute part or all of the net income as the trustee deems appropriate to any one or more then living of the beneficiaries, in amounts and proportions as the trustee determines. The IRS ruled that the trust will be taxable to the beneficiary (and will qualify to hold stock in an S corporation) if all gifts will be subject to this withdrawal power.

After analyzing Letter Ruling 201039010, I have very significant concern in having a pattern of the independent trustee making distributions each year, once the note is repaid and the beneficiary can no longer afford to pay the trust's taxes.[5139] Therefore, my future structure in light of this ruling will be to name the beneficiary as trustee to make distributions under an ascertainable standard and to name an independent trustee authorized to make distributions in excess of that. I would rather see the beneficiary take distributions for support, if necessary, since that does not cause estate tax inclusion problems; it still might get to the point that the independent trustee makes distributions to pay taxes, but that is less likely under my suggested structure. However, if the trust's governing law and the law of the state in which the beneficiary resides do not both affirmatively protect the beneficiary's interest in the trust from the beneficiary's creditors when the beneficiary serves as trustee, my preferred structure might have risk; fortunately, the Uniform Trust Code protects beneficiaries who serve as trustees.[5140] If

assets of a self-settled spendthrift trust. Thus Dexia was not required to submit any evidence that the PGR trust's trustees had never refused a request by Peter Rogan.

[5138] *Hanson v. Denckla*, 357 U.S. 235 (1958).

[5139] Rev. Rul. 2004-64 held that, if the trust's governing instrument or applicable local law granted the trustee the discretion to reimburse the grantor of a grantor trust for the grantor's income tax liability with respect to trust income, the existence of that discretion, by itself (whether or not exercised) will not cause the value of the trust's assets to be includible in the grantor's gross estate; see fns. 5273-5291, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the .. However, Situation 3 of the ruling included some important caveats. The ruling assumed no understanding, express or implied, between the grantor and the trustee regarding the trustee's exercise of discretion. It also said that inclusion might apply if the discretion to make distributions is combined with other facts, including without limitation an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of this discretion, a power retained by the grantor to remove the trustee and name the grantor as successor trustee, or applicable local law subjecting the trust assets to the claims of the grantor's creditors.

[5140] Uniform Trust Code § 504(e) provides, If the trustee's or cotrustee's discretion to make distributions for the trustee's or cotrustee's own benefit is limited by an ascertainable standard, a applicable state law is favorable in this area and the concern is over where the beneficiary might later move, I would still strongly consider my preferred structure, because a pattern of distributions by an independent trustee concerns me greatly;[5141] to address the concern over where the beneficiary might later move, perhaps the independent trustee could be given the power to eliminate the beneficiary's right to serve as trustee for distributions.

III.B.2.i.xi. Dealing with Code § 678(a)(2) Uncertainty

The person who obtained Letter Ruling 200949012 has suggested that the right to withdraw should not completely lapse, because Code § 678(a)(2) requires that the beneficiary "has previously partially released or otherwise modified" the withdrawal right, and a complete lapse would inconsistent with a "partial release." I asked whether the IRS agreed with his reading of Code § 678(a)(2), and he said, "The IRS did not express any such concern when I obtained Letter Ruling 200949012." The subsequent issuance of Letter Rulings 201038004 and 201216034 implicitly confirms that the IRS does not agree with his reading of Code § 678(a)(2).

Although private letter rulings tend to indicate the IRS' position at the time the ruling was issued, they do not bind the IRS with respect to other taxpayers. Furthermore, the IRS will not rule whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be

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creditor may not reach or compel distribution of the beneficial interest except to the extent the interest would be subject to the creditor's claim were the beneficiary not acting as trustee or cotrustee. North Carolina General Statutes § 36C-5-504(f). The Comments to Uniform Trust Code § 504 provide a helpful discussion of this issue. For a review of Uniform Trust code states, see Kingma, A Beneficiary Serving as Trustee May Affect Asset Protection, *Estate Planning Journal* (4/2011). Some states provide this level of protection even if an ascertainable standard is not used. Indiana (IC 30-4-2.1-14 through 30-4-2.1-17), Missouri (RSMo § 456.5-504.1), Nevada (NRS §§ 163.41731(d) and 163.4177.10), and Alaska (AS 34.40.110(g), providing that a beneficiary who is not the settlor does not lose spendthrift protection by serving as trustee) might be the only states where a beneficiary can be a trustee, have sole and absolute discretion as trustee to distribute the entire trust to himself or herself, and still have the trust's assets protected from his or her own creditors. I have been told that Hasseler, Trustee-Beneficiaries, Creditors, and New York's EPTL: The Surprises That Result and How the UTC Solves Them, 69 Albany Law Review 1169 (2006), is a good summary of New York law in this area; Hessler posits that New York law provides that a beneficiary who is a trustee is protected from creditors even if the trustee/beneficiary may distribute all of the trust's assets without any standards (assuming the beneficiary is not also a settlor).

[5141] What if the beneficiary has the right to remove and replace the trustee and applicable state law imputes the trustee's powers to the beneficiary? Presumably, a pattern of distributions following the beneficiary's desires would increase the risk of such an imputation. Note that Uniform Trust Code § 504(e) requires the beneficiary's discretion as trustee to be pursuant to a standard. If the beneficiary is imputed the trustee's power, and the trustee's power exceeds what is protected under Uniform Trust Code § 504(e) or other comparable applicable state law, then perhaps the beneficiary's creditors could reach the trust's assets. This line of reasoning makes me want to allow the beneficiary to serve as a trustee who can make distributions for his or own support and therefore rarely requests that the independent trustee make discretionary distributions; this mechanism would tend to avoid a pattern of distributions by the independent trustee. Indiana has done a great job of anticipating and refuting the creditor attacks about which this footnote expresses concerns; see IC 30-4-2.1-15.

the owner of the trust under Code § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of Code § 2041, if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.[5142] Thus, obtaining a private letter ruling to avoid this uncertainty might not be possible.

Absent a ruling, consider whether the following extra caution might be desirable: Instead of using the beneficiary's social security number as the trust's tax ID, obtain a separate tax ID for the trust. The trust files annual Form 1041, reporting its status as a grantor trust. The trust attaches an explanation setting forth why it is a beneficiary grantor trust. This will get the statute of limitations running with respect to this issue, which filing IRS Form 4810 can cut even shorter. Although private letter rulings are not precedent, they constitute authority on which one can rely to avoid penalties,[5143] and the large number of letter rulings – all reaching the same conclusion – should constitute substantial authority.[5144]

III.B.2.i.xii. Protecting Against Excessive Income Tax Estate Burn-Off

Consider that the beneficiary's income tax liability continuing forever might deplete the beneficiary's estate to uncomfortably low levels (estate burn-off). The beneficiary can sell assets to obtain funds to pay taxes, but eventually the beneficiary might run out of assets.

Arguably, recurring income tax payments are an ordinary part of a person's living expenses. Perhaps distributions to pay the beneficiary's taxes might be considered part of the beneficiary's support? If not, consider the mechanisms below.

Giving the beneficiary the power to borrow at the AFR without adequate security certainly gives the beneficiary a safety valve. However, a loan that the beneficiary will not be able to repay might be considered a distribution, if there is no intent to repay, and giving the beneficiary what might be tantamount to an unlimited withdrawal right could create exposure to creditors and estate tax. So the safety valve of borrowing might be considered a temporary solution.

The BDIT and other models might give an independent trustee the right to distribute as much as the independent trustee deems advisable, without any limit. As mentioned above, a pattern of making distributions whenever the beneficiary asks for money might be troublesome. Consider, however, having two separate independent trustees for such distributions.

1. Tax Distributions. One independent trustee (the "tax distribution trustee"), who the beneficiary can remove and replace, makes distributions to pay income taxes, but the distributions might start many years down the road, when the estate burn-off threatens to become excessive. The trustee might just pay the taxes directly,

[5142] Rev. Proc. 2013-5, Section 4.01(39).
[5143] Reg. § 1.6662-4(d)(3)(iii).
[5144] Rulings more than ten years old are generally accorded little weight. Reg. § 1.6662-4(d)(3)(ii). However, combined with recent rulings, they do demonstrate a consistent position.

preventing the creditors from attaching the money when it gets in the beneficiary's hands. Even if a creditor might somehow be able to attach these distributions, the creditor would have to fight the taxing authorities.

2. Other Distributions. The other independent trustee would be more difficult to remove and generally would not decide to make distributions. An exception might be if a gift tax audit finds that the beneficiary did not receive adequate and full consideration. The lack of adequate and full consideration might cause the beneficiary to be deemed the grantor of that portion of the trust. That portion of the trust would be an incomplete gift, as described further above, and therefore would be includible in the beneficiary's estate. The independent trustee might then distribute this portion to the beneficiary to try to cleanse the trust. This event would happen in the first several years of the trust, so estate burn-off would eventually cleanse the beneficiary's estate of these assets as well.

How much of the trust's income and gains are truly needed to support the beneficiary? Suppose a trust had $1 billion of assets and the beneficiary spent only $1 million per year? Some part of the trust would not be needed for the beneficiary's support. Consider the following approaches:

1. Release Power. The independent trustees release their power to make distributions beyond certain limits. The assets beyond those limits are not available for distribution, other than for the beneficiary's support. Therefore, not all of the assets are available for distribution to the beneficiary. This limits the amount of income and gains accumulated for the beneficiary's future use. The excess income would not be taxable to the beneficiary.[5145] One might consider special drafting to authorize the trustee to impose these limits without violating a duty to the beneficiary.

2. Split Trust. The beneficiary could exercise the beneficiary's power of appointment by appointing to a new trust such portion as is not needed to provide for the beneficiary's support. The beneficiary would not be a beneficiary of the new trust; or, alternatively, an adverse party would be appointed trustee to make Code § 677 not apply. Although this might constitute a taxable gift, the value of the taxable gift might be zero, if this splitting of the trust does not cause the beneficiary's distributions to decrease. The splitting of the new trust might be done in conjunction with a net gift agreement, in case any gift taxes are imposed.

III.B.2.i.xiii. QSST as an Alternative Form of Beneficiary Grantor Trust

If the income beneficiary elects to have a trust holding S corporation stock as a "qualified subchapter S trust" (QSST),[5146] the beneficiary is treated as the Code § 678(a) owner of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.[5147]

[5145] See *Townsend v. Commissioner*, 5 T.C. 1380 (1945).
[5146] See part III.A.3.e.i QSSTs for QSSTs generally and part III.A.3.e QSSTs and ESBTs generally for a comparison of the two types of trusts most commonly used when the grantor is no longer living or does not want to pay the trust's taxes.
[5147] Reg. § 1.1361-1(j)(8).

How does a QSST compare to other beneficiary grantor trusts? Other beneficiary grantor trusts will always be taxed to the beneficiary. With those other trusts, generally the beneficiary needs to rely on an independent trustee to distribute enough to pay tax, once the tax burn-off has reduced the beneficiary's estate to the beneficiary's target level. With a QSST, all of the trust's income must be distributed to the beneficiary, so an agreement that the S corporation make tax distributions would suffice to get income to the beneficiary to pay taxes. On the other hand, distributing the income to the beneficiary means that tax burn-off is not occurring, and generally distributions from the S corporation are being distributed to the beneficiary rather than being accumulated in the trust. Thus:

- If tax burn-off to deplete the beneficiary's other assets is a key goal, then either use a beneficiary grantor trust other than a QSST or use a QSST with an S corporation that does not distribute enough to pay its owner's taxes (the latter being unusual).

- If the goal is simply to facilitate a sale to trust to get the asset's appreciation outside of the estate tax system and the ability to toggle off grantor trust status is important, use a QSST. See part III.A.3.e.iv Flexible Trust Design.

For a description of the advantages and disadvantages of using a QSST in this manner, see part III.A.3.e.vi QSST as a Grantor Trust; Sales to QSSTs, especially part III.A.3.e.vi.(b) Disadvantages of QSSTs Relative to Other Beneficiary Grantor Trusts and III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (which also discusses how the asset's base value is not moved outside of the estate tax system).

III.B.2.i.xiv. Alternative Way to Have a Trust Benefitting Client: Sale to Trust Created by Spouse

Consider instead having the client's spouse establish a trust for the client.

The trust would be a grantor trust, taxable to the spouse under Code § 677 (with perhaps a swap power included).

When the client sells S corporation stock to the trust, the client would be deemed to have sold the stock to the client's spouse, and Code § 1041 would cause nonrecognition of the gain on sale.[5148] The interest income and expense would be recognized for income tax purposes.[5149] Although presumably the interest expense would be deductible by the spouse against the spouse's S corporation income, note that various phase-outs of deductions and exemptions work from adjusted gross income, so the inclusion of income would have a slightly adverse income tax effect. Also, an adverse tax consequence could occur if wife did not receive adequate and full consideration for the stock she transferred to the trust. The Code § 7872 below-market interest loan rules do not apply to transactions between spouses,[5150] so not charging interest would avoid income tax; however, I would charge interest to avoid a gift, because for gift tax purposes presumably the trust would be considered to be a separate entity.

[5148] If the sale is for a loss, see fn. 5517 in part III.B.6.d Divorce as an Opportunity to Transfer.
[5149] See fn. 5518 in part III.B.6.d Divorce as an Opportunity to Transfer.
[5150] Code § 7872(f)(7), treating a married couple as one person for purposes of Code § 7872 generally.

If the client's spouse dies, the trust would convert to a QSST, making the trust be a Code § 678 trust.

This, any sale that might be deemed to occur when the spouse dies would be a sale to the QSST, presumably the gain from which would be ignored under part III.B.2.i.xiv QSST as an Alternative Form of Beneficiary Grantor Trust.

A disadvantage of this relative to a sale to a beneficiary grantor trust is that the spouse could not be a beneficiary upon the client's death unless the trust is created in a jurisdiction that recognizes self-settled spendthrift trusts and the spouse is able to rebut any Code § 2036 or 2038 arguments.

III.B.2.i.xv. Conclusion

A beneficiary grantor trust can be a useful tool. It allows a beneficiary to reduce his or her estate by the taxes paid on its income. It might invest in a new business opportunity or buy the beneficiary's interest in a business entity, allowing the beneficiary to keep using the business interest, even though it is outside the estate tax system.

The best candidate for such a trust is a beneficiary who lives in a state that clearly provides that the lapse of the beneficiary's withdrawal right does not make the beneficiary deemed to be the settlor for asset protection purposes. If the beneficiary does not live in such a state, then creditors can press a conflict of laws issue. Such a case might very well occur, given that thinly-capitalized trusts, where the beneficiary can remove and replace the independent trustee at will, have been promoted as safe. A creditor victory might then open the door to IRS attack, making the conflict-of-laws issue more important to avoid.

The beneficiary's taxation on the trust's income seems well-settled as far as private letter rulings are concerned, but what if the IRS changes its approach? Extra attention might be given to lapses of hanging powers when a trust is funded with a large gift or bequest, since concern has been raised about the scope of Reg. § 1.671-3(a)(3). Fitting a lapse of a withdrawal right under Code § 678(a)(2) might cause doubt, unless one uses the structure of Letter Ruling 200949012 (but then one must consider conflict of laws issues, as the author of that ruling told me that Alaska and Delaware are the only states that would provide the beneficiary with protection from creditors).

The allocation of authority between the beneficiary as a trustee and an independent person as trustee needs to be carefully crafted. Once a beneficiary's assets are reduced to a particular level, the beneficiary will want consistent distributions. The beneficiary should be authorized as trustee to make distributions to himself or herself under an ascertainable standard than rely on distributions by an independent trustee. Not only will this make the beneficiary more comfortable with the situation, it will also prevent a potentially dangerous pattern of distributions by the independent trustee. However, if the beneficiary lives in or might move to a state that does not protect the beneficiary's interest in the trust from creditors and is relying on the law of another state, then a different approach should be considered.

Special care should be taken to protect against excessive estate burn off due to taxes imposed on the beneficiary.

In conclusion, a beneficiary grantor trust can be useful in many situations, but it requires careful structuring and consideration of obtaining a private letter ruling (if available). A sale to a trust created by the client's spouse might be a palatable alternative if a private letter ruling is available.

III.B.2.j. Tax Allocations upon Change of Interest in a Business

Both S corporations and partnerships are flow-through entities. The grantor trust rules treat a grantor as owner of the trust for federal income tax purposes. As such, the income generated by the grantor's business, through the trust, is imputed back to the grantor. This income, naturally, generates tax liability.

In the case of either a GRAT or sale to an irrevocable grantor trust, generally the grantor is taxed on all of the trust's income, and payments back to the grantor have no income tax consequences.[5151] A GRAT can be disastrous to the grantor if the company is very successful and the grantor has to pay income tax in excess of the grantor's payments (an "exploding GRAT"), so GRATs should allow the grantor to be reimbursed for income taxes on part or all of the GRAT's income. This generally is not necessary for an irrevocable grantor trust, which is usually drafted so that the grantor trust taxation can be turned off. The trust agreement may authorize an independent trustee to reimburse the grantor's income tax so long as the decision to reimburse is made in the trustee's absolute discretion and cannot be legally compelled by the grantor.[5152]

This issue is only magnified by the sale of the business. Now, instead of just the imputed income generated by the business, the grantor must pay taxes on any gain from the sale. Ideally, the grantor would like to "turn off" the grantor trust features, essentially making the trust the owner for income tax purposes.[5153] Turning off the grantor trust features generally would be deemed, for income tax purposes, as a transfer from the grantor to the trust at that time.[5154] If a person is treated as the owner of an entire trust (corpus as well as ordinary income), that person takes into account in computing that person's income tax liability all items of income, deduction, and credit (including capital gains and losses) to which that person would have been entitled had the trust not been in existence during the period that person is treated as owner.[5155] See also part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

[5151] For the lack of income tax on payments using appreciated property, see Rev. Rul. 85-13.

[5152] Rev. Rul. 2004-64, Situation 2; see fns. 5273-5291, found in part III.B.2.j.iv.(a) Grantor Trust Reimbursing for Tax Paid by the .

[5153] Be sure not to get too cute in deciding which trusts are grantor trusts and when to turn powers on or off. See Notice 2007-73.

[5154] See fns. III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation, especially timing issues described in fns. 4939-4940. See also part III.B.1.c Gifts With Consideration – Bargain Sales.

[5155] See part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation. Although various rulings discuss how this affects the accounting period the trust generally uses to report income, rulings discussing the exact timing are scarce. Rev Rul. 85-13 held:

(1) A's receipt of the entire corpus of the trust in exchange for A's unsecured promissory note constituted an indirect borrowing of the trust corpus which caused A to be the owner of the entire trust under section 675(3) of the Code.

The next part discusses the income tax effect of turning off grantor trust status, followed by tax allocations upon a change of interest in S corporations and partnerships. See also part III.A.3.c Deadlines for Trust Qualifying as S Corporation Shareholder.

III.B.2.j.i. Changing Grantor Trust Status

An article from a prolific tax planner discusses the effect of changing grantor trust status:[5156]

- Pass through entities
- Payments of estimated taxes
- Suspended losses
- Basis
- Carryovers (including excess deductions on termination under Code § 642(h).[5157]

Note that a change in grantor trust status would not be eligible[5158] for an S corporation accounting cut-off in which S corporation activity is taxed to those who owned the stock on a particular date rather than pro-rata, per-share, per-day,[5159] whereas such a cut-off may very well be available for a partnership interest.[5160] Thus, when a grantor trust owns S corporation stock, the grantor should consider turning off grantor trust status before January 1 of the year of sale if the grantor wants to avoid paying tax when the business is sold.

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(2) At the time A became the owner of the trust, A became the owner of the trust property. As a result, the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets. Accordingly, when A sold the shares of Corporation Z stock on January 20, 1984, A recognized gain of $30x (amount realized of $50x less adjusted basis of $20x). Further, this holding would apply even if the trust held other assets in addition to A's promissory note if A, under any of the grantor trust provisions, was treated as the owner of the portion of the trust represented by the promissory note because A would be treated as the owner of the purported consideration (the promissory note) both before and after the transaction. See section 1.671-3(a)(2) of the regulations.

[5156] Peebles, Mysteries of the Blinking Trust, *Trusts and Estates*, pp. 16-20 of Sept. 2008 issue, which is saved as Thompson Coburn LLP doc. no. 5654628.

[5157] See part II.J.3.i Planning for Excess Losses.

[5158] If the grantor trust does not hold all of the stock that the grantor owns or is deemed to own, an accounting cut-off is not available at all; see part III.B.2.j.ii.(b) Transfer of Less Than Shareholder's Entire Interest. Even if does own all of that stock, an accounting cut-off still is not available; see fn. 5172, found in part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest.

[5159] See generally part III.B.2.j.ii Tax Allocations on the Transfer of Stock in an S Corporation.

[5160] See part III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership, especially part III.B.2.j.iii.(e) Allocation of Specific Items, the latter which may require an accounting cut-off for various items.

III.B.2.j.ii. Tax Allocations on the Transfer of Stock in an S Corporation

III.B.2.j.ii.(a). General Rules for Tax Allocations on the Transfer of Stock in an S Corporation

Although basis adjustments apply to partnership assets when a partnership interest is transferred in a taxable event or at a partner's death,[5161] similar adjustments do not apply to the corporation's assets when stock in an S corporation is transferred in a taxable event or at a shareholder's death. The basis adjustment might be replicated by liquidating the corporation, in which case the corporation is deemed to sell its assets,[5162] increasing the assets' basis. The shareholders are taxed on the sale of the assets. Then the shareholders will have a loss on liquidation to the extent that their basis, increased by death (or purchase, etc.) and increased by their K-1 income from the deemed sale of the corporation's assets, exceeds the fair market value of the assets distributed. In a perfect world, if the sole shareholder dies, the K-1 income will be offset by the shareholder's loss on liquidation. However, the nature of the K-1 income might not be a pure long-term capital gain, as depreciation recapture and the related party rules relating depreciable or amortizable property might apply.[5163] Furthermore, if the shareholder is a QSST, the gain on the deemed asset sale passes through to the beneficiary, whereas the loss is trapped in the trust;[5164] thus, where possible, liquidate the S corporation before funding a QSST after a basis-changing event.

Below is a discussion of pro-rating income from the transfer of stock.[5165]

Big increases in income (such as from the sale of significant capital asset) toward the end of a taxable year can cause problems for a shareholder whose stock is transferred before the sale. The deadline for declaring a dividend is often 1-2 months after the

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5161 See text accompanying footnotes 4144-4164 and 5208-4174.

5162 Code § 336.

5163 Code § 1239. Pay careful attention to the Code § 267 attribution rules and exceptions to those rules. Code § 267(c)(1) has more limited attribution when trusts are involved, so Code § 1239 is easier to avoid when the decedent passes assets in trust rather than outright. II.Q.7.g Code § 1239: Distributions or Other Dispositions of Depreciable or Amortizable Property.

5164 Reg. § 1.1361-(j)(8) provides:

> Coordination with grantor trust rules. If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code.

5165 See footnote 191 for a distribution method to take into account varying interests.

record date, so that the transferring shareholder might not be eligible for the related tax distribution, even if the other shareholders would otherwise have agreed to use an earlier record date. One might consider requiring in the shareholders' agreement a requirement that an accounting cut-off be done so that the gain is allocated to the recipient shareholder and not the transferring shareholder.[5166] If the stock is held in trust before and after the transfer, the Uniform Principal and Income Act might remedy this mismatch.[5167]

III.B.2.j.ii.(b). Transfer of Less Than Shareholder's Entire Interest

A grantor who transfers only a portion of his or her interest in the S corporation has no choice of tax allocation method. The deemed transferor and transferee will be allocated a pro rata portion of S corporation items based upon a two-step process:[5168]

(1) each corporate item is assigned, in equal portion, to each day of the taxable year.

(2) that portion is divided pro rata among the shares outstanding on that day.

The grantor is treated as a shareholder for the day of disposition, including the day of his or her death.[5169]

III.B.2.j.ii.(c). Transfer of Shareholder's Entire Interest

When a grantor transfers the entire S corporation interest, he or she uses the daily proration rule of Code § 1377(a)(1) unless an election is made to apply the special rule of Code § 1377(a)(2), described below.

A grantor who terminates his or her entire interest, in conjunction with the remaining shareholders, may elect to terminate the corporation's tax year.[5170] This election is available:[5171]

> on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder.

5166 See text accompanying footnotes 5170-5174.

5167 Section 506 of the Uniform Principal and Income Act. The Comments mention that QSSTs were considered when drafting Section 506(a)(3).

5168 Code § 1377(a)(1).

5169 Reg. § 1.1377-1(a)(2)(ii).

5170 Code § 1377(a)(2).

5171 Reg. § 1.1377-1(b)(4), which also provides that, in determining whether a shareholder's entire interest in an S corporation has been terminated, any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity is disregarded.

However, if the grantor is deemed to terminate his or her entire interest merely because of a change in the trust's status from grantor trust to non-grantor trust, then generally this election will not be available.[5172] For an example of how this could be disastrous, see the indented text accompanying fn. 4941 in part III.B.2.d.i.(b) Portions of Irrevocable Grantor Trust Deemed Owned for Federal Income Taxation.

To effect this interim closing of the corporation's books, each of the affected shareholders and the corporation must consent to the election. An affected shareholder is defined as:[5173]

(1) the shareholder whose interest is terminated; and

(2) all shareholders to whom such shareholder has transferred shares during the taxable year (if such shareholder has transferred shares to the corporation, the affected shareholders include all persons who are shareholders during the taxable year).

Subsequently, the books will be treated as if the taxable year consisted of two taxable years, the first of which ends on the close of the day in which the grantor's entire interest in the S corporation is terminated.[5174]

However, the grantor probably will not be able or willing to divest himself or herself of his or her entire interest in the S corporation to effect this result. More likely, the grantor has structured the transfer so that he or she retains the voting shares of the company, while transferring the vast majority of corporate stock to the trust as non-voting shares. A conventional structure might have the grantor retaining 5% of the company shares as its only voting stock, while transferring 95% of the remaining non-voting stock to the trust. By terminating grantor trust status in such a situation, the grantor will not be able cut off his or her entire interest in the S corporation. Instead, the grantor should consider turning off the grantor trust powers before the tax year of sale to avoid this concern.

[5172] Reg. § 1.1377-1(a)(2)(iii) (last sentence). T.D. 8994 explains:

> A commentator suggested that a trust's conversion to an ESBT should result in a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2) because the incidence of taxation with respect to S corporation items will change as a result of the ESBT election….The final regulations do not adopt the suggestion that all conversions of a trust to an ESBT should be treated as a complete termination of the trust's interest in the S corporation for purposes of section 1377(a)(2)….When a trust changes from a wholly-owned grantor trust or QSST to an ESBT or from an ESBT to a QSST, the individuals who are shareholders of the S corporation under section 1361(c)(2)(B) remain the same. The election to terminate the taxable year provided in section 1377(a)(2) applies to the termination of a shareholder's interest in the S corporation. Accordingly, it is appropriate to treat the conversion of a trust described in section 1361(c)(2)(A)(ii) or (iii) to an ESBT or QSST as a termination of the prior trust's interest in the S corporation, but not to treat other conversions to an ESBT or QSST as terminations. The election under § 1.1368-1(g) is also not available because the conversion of the trust is not a qualifying disposition.

[5173] Code § 1377(a)(2)(B).

[5174] Reg. § 1.1377-1(b)(1).

See part II.A.2.l Terminating S Election regarding allocation of income between taxable periods when an S election terminates, which provides more liberal opportunities to do accounting cut-offs (but generally at a high tax cost).

III.B.2.j.ii.(d). Death of a Shareholder

The death of a shareholder (grantor) is treated as if the grantor had sold his or her entire interest in the S corporation. As such, the applicable tax allocation rules upon the death of the grantor are similar to those of a transfer of the entire interest, as enunciated above. If the shareholder dies (or if the shareholder is an estate or trust and the estate or trust terminates) before the end of the taxable year of the corporation, the shareholder's pro rata share of these items is taken into account on the shareholder's final return,[5175] with the date of death being reported on the decedent shareholder's final individual income tax return.[5176] Items from the portion of the corporation's taxable year after the shareholder's death will be taken into account by the estate or other person acquiring the stock.[5177]

General Rule (Default Rule) **— Daily Proration**

As above, the default rule of daily proration applies absent the corporation and shareholder's joint election for an interim closing of the books.

Special Rule (By Agreement) **— Interim Closing of the Books**

The executor or administrator of the deceased grantor's estate may consent to the termination election on behalf of the deceased grantor and his estate.[5178] As before, all affected shareholders must consent to the election.

III.B.2.j.ii.(e). Change in Qualification of Trust to Hold S Corporation Stock During Taxable Year

If, during an S corporation's taxable year, a trust that is an eligible shareholder of the S corporation converts from a trust described in Code § 1361(c)(2)(A)(i), (ii), (iii), or (v)[5179] for the first part of the year to a trust described in a different subpart of Code § 1361(c)(2)(A)(i), (ii), or (v) for the remainder of the year, the trust's share of the S corporation items is allocated between the two types of trusts.[5180] This includes a trust

[5175] Reg. § 1.1366-1(a)(1).

[5176] Reg. § 1.1377-1(a)(2)(ii) provides:

> *Determining shareholder for day of stock disposition*. A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder's death.

[5177] Senate Report, 1982 Subchapter S Revision Act, PL 97-354.

[5178] Reg. § 1.1377-1(b)(5)(ii).

[5179] See part III.A.3.b Comprehensive Description of Types of Trusts That Can Hold Stock in an S Corporation.

[5180] Reg. § 1.1377-1(a)(2)(iii).

that is an ESBT [5181] for part of the year and an eligible shareholder under Code § 1361(c)(2)(A)(i)-(iv) for the rest of the year.[5182]

The first day that a QSST[5183] or an ESBT is treated as an S corporation shareholder is the effective date of the QSST or ESBT election.[5184] Upon the conversion, the trust is not treated as terminating its entire interest in the S corporation for purposes of part III.B.2.j.ii.(c) Transfer of Shareholder's Entire Interest, unless the trust was a trust described in part III.A.3.b.ii A Trust That Was A Grantor Trust With Respect To All Of Its Assets Immediately Before The Death Of The Deemed Owner And Which Continues In Existence After Such Death or III.A.3.b.iii A Trust With Respect To Stock Transferred To It Pursuant To The Terms Of A Will, But Only For The 2-Year Period Beginning On The Day On Which Such Stock Is Transferred To It before the conversion. [5185]

III.B.2.j.ii.(f). Distribution after Transfer

Consider whether the donor or other transferor will need to receive distributions after the transfer and whether state law permits such transfers. For example, a shareholder might need a distribution to pay taxes but might not know how much until after the corporate income tax return for the year is filed.

State corporate law might impose time limits preventing distributions to shareholders more than a particular number of days after the record date.[5186] Using an LLC or other unincorporated entity for state law purposes might allow one to dispense with this limitation. Of course, the transferee could always agree to pay more to the transferor, but that imposes risk on the transferor with respect to the transferee's ability or willingness to perform.

One taxpayer argued that distributions the calendar year after her gave 95% of his stock should be applied against the basis of the donated stock, suggesting that the gift was not complete because that following calendar year he received distributions with respect to the donated stock, but the court didn't agree with his arguments.[5187]

III.B.2.j.iii. Tax Allocations upon Change of Interest in a Partnership

Special rules apply if a partnership interest is created by gift. See part III.B.1.a.iv.(b) Income Tax Aspects of Family Partnerships.

For implementation of the rules set forth in this part III.B.2.j.iii Tax Allocations upon Change of Interest in a Partnership, see part III.B.2.j.iii.(e) Allocation of Specific Items, which also applies in other situations.

[5181] See part III.A.3.e.ii ESBTs.
[5182] Reg. § 1.1361-1(m)(3)(iv). Reg. § 1.641(c)-1(d)(2)(i) refers to Reg. § 1.1361-1(m)(3)(iv), which in turn refers to Reg. § 1.1377-1(a)(2)(iii).
[5183] See part III.A.3.e.i QSSTs.
[5184] Reg. § 1.1377-1(a)(2)(iii).
[5185] Reg. § 1.1377-1(a)(2)(iii).
[5186] See, *e.g.*, R.S.Mo. § 351.250.
[5187] *Miller v. Commissioner*, T.C. Memo. 2011-189.

Rev. Rul. 72-352 held that a trust's distribution of its partnership interest to the remainderman on the termination of the trust did not terminate the taxable year of the partnership but the taxable year of the partnership did close with respect to the trust in its capacity as partner, so that the trustees must include in the gross income of the trust its distributive share of the partnership items and any guaranteed payments as though the partnership year had ended on the trust's termination date. Consider that ruling in the context of the rest of part III.B.2.j.iii, which describes regulations adopted after that ruling but do not expressly refer to that ruling.

III.B.2.j.iii.(a). Transfer of Less Than a Partner's Entire Interest

Generally, the partnership's taxable year does not close with respect to a partner who sells or exchanges less than his entire interest or whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise);[5188] even a transfer of a partner's entire interest by gift does not close the taxable year.[5189] However, the sale or exchange of at least 50% of a partnership terminates the partnership, closing the books,[5190] but a "sale or exchange" does not include the disposition of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest;[5191] see part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership for other consequences of such a termination.

Subject to certain exceptions, if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year are determined by the use of any method prescribed by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.[5192] The exceptions are:

- If during any taxable year of the partnership any partner's interest changes, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item[5193] shall be determined:[5194]

[5188] Code § 706(c)(2)(B); Reg. § 1.706-1(c)(3).

[5189] Reg. § 1.706-1(c)(5), which further provides that the income up to the date of gift attributable to the donor's interest shall be allocated to the donor under Code § 704(e)(2).

[5190] Reg. § 1.708-1(b)(3).

[5191] Reg. § 1.708-1(b)(2).

[5192] Code § 706(d)(1).

[5193] Code § 706(d)(2)(B) provides:

> For purposes of this paragraph, the term allocable cash basis item means any of the following items with respect to which the partnership uses the cash receipts and disbursements method of accounting:
> (i) Interest.
> (ii) Taxes.
> (iii) Payments for services or for the use of property.
> (iv) Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of this paragraph is appropriate to avoid significant misstatements of the income of the partners.

[5194] Code § 706(d)(2)(A).

- by assigning the appropriate portion of such item to each day in the period to which it is attributable,[5195] and
- by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.[5196]

- If during any taxable year of the partnership there is a change in any partner's interest in the partnership (the "upper tier partnership"), and such partnership is a partner in another partnership (the "lower tier partnership"), then (except to the extent provided in regulations) each partner's distributive share of any item of the upper tier partnership attributable to the lower tier partnership shall be determined by assigning the appropriate portion (determined by applying principles similar to the principles described in fn. 5195) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion assigned to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day.[5197]

III.B.2.j.iii.(b). Transfer of Partner's Entire Interest

The taxable year of a partnership closes "with respect to a partner whose entire interest terminates (whether by reason of death, liquidation or otherwise.)"[5198]

A partnership taxable year closes with respect to a partner:[5199]

- who sells or exchanges his entire interest in the partnership,[5200]

[5195] Code § 706(d)(2)(A)(i). Code § 706(d)(2)(C)(i) provides that, if any portion of any allocable cash basis item is attributable to any period before the beginning of the taxable year, such portion shall be assigned under this rule to the first day of the taxable year. Code § 706(d)(2)(D) provides that, if any portion of a deductible cash basis item is assigned under this rule to the first day of any taxable year, then such portion shall be allocated among persons who are partners in the partnership during the period to which such portion is attributable in accordance with their varying interests in the partnership during such period, and any amount allocated under this rule to a person who is not a partner in the partnership on such first day shall be capitalized by the partnership and treated in the manner provided for in Code § 755.
Code § 706(d)(2)(C)(ii) provides that, if any portion of any allocable cash basis item is attributable to any period after the close of the taxable year, such portion shall be assigned under this rule to the last day of the taxable year.

[5196] Code § 706(d)(2)(A)(ii).

[5197] Code § 706(d)(3).

[5198] Code § 706(c)(2)(A). See also part II.Q.8.e.i Distribution of Partnership Interests.

[5199] Reg. § 1.706-1(c)(2)(i).

[5200] Note also that Reg. § 1.706-1(c)(2)(iii) provides:

> *Deemed dispositions*. A deemed disposition of the partner's interest pursuant to § 1.1502-76(b)(2)(vi) (relating to corporate partners that become or cease to be members of a consolidated group within the meaning of §§ 1.1502-1(h)), 1.1362-3(c)(1) (relating to the termination of the subchapter S election of an S corporation partner), or 1.1377-1(b)(3)(iv) (regarding an election to terminate the taxable year of an S corporation partner), shall be treated as a disposition of the partner's entire interest in the partnership solely for purposes of section 706.

- whose entire interest in the partnership is liquidated, or

- who dies.

In such a case, the partner includes in the partner's taxable income for the partner's taxable year within or with which the partner's interest in the partnership ends the partner's distributive share of items described in Code § 702(a) and any guaranteed payments under Code § 707(c) for the partnership taxable year ending with the date of such termination.[5201]

The partnership's taxable year, with respect to the remaining partners, shall not close, unless the partnership is otherwise terminated, such as under Code § 708(b), which provides that the sale or exchange of a partnership interest which, by itself or aggregated with sales or exchanges in the preceding 12 months, transfers an interest of 50% or more of the total partnership capital or profits will effectively terminate the partnership.[5202]

III.B.2.j.iii.(c). Death of a Partner — Treated Like a Transfer of a Partner's Entire Interest

The death of a partner is treated as if the partner had transferred his or her entire interest in the partnership. Previously, the deceased partner's estate received all of the deceased partner's income for the partnership taxable year in which the death occurred. This is no longer true, and the taxable year closes with respect to a partner whose entire interest in the partnership has terminated.[5203] Thus, the death of a partner is treated as a transfer of the deceased partner's entire partnership interest to his or her estate.

If the decedent partner's estate or other successor sells or exchanges its entire interest in the partnership, or if its entire interest is liquidated, the partnership taxable year with respect to the estate or other successor in interest closes on the date of such sale or exchange, or the date of the completion of the liquidation.[5204]

Reg. § 1.706-1(c)(2)(ii) provides an example:

> H is a partner of a partnership having a taxable year ending December 31. Both H and his wife W are on a calendar year and file joint returns. H dies on March 31, 2016. Administration of the estate is completed and the estate, including the partnership interest, is distributed to W as legatee on November 30, 2016. Such distribution by the estate is not a sale or exchange of H's partnership interest. The taxable year of the partnership will close with

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5201 Reg. § 1.706-1(c)(2)(i). For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

5202 Reg. § 1.708-1(b)(3). See parts II.Q.8.e.i Distribution of Partnership Interests (when a distribution as a sale or exchange) and II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership (of Transfers of Partnership Interests).

5203 Code § 706(c)(2)(A).

5204 Reg. § 1.706-1(c)(2)(i). The sale or exchange of a partnership interest does not, for the purpose of this rule, include any transfer of a partnership interest which occurs at death as a result of inheritance or any testamentary disposition. *Id.*

> respect to H on March 31, 2016, and H will include in his final return for his final taxable year (January 1, 2016, through March 31, 2016) his distributive share of partnership items for that period under the rules of sections 706(d)(2), 706(d)(3), and § 1.706-4. W will include in her return for the taxable year ending December 31, 2016, her distributive share of partnership items for the period of April 1, 2016, through December 31, 2016, under the rules of sections 706(d)(2), 706(d)(3), and § 1.706-4.

Note that a partner's death can trigger a basis increase – or reduction – in that partner's share of the partnership's assets.[5205] Even absent a Code § 754 election, the possibility of reduction requires monitoring to make sure that the partnership's assets do not have a substantial built-in loss.[5206]

III.B.2.j.iii.(d). Other Occasions Calling for an Interim Closing of the Books

Because determination of the adjusted basis and fair market value is necessary to comply with Code § 755 allocations, a Code § 754 election[5207] by the partnership to adjust the basis of partnership assets for the benefit of a transferee partner[5208] or in the case of a liquidation[5209] will require an interim closing of the books.

Applying Code § 732(d) basis adjustments on distributions[5210] and Code § 708(b) partnership terminations[5211] might also require interim closings.

III.B.2.j.iii.(e). Allocation of Specific Items

The rules of this part III.B.2.j.iii.(e) apply for determining the partners' distributive shares of partnership items when a partner's interest in a partnership varies during the taxable year as a result of the disposition of a partial or entire interest in a partnership[5212] or if a partner sells or exchanges a part of his interest in a partnership or if the interest of a partner is reduced[5213] (collectively, a "variation").[5214] However, they do not override certain other provisions.[5215] In all cases, all partnership items for each taxable year must

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5205 See part II.Q.8.e.iii Inside Basis Step-Up (or Step-Down) Applies to Partnerships and Generally Not C or S Corporations.

5206 See part II.Q.8.e.iii.(c) When Code § 754 Elections Apply; Mandatory Basis Reductions When Partnership Holds or Distributes Assets with Built-In Losses Greater Than $250,000.

5207 For more on Code § 754 elections (and similar rules that apply without an election when the partnership has a substantial built-in loss), see part II.Q.8.e.iii.(b) Transfer of Partnership Interests: Effect on Partnership's Assets.

5208 Code § 743(b).

5209 Code § 734(b).

5210 See part II.Q.8.e.iii.(e) Code § 734 Basis Adjustment Resulting from Distributions, Including Code § 732(d) Requiring an Adjustment Without Making Code § 754 Election.

5211 See part II.Q.8.e.iv Transfer of Partnership Interests Resulting in Deemed Termination: Effect on Partnership.

5212 As described in Reg. § 1.706-1(c)(2) and (3).

5213 As described in Reg. § 1.706-1(c)(3), including by the entry of a new partner.

5214 Reg. § 1.706-4(a)(1).

5215 Reg. § 1.706-4(a)(2) provides:

> Items subject to allocation under other rules, including sections 108(e)(8) and 108(i) (which provide special allocation rules for certain items from the discharge or retirement of indebtedness section), section 704(c) (relating to allocations with respect to certain

be allocated among the partners, and no partnership items may be duplicated, regardless of the particular provisions that apply and regardless of the method or convention adopted by the partnership.[5216]

In allocating items, a partnership must take the following steps in the order indicated:[5217]

1. Determine whether certain additional exceptions apply:[5218]

   - This general rule will not preclude changes in the allocations among contemporaneous partners for the entire partnership taxable year (or among contemporaneous partners for a segment if the item is entirely attributable to a segment), if any variation in a partner's interest is not attributable to a contribution of money or property by a partner to the partnership or a distribution of money or property by the partnership to a partner; and the allocations resulting from the modification satisfy the provisions of Code § 704(b) and the regulations promulgated thereunder.[5219]

   - With respect to any taxable year in which there is a change in any partner's interest in a partnership for which capital is not a material income-producing factor, the partnership and such partner may choose to determine the partner's distributive share of partnership income, gain, loss, deduction, and credit using any reasonable method to account for the varying interests of the partners in the partnership during the taxable year provided that the allocations satisfy the provisions of Code § 704(b).[5220]

2. Determine which of its items are subject to allocation under certain special rules for extraordinary items, and allocate those items accordingly.[5221] Subject to a small item exception,[5222] extraordinary items that may not be prorated[5223] include: [5224]

> contributed property), § 1.704-3(a)(6) (relating to allocations with respect to revalued property), section 706(d)(2) (relating to the determination of partners' distributive shares of allocable cash basis items), and section 706(d)(3) (relating the determination of partners' distributive share of any item of an upper tier partnership attributable to a lower tier partnership), are not subject to the rules of this section. In addition, the rules of this section do not apply in making allocation of book items pursuant to § 1.704-1(b)(2)(iv)(e), (f), or (s).

[5216] Reg. § 1.706-4(a)(2).
[5217] Reg. § 1.706-4(a)(3).
[5218] Reg. § 1.706-4(a)(3)(i), referring to Reg. § 1.706-4(b).
[5219] Reg. § 1.706-4(b)(1).
[5220] Reg. § 1.706-4(b)(2). Whether capital is a material income-producing factor might have changed since the regulation was promulgated by T.D. 9728 on July 31, 2015. See part III.B.1.a.iv.(b) Income Tax Aspects of Family Partnerships.
[5221] Reg. § 1.706-4(a)(3)(ii), referring to Reg. § 1.706-4(e).
[5222] Reg. § 1.706-4(e)(3) provides:

> *Small item exception*. A partnership may treat an item described in paragraph (e)(2) of this section as other than an extraordinary item for purposes of this paragraph (e) if, for the partnership's taxable year the total of all items in the particular class of extraordinary items (as enumerated in paragraphs (e)(2)(i) through (xi) of this section, for example, all tort or similar liabilities, but in no event counting an extraordinary item more than once) is less than five percent of the partnership's gross income, including tax-exempt income

- Any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset;[5225]

- Any item from the disposition or abandonment (other than in the ordinary course of business) of property used in a trade or business;[5226]

- Any item from the disposition or abandonment of certain assets excluded from the definition of capital asset[5227] if substantially all the assets in the same

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described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items; and the total amount of the extraordinary items from all classes of extraordinary items amounting to less than five percent of the partnership's gross income, including tax-exempt income described in section 705(a)(1)(B), in the case of income or gain items, or gross expenses and losses, including section 705(a)(2)(B) expenditures, in the case of losses and expense items, does not exceed $10 million in the taxable year, determined by treating all such extraordinary items as positive amounts.

[5223] Reg. § 1.706-4(e)(1), which provides:

The partnership must allocate extraordinary items among the partners in proportion to their interests in the partnership item at the time of day on which the extraordinary item occurred, regardless of the method (interim closing or proration method) and convention (daily, semi-monthly, or monthly) otherwise used by the partnership. These rules require the allocation of extraordinary items as an exception to the proration method, which would otherwise ratably allocate the extraordinary items across the segment, and the conventions, which could otherwise inappropriately shift extraordinary items between a transferor and transferee. However, publicly traded partnerships (as defined in section 7704(b)) that are treated as partnerships may, but are not required to, apply their selected convention in determining who held publicly traded units (as described in § 1.7704-1(b) or (c)(1)) at the time of the occurrence of an extraordinary item. Extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for section 179 expenses).

[5224] Reg. § 1.706-4(e)(2).

[5225] As defined in Code § 1221 (determined without the application of any other rules of law). Reg. § 1.706-4(e)(2). Real estate might or might not constitute inventory. See part II.G.12 Future Development of Real Estate, especially fn. 1042.

[5226] As defined in Code § 1231(b) (determined without the application of any holding period requirement). Reg. § 1.706-4(e)(2)(ii).

[5227] Referring to the following provisions in Code § described in section 1221(a):

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
(2) [excluded from this list]
(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by-
    (A) a taxpayer whose personal efforts created such property,
    (B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
    (C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

category from the same trade or business are disposed of or abandoned in one transaction (or series of related transactions);[5228]

- Any item from assets disposed of in an applicable asset acquisition;[5229]

- Any item resulting from any change in accounting method initiated by the filing of the appropriate form after a variation occurs;[5230]

- Any item from the discharge or retirement of indebtedness (except items subject to special allocation rules provided in Code § 108(e)(8) and (i));[5231]

- Any item from the settlement of a tort or similar third-party liability or payment of a judgment;[5232]

- Any credit, to the extent it arises from activities or items that are not ratably allocated;[5233]

- For all partnerships, any additional item if, the partners agree[5234] to consistently treat such item as an extraordinary item for that taxable year; however, this rule does not apply if treating that additional item as an extraordinary item would result in a substantial distortion of income in any partner's return; any additional extraordinary items continue to be subject to any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year (for example, the limitation for Code § 179 expenses);[5235]

- Any item which, in the IRS' opinion, would, if ratably allocated, result in a substantial distortion of income in any return in which the item is included;[5236]

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(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by-

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A);

[remaining provisions of Code § 1221(a) are excluded from this list.]

5228 Reg. § 1.706-4(e)(2)(iii).

5229 Reg. § 1.706-4(e)(2)(iv), referring to Code § 1060(c).

5230 Reg. § 1.706-4(e)(2)(v).

5231 Reg. § 1.706-4(e)(2)(vi).

5232 Reg. § 1.706-4(e)(2)(vii).

5233 Reg. § 1.706-4(e)(2)(viii), giving as an example the Code § 47 rehabilitation credit, which is based on placement in service.

5234 Within the meaning of Reg. § 1.706-4(f) ; see fns. 5262-5265.

5235 Reg. § 1.706-4(e)(2)(ix).

5236 Reg. § 1.706-4(e)(2)(x).

- Any item identified as an additional class of extraordinary item in guidance published in the Internal Revenue Bulletin.[5237]

3. Determine with respect to each variation whether it will apply the interim closing method or the proration method.[5238] Absent an agreement of the partners[5239] to use the proration method, the partnership must use the interim closing method.[5240] The partnership may use different methods (interim closing or proration) for different variations within each partnership taxable year; however, the IRS may place restrictions on the ability of partnerships to use different methods during the same taxable year in guidance published in the Internal Revenue Bulletin.[5241]

4. Determine when each variation is deemed to have occurred under the partnership's selected convention (generally, daily, semi-monthly, or monthly).[5242]

5. Determine whether there is an agreement of the partners[5243] to perform regular monthly or semi-monthly interim closings.[5244] If so, then the partnership will perform an interim closing of its books at the end of each month (in the case of an agreement

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[5237] Reg. § 1.706-4(e)(2)(xi).
[5238] Reg. § 1.706-4(a)(3)(iii).
[5239] Within the meaning of Reg. § 1.706-4(f); see fns. 5262-5265.
[5240] Reg. § 1.706-4(a)(3)(iii).
[5241] Reg. § 1.706-4(a)(3)(iii).
[5242] Reg. § 1.706-4(a)(3)(iv), referring to the selected convention under Reg. § 1.706-4(c). However, all variations within a taxable year shall be deemed to occur no earlier than the first day of the partnership's taxable year, and no later than the close of the final day of the partnership's taxable year. Thus, for a calendar year partnership applying either the semi-monthly or monthly convention to a variation occurring on January 1st through January 15th, the variation will be deemed to occur at the beginning of the day on January 1st. Reg. § 1.706-4(c)(2)(i). Also, if a person becomes a partner during the partnership's taxable year as a result of a variation, and ceases to be a partner as a result of another variation, if both such variations would be deemed to occur at the same time under the rules of Reg. § 1.706-4(c)(1), then the variations with respect to that partner's interest will instead be treated as occurring on the dates each variation actually occurred. Reg. § 1.706-4(c)(2)(ii). Thus, the partnership must treat such a person as a partner for the entire portion of its taxable year during which the partner actually owned an interest; see Reg. § 1.706-4(c)(4), Example (2). However, Reg. § 1.706-4(c)(2)(ii) (by its own terms) does not apply to publicly traded partnerships (as defined in Code § 7704(b)) that are treated as partnerships with respect to holders of publicly traded units (as described in Reg. § 1.7704-1(b) or 1.7704-1(c)(1)).
[5243] Within the meaning of Reg. § 1.706-4(f); see fns. 5262-5265.
[5244] Reg. § 1.706-4(a)(3)(v), referring to closings under Reg. § 1.706-4(d). Reg. § 1.706-4(d)(1) provides:

> *Optional regular monthly or semi-monthly interim closings*. Under the rules of this section, a partnership is not required to perform an interim closing of its books except at the time of any variation for which the partnership uses the interim closing method (taking into account the applicable convention). However, a partnership may, by agreement of the partners (within the meaning of paragraph (f) of this section) perform regular monthly or semi-monthly interim closings of its books, regardless of whether any variation occurs. Regardless of whether the partners agree to perform these regular interim closings, the partnership must continue to apply the interim closing or proration method to its variations according to the rules of this section.

For a discussion of Reg. § 1.706-4(f) referred to above, see fns. 5262-5265.
Reg. § 1.706-4(d)(2) provides an example of the principles of Reg. § 1.706-4(d)(1).

to perform monthly closings) or at the end and middle of each month (in the case of an agreement to perform semi-monthly closings), regardless of whether any variation occurs.[5245] Absent an agreement of the partners to perform regular monthly or semi-monthly interim closings, the only interim closings during the partnership's taxable year will be at the deemed time of the occurrence of variations for which the partnership uses the interim closing method.[5246]

6. Determine the partnership's segments, which are specific periods of the partnership's taxable year created by interim closings of the partnership's books.[5247] The first segment starts with the beginning of the taxable year of the partnership and ends at the time of the first interim closing.[5248] Any additional segment begins immediately after the closing of the prior segment and ends at the time of the next interim closing.[5249] However, the last segment of the partnership's taxable year must end no later than the close of the last day of the partnership's taxable year.[5250] If no interim closings occur, the partnership has one segment, which corresponds to its entire taxable year.[5251]

7. Apportion the partnership's items for the year among its segments.[5252] The partnership determines the items of income, gain, loss, deduction, and credit of the partnership for each segment.[5253] Generally, a partnership treats each segment as though the segment were a separate distributive share period.[5254] For purposes of determining allocations to segments, any special limitation or requirement relating to the timing or amount of income, gain, loss, deduction, or credit applicable to the entire partnership taxable year will apply based upon the partnership's satisfaction of the limitation or requirement as of the end of the partnership's taxable year.[5255]

8. Determine the partnership's proration periods, which are specific portions of a segment created by a variation for which the partnership chooses to apply the proration method.[5256] The first proration period in each segment begins at the beginning of the segment and ends at the first time of the first variation within the segment for which the partnership selects the proration method.[5257] The next proration period begins immediately after the close of the prior proration period and

[5245] Reg. § 1.706-4(a)(3)(v).
[5246] Reg. § 1.706-4(a)(3)(v).
[5247] Reg. § 1.706-4(a)(3)(vi).
[5248] Reg. § 1.706-4(a)(3)(vi).
[5249] Reg. § 1.706-4(a)(3)(vi).
[5250] Reg. § 1.706-4(a)(3)(vi).
[5251] Reg. § 1.706-4(a)(3)(vi).
[5252] Reg. § 1.706-4(a)(3)(vii).
[5253] Reg. § 1.706-4(a)(3)(vii).
[5254] Reg. § 1.706-4(a)(3)(vii). For example, a partnership may compute a capital loss for a segment of a taxable year even though the partnership has a net capital gain for the entire taxable year. Reg. § 1.706-4(a)(3)(vii).
[5255] Reg. § 1.706-4(a)(3)(vii). For example, the expenses related to the election to expense a Code § 179 asset must first be calculated (and limited if applicable) based on the partnership's full taxable year, and then the effect of any limitation must be apportioned among the segments in accordance with the interim closing method or the proration method using any reasonable method. Reg. § 1.706-4(a)(3)(vii).
[5256] Reg. § 1.706-4(a)(3)(viii).
[5257] Reg. § 1.706-4(a)(3)(viii).

ends at the time of the next variation for which the partnership selects the proration method.[5258] However, each proration period ends no later than the close of the segment.[5259]

9. Prorate the items of income, gain, loss, deduction, and credit in each segment among the proration periods within the segment.[5260]

10. Determine the partners' distributive shares of partnership items by taking into account the partners' interests in such items during each segment and proration period.[5261]

Various provisions above refer to agreements by the partners.[5262] "Agreement of the partners" refers to:

- An agreement of all the partners to select the method, convention, or extraordinary item in a dated, written statement maintained with the partnership's books and records,[5263] or

- A selection of the method, convention, or extraordinary item made by a person authorized to make that selection,[5264] if that person's selection is in a dated, written statement maintained with the partnership's books and records.[5265]

In either case, the dated written agreement must be maintained with the partnership's books and records by the due date, including extension, of the partnership's tax return.

As mentioned in fn. 5215, a special rule for determining a partner's share of the partnership's allocable cash-basis items also applies.[5266] Each partner's distributive share of any allocable cash basis items shall be determined:[5267]

(1) by assigning the appropriate portion of such items to each day in the period to which it is attributable; and

(2) by allocating the portion assigned to any such day among the partners in proportion to their partnership interests at the close of such day.

[5258] Reg. § 1.706-4(a)(3)(viii).
[5259] Reg. § 1.706-4(a)(3)(viii).
[5260] Reg. § 1.706-4(a)(3)(ix).
[5261] Reg. § 1.706-4(a)(3)(x).
[5262] Reg. § 1.706-4(f) refers to Reg. § 1.706-4(a)(3)(iii) (relating to selection of the proration method), Reg. § 1.706-4(c)(3) (relating to selection of the semi-monthly or monthly convention), Reg. § 1.706-4(d) (relating to performance of regular monthly or semi-monthly interim closings), and Reg. § 1.706-4(e)(2)(ix) (relating to selection of additional extraordinary items).
[5263] One example is a selection that is included in the partnership agreement.
[5264] This might be under a grant of general authority provided for by state law or in the partnership agreement.
[5265] Reg. § 1.706-4(f).
[5266] Code § 706(d)(2).
[5267] Code § 706(d).

Also, the modified accrual method must be applied with respect to the following allocable cash basis items, as paid or received by the partnership:[5268]

(1) interest; or

(2) taxes; or

(3) payments for services or for the use of property (for example, rent); or

(4) any other item specified by regulations.

III.B.2.j.iv. Income Tax Reimbursement Clause

III.B.2.j.iv.(a). Grantor Trust Reimbursing for Tax Paid by the Deemed Owner

I usually include a clause providing that the trust cannot reimburse the grantor, to avoid a possible argument that the grantor has an equitable right to be reimbursed that may be included in the grantor's estate for estate tax purposes. The Uniform Trust Decanting Act[5269] suggests that decanting may allow a trust to be switched from grantor trust to nongrantor trust or vice versa.[5270]

If the grantor cannot achieve accounting cut off or cannot terminate his grantor trust powers to escape the dire tax consequences of an exploding GRAT or irrevocable

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[5268] Code § 706(d)(2)(B)(i-iv).

[5269] As adopted July 2015. See http://www.uniformlaws.org/Act.aspx?title=Trust Decanting.

[5270] Section 19(b)(9) provides:

> Subject to paragraph (4):
>
> (A) except as otherwise provided in paragraph (7), the second trust may be a nongrantor trust, even if the first trust is a grantor trust; and
>
> (B) except as otherwise provided in paragraph (10), the second trust may be a grantor trust, even if the first trust is a nongrantor trust.

Section 19(b)(4) prohibits decanting that would mess up an S election. For example, I do not believe that a QSST's S corporation stock can be transferred into another trust by decanting, but the Act authorizes decanting to take the form of a trust amendment without actually transferring the stock, which may be permissible by a QSST, depending on the amendment. See part III.A.3.e.i.(a) QSSTs Generally, especially fn 4463.

Section 19(b)(7) protects grantor trust status under Code § 672(f)(2)(A), which describes the conditions under which the grantor trust rules treat a nonresident alien as a deemed owner.

Section 19(b)(10) provides:

> An authorized fiduciary may not exercise the decanting power if a settlor objects in a signed record delivered to the fiduciary within the notice period and:
>
> (A) the first trust and a second trust are both grantor trusts, in whole or in part, the first trust grants the settlor or another person the power to cause the first trust to cease to be a grantor trust, and the second trust does not grant an equivalent power to the settlor or other person; or
>
> (B) the first trust is a nongrantor trust and a second trust is a grantor trust, in whole or in part, with respect to the settlor, unless:
>
> (i) the settlor has the power at all times to cause the second trust to cease to be a grantor trust; or
>
> (ii) the first-trust instrument contains a provision granting the settlor or another person a power that would cause the first trust to cease to be a grantor trust and the second-trust instrument contains the same provision.

grantor trust, an income tax reimbursement clause may be a valuable tool to remedy this problem. In its simplest form, the income tax reimbursement clause authorizes the trustee with a discretionary power to reimburse the grantor for income taxes incurred in excess of the annuity or note payments.

An income tax reimbursement provision will cause inclusion of the trust assets in the grantor's gross estate if it constitutes a transfer with a retained life estate interest in the trust assets.[5271] Any retention of a right to apply the trust property towards the discharge of a legal obligation causes inclusion under Code § 2036[5272] and, if the right is absolute, Code § 2041. GRATs should include income tax reimbursement clauses, which potentially makes them includible in the grantor's gross estate. Often, this is not a concern, because GRATs are often fully included in the grantor's estate if the grantor dies during the annuity term. However, in the case of a sale to the irrevocable grantor trust, only the note is included under Code § 2036; therefore, avoiding estate inclusion due to tax reimbursement clauses is particularly important.

Rev. Rul. 2004-64 provides specific guidance on this point.[5273] When trust language provides an unrelated trustee[5274] discretionary power to reimburse the grantor for excess income taxes, the reimbursement clause will not necessarily cause estate inclusion, if there is no understanding that the trustee will reimburse the grantor.[5275] Subsequent rulings discussing tax reimbursement clauses include:

- In Letter Ruling 200822008, the trust was to be modified authorizing the trustee "to pay to the Grantor or the Grantor's legal representative those amounts sufficient to satisfy the Grantor's federal, state, or local income tax liability actually incurred by the Grantor attributable to the 'pass through' of the Trust's taxable income." Such distributions would be subject to the consent of an independent "Reimbursement Committee"[5276] and an adult child who qualifies as a Code § 672(c) adverse party;

[5271] Code § 2036(a). The right to be reimbursed for tax liability over the annuity or note amount, presumably, could be deemed as the possession or enjoyment of, or the right to the income from, the property or the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.
[5272] Reg. § 20.2036-1(b)(2). The grantor is legally obligated to pay his or her income taxes, thus any right to reimbursement for this legal obligation may be included in the grantor's gross estate.
[5273] See also Forsberg & Worthington, Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts – When to Use Them and When Not to Use Them, *Probate & Property*, Vol. 19, No. 3, May/June 2005.
[5274] Rev. Rul. 2004-64 includes in its facts, "The governing instrument of Trust requires that the trustee be a person not related or subordinate to [the grantor] within the meaning of § 672(c) of the Internal Revenue Code.
[5275] Rev. Rul. 2004-64, Situation 3. See Letter Ruling 201647001, described in fn. 5288.
[5276] The ruling included the following details:

> The initial member of the Reimbursement Committee will be A. It is represented that A is neither an employee of Grantor, nor an employee of a corporation whose stock is owned by the Grantor (or Trust, Exempt Trust or Non-Exempt Trust) or whose executives include Grantor, nor a relative of the Grantor listed in section 672(c). Spouse, if she is then living, otherwise Grantor's living children by majority vote, or if there are no then living children of Grantor, then Grantor's living issue (by majority vote) may remove any persons then serving on the Reimbursement Committee, and or appoint additional persons at any time with or without cause. However, no one related or subordinate to the

including the child seems unnecessary[5277] and potentially harmful, given that a child who is an adverse party may make a taxable gift by consenting.[5278]

- In Letter Ruling 200944002, instead of providing an income tax reimbursement right,[5279] the trust authorized distributions to the grantor, among other beneficiaries, in the trustee's sole and absolute discretion.[5280] The trustee was independent.[5281] State law respected spendthrift provisions regarding the settlor.[5282] The ruling held

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> Grantor within the meaning of § 672(c), can be appointed to the Reimbursement Committee.

The ruling elaborated on A's relationship:

> In addition, because A's only relationship to the Grantor presumably is that of the Grantor's independent attorney, A also does not meet the definition of a related or subordinate party under § 672(c). Accordingly, the Reimbursement Committee consisting of A will not be considered a related or subordinate party within the meaning of § 672(c).

5277 The ruling noted:

> Under the terms of the provision, a consenting child beneficiary must be an adverse party; therefore, such a child beneficiary does not meet the definition of a related or subordinate party under § 672(c). Accordingly, a consenting child beneficiary will not be considered a related or subordinate party within the meaning of § 672(c). We note that this conclusion does not require us to address whether the beneficiary children of the Grantor are in fact adverse parties (and if they are, to what extent, *i.e.*, part or all of the Trust), because the Reimbursement Provision requires a child beneficiary be an adverse party.

5278 To be an adverse party, the child must have "a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust." See part III.B.2.h.vi Distribution Provisions Might Prevent Turning Off Grantor Trust Status, especially the text accompanying fns. 5041-5047. By negative implication, Reg. § 25.2511-1(g)(1) suggests the possibility that a trustee's decision to make distributions may be a gift if the trustee is a beneficiary: "A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee…." Reg. § 25.2511-1(g)(2) elaborates:

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. A clearly measurable standard under which the holder of a power is legally accountable is such a standard for this purpose.

Without suggesting whether or not the tax reimbursement clause fits this exception, I would prefer to avoid the issue.

5279 The trust agreement "provides that trustee shall not pay Grantor or Grantor's executors any income or principal of Trust in discharge of Grantor's income tax liability." See text accompanying fn. 5290.

5280 The trust provided that:

> trustee will pay over the income and principal of Trust in such amounts and proportions as trustee in its sole and absolute discretion may determine for the benefit of one or more members of the class consisting of Grantor, Grantor's spouse and Grantor's descendants.

5281 The trust provided that:

> the following persons may not be a trustee of Trust or any other trust created under trust: (1) Grantor; (2) the spouse or a former spouse of Grantor; (3) any individual who is a beneficiary of Trust or a trust created under Trust; (4) the spouse or a former spouse of a beneficiary of any trust hereunder; (5) anyone who is related or subordinate to Grantor within the meaning of § 672(c).

5282 The ruling described applicable state law:

no Code § 2036 inclusion so long as no pre-arrangement regarding distributions to the settlor.[5283]

- Letter Ruling 201647001 approved modifying a trust to authorize independent trustees[5284] to reimburse income tax[5285] when, due to "unforeseen and unanticipated

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State Statute provides that a person who in writing transfers property in trust may provide that the interest of a beneficiary of the trust, including a beneficiary who is the settlor of the trust, may not be either voluntarily or involuntarily transferred before payment or delivery of the interest to the beneficiary by the trustee. Under State Statute, if the trust instrument contains this transfer restriction, it prevents a creditor existing when the trust is created or a person who subsequently becomes a creditor, from satisfying a claim out of the beneficiary's interest in the trust unless, (1) the trust provides that the settlor may revoke or terminate all or part of the trust without the consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; (2) the settlor intends to defraud a creditor by transferring the assets to the trust;(3) the settlor is currently in default of a child support obligation by more than 30 days; or (4) the trust requires that all or a part of the trust's income or principal, or both, must be distributed to the settlor.

[5283] After citing the non-reimbursement clause in fn. 5279, the ruling reasoned and held:

Although Rev. Rul. 2004-64 does not consider this situation, it is clear from the analysis, that because the trustee is prohibited from reimbursing Grantor for taxes Grantor paid, that Grantor has not retained a reimbursement right that would cause Trust corpus to be includible in Grantor's gross estate under § 2036. See Rev. Rul. 2004-64. In addition, the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036.

We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036.

[5284] The ruling analyzed the trustee provisions:

Trust prohibits Grantors from serving as trustees of Trust and any trusts created thereunder. However, pursuant to the modifications to Article 8 of Trust, Grantors will retain the power to remove and replace the Trustees, including the Independent Trustee. However, any successor Independent Trustee appointed by Grantors cannot be related or subordinate within the meaning of § 672(c) to the Grantors. Accordingly, under Rev. Rul. 95-58, Grantor's retained removal and replacement powers are not considered the reservation of the Independent Trustee's powers for purposes of § 2038. Further, the Family Trustees do not possess any powers to distribute income or corpus to the Trust beneficiaries. Therefore, Grantors' powers to remove and replace the Family Trustees will not cause the Trust corpus to be included in the gross estate of either Grantor under § 2038. Accordingly, we conclude that the modifications to Article 8 which grants Grantors the power to remove and replace the Trustees will not cause the Trust corpus to be included in the gross estate of either Grantor under § 2038.

[5285] The modification included:

Section 13.3(b) is modified to include a tax reimbursement clause requiring compliance with Situation 3 of Rev. Rul. 2004-64, 2004-2 C.B. 7. Specifically, Section 13.3(b), as modified, provides that Grantors shall not be entitled to any right of reimbursement under any applicable law for their tax liability (whether federal, state or otherwise), if any, attributable to a trust being treated as a "grantor trust" as to either Grantor under §§ 671 through 679. If in any calendar year, a trust created hereunder is treated as a "grantor trust" as to either Grantor under §§ 671 through 679, an Independent Trustee may from circumstances," the grantors' payment of income tax had become "unduly burdensome." Letter Ruling 201647001 held that the children did not make a gift when the trust was modified, because the reimbursement clause was "administrative in nature" and did not "result in a change in beneficial interests" in the trust, meaning the changes did not constitute a gift[5286] and did not cause it to lose its zero inclusion ratio for GST purposes.[5287] Subject to qualifications regarding any prearrangement, the ruling held no inclusion in the grantors' estates.[5288] (Note that, if the trustee

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> time to time, distribute to a Grantor so much of the income or principal of the trust as may be sufficient to satisfy all or part of such Grantor's personal income tax liability attributable to the inclusion of all or part of the trust's income in such Grantor's taxable income in excess of the amount of such taxes that would have been imposed if the trust's income, gains, losses and deductions had not been included in the determination of such Grantor's income tax liability.

[5286] "The proposed modifications to Articles 5, 6, 9, 12, and 13 are administrative in nature and do not result in a change in beneficial interests in Trust. We conclude that these modifications do not result in a deemed transfer by any of the children for purposes of § 2501."

[5287] The ruling reasoned and held:

> In the instant case, Trust became irrevocable after September 25, 1985. It is represented that sufficient GST exemption was allocated to Trust so that Trust has an inclusion ratio of zero under § 2642. No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, should similarly not affect the exempt status of such a trust.
>
> Article 5.1 is modified only to the extent to provide that the modification to Trust may not extend the term of any trust created under Trust. Under Rulings 2 and 4, we concluded that the proposed modifications to do not constitute the release, exercise, or lapse of powers of appointment for purposes of §§ 2041 and 2514. Accordingly, the proposed modifications do not constitute constructive additions to Trust. The modifications were effected in accordance with state law and pertain to the administration of Trust.
>
> Accordingly, the proposed modifications to Articles 5, 6, 8, 9, 12, and 13 of Trust are administrative in nature and under § 26.2601-1(b)(4)(i)(D)(2), will not be considered to shift a beneficial interest to a lower generation in the trust or extend the time for vesting of any beneficial interest in the trust beyond the period provided for in Trust. See Example 10 of § 26.2601-1(b)(4)(i)(E).
>
> Therefore, based upon the facts submitted and representations made, we conclude that the proposed modifications of Trust will not cause Trust, as modified, to lose its zero inclusion ratio for GST tax purposes under chapter 13.

[5288] The ruling reasoned and held:

> In this case, under the terms of Section 13.3(b), as proposed, the Independent Trustee will have the discretion to reimburse either Grantor with respect to the income tax liability actually incurred by the Grantor attributable to Trust items, for periods after the Trust instrument is modified. Only a Trustee who is not related or subordinate to either Grantor, within the meaning of § 672(c) may exercise the powers to reimburse either Grantor. Accordingly, assuming there is no understanding, express or implied, between either Grantor and the Independent Trustee regarding the Independent Trustee's exercise of discretion, the Independent Trustee's discretion to satisfy either of the Grantor's obligation would not alone cause the inclusion of the trust in either of the Grantor's gross estate for federal estate tax purposes. However, as noted in Rev. Rul. 2004-64, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between either of the Grantor and the Independent Trustee regarding the Independent Trustee's exercise of this discretion; a power retained by either Grantor to remove the trustee and name the grantor as

mistakenly taxes the sale to a beneficiary, reimbursing the beneficiary should not generate any transfer tax consequences.[5289])

However, if the grantor has an enforceable right to reimbursement, the reimbursement right will cause estate inclusion.[5290] Furthermore, applicable local law subjecting the trust assets to the claims of the grantor's creditors may cause inclusion of the trust in the grantor's gross estate.[5291] This raises the issue of whether or not the availability of self-settled trusts (spendthrift trusts in which the grantor is the beneficiary) to the grantor's creditors subjects the trust to inclusion under Code § 2036.

The general rule is that the grantor's creditors can require distribution of self-settled trust assets to the extent which the trustee had discretion to make distributions.[5292] To the extent creditors can reach a self-settled trust, they are generally includible under Code § 2036 or an incomplete gift due to the grantor's retained power to terminate the trust by consigning his or her creditors to the trust assets.[5293] However, some states permit self-settled trusts to be protected from the grantor's creditors generally[5294] and some states only with respect to reimbursing taxes.[5295]

The Bankruptcy Abuse and Prevention Act of 2005, however, causes some concern about how well domestic asset protection trusts ("DAPTs") prevent creditors from gaining access to trust assets. Of particular concern is the 10-year lookback provision, which states that transfers to self-settled trusts by the debtor in which the debtor is a beneficiary of the trust within ten years before filing for bankruptcy.[5296] However, the language of the Act included a scienter requirement indicating that the grantor, by means of the transfer, intended to hinder, delay, or defraud any party to which the debtor was indebted.[5297] In other words, the burden would lay on the bankruptcy trustee to show that the filer had the necessary fraudulent intent. Thus, DAPTs formed for legitimate purposes, such as transfer tax minimization, will retain their usefulness as

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> successor trustee; or applicable local law subjecting the trust assets to the claims of either of the Grantor's creditors) may cause inclusion of Trust's assets in either of the Grantor's gross estate for federal estate tax purposes.
>
> Based upon the facts submitted and representations made, we conclude that the proposed modifications of Trust will not cause the property of Trust to be included in the gross estate of either Grantor for federal estate tax purposes.

[5289] See part II.J.12 Equitable Adjustments to Reimburse Income Tax Paid or Tax Benefit Received by a Party That Does Not Bear the Burden Under the Principal & Income Act, especially fn. 1988.

[5290] Rev. Rul. 2004-64, Situation 2.

[5291] Rev. Rul. 2004-64, Situation 3.

[5292] Rev. Rul. 76-103; Forsberg & Worthington, Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts – When to Use Them and When Not to Use Them, *Probate & Property*, Vol. 19, No. 3, May/June 2005, note 27 at 7 (citing 2A Austin W. Scott, *Trusts* § 156).

[5293] Rev. Rul. 76-103; Code § 2038(a)(1).

[5294] See "Comparison of the Domestic Asset Protection Statutes," edited by David G. Shaftel and available to ACTEC Fellows on the State Surveys page at http://www.actec.org/resources/state-surveys.

[5295] See, *e.g.*, Texas Trust Code § 112.035(d)(1) (see Thompson Coburn LLP doc. no. 6599538).

[5296] 11 U.S.C. § 548(e)(1)(A-C).

[5297] 11 U.S.C. § 548(e)(1)(D).

estate planning tools.[5298] However, at least one commentator has noted that it would be difficult for a filer to argue that the transfer of assets to a DAPT was not intended to delay or hinder a creditor.[5299] As such, some uncertainty remains as to whether a grantor will be required to wait the full ten years before the hole in the DAPT is plugged so that creditors will be unable to reach the trust assets. With this lingering uncertainty about the 2005 Act, it will be difficult for practitioners to definitively say that these self-settled trusts are free from creditor claims, and subsequently, not includible in the grantor's gross estate. Keep that in mind when considering using a tax reimbursement clause.

If the grantor is concerned about being able to pay the income tax and cannot structure the trust to allow the grantor to turn off grantor trust status, the grantor should consider retaining a sizable portion of the asset being transferred. That retention may frustrate the grantor's goal of minimizing estate tax, but the grantor needs to be able to sleep at night.

III.B.2.j.iv.(b). Tax Distributions from Partnerships and S Corporations after Termination of Interest

Partnerships and S corporations typically make distributions to pay their owners' taxes. Usually these consist of just enough to their quarterly estimated tax payments, followed by a distribution the following March or April so that their owners can pay any balance due on undistributed income, to the extent not covered by the distributions to make the required quarterly estimated tax payments.

This practice causes certain issues to arise when an interest terminates before distributions are made to pay all of the tax incurred on income earned before termination. Language to address this issue is included in part III.A.3.d Special Fiduciary Income Tax Issues Regarding Bequeathing S Corporation Stock and Partnership Interests.

III.B.3. Defined Value Clauses in Sale or Gift Agreements or in Disclaimers

III.B.3.a.i. Overview

Usually property sold to an irrevocable grantor trust is a difficult-to-value asset. The IRS might assert that the property that was sold was worth more than what the seller received and that therefore the seller made a large gift. A defined value clause often provides that any such excess goes to an entity, gifts to which do not trigger gift tax. The excess might go to a charity, marital deduction trust, or a GRAT (the latter being most likely to be attacked by the IRS). However, *Wandry* (described in part III.B.3.a.vi) approved a gift of LLC interests defined by a fixed dollar amount, without any excess going to a charity or other entity, so we have a path for making such gifts; on the other hand:

[5298] Shaftel & Bundy, D.A.P.T. 2005: The Report of My Death Was an Exaggeration, *Steve Leimberg's Asset Protection Planning Newsletter* #68 (May 23, 2005), available at http://www.leimbergservices.com.

[5299] Jay Adkisson & Chris Reiser, Bankruptcy Act Impact on Life Insurance and Domestic Asset Protection Trusts, *Steve Leimberg's Asset Protection Planning Newsletter* #66 (May 3, 2005), available at http://www.leimbergservices.com.

- The IRS officially said that it disagreed with the case (it has been suggested that the IRS feared appealing the case because of the 10th Circuit's taxpayer-favorable holding described in *King*, which is found in part III.B.3.a.iv).

- It has been suggested that:[5300]

  - "The finality rules apply to the value of a prior gift but not necessarily to the extent of the property transferred."[5301]

  - "There may not be a mechanism in the first place for achieving a final determination of the extent of the property transferred."[5302]

5300 Bramwell and Dillion, "Not Another Wandry Article: Real Issue With Wandry Formulas," *Estate Planning Journal* (5/2014).

5301 The authors point out that Code §§ 2504(c) and 2001(f) provide that the statute of limitations runs regarding the valuation of gifts but do not refer to other issues. However, the authors also point out that, using language similar to that of Reg. § 25.2504-2(b), Reg. § 20.2001-1(b) provides:

> *Adjusted taxable gifts and section 2701(d) taxable events occurring after August 5, 1997*. For purposes of determining the amount of adjusted taxable gifts as defined in section 2001(b), if, under section 6501, the time has expired within which a gift tax may be assessed under chapter 12 of the Internal Revenue Code (or under corresponding provisions of prior laws) with respect to a gift made after August 5, 1997…, then the amount of the taxable gift will be the amount as finally determined for gift tax purposes under chapter 12 of the Internal Revenue Code and the amount of the taxable gift may not thereafter be adjusted. The rule of this paragraph (b) applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law.

5302 The authors suggest:

> Section 2001(f)(2), however, only defines the "final determination" of a gift's "value." It does not explain how a "final determination" of any other issue can be achieved. Based on the text of Section 2001(f)(2), therefore, it is unclear whether there is a mechanism for resolving whether the taxpayer has correctly determined how much property he or she previously transferred by dollar formula.
>
> Moreover, it does not appear that a court would have jurisdiction even to decide what portion was transferred by a *Wandry* formula.[23] The Tax Court does not generally issue declaratory judgments….
>
> 23 Strictly speaking, the nature of the property transferred by dollar formula is a question of state law, not federal law. However, federal courts must understand what rights are created under state law in order to decide the federal tax questions. See, *e.g*., *Pierre*, 133 TC 24 (2009) ("A fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights.").
>
> Without such a declaration, however, or without at least the possibility of such a declaration,[28] a taxpayer cannot achieve a final determination of the extent of the property transferred by a Wandry formula. Even after the statute of limitations for assessment of gift tax has lapsed, therefore, the IRS might still contend, upon a later transfer, that more of the property previously transferred by dollar formula remained in the hands of the taxpayer than the taxpayer supposed. A Wandry-style gift does not so much reduce or eliminate gift tax risk as postpone it until a later time.
>
> 28 The concept of a "final determination" implies that a court could have made a determination, even if the parties ultimately agree or one party concedes. After all, if the extent of property transferred by Wandry-style formula is contested but no court has

- Finality rules are strictly construed in favor of the government,[5303] so the uncertainty described in the above bullet points may be interpreted against the taxpayer.

It has been suggested that fixing the excess value to a charity provides an independent third party that has the attorney general and the IRS (through intermediate sanctions) looking over its shoulder. In *Petter* (described in part III.B.3.a.ix) and *McCord* (described in part III.B.3.a.x), representatives from the charity described their due diligence. That was absent in *Christiansen* (described in part III.B.3.a.viii), involving a formula disclaimer in favor of charity, but the executor was able to describe her fiduciary duties. The tension between taxable and deductible is already present when we do formula marital bequests. However, having different interests in the buyer and recipient of the gift suggests a tension between the parties involved that would lead to the defined value clause being enforced independent of IRS attack, providing the defined value clause with more credibility. *Petter* and *Christiansen* are great for families who don't mind getting more money to charities, because they involved increased gifts to charity. *McCord* is better for those who want to agree up front, because it involved a formula clause that the charity and donee settled without the donor's involvement. Regardless of the approach, see part III.B.3.a.iii Example of Charity Undergoing Due Diligence.

An alternative is to have a defined value purchase clause:

- Suppose the buyer has liquidity to pay the entire purchase price up front.[5304] The grantor sells to the trust an interest in an operating business in exchange for an interest in an LLC that holds marketable securities. The LLC is designed to try to avoid valuation discounts; for example, any member can withdraw at will and receive cash or marketable securities. The consideration is so much of the buyer's interest in the LLC as has a value equal to the interest in the operating business.

- For a leveraged deal, use have a promissory note, the principal of which is the fair market value, as finally determined, of the transferred asset, relying on part III.B.3.a.iv Defined Consideration Clause.

- In either event, clauses providing for a gift over leave some unfinished business, particularly if the gift over goes to a trust that continues to be inside the estate tax system. Furthermore, retroactively adjusting cash flows from the transferred asset might be awkward. It might very well be easier simply to adjust the principal on a note, recharacterizing past payments and extending the payment term a little.

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jurisdiction to resolve the dispute, it is unclear whose position—the taxpayer's or the IRS's—should prevail.

[5303] The authors suggest:

The United States Supreme Court has held that "statutes of limitation ... must receive a strict construction in favor of the government."[29] The finality rules, meanwhile, are "essentially ... statute of limitations provision[s]."[30] Consequently, the finality rules must be construed against the taxpayer.

[29] *Badaracco*, 53 AFTR 2d 84-446, 464 US 386, 78 L Ed 2d 549, 84-1 USTC ¶ 9150, 1984-1 CB 254 (1984).

[30] Estate of Smith, *supra* note 13. [Note 13 cited *Estate of Smith v. Commissioner*, 94 T.C. 872 (1990).]

[5304] Carlyn McCaffrey suggested this idea at the 2011 Heckerling Institute.

Whether the consideration itself has a defined value or simply is a note with principal equal to a formula amount, transferring the entire difficult-to-value asset provides certainty that growth in the asset is outside the estate tax system; if one instead transferred a portion of that asset determined by formula, then an IRS audit might bring part of that asset (and its growth) back into the transferor's estate.

Defining the transfer or consideration received based on finally determined values, rather than making a transfer and causing a subsequent transfer to avoid gift tax, remains an important distinction. In December 2014, the Fourth Circuit reaffirmed in a different context [5305] its commitment to *Procter* (described in part III.B.3.a.xi *Procter* and Other Cases) and refused to recognize a transfer made after a determination; the Tax Court continues to strongly reject conditions subsequent.[5306]

III.B.3.a.ii. Sale from One Trust to Another

Suppose a trust sells a difficult-to-value asset to another trust. Ideally, all of the living beneficiaries of the trust have identical interests before and after, so that all one really is doing in the event of a gift is changing the terms of their limited powers of appointment (relating on how far into the future they can appoint the property). Whether or not one is in that situation, let's discuss the type of formula valuation clause to use - define what is transferred or define the purchase price?

- If the transaction is adjusted in the former, then the refunded business interest will need to be transferred, leaving one with the valuation issue again.

- If the transaction is adjusted in the latter, then it's just an additional purchase price that needs to be paid.

How would one run the statute of limitations? Would each beneficiary file a gift tax return? If not, then one never has finality for gift tax purposes, and formula valuation clauses that depend on gift tax return finality would not apply.

The main concern might be GST exemption. If the sale is challenged, it might be a constructive or actual addition that affects the trust's exclusion from the GST system (in the case of a grandfathered trust) or a gift that changes the inclusion ratio (for other trusts). Advise the trustee of the recipient trust to make a small taxable distribution after the sale and do appropriate reporting relating to Form 706-GS(D), so that the statute of limitations runs on the issue of inclusion ratio:

- Each time a distribution from a trust that is not grandfathered from the GST system is made to a skip person, the trustee must file Form 706-GS(D-1), Notification of Distribution from a Generation-Skipping Trust, with the IRS and gives to the beneficiary. This form is required even if the trust has a zero inclusion ratio.

- The first time a distribution is made after the sale, the beneficiary files Form 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions, in which the

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[5305] *Belk v. Commissioner*, 774 F.3d 221, *aff'g* 140 T.C. 1 (2013) (savings clause did not fix provision expressly prohibited by conservation easement regulations).
[5306] See fn. 5323 in part III.B.3.a.viii *Christiansen*.

beneficiary reports zero GST tax due. Presumably no matter how small or large the distribution is, this filing runs one prong of the statute of limitations (SOL) for the inclusion ratio; the SOL runs on the later of that or when the SOL runs for the transferor's estate tax return.[5307] Because the form's instructions say that a beneficiary is not required to file if the trust has a zero inclusion ratio, the beneficiary would not file any more Forms 706-GS(D) after SOL on the inclusion ratio has run until some event occurs that might change the trust's inclusion ratio.

Note that Reg. § 301.6501(c)-1 requires "adequate disclosure" for only Chapters 12 (gift tax) and 14 (special valuation rules applying to lifetime transfers), not for Chapter 13 (GST tax). The instructions to Form 706-GS-(D) and Form 706-GS(D-1) do not require evidence of inclusion ratio. Therefore, it looks like we don't need to provide any particular information that would help the IRS decide whether to audit, other than letting it know of the bare existence of the distribution.

III.B.3.a.iii. Example of Charity Undergoing Due Diligence

At a meeting I attended, one charity stated that it vets gifts very seriously because it has large reputational exposure with the IRS. Due diligence includes:

- Reviewing the governing documents of the business entity, the interest of which is being transferred. This includes closely-held business entities, real estate, restricted stock, and cash value life insurance.

- Having an exit strategy within a reasonable amount of time to sell to someone who is not the donor and is not a family member but can include the company (if the other shareholders have similar price when they retire, die, etc.). Transfer restrictions cannot burden the sale too much. However, they are careful to avoid assignment of income.

[5307] Reg. § 26.2642-5(b) provides:

> (b) *Other GSTs*. With respect to taxable distributions and taxable terminations, the inclusion ratio for a trust becomes final, on the later of—
>
> (1) The expiration of the period for assessment with respect to the first GST tax return filed using that inclusion ratio (unless the trust is subject to an election under section 2032A in which case the applicable date under this subsection is the expiration of the period of assessment of any additional GST tax due as a result of a cessation, etc. of qualified use under section 2032A); or
>
> (2) The expiration of the period for assessment of Federal estate tax with respect to the estate of the transferor. For purposes of this paragraph (b)(2), if an estate tax return is not required to be filed, the period for assessment is determined as if a return were required to be filed and as if the return were timely filed within the period prescribed by section 6075(a).

For gifts to a trust, an additional GST rule informs us about finality. The inclusion ratio is 1 minus the applicable fraction. Code § 2642(a)(1). The applicable fraction is based on allocations of GST exemption to the trust, Code § 2642(a)(2)(A), and the growth of property to which GST exemption has already been allocated, Code 2642(d). Reg. § 26.2642-2(a)(1) helps some – particularly with initial transfers to a trust that are reported timely.

> In the case of a timely allocation under § 26.2632-1(b)(2)(ii), the denominator of the applicable fraction is the fair market value of the property as finally determined for purposes of chapter 12.

- Leaving some money in escrow if any contingent liabilities, capital calls, or unrelated business income tax are involved.

- Donor needs to get appraisal and file Form 8283. The charity will file Form 8282 reporting a sale within two years of donation.

Examples of what that charity has done:

- Donor wanted to make serial gifts of $10K per year. The charity asked whether governing documents permit the transfer, what its transfer rights were, how the redeemed stock would be valued, and what was the redemption plan (including company's financial capability to redeem). The company eventually put together a standing charitable plan.

- Donor wanted to give S corporation stock. The fund escrowed 20% to pay unrelated business income tax and for accounting fees. The fund keeps an escrow until the three-year statute of limitations runs.

The lawyer who has beaten the IRS in these cases cautions us not to refer to the gift over as a contingent or conditional gift. This is a fixed gift, and he like to see not just a lid but a real gift to the charity that occurs at the time of the transaction. This gives the charity incentive to audit the gift. The charity's due diligence is strong evidence of substance/bona fides.

One advisor views donor advised funds as the best charitable donees. Minimum distribution, excess business holding, self-dealing, and jeopardizing investment rules burden planning for a private foundation, particularly when an uncertain interest is being donated.

III.B.3.a.iv. Defined Consideration Clause

Although a gift to an alternative taker, particularly but not necessarily a charity, has worked well in recent cases, consider instead defining the consideration to be paid. Below is an example; readers are cautioned not to rely on this example but rather to analyze the law themselves in determining what might be appropriate language.

A clause in the sale agreement might provide:

> In consideration of a sum equal to the "Fair Market Value" (defined below) of the Transferred Property (the "Sale Price"), concurrently with its execution of this Agreement on the Effective Date, Seller is irrevocably granting, selling, transferring and conveying the Transferred Property to Buyer on the terms set forth herein.
>
> The "Fair Market Value" of the Transferred Property shall be such value as finally determined for federal gift tax purposes on the transfer of the Transferred Property by Seller as of the Effective Date, in accordance with the valuation principles set forth in United States Treasury Regulation section 25.2512-1.

> Seller agrees to file a gift tax return reporting this transaction so as to cause the gift tax statute of limitations to run.[5308]

A promissory note might refer to the Sale Price in the sale agreement and then provide:

> Promptly after the initial determination of the Sale Price and again upon the final determination for federal gift tax purposes of the Sale Price under the Sale Agreement, Holder shall be entitled to attach to this Note a statement fixing the amount of principal due under this Note in a manner appropriate to make this Note a "negotiable instrument" within the meaning of Section 3-104 of the Uniform Commercial Code as in effect in the State of ____.

An Allonge might then estimate the purchase price once the appraisal is finalized:

> Effective as of the date of such Promissory Note, the initial principal amount of the Promissory Note is estimated to be $__________________.

In the examples above, the purchase price is the finally determined gift tax value. Any amount in the promissory note is expressly referred to as an estimate.

Although *King* below approved a defined consideration clause, it did not follow procedures as strong as that suggested above. Following *King* are some cases that set initial prices and required subsequent action to adjust the price to the gift tax value, rather than referring to the gift tax value as the sale price the way the example above does. These other cases might be viewed as falling into Rev. Rul. 86-41, Situation 2, quoted further below.[5309] As of the Fall of 2016, the IRS appears to be attacking a formula purchase price that does not quite follow my example.[5310]

King v. United States[5311] approved the following clause:

> ... However, if the fair market value of The Colorado Corporation stock as of the date of this letter is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the same manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service.

[5308] If the seller is the client's revocable trust, the client would sign the sale agreement as an individual, personally making the promise to file the gift tax return.

[5309] The text accompanying fn. 5334, found in part III.B.3.a.xi *Procter* and Other Cases, reproduces Rev. Rul. 86-41.

[5310] Steve Akers' November 2016 report on *True v. Commissioner*, Tax Court Docket Nos. 21896-16 and 21897-16 (petitions filed October 11, 2016), states:

> According to the petition, the transfer agreement for the sales to his children provided that if it is determined for federal gift tax purposes that the interests sold were undervalued by FMV Opinions, the purchase price would be increased to reflect the finally-determined fair market values.

The description above seems to lie somewhere between *King* and *McLendon*, both described below.

[5311] 545 F.2d 700 (10^{th} Cir. 1976).

The Tenth Circuit held:

> The district court distinguished the facts in the case at bar from those in *Procter*, *supra*, finding that the parties intended that the trusts pay a full and adequate consideration for the stock and that the clause was a proper means of overcoming the uncertainty in ascertaining the fair market value of the stock. The court concluded that there was an intention to cause the trusts to pay full and fair consideration for the stock and to make an actual adjustment of the price paid upon the event of a determination by the IRS. We agree. It is important to observe that the IRS does not dispute the contention that it was difficult, if not impossible, to accurately value the stock at the time of its transfer in 1969 and that the parties inserted the specific valuation paragraph in the agreement because the transaction was intended as a sale and not as a gift. The trial court's determination was one of fact. That finding is not clearly erroneous.
>
> We believe that the IRS reliance on *Procter*, *supra*, is misplaced. Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees was made to reconvey the stock to King or to cancel the notes in anticipation of an unfavorable valuation ruling.
>
> Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the *nature* of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not affect the *nature* of the transaction. But, argues the IRS, even though the parties may have intended to pay full consideration for the stock, still this fact is immaterial for gift tax purposes because the test is solely objective, i.e., whether the transfer was made for full and adequate consideration. In a nutshell, IRS contends that if King's intent to make a sale would not be sufficient to prevent the gift tax were the price adjustment clause absent, "that intent obviously cannot be used to legitimate the presence of the clause so as to avoid the tax". [Br. of Appellant, p. 16]. Treasury regulations, references and citations are relied upon. The IRS presents persuasive arguments, based upon its rules that (a) for accounting purposes, absent specific statutory language to the contrary, tax consequences attach at the end of fixed and regular accounting periods, regardless how subsequent events might affect the economic or tax results of the transaction, (b) taxpayers cannot amend a transaction retroactively to avoid the federal tax consequences of prior taxable periods and (c) the difficulty of valuing the property transferred does not make the gift tax inapplicable. IRS further contends that the record does not show an attempt by the parties at the time of suit to make an actual price adjustment and the gift tax would be virtually emasculated if the parties' intention to effect a transfer for a full consideration were enough to satisfy the requirements of 26 U.S.C.A. §2512(b) of the Internal Revenue Code of 1954.
>
> The trial court's finding that there was no donative intent and that the transaction was made in the ordinary course of business at arm's length is not clearly erroneous. Further, it does not work an abuse upon the operative intent of § 2512, *supra*, *i.e.*, to reach donative transfers and to exclude transfers whose consideration is not reducible to money or moneys worth. The transfers involved here can be ultimately reduced to moneys worth and are, accordingly, excluded

from the gift tax consequences. No diminution of King's estate can result from the trial court's finding.

The statutory framework underlying the federal gift tax scheme is clear on its face. § 2501 imposes a tax on the transfer of property by gift. § 2512(a) provides that if the gift made is in property, the value thereof at the date of the gift shall be considered the amount of the gift. In the case of a holding company such as The Colorado Corporation, gifts of its shares of stock are governed by Treas. Reg. § 25.2512-2 (26 C.F.R.) which provides general guidance for valuing the shares of stock based on bid and asked prices, where selling prices and bid and asked prices are not available for dates both before and after date of gifts, where selling prices or bid and asked prices do not represent fair market value and where selling prices or bid and asked prices are unavailable. Treas. Reg. §25.2512(1)(1968) is the general valuation rule. It provides that "the value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts".

We are cognizant of the rule that in reviewing a challenged regulation, the regulation must be sustained if found to be reasonable and consistent with the statute. *Commissioner of Internal Revenue v. South Texas Lumber Co.*, 333 U.S. 496 (1948). We are also aware of the rule that where there is a possibility that several methods of valuation are permissible, any one chosen by the IRS may not be set aside. *DuPont's Estate v. Commissioner of Internal Revenue*, 233 F.2d 210 (3rd Cir. 1956), *cert. denied* 352 U.S. 878 (1956).

The IRS contention that the price adjustment clause violates public policy in that it deters administrative enforcement of the gift tax provisions is valid *only* if the transaction be construed as an inter vivos transfer undertaken to reduce King's estate. The IRS argument would be applicable if we were to hold that the trial court's finding that King intended that the trust pay full and adequate consideration predicated upon the price-adjustment proviso is clearly erroneous. It is not. Under the facts found, King is not subject to the gift tax under Treas. Reg. § 25.2512-8 because the transaction was made in the ordinary course of business at arm's length, free from any donative intent. We hold that the trial court did not err in holding that the aforesaid stock transfers are not subject to a gift tax.

To be sure, it has been held that the absence of a donative intent will not alone prevent a transfer from being subject to gift taxation, but this is not the controlling factor when the transfer has been found to have been made "at arm's length in the ordinary course of business". *Commissioner of Internal Revenue v. Wemyss*, 324 U.S. 303, 307 (1945). See also 156 A.L.R. 1022. Interpretive of the Code requirements of "an adequate and full consideration in money or money's worth" the Supreme Court has held that the return must be an adequate and full equivalent and that the requisite consideration cannot be equated with mutual promises satisfying common law consideration sufficient to support an agreement. *Taft v. Commissioner*, 304 U.S. 351 (1938); 116 A.L.R. 346.

Significantly, we believe, is the fact that perhaps the main purpose of the gift tax was to prevent or compensate for the avoidance of death taxes by taxing the gifts

> of property inter vivos which, but for the gifts, would be subject in its original or converted form to the tax laid upon transfers at death. *Sanford's Estate v. Commissioner*, 308 U.S. 39 (1939). No such risk is involved in the instant case.
>
> We hold that the trial court did not err in finding that the stock sold to Trusts No. 1 under the "price adjustment" proviso is not subject to the gift tax provisions.

Estate of McLendon v. Commissioner[5312] rejected a clause that did not define the purchase price as the gift tax value but rather set a price that would later be adjusted:

> The parties here to recognize that the valuation of many of the assets set out on attached Exhibit A are, by their nature, as determined by the best judgement of the parties and independent consultants engaged to assist in the valuation process and may be subject to differing opinions. Therefore, the parties agree that, to the extent any of the values on the attached Exhibit A are changed through a settlement process with the Internal Revenue Service, or a final decision of the United States Tax Court, the purchase price hereunder shall be adjusted accordingly, with interest on said adjustment at the rate of ten percent (10%) from the date hereof until said final determination of value, and the annuity payments due and payable hereunder shall likewise be adjusted to reflect any such change in valuation.

In *Harwood v. Commissioner*,[5313] the Tax Court reviewed the following provision, which did not define the purchase price as the gift tax value but rather set a price that would later be adjusted:

> Article First. Property subject to this instrument listed in Schedule "A" is referred to as the "trust estate" and shall be held, administered, and distributed in accordance with this instrument. In the event that the value of the partnership interest listed in Schedule "A" shall be *finally determined* to exceed $400,000 for purposes of computing the California or United States Gift Tax, and in the opinion of the Attorney for the trustee a lower value *is not reasonably defendable*, the trustee shall immediately execute a promissory note to the trustors in the usual form at 6 percent interest in a principal amount equal to the difference between the value of such gift and $400,000. The note shall carry interest and be effective as of the day of the gift. [Emphasis supplied.]

The court held:

> In the instant case, we have found that the interests in HIC held by the Harwood Family Trusts were worth substantially in excess of $400,000.
>
> The trustees were aware (we assume) of the Kleiner report and the IRS's gift tax determination, but they evidently believed that a value lower than the appraised value and the value determined by IRS was defensible, and did not issue promissory notes to the trust grantors. There, we believe, the matter ends, since we do not believe the savings clause in issue requires (or entitles) the trustees to issue promissory notes to the trust grantors in the event of a court judgment

[5312] T.C. Memo. 1993-459.
[5313] 82 T.C. 239 (1984).

finding a value above $400,000 for the limited partnership interests given to the trusts.[28]

We hold that the savings clause in the Morris J. Harwood 1976 Family Trust and the Arthur H. Harwood 1976 Family Trust has no effect on the amount of the gifts we have otherwise determined were made to the trusts by petitioners herein.[29]

[28] It might be thought that *King v. United States,* 545 F.2d 700 (10th Cir. 1976), should control because no diminution of petitioners' estates will occur if we find that neither trust received a gift in excess of $400,000, since arguably they will be compensated by the trusts for any amount that the value of the interests in HIC donated to the trusts exceeded $400,000. Since we have no guarantee that the trusts will ever issue notes to petitioners, and, indeed, since on our reading of the trust instruments the time for issuing notes is past, we are unable to accept this position.

[29] We express no opinion as to what result we would have reached had the trustees issued notes to the grantors, or had HIC been bankrupt at the time of trial, or had the savings clause required the issuance of notes if a final judgment by a court found that the interests in HIC donated to each trust had values in excess of $400,000.

III.B.3.a.v. *Graev* (dictum)

Graev v. Commissioner[5314] involved a side letter in which the charity agreed to return the donation if the charitable deduction was allowed. The court held that the chance of disallowance was not so remote as to be negligible, so the existence of that reversionary interest disallowed the deduction.

The court then rebuffed an IRS attack on the formula gift aspect:

> Third, although the final judgment in the IRS's favor would cause the side letter to be operative, the return of the contribution pursuant to the side letter would not operate to undo the judgment, as was the case in *Procter*. The return would have no effect on the Graevs' tax liabilities.
>
> Other cases have similarly distinguished *Procter* and have held that certain tax contingency provisions are not void as against public policy. See *Estate of Christiansen v. Commissioner*, 130 T.C. 1, 8 n.7, 17-18 (2008) (a clause that "increases the amount donated to charity should the value of the estate be increased", "would not make us opine on a moot issue [i.e., the value of the estate], and wouldn't in any way upset the finality of our decision in this case"), *aff'd*, 586 F.3d 1061 (8th Cir. 2009); *Estate of Dickinson v. Commissioner*, 63 T.C. 771, 777 (1975) (stating that the "agreement makes no attempt to nullify *** [the Court's] determination" (citing *Surface Combustion Corp. v. Commissioner*, 9 T.C. 631, and *O'Brien v. Commissioner*, 46 T.C. 583)); *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280 ("a judgment adjusting the value of each unit will actually trigger a reallocation of the number of units

[5314] 140 T.C. 377 (2013).

between the trusts and the foundation under the formula clause. So we are not issuing a merely declaratory judgment"), *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

III.B.3.a.vi. *Wandry*

Wandry v. Commissioner[5315] approved a defined value gift of LLC interests, rejecting the IRS' usual arguments:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:
>
> | Name | Gift Amount |
> |---|---|
> | Kenneth D. Wandry | $261,000 |
> | Cynthia A. Wandry | 261,000 |
> | Jason K. Wandry | 261,000 |
> | Jared S. Wandry | 261,000 |
> | Grandchild A | 11,000 |
> | Grandchild B | 11,000 |
> | Grandchild C | 11,000 |
> | Grandchild D | 11,000 |
> | Grandchild E | 11,000 |
> | | 1,099,000 |
>
> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

After filing a notice of appeal and then dropping its appeal, the IRS nonacquiesced in *Wandry*, viewing the adjustment as a reversion that occurred after the date of the gift.[5316] The nonacquiescence might be viewed as an implicit acquiescence in *Petter*.[5317]

[5315] T.C. Memo. 2012-88.

[5316] AOD 2012-004 asserted that the initially estimated amount of the gift was a completed gift of that amount, reasoning:

> In determining the scope of the transfer, the Tax Court dismissed the entries on the LLC's books and records, the entries on the taxpayers' gift tax returns, and the entries on the LLC's subsequent income tax returns, finding that the instrument of transfer best

III.B.3.a.vii. *Hendrix*

Hendrix v. Commissioner,[5318] was similar to *McCord*[5319] with respect to having a formula division between charitable and noncharitable donees, and the Tax Court followed the Fifth Circuit's holding.

III.B.3.a.viii. *Christiansen*

Estate of Helen Christiansen v. Commissioner,[5320] affirming a unanimous decision of the Tax Court, approved a formula disclaimer based on fixed dollar values, with the residue passing to other beneficiaries based on values as finally determined for estate tax purposes.

The reasoning would also apply to defined value clauses. The case is strongest when those who benefit from an increase in value have interests adverse to those who benefit from a decrease in value. The presence of a charity was helpful in this case, but that didn't necessarily decide the outcome - it simply rebuffed one of the IRS' complaints about the effect of the holding.

The Tax Court, in a unanimous reviewed opinion,[5321] had held that a partial disclaimer was valid at least as to an amount that subsequently passed to a foundation that Helen Christiansen ("Christiansen") named as a contingent beneficiary in her will. The Tax Court also held that Christiansen's estate was entitled to a charitable deduction for this amount.

> described the gifts. Based on the LLC's books and records, the gift tax returns, and the LLC's income tax returns, however, it is undisputed that on the date of the gift, each taxpayer transferred a 2.39 percent interest to each donee, subject to a return of a portion of that interest in the event of a final determination of a greater value . The final determination of value for federal gift tax purposes is an occurrence beyond the taxpayers' control. Thus, on the date of the gift the taxpayers relinquished all dominion and control over the fixed percentage interests. The fact that the contingency occurred, and that the taxpayers are now entitled to a return of a portion of the interests, does not change this fact. See Treas. Reg. § 25.2511-2(b)…. Accordingly, the Tax Court erred in determining that the property transferred for federal gift tax purposes was anything other than the fixed percentage membership interest, *i.e.*, a 2.39 percent interest, transferred on the date of the gift to each donee.

[5317] See part III.B.3.a.ix. AOD 2012-004 reasoned:

> *Estate of Petter v. Commissioner*, *supra*, is not to the contrary. In *Petter*, there was no possibility that the transferred property would return to the donor, and thus, the court had no need to consider the extent to which the gift was complete.

[5318] T.C. Memo. 2011-133.

[5319] See part III.B.3.a.x McCord (2003, 2006).

[5320] 586 F.3d 1061 (8th Cir. 2009).

[5321] 130 T.C. 1 (2008).

Christiansen's only child, who was also the executor of Christiansen's estate, disclaimed her interest in the estate "as finally determined for federal estate tax purposes" as to all amounts over $6.35 million. The disclaimer read:[5322]

> A. Partial Disclaimer of the Gift: Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 Dollars ($6,350,000.00) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001 ("the Disclaimed Portion"). For purposes of this paragraph, the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, shall be the price at which the Gift (before payment of debts, expenses and taxes) would have changed hands on April 17, 2001, between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 11 of the [Internal Revenue] Code, as such value is finally determined for federal estate tax purposes.
>
> Christiansen's will provided that 25% of any disclaimed amounts were to go to a charitable foundation. The IRS challenged both the validity of the disclaimer and the amount reported as the estate's overall value.
>
> The parties eventually settled regarding a substantially increased valuation for the estate based largely on adjustments to marketability discounts the estate had claimed for limited partnership interests in a family ranching enterprise. This resulted in a corresponding increase in the valuation of the contribution to the charitable foundation. However, the IRS denied the estate an increased charitable deduction. The IRS argued that the act of challenging the estate's return and the resulting adjustment to the estate's value served as post-death, post-disclaimer contingencies that disqualified the disclaimer under Code § 2518 and Reg. § 20.2055-2(b)(1). The estate appealed to the Tax Court, and the Tax Court rejected the IRS' arguments.

On appeal to the Eighth Circuit, the IRS argued two points:

1. Because the overall value of the estate was not finally determined at the time of death, but only after the Commissioner's partially successful challenge, the transfer to the foundation was, ultimately, "dependent upon the performance of some act or the happening of a precedent event," violating Reg. § 20.2055-2(b)(1). The IRS claimed that the challenge mounted against the estate's initial return and the ultimate process of settling the estate's value constituted the purported "precedent event" or contingency.

2. The IRS asserted policy concerns related to the incentives and disincentives that exist regarding the decision to conduct audits in any given case. In particular, the IRS argued that the Eighth Circuit should disallow fractional disclaimers that have a

[5322] 130 T.C. at 5.

> practical effect of disclaiming all amounts above a fixed-dollar amount. The IRS maintained that such disclaimers fail to preserve a financial incentive for it to audit an estate's return. With such a disclaimer, any post-challenge adjustment to the value of an estate could consist entirely of an increased charitable donation. Because this scenario would provide no possibility of enhanced tax receipts as an incentive for the IRS to audit the return and ensure accurate valuation of the estate, the IRS argued such disclaimers should be categorically disqualified as against public policy.

Regarding the first argument, the court rejected the IRS' interpretation of Reg. § 20.2055-2(b)(1). The court held that the regulation is clear and unambiguous and it does not speak in terms of the existence or finality of an accounting valuation at the date of death or disclaimer; rather, it speaks in terms of the existence of a transfer at the date of death. The court quoted Reg. § 20.2055-2(b)(1): "If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible." It also pointed out that Code § 2518(a) provides that a qualifying disclaimer relates back to the time of death by allowing disclaimed amounts to pass as though the initial transfer had never occurred, which was consistent with applicable state law. The court held that all that remained uncertain following the disclaimer was the valuation of the estate, and therefore, the value of the charitable donation; the foundation's right to receive 25% of those amounts in excess of $6.35 million was certain.

The court criticized the IRS for failing to distinguish between events that occur post-death that change the actual value of an asset or estate and events that occur post-death that are merely part of the legal or accounting process of determining value at the time of death. The IRS cited several cases in which courts disallowed deductions because future contingent events might have defeated a transfer or a charitable contribution, but the court pointed out that, in each cited case, the actual contingencies under scrutiny were outside the legal or accounting process of determining a date-of-death value for the estate or an asset. The court pointed out that none of the cited cases stands for the proposition that deductions are to be disallowed if valuations involve lengthy or disputed appraisal efforts or if the IRS actions in challenging a return result in determination of an adjusted value. The court agreed with the Tax Court's statement:

> That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its existence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future.

The court pointed out that, in a different subsection of the regulation, Treasury recognizes that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" for purposes of qualifying as a guaranteed annuity interest. Reg. §20.2055-2(e)(2)(vi)(a). In doing so, Treasury expressly uses the above-quoted language to distinguish fixed determinable amounts from fluctuating formulas that depend upon future conditions for their determination. The regulation provides:

> An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the appropriate valuation date. For example, the amount to be paid may be a stated sum for a term of years, or for the life of the decedent's spouse, at the expiration of which it may be changed by a specified amount, but *it may not be redetermined by reference to a fluctuating index such as the cost of living index*. In further illustration, the amount to be paid may be expressed in terms *of a fraction or a percentage of the net fair market value, as finally determined for Federal estate tax purposes*, of the residue of the estate on the appropriate valuation date, or it may be expressed in terms of a fraction or percentage of the cost of living index on the appropriate valuation date.

Id. (Emphasis added by the court). The court held that references to value "as finally determined for estate tax purposes" are not references that are dependent upon post-death contingencies that might disqualify a disclaimer. Because the only uncertainty in this case was the calculation of value to be placed on a right to receive 25% of the estate in excess of $6.35 million, and because no post-death events outside the context of the valuation process are alleged as post-death contingencies, the court held that the disclaimer was a "qualified disclaimer" under Code § 2518(a). The court strongly rejected the IRS' assertion that its challenge to the estate's return and the ultimate valuation process and settlement are the type of post-death events that may disqualify a partial disclaimer.

The court then addressed the IRS' second argument. It agreed with the IRS that the Tax Court's ruling in this case may marginally detract from the incentive to audit estate returns. The court accepted the possibility that in some hypothetical case involving a fixed-dollar-amount partial disclaimer, a post-challenge correction to an estate's value could result in a charitable deduction equal to the increase in the estate, resulting in no increased estate tax (which was not the case here, but the court said that it would not have changed the result). The IRS argued that a policy supporting audits as a means to enforce accurate reporting requirements mandates that the court disallow fixed-dollar-amount partial disclaimers because of the potential moral hazard or untoward incentive they create for executors to undervalue estates.

For several reasons, the court rejected the IRS' demand that it interpret the statute and regulations in an effort to maximize the incentive to audit:

a. The court noted that the IRS' role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws, citing Code §§ 7801(a)(1), 7803(a)(2).

b. The court found no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The court found Congress' relevant policy to be to encourage charitable donations by allowing deductions for such donations and held that allowing fixed-dollar-amount partial disclaimers supports this broad policy.

c. The court placed weight on the fact that, even if it were to find a general congressional intent regarding a need to maximize the incentive-to-audit, no corresponding rule of construction would be necessary in the present context to promote accurate reporting of estate values. The IRS' policy argument assumed that executors and administrators will purposefully undervalue assets in order to take advantage of his marginally decreased incentive to audit. In this case, executors must accurately report estate values, not only because of general state law fiduciary duties but also because and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations.

d. Finally, the court pointed out, with a fixed-dollar-amount partial disclaimer, the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor does not under-report the estate's value. Thus, the contingent beneficiaries have an interest in serving a watchdog function, which is aligned with the IRS' interest in ensuring accurate reporting of estate values. Furthermore, the daughter was not only the primary beneficiary who made the contested partial disclaimer, she was also the executor of the estate and a board member for the charity that benefitted from the disclaimer. Because she owed a fiduciary obligation to both the estate and the foundation, any self-dealing in this instance would clearly violate her general state law fiduciary obligation to put the charity's interests above her own and possibly also violate state and federal statutory prohibitions on certain forms of self-dealing. The court held that, in general and on the specific facts of the present case, sufficient mechanisms were in place to promote and police the accurate reporting of estate values beyond just the threat of IRS audit, thereby undercutting the IRS' policy-based argument.

Although the Eighth Circuit had more sympathy for the taxpayer because charity was involved, the court emphasized that it rejected the IRS' policy for broader policy reasons. This was a big taxpayer win as to the foundation.

However, the Tax Court did not respect a disclaimer of the primary beneficiary's interest in a trust, because the beneficiary did not disclaim her contingent remainder interest. Over a lone dissent, the court rejected the disclaimer's savings clause, in which the beneficiary "hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer." The court held:[5323]

> Such contingent clauses—contingent because they depend for their effectiveness on a condition subsequent—are as ineffective as disclaimers as

---

[5323] 130 T.C. at 13-14. In denying the use of a savings clause to qualify a conservation easement for a charitable deduction, *Palmolive Building Investors v. Commissioner*, 149 T.C. No. 18 (10/10/2017) (a unanimous reviewed decision) reaffirmed its rejection of conditions subsequent, holding:

> We have previously held that the requirements of section 170 must be satisfied at the time of the gift. See *Kaufman II*, 136 T.C. at 309; *Mitchell v. Commissioner*, at *13-*14. Additionally, this Court and others have held that "[w]hen a savings clause provides that a future event alters the tax consequences of a conveyance, the savings clause imposes a condition subsequent and will not be enforced." *Belk v. Commissioner*, 774 F.3d 221, 229 (4th Cir. 2014), *aff'g* T.C. Memo. 2013-154; see also *Commissioner v. Procter*, 142 F.2d 824, 827 (4th Cir. 1944); *Estate of Christiansen v. Commissioner*, 130 T.C. 1, 13, (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009). The saving clause cannot retroactively modify the Deed to comply with section 170 and its regulations.

See part III.B.3.a.xi *Procter* and Other Cases.

> they are for revocable spousal interests, see *Estate of Focardi v. Commissioner*, T.C. Memo. 2006-56, and gift adjustment agreements, see *Ward v. Commissioner*, 87 T.C. 78, 110-11 (1986).

For more about *Ward*, see the text following fn. 5335 in part III.B.3.a.xi *Procter* and Other Cases.

III.B.3.a.ix. *Petter*

In *Estate of Petter v. Commissioner*,[5324] the donor (Anne) inherited a large amount of valuable stock and set up an LLC to hold it. She divided ownership of the company among herself, trusts for her children's benefit, and charities, using the following formula gift:

> 1.1 Transferor * * *
>
> 1.1.1 assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the minimum[5325] dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of this gift should be $453,910; and
>
> 1.1.2 assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.
>
> 1.2
>
> The Trust agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1, Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to The Seattle Foundation as soon as practicable.
>
> The Foundations similarly agree to return excess units to the trust if the value of the units is "finally determined for federal gift tax purposes" to be less than the amount described in section 1.1.1. Donna's documents are similar but substitute the Kitsap Community Foundation for the Seattle Foundation.

[5324] T.C. Memo. 2009-280 (Judge Holmes).

[5325] The court noted here:

> This is a typo. The intention of all the parties involved was to refer to the maximum amount that could pass free of gift tax. The Commissioner did not raise any problems that this language might cause, and we find it to have been a mere scrivener's error.

The formula sale included the following:

> 1.1 Transferor * * *
>
> 1.1.1 assigns and sells to the Trust the number of Units described in Recital C above that equals a value of $4,085,190 as finally determined for federal gift tax purposes; and
>
> 1.1.2 assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned and sold to the Trust in Section 1.1.1.
>
> 1.2
>
> The Trust agrees that, if the value of the Units it receives is finally determined to exceed $4,085,190, Trustee will, on behalf of the Trust and as a condition of the sale to it, transfer the excess Units to The Seattle Foundation as soon as practicable. Likewise, the Seattle Foundation agrees to transfer shares to the trust if the value is found to be lower than $4,085,190.

The court stated, "We have no doubt that behind these complex transactions lay Anne's simple intent to pass on as much as she could to her children and grandchildren without having to pay gift tax, and to give the rest to charities in her community."

In summarizing *Christiansen* and *McCord* (the latter discussed further below), the court said:

> A shorthand for this distinction is that savings clauses are void, but formula clauses are fine. But figuring out what kind of clause is involved in this case depends on understanding just what it was that Anne was giving away. She claims that she gave stock to her children equal in value to her unified credit and gave all the rest to charity. The Commissioner claims that she actually gave a particular number of shares to her children and should be taxed on the basis of their now-agreed value.

After giving various reasons for its decision, the court held:

> Again, we fail to see how Anne's gift to the trusts was not an "assignment of a … fraction of a certain value." Anne's initial gift to her children could have been expressed as a gift of the number of units equal to the lesser of 940 or the fraction with the numerator of $453,910 and the denominator of the value of a unit as finally determined for Federal tax purposes. Her gift to the foundations would then be expressed as 940 less the fraction where the numerator is $453,910 and the denominator is the value of a unit as finally determined for Federal tax purposes, or:
>
> 940 - 453,910 /(Value of a unit for tax purposes) = charitable gift
>
> The sales could be expressed in a similar mathematical formula. In fact, only the charities could take a gift of an "open ended amount;" the children's gifts and

sales were capped at the dollar amounts set in the transfer documents. We are again unpersuaded. We refuse to hold against Anne simply because she chose to express her intended allocation of the gift in plain English, rather than the kind of mathematical formula outlined in regulations for other types of transfers.

> In summary, Anne's transfers, when evaluated at the time she made them, amounted to gifts of an aggregate and set number of units, to be divided at a later date based on appraised values. The formulas used to effect these transfers were not void as contrary to public policy, as there was no "severe and immediate" frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place.

Thus, in addition to the Tax Court approving formula disclaimers in *Christiansen*, we now have a Tax Court case approving a formula sale. The approved formula sale included a condition subsequent - if the value of the property the buyer receives were finally determined to exceed the sale price, the trustee, on behalf of the trust and as a condition of the sale to it, would be required to transfer the excess property to the charity as soon as practicable.

III.B.3.a.x. *McCord* (2003, 2006)

In *McCord v. Commissioner* taxpayers prevailed in the Fifth Circuit[5326] after losing in the Tax Court in a reviewed opinion.[5327] *McCord* involved an assignment of limited partnership interests, which the Fifth Circuit described as:

> a sequentially structured "defined value clause":
>
> 1. First, to the Generation Skipping Tax Trusts ("GST trusts"), "a dollar amount of fair market value in interest of MIL equal to the dollar amount of Taxpayers' net remaining generation skipping tax exemption, reduced by the dollar value of any transfer tax obligation owed by these trusts by virtue of their assumption thereof.
>
> 2. Second, to the Sons $6,910,932.52 worth of fair market value in interest of MIL, reduced by the dollar value of (1) the interests in MIL given to the GST trusts, and (2) any transfer tax obligation owed by the Sons by virtue of their assumption thereof.
>
> 3. Third, to the Symphony, $134,000.00 worth of such in interest of MIL.
>
> 4. Last, to CFT,[5328] the dollar amount of the interests of the Taxpayers in MIL, if any, that remained after satisfying the gifts to the GST trusts, the Sons, and the Symphony.
>
> All gifts were complete on execution of the Assignment Agreement on January 12, 1996. No other agreements — written or oral, express or implied —

[5326] 461 F.3d 614 (2006).
[5327] 120 T.C. 358 (2003).
[5328] The court's abbreviation for the Community Foundation of Texas, Inc.

were found to have existed between the Taxpayers and (1) the Sons, (2) the GST trusts, (3) the Symphony, or (4) CFT, as to what putative percentage interest in MIL belonged to, or might eventually be received by, any of the donees under the dollar-value formula clause. Rather, because the interests donated by the Taxpayers to the GST trusts, the Sons, and the Symphony were expressed in dollars, "fair market value" is defined in the Assignment Agreement in terms of the applicable "willing-buyer/willing-seller" test specified in the applicable Treasury Regulation.[5329]

About one and one-half months after signing the assignment, an independent appraisal valued the interests, and then the parties entered into an agreement defining their rights based on that appraisal. The IRS attacked the transaction, and a majority of the Tax Court, rejecting the trial judge's view, found for the IRS. The Fifth Circuit upheld the plain language of the assignment.

Part of the formula language that the Tax Court had disallowed but to which the Fifth Circuit gave effect was the net gift treatment (reducing the value of a gift by any liabilities assumed by the donee) of the transferees' agreement to pay any estate tax on gift tax brought back into the donor's estate with respect to gifts made within three years before death.[5330] In a 2013 reviewed decision, the Tax Court reversed its position on this net gift treatment, so that the net gift should work in all jurisdictions.[5331] Although unpaid gift taxes on gifts made by a decedent are deductible,[5332] the donee's agreement to pay the gift tax makes the gift tax nondeductible for estate tax purposes.[5333]

III.B.3.a.xi. *Procter* and Other Cases

The IRS has been trying to use its victory in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied,* 323 U.S. 756 (144), reversing a Tax Court Memorandum Opinion dated July 6, 1943 (1943 WL 9169). The Fourth Circuit was disturbed by:

> the following provision of the trust indenture making the gift, viz.:
>
> > Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created.
>
> We do not think that the gift tax can be avoided by any such device as this. Taxpayer has made a present gift of a future interest in property. He attempts to provide that, if a federal court of last resort shall hold the gift subject to gift tax, it

[5329] Citing Reg. § 25.2512-1.
[5330] Code § 2035(b).
[5331] *Steinberg v. Commissioner*, 141 T.C. 258.
[5332] Reg. § 20.2053-6(d).
[5333] *Estate of Sommers v. Commissioner*, 149 T.C. No. 8 (2017).

shall be void as to such part of the property given as is subject to the tax. This is clearly a condition subsequent and void because contrary to public policy. A contrary holding would mean that upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax. Such holding, however, being made in a tax suit to which the donees of the property are not parties, would not be binding upon them and they might later enforce the gift notwithstanding the decision of the Tax Court. It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained.

The condition is contrary to public policy for three reasons: In the first place, it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift. In the second place, the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the condition were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax. The donor would thus secure the opinion of the court as to the taxability of the gift, when there would be before the court no controversy whatever with the taxing authorities which the court could decide, the only possible controversy being as to the validity of the gift and being between the donor and persons not before the court. *Cf. Lord v. Veazie*, 8 How. 251, 12 L.Ed. 1067; *Van Horn v. Kittitas County, C.C*., 112 F. 1. As was well said by Chief Justice Taney *in Lord v. Veazie*, *supra* [8 How. 255, 12 L.Ed. 1067]:

> It is the office of courts of justice to decide the rights of persons and of property, when the persons interested cannot adjust them by agreement between themselves,—and to do this upon the full hearing of both parties. And any attempt, by a mere colorable dispute, to obtain the opinion of the court upon a question of law which a party desires to know for his own interest or his own purposes, when there is no real and substantial controversy between those who appear as adverse parties to the suit, is an abuse which courts of justice have always reprehended, and treated as a punishable contempt of court.

In the third place the condition is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered. It should be remembered that it is not possible to obtain a declaratory judgment from a federal court as to whether the gift in question is subject to the gift tax. 28 U.S.C.A. § 400; *Wilson v. Wilson*, 4 Cir., 141 F.2d 599. The only way, therefore, in which it could be determined by "final judgment" of a federal court of last resort that any part of a transfer was subject to a gift tax would be for a tax to be assessed by the Commissioner and upheld by such court in the course of legal proceedings instituted for its enforcement or for its recovery after payment. This final judgment would fix the liability of the donor for the tax; and only then could the condition become operative. The condition, [pg. 754] however, could not be given the effect of invalidating a judgment which had been rendered when the instrument containing the condition was before the court, since all matters are merged in the judgment. To state the matter differently, the condition is not to become operative until there has been a judgment; but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment.

The IRS' view of *Procter* is enshrined in Rev. Rul. 86-41:[5334]

Situation 1.

In 1982, A transferred an interest in a tract of income producing real property to B. Under the deed of transfer, B received a one-half undivided interest in the tract. However, the deed further provided that if the one-half interest received by B were ever determined by the Internal Revenue Service to have a value for federal gift tax purposes in excess of $10,000, then B's fractional interest would be reduced so that its value equaled $10,000. Under local law the adjustment clause operated as a condition subsequent. Thus, if the Service determined that a gift was made in excess of $10,000, the adjustment clause would effectively reconvey to A a fractional share of the tract of real property sufficient to reduce the value of B's interest to $10,000 as of the date of the gift.

On A's federal gift tax return, A reported that the fair market value of the one-half interest transferred by gift to B was $10,000 (one-half the value of the entire tract), and applied the annual exclusion against the gift. On examination of A's 1982 federal gift tax return, it was determined that the fair market value of a one-half interest in the tract subject to the transfer to B was $15,000 rather than $10,000.

Situation 2.

The facts are the same as in Situation 1, except that B was not required to reconvey any property to A. Rather, the transfer contained the condition that if the Internal Revenue Service determined that B received a gift in excess of $10,000, B would transfer to A consideration equal to the amount of the excess.

The IRS held:

In *Situations 1 and 2*, the facts demonstrate that A intended to make a gift to B of a present one-half interest in the property. In both cases, the purpose of the adjustment clause was not to preserve or implement the original, bona fide intent of the parties, as in the case of a clause requiring a purchase price adjustment based on an appraisal by an independent third party retained for that purpose. Rather, the purpose of the clause was to recharacterize the nature of the transaction in the event of a future adjustment to A's gift tax return by the Service. As in Rev. Rul. 65-144, the terms of the deed of transfer to B providing for the reduction of the portion transferred would tend to discourage the examination of returns and the collections of tax and therefore are ineffective for federal gift tax purposes. Because the reduction provision is ineffective for federal gift tax purposes, A has made a gift of a present one-half interest in the property, the first $10,000 of which qualifies for the annual exclusion under

[5334] Situation 2 is referred in fn. 5309, which is found in part III.B.3.a.iv Defined Consideration Clause.

> section 2503 of the Code. The value of the gift is $15,000, the fair market value of a one-half interest in the tract as determined on examination. The fact that, in *Situation 2*, the adjustment of the gift was to be made by recharacterizing the transfer as a part-gift/part-sale is irrelevant…..
>
> In both *Situations 1* and *2,* if the donor transfers a specified portion of real property under terms that provide for a recharacterization of the transaction depending on the Service's valuation of the property for federal gift tax purposes, the adjustment clause will be disregarded for federal tax purposes. Consequently, in both cases the value of the gift will be determined without regard to the adjustment clause and the first $10,000 in the value of the gift, as so determined, will qualify for the annual exclusion from gift tax.

In *Ward v. Commissioner,*[5335] the Tax Court rejected the following clause as void as against public policy:

> 2. Future Adjustment. Each party hereto agrees that if it should be finally determined for Federal gift tax purposes that the fair market value of each share of capital stock of the Corporation exceeds or is less [pg. 88] than $2,000.00 an adjustment will be made in the number of shares constituting each gift so that each Donor will give to each Donee the maximum number of full shares of capital stock of the Corporation, the total value of which will be $50,000.00 from each Donor to each Donee and a total of $150,000 from each Donor to all Donees. Any adjustment so made which results in an increase or decrease in the number of shares held by a stockholder of the Corporation will be made effective as of the same date as this Agreement, and any dividends paid thereafter shall be recomputed and reimbursed as necessary to give effect to the intent of this Agreement.

The court held:[5336]

> [T]he agreement here purports to retroactively alter the amount of an otherwise completed gift. Furthermore, since there is no assurance that the petitioners will either recover the excess shares or, at the time of their deaths, possess the power to recover such shares, and since the shares are not worthless, the petitioners' estates may be reduced by the transfer of the shares. See *Harwood v. Commissioner*, 82 T.C. at 275 n. 28.
>
> Accordingly, we conclude that the gift adjustment clause involved here is void as contrary to public policy and has no effect on the gift taxes otherwise due on the gifts of stock to the petitioners' sons.

For the continued viability of *Ward*, see part III.B.3.a.viii *Christiansen*, text accompanying fn. 5323.

[5335] 87 T.C. 78 (1986).

[5336] For the clause that *Harwood* (cited in the quote below) struck down, see the text accompanying fn. 5313 in part III.B.3.a.iv Defined Consideration Clause.

Estate of Dickinson, Jr. v. Commissioner[5337] involved the following corporate agreement entered into in 1961:

> 1. (a) Dickinson for himself, his heirs, executors and administrators agrees that his estate shall sell to the Company and the Company agrees that it will purchase from said estate a number of shares of the Company's stock which shall be the lesser of the following two numbers of shares: either (i) 8795 shares of the Company's stock owned by Dickinson at the date of this agreement, or (ii) the number of shares whose total price computed in accordance with paragraph 3 below shall have a total equal to the sum of the estate, inheritance and succession taxes (including any interest collected as part of such taxes) imposed because of the death of Dickinson. ***
>
> 2. Dickinson agrees that during his lifetime he will not, by sale or other disposition, reduce the number of shares of the Company's stock held by him below 8795 shares.
>
> 3. The price per share to be paid by the Company for the shares which it is obligated to purchase from Dickinson's estate shall be the sum of the following items taken from the Company's balance sheet—(a) Reserve for Replacement and Advertising, (b) Employees' Pension and Contingency Reserve, (c) Common Stock, (d) Capital Surplus, (e) Earned Surplus—divided by the number of shares of stock of the Company outstanding at the date of said balance sheet. The balance sheet to be used in computing the price per share, in accordance with this paragraph 3, shall be that set forth in the Company's Federal Corporation Income Tax Return (Treasury Form 1120, Schedule L or such equivalent schedule as may hereafter be required by law) for the end of the taxable period ending next prior to the death of Dickinson.

In the course of estate administration, the parties entered into the following agreement:

> Whereas, *** [Mr. Dickinson] is irrevocably bound by an Agreement between him and *** [the company] dated June 29th, 1961, so that his executors will be required to sell to the Company a number of shares of stock in the Company as provided in paragraph 1(a) of *** [the 1961] Agreement at a specified price as provided in paragraph 3 of *** [the 1961] Agreement, and *** [Mr. Dickinson] is precluded by *** [the 1961] Agreement from selling such shares to others during his lifetime; and ***
>
> Whereas, *** [Mrs. Dickinson, E. E. Dickinson III, and Alan Page Dickinson] hold all of the common stock in the Company not held by *** [Mr. Dickinson] and desire that *** [the 1961] Agreement remain in full force and effect;
>
> Now Therefore:
>
> In consideration of the foregoing and of the sum of One (1) Dollar and other good and valuable considerations, the parties hereto do hereby agree as follows:

[5337] 63 T.C. 771 (1975).

1. (a) In the event that the Internal Revenue Service should take an action which would disregard for estate tax valuation purposes the price for said shares as provided in paragraph 3 of *** [the 1961] Agreement or take an action which would in effect deny the benefits of Section 303 and thereby be contradictory to the intentions of Congress in enacting this section governing the redemption of stock to pay death taxes, the personal representatives of *** [Mr. Dickinson] may, if they in their sole discretion deem such action by the Internal Revenue Service to threaten a damaging result either to the estate, heirs, devisees and legatees of *** [Mr. Dickinson], or to the remaining stockholders of the Company, request to be relieved of the estate's obligation to sell said stock pursuant to *** [the 1961] agreement, and *** [Mrs. Dickinson, E. E. Dickinson III, and Alan Page Dickinson] agree for themselves, their heirs, executors, administrators and assigns, that upon receipt of such request they will whether acting as stockholders and/or directors of the Company cause the Company to release the estate of *** [Mr. Dickinson] from such obligations as it may have under *** [the 1961] Agreement.

The court held:

There is no doubt about what Mr. Dickinson wished to happen and about what has in fact taken place. After having made the 1961 agreement, apparently he became concerned about its tax consequences and sought the advice of his counsel. The counsel advised him that the "buy-sell" agreement might not be effective for purposes of determining the value of the stock subjected to taxation. He was also advised that if the 1961 agreement were not modified, the estate might encounter the very situation which now exists—namely, the Commissioner would take the position that the fair market value of the stock should be used for valuation purposes, but that the agreement should be applied for purposes of administering the estate. To avoid such paradoxical results, Mr. Dickinson and his family made the 1962 agreement, which was designed to enable his family to set aside the 1961 agreement for all purposes, if the Commissioner sought to set it aside for valuation purposes. Since the Commissioner has adopted the anticipated position as to the valuation of the stock, the family has carried out Mr. Dickinson's wishes and set the 1961 agreement aside for all purposes. Thus, we have a situation in which the "buy-sell" agreement has been duly set aside, and it should have no effect in administering the estate, unless we hold that it is to be given effect notwithstanding the efforts to terminate it.

In our judgment, there are no reasons for refusing to give effect to the 1962 agreement and the actions taken pursuant thereto. See *Estate of Arthur H. Hull,* 38 T.C. 512 (1962), reversed on another issue 325 F.2d 367 (C.A. 3, 1963); *Estate of Mary Redding Shedd,* 37 T.C. 394 (1961), *aff'd* 320 F.2d 638 (C.A. 9, 1963); cf. *Welch v. Hall,* 134 F.2d 366 (C.A. 1, 1943); compare *William H. Board,* 14 T.C. 322 (1950). The Commissioner relies upon *Commissioner v. Procter,* 142 F.2d 824 (C.A. 4, 1944), reversing and remanding a Memorandum Opinion of this Court, certiorari denied 323 U.S. 756 (1944), in which the grantor of a trust provided that if one of the gifts was held by a court to be subject to the gift tax, the gift was to be revoked. The court held that such a clause was void because it would tend to discourage administrative action and would cause a judicial decision to become a mere nullity. However, the rationale of *Procter* is not applicable to the facts of the case before us. In this case, the Commissioner has taken the position that the 1961 agreement should be disregarded for purposes of fixing the value of the stock subjected to taxation, and the estate has accepted that position. The 1962 agreement makes no attempt to nullify that determination; its only objective is to establish consistency in the administration of the estate. Mr. Dickinson recognized that if the stock was to be taxed on the basis of its fair market value, his estate plan would be distorted if the formula price was used for other purposes, and the only purpose of the 1962 agreement was to avoid such a distortion of his plan. That agreement was a reasonable and appropriate means of anticipating possible future adverse action by the Commissioner and avoiding its consequences. Such agreement is similar to those provisions which we have recognized in *Surface Combustion Corp.,* 9 T.C. 631 (1947), *aff'd* 181 F.2d 444 (C.A. 6, 1950), and *William D. O'Brien,* 46 T.C. 583 (1966).

Nor are we convinced by the Commissioner's other objection to the 1962 agreement. Both parties agree that the 1961 and 1962 agreements have no effect on the value of the stock to be included in the estate. Once the 1962 agreement was made, there was no serious uncertainty about what would ultimately take place. One could be assured that the Commissioner would not accept the formula price for purposes of valuing the stock (section 20.2031-2(h), Estate Tax Regs.), and once he takes that action, it would set in motion proceedings under the 1962 agreement to set aside the 1961 agreement for all purposes. Thus, there was no genuine difficulty in determining the value of the interests that would pass under the will. Cf. *Estate of Inez G. Coleman,* 52 T.C. 921 (1969). Accordingly, we hold that the parties to the 1962 agreement have effectively terminated any obligations under the 1961 agreement and that the formula price has no effect in determining the amount of the estate which passes under the will and the value of the interests passing thereunder.

Readers are encouraged to reconcile the clauses described in the above cases and the reasoning set forth by the courts and the IRS.

III.B.3.a.xii. Beneficiary Grantor Trust as an Alternative to Formula Sale

The beneficiary grantor trusts discussed in part III.B.2.i, Code § 678 (Beneficiary Grantor) Trusts, generally include a broad non-general power of appointment exercisable at the beneficiary's death.

If a beneficiary makes a sale to such a trust, any resulting gift is likely to be an incomplete gift and therefore protected from gift tax. However, that portion would be subject to estate tax.

If one wants to a do a formula sale to a beneficiary grantor trust, consider making part of the transfer a completed gift to another transferee.[5338] Consider whether the formula clause might refer to value as finally determined for "transfer tax" purposes, instead of "gift tax" purposes, so that estate tax finality would work if the gift tax statute of limitations does not run.

[5338] See text accompanying fns. 5346-5347, found in part III.B.4 Adequate Disclosure on Gift Tax Returns.

III.B.4. Adequate Disclosure on Gift Tax Returns

If any gift of property the value of which is required to be shown on a gift tax return and is not shown on such return, any gift tax on such gift may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.[5339] However, any understatement of use of lifetime gift tax exemption that causes for future returns does not prevent the statute of limitations for the future returns from running, unless the understatement resulted from a false or fraudulent return with intent to evade tax or willful attempt to defeat or evade tax.[5340]

When an election to split gifts was improperly applied to split a gift to trust in which a spouse had an interest that was not susceptible of determination, the running of the statute of limitations precluded adjusting the split gift reporting to correct the error.[5341]

[5339] Code § 6501(c)(9), which also provides:

> The preceding sentence shall not apply to any item which is disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item.

[5340] CCA 201614036, which reasoned:

> Under the regs, only the failure to disclose a gift on the return for the year of that gift keeps the ASED open, not a failure to accurately report the sum of prior year gifts on a return for a later year.
>
> As a result, if the only problem with the subsequent year gift tax returns is understatement of the amounts of prior year gifts, then the understatement of gift tax due for those subsequent years may be assessed only within the normal § 6501(a) 3-year period. The returns for [Redacted Text] should be carefully evaluated, because the ASEDs for those returns should still be open.
>
> The six-year ASED for substantial omission in § 6501(e)(2) will not extend the ASED for gift tax returns whose only defect is underreported prior year gifts, because the language "if the taxpayer omits from... the total amount of the gifts made during the period for which the return was filed" also refers to the current-year gifts; gift tax returns are annual returns, even if the taxpayer is required to report prior year gifts and to properly use those when calculating the tax on the current year gifts.
>
> It would take a legislative fix to § 6501(c)(9) and (e)(2) to close this gap.

See also CCA 201643020, which held:

> In this case, the $a gift was reported on the tax year Y31 gift tax return. Thus, step one is met and the matter is concluded. Therefore, despite X's failure to report prior years' gifts on the Y31 return, the special limitation period in section 6501(c)(9) does not apply to the $a gift.

[5341] Letter Ruling 201523003 reasoned:

> In Rev. Rul. 56-439, 1956-2 C.B. 605, a gift is made in trust pursuant to which the trustee is to distribute any part or all of the income or principal of the trust to or among the spouse of the donor and other descendants of the donor at such times and in such proportions and amounts as the trustee determines in its sole discretion. The ruling concludes that, under the facts presented, the value of the right to receive the income or principal to be distributed to the spouse is not susceptible of determination. Therefore, the gift to the spouse is not severable from the gifts to the other beneficiaries, and the gift may not to any extent be considered as made one-half by the donor and one-half by his spouse within the meaning of § 2513.
>
> In this case, in Year 1, Husband transferred property to Family Trust, Trust 1, and Trust 2. On their Year 1 Forms 709, Husband and Wife each elected gift split treatment for those gifts. The property of Trust 1 and Trust 2 was transferred to Family Trust at the

If the taxpayer omits from the total amount of the gifts made during the period for which the return was filed such total gifts as exceed in amount 25% of the total amount of gifts stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed.[5342] However, in determining the items omitted from the total gifts, any item that is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the IRS of the nature and amount of such item, is not taken into account any item which is omitted from the total gifts stated in the return.[5343] Furthermore, any increases in the valuation of assets disclosed on the return are not taken into account in computing the 25% omission from the total gifts stated in the gift tax return.[5344]

Consider disclosing the transfer on a gift tax return as a sale that is not taxed as a gift but is disclosed for the sake of completeness, including running the statute of limitations on whether a transaction is an incomplete gift. The description might be along these lines:

> Information relating to this transaction, including an appraisal that considers discounts for lack of marketability and lack of a right to vote, is attached to this gift tax return as Exhibit A and is disclosed under United States Treasury Regulation § 301.6501(c)-1(f)(4). This transfer is not a gift under Chapter 12 of the Internal Revenue Code as it is a bona fide sale for an adequate and full consideration in money or money's worth.

If the sale is to a beneficiary grantor trust, additional considerations arise. Any gift to the trust would be an incomplete gift.[5345] It has been suggested that the gift tax statute of limitations would not run because any such gift being an incomplete gift would make the

---

end of the annuity terms of those trusts. Wife is an income and principal beneficiary of Family Trust. Family Trust provides that the independent trustee may pay to or use for the benefit of any one or more of Wife, Husband's descendants, and his descendant's spouses so much or all of the income and principal of the trust in such proportions as the independent trustee, in the trustee's discretion, determines to be desirable for their respective welfare and best interests. Wife's interests in the income and principal of Family Trust are not susceptible of determination and, therefore, Wife's interests are not severable from the interests that the other beneficiaries have in Family Trust. See Rev. Rul. 56-439. However, under § 2504(c), the time for determining whether gift split treatment is effective with respect to the Year 1 through Year 3 transfers of property to Family Trust has expired. Therefore, the gift split treatment is irrevocable for purposes of the Year 1 transfer to Family Trust and the Years 2 and 3 transfers of property from Trust 1 and Trust 2 to Family Trust.

In Year 3, on their Forms 709, Husband and Wife each elected gift split treatment for the transfers to Trusts 3 and 4. Under § 25.2513-1(b)(4), the election to split gifts is not effective. The period of limitations has not expired for Year 3. Accordingly, Husband is not precluded under § 2504(c) from filing a supplemental Year 3 Form 709 to report the Year 3 transfers to Trust 3 and Trust 4 as being made solely by him.

[5342] Code § 6501(e)(2).

[5343] Code § 6501(e)(2).

[5344] Reg. § 301.6501(e)-1(b)(2).

[5345] Reg. § 301.6501(c)-1(f)(5).

sale not constitute a "completed transfer."[5346] Whether that argument is correct is up to the reader to decide. If one is concerned about that argument, one might consider including a gift of a portion of the transferred asset to a donee as to whom a gift would be completed.[5347]

Special rules apply to disclosing transfers under Chapter 14.[5348]

If one fails to adequately disclose, one can file a supplemental gift tax return with adequate disclosure to get the statute of limitations running.[5349] In Letter Ruling 201638017, a gift in trust was reported as an outright gift to the primary beneficiary, and the donor was allowed to file a supplemental gift tax return retroactively allocating GST exemption to the trust.

An informal IRS memo discussed adequate disclosure a little and asserted that failure to report a complete and accurate EIN for the business entity that was the subject of the gift caused the statute of limitations not to run when a qualified appraisal was not attached.[5350] A qualified appraisal must, in addition to stating the appraiser's qualifications, contain:[5351]

(A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

[5346] Mulligan, "Searching for Transfer Tax Finality With Sales to BIDITs," *Journal of Taxation* (Nov. 2013), criticized reporting sale treatment as causing finality. He asserts that reporting the sale as a completed gift misleads the IRS because any gift would, in fact, be incomplete. I disagree with the criticism, which perhaps was directed against statements that the gift is complete. The reporting I do does not mention whether the gift is complete or incomplete; it merely states that a sale was made that the IRS can audit and is accompanied by copies of the trust and transactional documents. I believe that disclosing the sale puts the IRS on notice that a transfer was made that can be audited and does not discourage the IRS from auditing the way that a disclosure under Reg. § 301.6501(c)-1(f)(5) would. Furthermore, that author suggested that the trust include language providing that any beneficial interest and any inter vivos or testamentary power of appointment conferred on the beneficiary does not apply to any assets that are ultimately determined for federal gift tax purposes to have been transferred by the beneficiary to the trust for less than adequate and full consideration. Such a provision would eliminate any interest or power in assets that the transfers to the trust that would cause the transfer to be an incomplete gift, which would also undermine the purpose of a sale to that trust.
More on point is Reg. §§ 301.6501(c)-1(f)(4), which applies only to a completed transfer, without defining or otherwise describing what a completed transfer is. Is a sale to a trust a completed transfer whenever the sale completely transfers the property? The article implicitly assumes that completed transfer requires that, if the fair market value of the property transferred exceeds the sales price, the excess must be a completed gift.

[5347] See text accompanying fn. 4615, found in part III.A.3.e.vi.(c) Required Structure for a Sale to a QSST (Including Possible Pitfalls).

[5348] See text accompanying fn. 5528, found in part III.B.7 Chapter 14.

[5349] Rev. Proc. 2000-34.

[5350] LAFA 20152201F commented:

> Our research identified only two opinions involving adequate disclosure under I.R.C.§ 6501(c)(9): *Lewis v. Commissioner* (*In re Estate of Brown*), T.C. Memo. 2013-50 and *Estate of Sanders v. Commissioner*, T.C. Memo. 2014-100. Both opinions deny motions for summary judgment without analyzing whether the respective taxpayers had adequately disclosed their gifts under the applicable regulations.

[5351] Reg. § 301.6501(c)-1(f)(3)(ii).

(B) A description of the property.

(C) A description of the appraisal process employed.

(D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

(E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

(F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

(G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

(H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

It is not unusual to see a draft appraisal omitting the date of transfer and including what might be an incomplete description of the property (value per share rather than valuing the block of stock actually transferred). If one uses a defined value clause determining the price of sold property or the quantity of ownership interest transferred,[5352] one can readily have the appraisal finalized after the transfer to include the date of transfer and provide a full description of the property transferred. Also, it is not unusual for financial information to be available only through the end of the month or quarter preceding the sale, in which case management would represent no material changes in operations between the end of that month or quarter and the date of the sale, and the appraisal is provided as of the date of the transfer (as stated in Reg. § 301.6501(c)-1(f)(3)(ii)(A) above) rather than as of month-end or quarter-end.

Note that running the gift tax statute of limitations (SOL) does not run the SOL on the trust's being exempt from GST tax. To do the latter, the trustee makes a distribution to a skip person and files the appropriate forms to run the statute of limitations on the GST inclusion ratio.[5353]

III.B.5. Estate Tax Issues

Estate tax issues include general valuation problems, deferral under Code § 6166, and marital deduction considerations and related planning.

[5352] See the other provisions of this part III.B.3 Defined Value Clauses in Sale or Gift Agreements or in Disclaimers.

[5353] See part III.B.3.a.ii Sale from One Trust to Another, especially the text accompanying fns. 5307.

III.B.5.a. Promissory Notes

Notes or other claims held by the decedent are likewise included even though they are cancelled by the decedent's will.[5354]

Although for gift tax purposes a note's value generally is equal to its face amount under Code § 7872 principles,[5355] for estate tax purposes valuation discounts might apply.[5356]

However, discounts often will generate the equivalent of taxable interest when the principal is collected.[5357] Given that federal[5358] and state income tax rates tend to exceed estate tax rates, one might actually pay more tax overall by pursuing this strategy – in addition to angering an IRS examiner when one takes full credit for the note for gift tax purposes and reports a lower value for estate tax purposes.

A gift[5359] or bequest[5360] of a promissory note to the borrower usually would not result in cancellation of debt income.

[5354] Reg. § 20.2033-1(b).

[5355] *Frazee v. Commissioner*, 98 T.C. 554 (1992), held that Code § 7872, not Code § 483(e) or 1274, applies in valuing a promissory note in a transaction that was part gift and part sale. See part III.B.1.c Gifts With Consideration – Bargain Sales.

[5356] Blattmachr et al, "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," *Journal of Taxation*, Vol. 109, No. 01 (7/2008). Informal views of another excellent commentator are in my document number 5780917. See also Reg. § 20.2031-4, TAM 8229001, and Letter Ruling 9240003 (valuing notes based on the borrower's ability to repay them), the latter based on *Estate of Harper v. Commissioner*, 11 T.C. 717 (1948), *acq.* 1949-1 C.B. 2.

[5357] Code § 1276(a)(4). Note that Code § 1278(a)(1)(D) provides that:

> the term market discount bond shall not include any bond acquired by the taxpayer at its original issue.

Query whether a note involving a grantor trust that terminates by reason of the deemed owner's death is deemed to have been issued to the holder as of the deemed owner's death.

[5358] Including the Code § 1411 tax on net investment income; see part II.I 3.8% Tax on Excess Net Investment Income.

[5359] *Bosse v. Commissioner*, T.C. Memo. 1970-355. For a discussion of not only intra-family but also commercial cases treating the cancellation of loans as income-tax-free gifts, see Bittker & Lokken, ¶7.4. Spurious Cancellations of Indebtedness, *Federal Taxation of Income, Estates, and Gifts* (WG&L). What is the result when a trust holding a promissory note merges with the trust that owes the note? Although it did not address this issue, Letter Ruling 200552009 held:

> It is consistent with the Supreme Court's opinion in *Cottage Savings* to find that the interests of the beneficiaries of the New Trusts will not differ materially from their interests in Trust 4, Trust 2, Trust 3 and Trust 4 before the merger and division. Each beneficiary will continue to hold, through his or her interest in a New Trust, the same beneficial interest in each asset of Trust 4, Trust 2, Trust 3 and Trust 4 that he or she held before the merger and division, and each interest in the divided trust will contain substantially the same terms. Accordingly, the proposed trust merger and division will not result in a material difference in kind or extent of the legal entitlements, and no gain or loss is recognized on the trust merger and division by any trust or trust beneficiary for purposes of § 1001(a).

Note that the ruling addressed Code § 1001(a), regarding gain on the sale or exchange of assets, and did not address Code § 61(a)(12), Income from discharge of indebtedness.

[5360] Letter Ruling 9240003 held:

See also part III.B.1.a.i.(c) Refinancing or Cancelling Loans.

III.B.5.b. Income Payable to Decedent or Estate Included in Estate

Interest and rents accrued at the date of the decedent's death constitute a part of the gross estate.[5361]

Regarding dividends:

- Dividends declared on publicly-traded shares of stock before the decedent's death but payable to stockholders of record on a date after the decedent's death are not includible in the decedent's gross estate.[5362] However, if the stock is selling "ex-dividend" on the date of the decedent's death, the amount of the dividend is added to the ex-dividend quotation in determining the fair market value of the stock as of the date of the decedent's death.[5363]

- Dividends payable to the decedent or estate, by reason of the fact that on or before the date of the decedent's death the decedent was a stockholder of record (but

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A testamentary cancellation of any intrafamily debt is an example of the detached and disinterested generosity . . . affection, respect, admiration, charity or like impulses that characterize a gift excludable from the recipient's income. *See, Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960). It is well settled that cancellation of a debt can be the means of effecting a gift. *See, e.g., Helvering v. American Dental*, 318 U.S. 322 (1943), which holds that where a creditor gratuitously forgives a debt, the forgiveness is a gift and not income. *Compare Commissioner v. Jacobson*, 336 U.S. 28 (1949), which holds that where a creditor cancels a debt involuntarily in an arm's length setting, the cancellation is income and not a gift. A testamentary cancellation of a debt owing to the decedent can similarly be the means of effecting a gift in the form of a bequest.

The issue is primarily a question of fact, and under some circumstances -- for example, where donative intent is absent -- a testamentary cancellation of a note may result in discharge of indebtedness income. In some circumstances, other requirements of making a testamentary gift may not be met. *See Bosse v. Commissioner*, T.C. Memo. 1970-355, which involved, among other issues, whether certain actions and statements of the decedent effected a testamentary gift under state law. However, in this case, there is no evidence that anything other than donative intent was involved in the cancellation of the note. Therefore, the cancellation qualifies as a testamentary bequest under section 102 of the Code.

Further, the estate would not realize cancellation-of- indebtedness income, because the estate was never an obligor on the note.

Accordingly, the decedent's cancellation of the note was in the nature of a testamentary bequest excludable from gross income under section 102 of the Code rather than a discharge of a debt giving rise to discharge of indebtedness income under section 61(a)(12).

[5361] Reg. § 20.2033-1(b).

[5362] Rev. Rul. 54-399, citing *Estate of George McNaught Lockie v. Commissioner*, 21 T.C. 64 (1953) (a reviewed decision), *acq.* 1954-1 C.B. 5.

[5363] Reg. § 20.2031-2(i), which regulation was upheld as valid by *Estate of McNary v. Commissioner*, 47 T.C. 467 (1967). Presumably, this reference to selling ex-dividend has its roots in Rev. Rul. 54-399, which applied that rule to stock that is being traded on an exchange. If the decedent dies on a weekend and stocks began selling ex-dividend on the trading day immediately after death, the amount of the dividend is added to the post-mortem price that is being averaged. Rev. Rul. 68-610.

> which have not been collected at death), constitute a part of the gross estate.[5364] However, the dividends need to have been declared before death to be includible.[5365]

For purposes of the alternate valuation rules, Reg. § 20.2032-1(d)(4) provides:

> *Stock of a corporation*. Shares of stock in a corporation and dividends declared to stockholders of record on or before the date of the decedent's death and not collected at the date of death constitute "included property" of the estate. On the other hand, ordinary dividends out of earnings and profits (whether in cash, shares of the corporation, or other property) declared to stockholders of record after the date of the decedent's death are "excluded property" and are not to be valued under the alternate valuation method. If, however, dividends are declared to stockholders of record after the date of the decedent's death with the effect that the shares of stock at the subsequent valuation date do not reasonably represent the same "included property" of the gross estate as existed at the date of the decedent's death, the dividends are "included property", except to the extent that they are out of earnings of the corporation after the date of the decedent's death. For example, if a corporation makes a distribution in partial liquidation to stockholders of record during the alternate valuation period which is not accompanied by a surrender of a stock certificate for cancellation, the amount of the distribution received on stock included in the gross estate is itself "included property", except to the extent that the distribution was out of earnings and profits since the date of the decedent's death. Similarly, if a corporation, in which the decedent owned a substantial interest and which possessed at the date of the decedent's death accumulated earnings and profits equal to its paid-in capital, distributed all of its accumulated earnings and profits as a cash dividend to shareholders of record during the alternate valuation period, the amount of the dividends received on stock includible in the gross estate will be included in the gross estate under the alternate valuation method. Likewise, a stock dividend distributed under such circumstances is "included property".

Also, where an estate holds publicly-traded stocks selling ex-dividend on the alternate valuation date, and that date comes after a declaration of dividends, but before the record date, the value of the stock includes the amount of the dividends declared.[5366]

[5364] Reg. § 20.2033-1(b), which regulation was upheld as valid by *Estate of McNary v. Commissioner*, 47 T.C. 467 (1967).

[5365] A rule including dividends declared after death would make no sense, in that only rights that exist at death are measured. However, a very close reading of Reg. § 20.2033-1(b) is required for this result:

> Interest and rents accrued at the date of the decedent's death constitute a part of the gross estate. Similarly, dividends which are payable to the decedent or his estate by reason of the fact that on or before the date of the decedent's death he was a stockholder of record (but which have not been collected at death) constitute a part of the gross estate.

Similarly implies that the dividends are accrued the way that interest and rents were accrued. A dividend is not accrued until it is declared. Therefore, a dividend must be declared before it is includible under Reg. § 20.2033-1(b).

[5366] *Estate of Fleming v. Commissioner*, T.C. Memo. 1974-307. Rev. Rul. 60-124 held:

III.B.5.c. Farmland or Other Closely-Held Business Property

Code § 2032A allows for using a reduced value for real property used as a farm for farming purposes or used in a trade or business other than farming. The estate tax value applies for date-of-death income tax basis determinations as well.[5367]

For the interplay of Code § 2032A with marital deduction issues, see TAMs 8240015 and 8314005.[5368]

The aggregate decrease in the value of qualified real property taken into account for estate tax purposes with respect to any decedent is limited to $750,000, indexed for post-1997 inflation.[5369] The 2014 limitation is $1,090,000.[5370]

Given this limitation on the valuation reduction, if it appears that the surviving spouse's estate will (or perhaps might) be subject to estate tax, consider making the Code § 2032A election on the first spouse's estate tax return so that two Code § 2032A reductions can be made. However, the trade-off between a known basis reduction and a possible estate tax reduction might require a difficult judgment call.

III.B.5.d. Estate Tax Deferral or Financing; Tax Liens

III.B.5.d.i. Overview of Discretionary Extensions Under Section 6161

Use IRS Form 4768 to request the extensions of time to pay described below.[5371]

> … in the determination of the value of a decedent's gross estate, dividends declared before death, on stock includible in the gross estate, payable to stockholders of record after the date of the decedent's death must be considered in making an adjustment in the ex-dividend quotation of the stock at the date of the decedent's death. Such dividends may not be included in the gross estate under the alternate method of valuing the gross estate either as a separate asset or as an adjustment of the ex-dividend quoted value of the stock as of one year after the date of the decedent's death or as of some intermediate date.
>
> Under the alternate method of valuing the gross estate, stock includible in the gross estate and selling ex-dividend is to be valued at its ex-dividend quoted selling price as of one year after the date of the decedent's death or at any intermediate valuation date, increased by the amount of dividends declared on the stock during the alternate valuation period payable to stockholders of record subsequent to the date which is one year after the date of the decedent's death or such intermediate date. No part of the value so determined is deemed to be excluded property in determining the value of the gross estate.

[5367] Code § 1014(a)(3); *Van Alen v. Commissioner*, T.C. Memo. 2013-235 (beneficiaries were barred from contesting alternate valuation, especially with the estate tax statute of limitations having expired; 20% accuracy-related penalty imposed).

[5368] ACTEC Fellow Ed Hertenstein procured TAM 8314005.

[5369] Code § 2032A(a)(3).

[5370] Rev. Proc. 2013-35, Section 3.33.

[5371] Although an extension of time to pay is authorized under a different statute than an extension of time to pay, they are generally requested on the same form, so a comment about an extension of time to file might be helpful. A taxpayer may request an extension of time to file using IRS Form 4768 after the deadline, if it contains a detailed explanation of why it is impossible or impractical to file a reasonably complete return by the due date, as well as good cause for not

III.B.5.d.i.(a). Extensions for Tax Shown on the Return

Code § 6161(a)(2) provides for tax reported by the executor:

> The Secretary may, for reasonable cause, extend the time for payment of—
>
> (A) any part of the amount determined by the executor as the tax imposed by chapter 11, or
>
> (B) any part of any installment under section 6166 (including any part of a deficiency prorated to any installment under such section),
>
> for a reasonable period not in excess of 10 years from the date prescribed by section 6151(a) for payment of the tax (or, in the case of an amount referred to in subparagraph (B), if later, not beyond the date which is 12 months after the due date for the last installment).

Reg § 20.6161-1(a)(1) provides a "reasonable cause" extension for tax shown on the return:

> [An] extension of time beyond the due date to pay any part of the tax shown on the estate tax return may be granted for a reasonable period of time, not to exceed 12 months by the district director or the director of a service center, at the request of the executor, if an examination of all the facts and circumstances discloses that such request is based upon reasonable cause.

Below are examples of "reasonable cause" under Reg § 20.6161-1(a):

> *Example (1)*. An estate includes sufficient liquid assets to pay the estate tax when otherwise due. The liquid assets, however, are located in several jurisdictions and are not immediately subject to the control of the executor. Consequently, such assets cannot readily be marshaled by the executor, even with the exercise of due diligence.
>
> *Example (2)*. An estate is comprised in substantial part of assets consisting of rights to receive payments in the future (i.e., annuities, copyright royalties, contingent fees, or accounts receivable). These assets provide insufficient present cash with which to pay the estate tax when otherwise due and the estate cannot borrow against these assets except upon terms which would inflict loss upon the estate.
>
> *Example (3)*. An estate includes a claim to substantial assets which cannot be collected without litigation. Consequently, the size of the gross estate is unascertainable as of the time the tax is otherwise due.

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requesting the automatic extension. Reg. § 20.6081-1(c). The IRS must consider the estate's good cause explanation; it cannot just reject it out-of-hand for being late. *Estate of Paul Proske v. United States*, No. 2:09-cv-00670 (D. N.J. 5/25/2010).

> *Example (4)*. An estate does not have sufficient funds (without borrowing at a rate of interest higher than that generally available) with which to pay the entire estate tax when otherwise due, to provide a reasonable allowance during the remaining period of administration of the estate for the decedent's widow and dependent children, and to satisfy claims against the estate that are due and payable. Furthermore, the executor has made a reasonable effort to convert assets in his possession (other than an interest in a closely held business to which section 6166 applies) into cash.

Reg § 20.6161-1(a)(2)(i) provides an "undue hardship" extension for tax shown on the return:

> [I]n any case where the district director finds that payment on the due date of any part of the tax shown on the return, or payment of any part of an installment under section 6166 (including any part of a deficiency prorated to an installment the date for payment of which had not arrived) on the date fixed for payment thereof, would impose undue hardship upon the estate, he may extend the time for payment for a period or periods not to exceed one year for any one period and for all periods not to exceed 10 years from the date prescribed in section 6151(a) for payment of the tax.

Reg § 20.6161-1(a)(2)(ii) defines "undue hardship" relating to tax shown on the return:

> The extension provided [for] undue hardship … will not be granted upon a general statement of hardship or merely upon a showing of reasonable cause. The term "undue hardship" means more than an inconvenience to the estate. A sale of property at a price equal to its current fair market value, where a market exists, is not ordinarily considered as resulting in an undue hardship to the estate. The following examples illustrate cases in which an extension of time will be granted based on undue hardship pursuant to this paragraph:
>
> *Example (1)*. A farm (or other closely held business) comprises a significant portion of an estate, but the percentage requirements of section 6166(a) (relating to an extension where the estate includes a closely held business) are not satisfied and, therefore, that section does not apply. Sufficient funds for the payment of the estate tax when otherwise due are not readily available. The farm (or closely held business) could be sold to unrelated persons at a price equal to its fair market value, but the executor seeks an extension of time to facilitate the raising of funds from other sources for the payment of the estate tax.
>
> *Example (2)*. The assets in the gross estate which must be liquidated to pay the estate tax can only be sold at a sacrifice price or in a depressed market if the tax is to be paid when otherwise due.

Reg § 20.6161-1(b) explains the procedural issues when filing the appropriate form, highlights of which include:

> …. An application for an extension of time for payment of the tax, or of an installment under section 6166 … will not be considered unless the extension is applied for on or before the date fixed for payment of the tax or installment….

> The granting of the extension of time for paying the tax is discretionary with the appropriate internal revenue officer and his authority will be exercised under such conditions as he may deem advisable. However, if a request for an extension of time for payment of estate tax under this section is denied by a district director or a director of a service center, a written appeal may be made … to the regional commissioner with authority over such district director or service center director within 10 days after the denial is mailed to the executor…. When received, the appeal will be examined, and if possible, within 30 days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified.

The phrase "undue hardship" was in the statute when the regulations were promulgated but has since been removed. Presumably the regulations should be updated to remove the requirement of "undue hardship."

III.B.5.d.i.(b). Deficiencies Resulting from IRS Audit

Code § 6161(b)(2) provides for tax assessed by the IRS:

> Under regulations prescribed by the Secretary, the Secretary may, for reasonable cause, extend the time for the payment of any deficiency of a tax imposed by chapter 11 for a reasonable period not to exceed 4 years from the date otherwise fixed for the payment of the deficiency.

Reg § 20.6161-2 is much more stringent for tax arising from a deficiency. An extension may be granted for "undue hardship" only. Furthermore, Reg § 20.6161-2(b) provides for a more stringent definition of "undue hardship":

> The extension will not be granted upon a general statement of hardship. The term "undue hardship" means more than an inconvenience to the estate. It must appear that a substantial financial loss, for example, due to the sale of property at a sacrifice price, will result to the estate from making payment of the deficiency at the date prescribed therefor. If a market exists, a sale of property at the current market price is not ordinarily considered as resulting in an undue hardship. No extension will be granted if the deficiency is due to negligence or intentional disregard of rules and regulations or to fraud with intent to evade the tax.

The phrase "undue hardship" was in the statute when the regulations were promulgated but has since been removed. Presumably the regulations should be updated to remove the requirement of "undue hardship."

Reg § 20.6161-2(c) procedural requirements include:

> … When received, [the application for extension] will be examined, and, if possible, within thirty days will be denied, granted, or tentatively granted subject to certain conditions of which the executor will be notified. The district director will not consider an application for such an extension unless it is applied for on or before the date prescribed for payment of the deficiency, as shown by the notice

> and demand from the district director…. The granting of the extension of time for paying the deficiency is discretionary with the district director.

Internal Revenue Manual ("IRM") 5.5.5.5(1) requires a denial of an extension to notify the taxpayer:

> A written appeal may be made to the Examination Area Director within 10 days from the time the denial is mailed. Show the CSCO address for the Appeals office address unless the liability was created by an examination.

Whether the extension is for tax shown on the return or for a deficiency, the IRS grants the extension only one year at a time.

IRM 5.5.5.8 provides:

> (6) In addition to establishing reasonable cause, these cases require an analysis of the progress of efforts being made to borrow or liquidate assets or to otherwise pay the amounts to be extended. Some suggested additional information required in this analysis include:
>
> > a. Balance sheets listing all assets, disbursements, liabilities and earnings for the estate and relating to the prior extension period. Real estate should be listed with the value and location identified (city, county, and state).
> >
> > b. An accounting of the actions taken during the past extension period to resolve the indebtedness. Examples include marketing property, resolving suits, or seeking loans.
> >
> > c. Information on the executor's proposal to make partial payments during the extension being requested.
>
> (7) Contact the executor within 30 days of the date of the extension request to
>
> > a. advise them that you are reviewing the request,
> >
> > b. gather information to support your determination, and
> >
> > c. estimate the date of completion.
>
> ….
>
> (10) Most requests for an extension to pay are necessary because the estate representative or executor needs additional time to liquidate what are often very valuable properties that cannot be marketed within the 9 month period following the death of the taxpayer. Provided the executors verify that all steps necessary to sell property to pay the tax are being taken in an expeditious manner, and that all liquid assets not needed for the payment of anticipated administrative expenses are paid over, extensions to pay should generally be granted….

> (12) When evaluating extension to pay requests bear in mind that denial of the request may have adverse financial ramifications to the estate far in excess of the failure to pay penalty which will begin to accrue if the request is denied….

III.B.5.d.i.(c). Additional Extensions; Miscellaneous Rules

For additional extensions, IRM 5.5.5.3 instructs, "Evaluate progress of efforts made by the executor to borrow, liquidate assets, or otherwise pay the amount to be extended."

Code § 6161(d) provides additional rules:

> (1) *Period of limitation*. For extension of the period of limitation in case of an extension under subsection (a)(2) or subsection (b)(2), see section 6503(d).
>
> (2) *Security*. For authority of the Secretary to require security in case of an extension under subsection (a)(2) or subsection (b), see section 6165.
>
> (3) *Postponement of certain acts*. For time for performing certain acts postponed by reason of war, see section 7508, and by reason of Presidentially declared disaster or terroristic or military action, see section 7508A.

Code § 6503(d) suspends the statute of limitations while an extension is in effect. However, when a default occurs during the extension period, the statute of limitations begins to run again.[5372]

Code § 6165 provides:

> In the event the Secretary grants any extension of time within which to pay any tax or any deficiency therein, the Secretary may require the taxpayer to furnish a bond in such amount (not exceeding double the amount with respect to which the extension is granted) conditioned upon the payment of the amount extended in accordance with the terms of such extension.

However, bonds generally are not practical.

III.B.5.d.ii. Code § 6166 Deferral

Code § 6166 allows the payment of estate tax to be deferred for certain closely-held businesses,[5373] if the value of such businesses exceeds 35% of the adjusted gross

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[5372] *U.S. v. Johnson*, 109 A.F.T.R.2d 2012-2253 (D.C. UT) (Code § 6166 election tolled the statute of limitations for beginning an action against the estate, but a default of an installment payment stopped the tolling of the statute of limitations).

[5373] For nuances of the ownership tests, see Gorin et al., Internal Revenue Code Section 6166: Comments To Tax Counsel For The Senate Finance Committee, 41 *Real Property, Probate & Trust Journal* 73 (Spring 2006); see also Rev. Rul. 2006-34, which was issued after that article was published. See also Blattmachr, Gans, and Madden, Untangling Installment Payments of Estate Tax Under Section 6166, *Estate Planning Journal* (7/2009) (which discusses Rev. Rul. 2006-34). For a good summary of various aspects of Code § 6166, see Madden, *Tax* estate.[5374] For this calculation, "adjusted gross estate" means the value of the gross estate reduced by deductions under Code § 2053 or Code § 2054.[5375] Code § 2053(a) authorizes deductions for funeral expenses, administration expenses, claims against the estate, and certain debts. Claims include a pledge to the extent that either (1) the liability was contracted bona fide and for an adequate and full consideration in cash (or its equivalent) or (2) payment of the pledge would have constituted an allowable charitable deduction under Code § 2055 if it had been a bequest.[5376] Code § 6166(g) accelerates estate tax if certain changes occur post-mortem.[5377]

Failure to fully comply with ***all*** of the requirements for making an election on a timely filed return (including extensions) invalidates the election.[5378]

If there is any doubt whether the estate might not qualify for a Code § 6166 deferral and the return is being extended, consider filing for an extension of time to pay as well, explaining the issue. Otherwise, when the return is filed, if the estate does not qualify for the Code § 6166 deferral then the IRS might assert penalties for late payment.[5379]

Planning for Highly Compensated Individuals (WG&L), ¶ 10.07 Installment Payment of Estate Taxes - Section 6166.

[5374] Code § 6166(a)(1).

[5375] Code § 6166(b)(6).

[5376] Reg. § 20.2053-5(a).

[5377] Letter Ruling 201403012, allowing the reorganization of a business not to cause acceleration under Code § 6166(g), demonstrates the continued vitality of Rev. Rul. 66-62 and the legitimacy of looking to regulations under former Code § 6166A to help construe current Code § 6166. However, Letter Ruling 200613020 indicates that Code § 6166(g)(1)(D) is more favorable than the old regulations.

[5378] Reg. § 20.6166-1(b) provides:

> *Time and manner of election*. The election provided under section 6166(a) is made by attaching to a timely filed estate tax return a notice of election containing the following information:
>
> (1) The decedent's name and taxpayer identification number as they appear on the estate tax return;
> (2) The amount of tax which is to be paid in installments;
> (3) The date selected for payment of the first installment;
> (4) The number of annual installments, including the first installment, in which the tax is to be paid;
> (5) The properties shown on the estate tax return which constitute the closely held business interest (identified by schedule and item number); and
> (6) The facts which formed the basis for the executor's conclusion that the estate qualifies for payment of the estate tax in installments.

Woodbury v. Commissioner, T.C. Memo. 2014-66, held that failure to comply with (5) and (6) invalidated the election. The court was not sympathetic to arguments of substantial compliance, because those provisions were essential to provide information the IRS could use to decide whether to audit the return.

[5379] The IRS attempted to impose such penalties in *Estate of John R.H. Thouron v. U.S.*, 752 F.3d 311 (3rd Cir. 2014), *rev'g* 110 A.F.T.R.2d 2012-6572 (E.D. Pa.). Applying Reg. § 301.6651-1(c)(1), the Third Circuit held that, although one cannot rely on a tax advisor to perform ministerial filing acts, a taxpayer's reliance on the advice of a tax expert may constitute reasonable cause for failure to pay by the deadline if the taxpayer can also show either an inability to pay or undue hardship from paying at the deadline.

An August 2013 email from another estate planning lawyer suggested that an IRS source in Cincinnati stated that a Code § 6166 election will automatically draw an audit. Given that the number of estate tax returns reporting tax due has dramatically decreased, that suggestion is not to be taken lightly.

III.B.5.d.ii.(a). What is a Business?

The IRS views the decedent's real property as being a closely-held business if it is used in the decedent's business or if the decedent, directly or through a company that the decedent managed and in which the decedent owned a 1% general partner interest and a 20% limited partnership interest, reasoning:[5380]

> In determining whether the activities of the decedent, partnership, LLC or corporation constitute an active trade or business, the activities of agents and employees of the decedent, the partnership, LLC or corporation are also taken into consideration. The fact that some of the activities are conducted by third parties such as independent contractors who are neither agents nor employees of the decedent, partnership, LLC or corporation, will not prevent the business from qualifying as an active trade or business so long as these third-party activities are not of such a nature that the activities of the decedent, partnership, LLC or corporation (and their respective agents and employees) are reduced to the level of merely holding investment property.
>
> Often, day-to-day real estate operations and activities are performed by independent contractors, such as property management companies. If a decedent, partnership, LLC, or corporation uses an unrelated property management company to perform most of the activities associated with the real estate interests, that fact suggests that an active trade or business does not exist.
>
> To determine whether a decedent's interest in real property is an interest in an asset used in an active trade or business, the Service will consider all the facts and circumstances, including the activities of agents and employees, the activities of management companies or other third parties, and the decedent's ownership interest in any management company or other third party. The Service will consider the following nonexclusive list of factors:
>
> - The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business;
>
> - Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose;

[5380] Rev. Rul. 2006-34, which was analyzed in Planning for the Payment of Estate Taxes for Illiquid Estates Owning Real Estate-The Code § 6166 Deferral, *Probate & Property* (March/April 2009). Rev. Rul. 2006-34 revoked all of Rev. Rul. 75-365 and the portion of Rev. Rul. 75-367 relating to the eight rental homes.

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) was actively involved in finding new tenants and negotiating and executing leases;

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) handled tenant repair requests and complaints.

No single factor is dispositive of whether a decedent's activities with respect to the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business for purposes of section 6166.

The IRS applied these factors as follows:

(1) In Situation 1, A provided significant services to the strip mall tenants. A personally handled the day-to-day operation, management and maintenance of the strip mall. A's activities went beyond those of a mere investor collecting profits from a passive asset. Moreover, even in situations in which A hired independent contractors to perform repairs that A could not perform personally, A was involved in the selection of the contractors and reviewed and approved the work performed. Under these circumstances, the use of independent contractors on occasions when A could not personally perform the work does not prevent A's activities from rising to the level of the conduct of an active trade or business. Thus, A's ownership of the strip mall qualifies as an interest in a closely held business for purposes of section 6166. (The result would be the same if the strip mall had instead been held in a single-member LLC owned by A, and the LLC were disregarded as an entity that is separate from its owner under §§ 301.7701-1 through 3 of the Procedure and Administration Regulations.)

(2) In Situation 2, in determining whether B was a proprietor carrying on an active trade or business with respect to B's interest in the office park, the activities of DEF Management Corporation (DEF) and its relationship with B are taken into account. DEF and its employees provided all necessary services for B's office park. B had no ownership interest in DEF. B's reliance on DEF to perform all necessary services, B's lack of any significant participation in the management or oversight of the property, and B's lack of any ownership interest in DEF are all factors that weigh heavily against a finding that the office park was used by B in an active trade or business. Thus, B was not a proprietor in an active trade or business and B's interest in

the office park does not qualify as an interest in a closely held business for purposes of section 6166.

(3) In Situation 3, DEF provided all necessary services with regard to the management and maintenance of the office park, including advertising to attract new tenants, showing the property to prospective tenants, negotiating and administering leases, collecting the monthly rent, and arranging for third party independent contractors to provide all necessary services to maintain the buildings and grounds of the office park, including snow removal, security, and janitorial services. These activities are sufficient to conclude that DEF was actively managing the office park. Because B owned a significant interest in DEF, the activities of DEF with regard to the office park allow B's interest in the office park to qualify as an interest in a closely held business for purposes of section 6166.

(4) In Situation 4, the determination of whether the limited partnership was carrying on a trade or business for purposes of section 6166 is made with reference to the partnership's activities. Because the limited partnership, rather than C, owned the interest in the strip malls, the nature and level of the activities of the limited partnership must be evaluated. The limited partnership, acting through its general partner C, handled the day-to-day operations and management of the strip malls. The activities of C on behalf of the limited partnership included (either personally or with the assistance of employees or agents) performing daily maintenance of and repairs to the strip malls (or hiring, reviewing and approving the work of third party independent contractors for such work), collecting rental payments, negotiating leases, and making decisions regarding periodic renovations of the strip malls. Thus, the limited partnership carried on an active trade or business. Because the strip malls were used in carrying on the partnership's active trade or business, they are not passive assets under section 6166(b)(9) and their value is not excluded from the value of C's interest in the partnership for purposes of section 6166. C's interest in the limited partnership qualifies as an interest in a closely held business for purposes of section 6166. (Because C owned at least 20 percent of the partnership, the conclusion would be the same even if C's activities were instead performed by another employee, partner or agent of the partnership).

(5) In Situation 5, MNO was engaged in an automobile dealership business. Thus, MNO was conducting an active trade or business at the time of D's death. Consequently, D's 100 percent stock interest in MNO qualifies as an interest in a closely held business. In addition, Real Property P was used exclusively in the business of MNO under a net lease from D. As in Situation 3, because D owned a significant interest in MNO, whose activities with regard to Real Property P constituted active management, D's interest in Real Property P also qualifies as an interest in a closely held business.

Letter Ruling 201343004 approved Code § 6166 treatment for businesses that engaged in personal and real estate rental activities. Rev. Rul. 75-366 approved a crop-sharing arrangement as eligible for Code § 6166 deferral.[5381]

III.B.5.d.ii.(b). Tiered Structures

In determining what is eligible for Code § 6166 deferral, the value of any interest in a closely held business shall not include the value of that portion of such interest which is attributable to passive assets held by the business.[5382] "Passive asset" means any asset not used in carrying on a trade or business.[5383]

Any "stock in another corporation"[5384] is a passive asset unless a certain holding company election is made[5385] or a certain active corporation exception applies.[5386]

Another exception might apply in the case of S corporations – an exception that might make an S corporation structure better for Code § 6166 purposes than a partnership or C corporation. It appears that the assets of a qualified subchapter S subsidiary are

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[5381] The facts were:

> The farms were operated by tenant farmers under agreements whereby the decedent received 40 percent of the crops and bore 40 percent of the expenses. The decedent had participated with the tenants in important management decisions, such as what crops to plant, what fields to plant or pasture, how to utilize the subsidy program, what steps to take as to weed control, etc. The decedent had lived several miles from the farms but had made almost daily visits to inspect and discuss operations, and occasionally delivered supplies to the tenants.

In ruling in favor of the real estate being a Code § 6166 business interest, the IRS reasoned:

> An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of investment assets.
>
> In the present case the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.

[5382] Code § 6166(b)(9)(A).

[5383] Code § 6166(b)(9)(B)(i).

[5384] By referring to another corporation, Code § 6166(b)(9)(B)(ii) seems to apply only to a corporation holding stock in another corporation and not to a partnership holding stock in a corporation.

[5385] Code § 6166(b)(9)(B)(ii) excludes from passive asset treatment stock that a Code § 6166(b)(8) election treats as held by the decedent and qualified under Code § 6166(a)(1).

[5386] Code § 6166(b)(9)(B)(iii) provides:

> *Exception for active corporations*. If—
>
> (I) a corporation owns 20 percent or more in value of the voting stock of another corporation, or such other corporation has 45 or fewer shareholders, and
>
> (II) 80 percent or more of the value of the assets of each such corporation is attributable to assets used in carrying on a trade or business,
>
> then such corporations shall be treated as 1 corporation for purposes of clause (ii). For purposes of applying subclause (II) to the corporation holding the stock of the other corporation, such stock shall not be taken into account.

treated as directly owned by its ultimate parent; see part II.A.2.e.i Benefits of Estate Planning Strategies Available Only for S Corporation Shareholders.[5387]

If one uses a tiered partnership structure, one does not receive the benefit of these safe harbors.[5388] Generally, one would want to make the case that the partnership structure was one integrated business. Query whether making that case might undermine the protection from creditors that having separate entities tends to provide.[5389] This asset protection inquiry has two aspects:

1. One is always responsible for one's own actions. If a parent actively manages its subsidiary, the parent will be responsible in tort for the parent's actions.

2. Entity structures protect one from strict liability. For example, suppose the parent is responsible for strategic management but not daily operations. Generally, the parent might be responsible for the actions of those it directly supervises if and to the extent that the parent failed to exercise sufficient care in hiring or supervising them, but the parent would not be responsible for their actions or the actions of others in the company beyond that. The parent also would not be responsible for any liabilities arising from the subsidiary's mere ownership of the property or for any of the subsidiary's contractual obligations. However, this strict liability protection might break down if the subsidiary is not run in a financially responsible way, so the parent would want to make sure that the subsidiary has sufficient capital needed to run its daily operations and fulfill its recurring obligations, as well as sufficient insurance protection.

A parent might very well be able to run its subsidiaries as part of a single strategic business operation while managing these concerns. Although this process appears manageable, I would prefer to use estate planning tools to avoid estate tax and consider insurance to fund potential estate tax payments until the estate planning tools have succeeded.

III.B.5.d.ii.(c). Terms of Extension

Generally, interest is paid on the 1st through 4th anniversary of the estate tax return due date, and interest and one-tenth of the principal are paid on the 5th through 14th anniversary of the estate tax return due date. Failure to make a payment when due terminates the election[5390] unless paid 6 months late with a penalty,[5391] and impossibility is not a defense.[5392] The election does not apply to GST tax imposed on a taxable termination.[5393] The election must be made on a timely filed return.[5394]

[5387] Especially the text accompanying fns. 91-93

[5388] Code § 6166 needs serious updating regarding its application to partnerships. See Gorin et al., Internal Revenue Code Section 6166: Comments To Tax Counsel For The Senate Finance Committee, 41 *Real Property, Probate & Trust Journal* 73 (Spring 2006).

[5389] For more on using separate entities for asset protection, see part II.F Asset Protection Planning.

[5390] Code § 6166(g)(3)(A).

[5391] Code § 6166(g)(3)(B).

[5392] *Estate of Adell v. Commissioner*, T.C. Memo. 2013-228.

[5393] Letter Ruling 200939003.

For adjustments on audit, see Rev. Rul. 81-294. If an estate makes a protective election but does not make a final election when audited, the protective election does not constitute a Code § 6166 election; accordingly, the IRS cannot collect tax as if the extension had been made.[5395]

If an estate overpays its non-deferred estate tax liability, the overpayment is not refunded but instead is applied to the deferred tax.[5396]

Also, if any portion of an interest in a closely held business, for which the Code § 6166 election is made, is distributed, sold, exchanged, or otherwise disposed of[5397] or money and other property attributable to such an interest is withdrawn from such trade or business, and the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50% of the value of such interest, then the Code § 6166 extension of time for payment of tax shall cease to apply, and the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the IRS.[5398] This rule does not apply to certain reorganizations,[5399] nor does it apply to a transfer of property of the decedent to a person entitled by reason of the decedent's death to receive such property under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent or to certain subsequent transfers of the property by reason of death to certain family members.[5400]

For a discussion of liens associated with Code § 6166 elections, see parts III.B.3.c.iv Liens: Selected Internal Revenue Manual Materials and III.B.3.c.iv Effect of Liens on Dealings with Third Parties.

III.B.5.d.ii.(d). Effect of Code § 6166 Election on Statute of Limitations for Collection

A Code § 6166 election, among others, suspends the statute of limitations for collecting estate tax.[5401]

If the IRS sends the taxpayer a notice that it is treating the Code § 6166 as terminated, the statute of limitations is no longer suspended.[5402]

[5394] Code § 6166(d). Because the deadline is statutory, Letter Ruling 201015003 denied Code § 9100 relief on a return that was filed late, even though it held that the estate was entitled to elect special use valuation for the farm property under Code § 2032A and to have its farm property treated as a qualified family owned business interest under Code § 2057.

[5395] *U.S. v. Baileys*, 113 A.F.T.R.2d 2014-1838 (D. Central Ca. 3/25/2014).

[5396] *Estate of Adell v. Commissioner*, T.C. Memo. 2014-89, interpreting Code § 6403; *Estate of McNeely v. U.S.*, 113 AFTR.2d 2014-2520 (D. Minn. 6/12/2014), interpreting Code §§ 6402, 6403

[5397] For dispositions of holding companies or of their interests in the relevant business, see Code § 6166(g)(1)(E), (F).

[5398] Code § 6166(g)(1)(A). For the extent to which a redemption to pay estate tax, administrative expenses, etc. constitutes a disposition, see Code § 6166(g)(1)(B).

[5399] Code § 6166(g)(1)(C).

[5400] Code § 6166(g)(1)(D).

[5401] Code § 6503(d) provides:

> The running of the period of limitation for collection of any tax imposed by chapter 11 shall be suspended for the period of any extension of time for payment granted under the provisions of section 6161(a)(2) or (b)(2) or under the provisions of section 6163 or 6166.

III.B.5.d.iii. *Graegin* Loans

III.B.5.d.iii.(a). *Graegin* Loans: Tax Issues

In Rev. Rul. 84-75, the IRS ruled:

- If a loan is obtained to avoid a forced sale of assets, the loan is reasonably and necessarily incurred in administering the estate. Therefore, interest incurred on the loan is deductible as an expense of administration under Code § 2053(a)(2).[5403]

- However, in situations where the estate's obligation to make installment payments may be accelerated, the amount of future interest that will be paid is indefinite because a premature repayment will stop the accrual of interest. Therefore, for purposes of Code § 2053, a deduction is not allowable for the estimated amount of interest that will accrue upon funds borrowed by an executor on behalf of an estate to pay the federal estate tax if repayment of the loan could be accelerated. The interest is deductible as an administrative expense only to the extent it has accrued.

In *Estate of Graegin v. Commissioner*,[5404] a related corporation loaned money to the estate to pay estate tax, because the estate did not have sufficient liquidity to pay estate tax. It was a balloon note, payable in 15 years, which was the decedent's widow's life expectancy. The loan was not prepayable, so the Tax Court allowed the estate to deduct the entire 15-years' interest, which was payable at the then-15% prime rate. This resulted in a tremendous estate tax saving. The downside is that, during estate administration, the family member lender has interest income and the estate cannot deduct the interest for income tax purposes (because it was already deducted for estate tax purposes).[5405]

A year later, the IRS said that it will challenge deductions for balloon payments:[5406]

[5402] *U.S. v. Godley, Jr.*, 116 A.F.T.R.2d 2015-6302 (D. N.C. 2015).

[5403] A paper by Steve Akers and Phil Hayes of Bessemer Trust pointed out: Various cases have permitted deduction of interest on amounts borrowed to pay federal estate tax, in situations where the loan was necessary to avoid a forced sale of assets, citing *Estate of Todd v. Commissioner*, 57 T.C. 288 (1971), *acq.* 1973-2 C.B. 4; *Estate of Sturgis v. Commissioner*, T.C. Memo. 1987-415; *Hipp v. United States*, 1972-1 U.S.T.C. ¶12824 (D. S.C. 1971); *Estate of Webster v. Commissioner*, 65 T.C. 968 (1976); *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477; *Estate of Huntington v. Commissioner*, 36 B.T.A. 698, 726 (1937).

[5404] T.C. Memo. 1988-477.

[5405] Code § 642(g). If an estate incorrectly deducts the interest for income tax purposes after deducting it for estate tax purposes, that's an income tax issue that does not affect the estate tax deduction. *Estate of Stick v. Commissione*r, T.C. Memo 2010-192.

[5406] Litigation Guideline Memorandum TL-65 (1989). CC 2017-001 obsoleted all LGMs but stated:

> While LGMs are no longer directly applicable to cases handled by Chief Counsel attorneys, they can serve as useful research tools and historical records of positions previously taken by the Office of Chief Counsel on issues in litigation. Redacted versions of LGMs remain publicly available on commercial on-line services such as Lexis and WestLaw. Attorneys seeking current guidance on issues that were previously the subject of an LGM should determine whether updated guidance has been provided in the form of a Chief Counsel Notice or other Chief Counsel work products, or request formal or

- when there is doubt as to the bona fide nature of the indebtedness,

- where the liability for interest is not certain or for a reasonably estimable amount, or

- when a convincing argument can be made that borrowing is unnecessary.[5407]

Two 1999 Letter Rulings allowed deductions for interest for a loan from a commercial bank (the latter guaranteed by the family business), but each qualified the deduction:[5408]

> Accordingly, in view of the terms of the loan, we conclude that a deduction may be claimed on the Form 706 for the entire amount of the post-death interest expense to be incurred by the estate, provided the expense is necessarily incurred in the administration of the estate within the meaning of section 20.2053-3(a) and is allowable under local law. Whether the interest expense will be necessarily incurred in the administration of the estate is a factual determination and we are specifically not ruling on this issue.

On the other hand, Technical Advice Memorandum 200513028 disallowed deductions for interest on a loan from a family limited partnership that held marketable securities (57.6%), real property (17.5%) and personal notes on the partnership's prior sale of real estate (24.7%).

In *Estate of Murphy v. United States*,[5409] a family limited partnership was formed with approximately $91 million of restricted publicly-traded stock, of which the decedent contributed $89 million and the general partner LLC (to which the decedent contributed 49% and two children contributed the balance) contributed approximately $2 million. The estate borrowed $11 million from the partnership to pay estate tax, committing to pay $3 million of interest. The IRS claimed that the partnership's assets were includible in the estate under Code § 2036 and disallowed the interest. The court rejected both arguments and allowed the estate to deduct the interest.

In *Estate of Black v. Commissioner,*[5410] the interest on the loan was payable in a lump sum on the due date, more than 4 years from the date of the loan, and was deducted in full on the estate tax return. The court held that a loan from a limited partnership to the estate was not "necessarily incurred in the administration of the decedent's estate":

> Even assuming equivalent income and distributions to partners between February 25, 2003, the date of the loan, and November 30, 2007, the purported due date for repayment of the loan, timely repayment by the borrowers of the $71 million loan principal out of partnership distributions (derived almost entirely

informal Chief Counsel advice from the Office of Associate Chief Counsel with subject matter jurisdiction over the issues.

[5407] If an estate has liquid assets sufficient to pay funeral and administration expenses, and federal and state death taxes, borrowing to pay estate tax is not necessary and therefore not deductible. *Estate of Stick v. Commissioner*, T.C. Memo 2010-192.

[5408] Letter Rulings 199903038 and 199952039.

[5409] 104 AFTR 2d 2009-7703 (D. Ark. 2009).

[5410] 133 T.C. 340 (2009). The taxpayer prevailed on the IRS' assertion Code § 2036 inclusion regarding the limited partnership, so in some ways the case was a taxpayer victory.

> from dividends on Black LP's Erie stock) was, on the date of the loan, inconceivable. Thus, the borrowers knew (or should have known) that, on the loan date, payment of the promissory note, according to its terms, could not occur without resort to Black LP's Erie stock attributable to the borrowers' class B limited partnership interests in Black LP. Our conclusion that repayment of the note necessarily would require a sale of the Erie stock attributable to the borrowers' partnership interests in Black LP is premised on the assumption that, on the date they executed the promissory note, the borrowers intended to repay the loan in full on Nov. 30, 2007. Petitioner does not argue to the contrary. He argues only that the eventual decision to refinance the loan does not alter its status as a bona fide loan.
>
> Petitioner argues that the borrowers had no right under the partnership agreement to require a distribution to them of assets (i.e., Erie stock) either as part of a pro rata distribution to partners or in partial redemption of their partnership interests. But the partnership agreement provided for the modification thereof, and a modification permitting either a pro rata distribution of Erie stock to the partners or a partial redemption of the borrowers' partnership interests would not have violated petitioner's fiduciary duties, as managing partner, to any of the partners.

Estate of Duncan v. Commissioner[5411] clarified *Black*, permitting a (formerly) revocable trust to deduct interest paid to an irrevocable trust that had identical trustees and beneficiaries. The trustees determined the interest rate by asking the corporate trustee's loan department what rate would normally be charged; the rate was above the AFR and below the prime rate. The court rejected the IRS' argument that the parties needed to negotiate the interest rate with each other, since such a negotiation would have been meaningless. The court rejected the IRS' argument that the revocable trust should have sold assets to the irrevocable trust, given their identity of interest; the court recognized that, under Illinois, the two trusts must be respected as separate, and the court refused to require a sale at the discount that would have been required. In refusing to require a sale, the court distinguished *Black*:

> [In *Black*, we] did not hold that the loan was unnecessary because the estate could have sold stock. We held the loan was unnecessary because the estate would have had to sell the stock under any circumstance. The sale of the stock was inevitable, and the estate therefore could not have entered into the loan for the purpose of avoiding that sale.

Similarly, the court rejected the IRS' argument that the parties could get together and agree to prepay the note that, by its terms, was not prepayable; again, the party that had the benefit of an interest rate above or below prevailing rates would not want to give up that benefit.

In *Keller v. United States*,[5412] a family limited partnership was formed with approximately $250 million in bonds. The estate borrowed from the partnership to pay federal estate taxes, Texas inheritance taxes, and other debts and obligations arising from the

[5411] T.C. Memo. 2011-255. Carol Harrington represented the taxpayer.
[5412] 104 AFTR.2d 2009-6015 (S.D. Texas 2009).

partnership. The note totaled $114 million and was due approximately 8-9 years from the date the estate tax return was filed, with 5% interest. The interest payments made on the note amounted to approximately $30 million, were paid to the partnership, reported as income to the partnership, passed through to its owners, each of whom paid income tax on such amounts. The IRS claimed that the partnership's assets were includible in the estate under Code § 2036 and disallowed the interest. The court rejected both arguments and allowed the estate to deduct the interest.

In affirming the District Court, the Fifth Circuit held:[5413]

> Disregarding the Estate's remaining illiquid assets, the Government instead re-urges that the loan between the FLP and the Estate could have been characterized another way, *e.g.*, as a distribution, rendering the loan (and its interest) "unnecessary." This position, as just noted, takes *Black* too far. The Government also contends that the Estate's and FLP's common control between related entities renders any potential economic distinctions between the Estate and FLP as well as the chosen financing structure little more than a legal pretense or an indirect use. What this ignores is that after the effective transfer of the Community Property bonds to the FLP, they were no longer property of the Estate. The Estate, having realized it improperly disposed of bonds belonging to another legal entity (the FLP was actually controlled by other family members), was forced to rectify its mistake using the assets it had available — largely illiquid land and mineral holdings. In lieu of liquidating these holdings, it borrowed from the FLP. As did *Graegin*, we refuse to collapse the Estate and FLP to functionally the same entity simply because they share substantial (though not complete) common control. The district court correctly permitted a deduction for the interest on the resulting loan.

Finally, if the beneficiaries have cash sufficient to pay the interest while the estate is looking for an unrelated buyer, the estate could avoid the *Graegin* controversy and sell enough of the illiquid assets to the beneficiaries to pay the interest. One might need to place the illiquid assets in an LLC first, so that the trustee can continue to control the sale of the underlying assets; the LLC idea would not work with an S corporation, but selling nonvoting stock to the beneficiaries and having a binding shareholders' agreement would probably be sufficient to address the control concern.

Koons v. Commissioner[5414] involved what appears to be a greedy taxpayer. In 2006, an LLC owned over 70% by the decedent's revocable trust loaned the trust $10,750,000 in exchange for a term promissory note in the principal amount of $10,750,000 at 9.5% per year interest with principal and interest due in 14 equal installments of approximately $5.9 million each between 2024 and 2031 (note the 18-year deferral of any payments). The terms of the loan prohibited prepayment. The total interest component of the 14 installments was $71,419,497. The proceeds of the loan were used to make a payment toward the estate and gift tax liabilities, and the taxpayer attempted to deduct the interest. The court held that the trust would need to use LLC distributions to repay the loan and the loan would unduly prolong estate administration, so there was no point to

[5413] 110 AFTR.2d 2012-5312 (5th Cir. 2012).
[5414] T.C. Memo. 2013-94.

loaning the money instead of distributing it. In affirming, the Eleventh Circuit summarized the *Graegin* line of cases:[5415]

> Interest payments are not necessary expenses where: (1) the entity from which the estate obtained the loan has sufficient liquid assets that the estate can use to pay the tax liability in the first instance; and (2) the estate lacked other assets such that it would be required to eventually resort to those liquid assets to repay the loan.

A few other cases have addressed deductions for borrowing from related parties to pay estate tax.[5416]

From a tax-planning perspective, the point to a *Graegin* loan is to obtain an immediate estate tax deduction for the entire amount of interest to be paid, without any discounting for the time value of money. Note that the interest on a *Graegin* note is taxable income, and an income tax deduction would not be allowed because the interest was used to pay taxes, making it nondeductible personal interest (although it might be considered an administration expense). The income tax deferral, compared to the immediate estate tax benefit, is what makes it attractive. On the other hand, federal and state income tax rates in the year of repayment might exceed the estate tax rate. If the interest deduction is disallowed on the estate tax return, then the lender is stuck with ordinary income with the possibility of no offsetting deduction. A *Graegin* loan might very well draw an audit and a court date, as the IRS continues to litigate these cases.

Before doing a seller-financed *Graegin* loan, consider looking for one from a bank. The lack of an intra-family transaction should reduce exposure. If one then decides that a seller-financed *Graegin* loan is desirable, one can document the reasons relative to the potential bank loan that was rejected.

III.B.5.d.iii.(b). *Graegin* Loans: Using a Bank

Except for home mortgages and certain other transactions, banks tend to avoid fixed rate loans.

[5415] 119 A.F.T.R.2d 2017-1609 (11th Cir. 4/27/2017).

[5416] *Estate of Kahanic v. Commissioner*, T.C. Memo. 2012-81 (loan by surviving spouse when estate had sufficient assets to pay tax, but they were illiquid, and lender refrained from collecting until after estate tax proceedings were concluded); *Beat v. U.S.*, 107 A.F.T.R.2d 2011-1804 (D.C. Kan.) (IRS did not object to deduction of future interest on *Graegin* loan when summary judgment was ruled upon; when it later noticed its omission, its appeal to the court was rejected rather summarily, the court holding that the loan was necessary and beneficial to the Estate); *McKee v. Commissioner*, T.C. Memo. 1996-362 (It is not our province, and we are not prepared, to second guess the business judgments of the executors, for the executors have not been shown to have acted other than in the best interests of the estate. We believe that the executors' decision not to make a section 6166 election was prudent because, among other reasons, the estate benefited from increases in value to the Company stock and, consequently, decedent's estate was in a better situation to face contingencies such as an increased estate or gift tax liability. These loans allowed the estate to pay its Federal estate obligation in full shortly after decedent's death.); *Estate of Thompson v. Commissioner*, T.C. Memo. 1998-325 (the regulations under section 2053 do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary.).

If one encounters that, consider obtaining an interest rate swap contract that allows the estate's overall interest obligation to be fixed and locked in during the desired term.[5417]

III.B.5.d.iv. Federal Estate Tax Liens

The discussion on liens below focuses on liens that are placed on transfers. Not covered below is the effect of a federal tax lien against a beneficiary on the beneficiary's interest in the trust, which might very well disrupt trust administration in a big way.[5418]

5417 See our Firm File Manager internal electronic files for client 5586/47287, which have a separate folder for the loan. Those would need to be sanitized before providing them externally.

5418 Camp, Protecting Trust Assets from the Federal Tax Lien, *Estate Planning & Community Property Law Journal*, Vol. 1, p. 295, 2009, Texas Tech Law School Research Paper No. 2010-09, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1424666&http://www.actec.org/private/committees/ShowMinutes.asp?MinID=748. *Duckett v. Enomoto*, 117 A.F.T.R.2d 2016-1358 (D. AZ 2016), held that a federal tax lien attached to the following beneficial interest:

> The Trustee shall pay to DENNIS MASAKI ENOMOTO so much or all of the net income and principal of the trust as in the sole discretion of the Trustee may be required for support in the beneficiary's accustomed manner of living, for medical, dental, hospital, and nursing expenses, or for reasonable expenses of education, including study at college and graduate levels. Any income not so paid shall be accumulated and added to the principal of such trust at the end of the trust's tax year. In the Trustee's sole discretion and to the extent the Trustee deems advisable, the Trustee may consider or disregard the funds available to the beneficiary from other sources or the duty of anyone to support the beneficiary. Should the principal of the trust drop below $10,000, the Trustee shall distribute the balance of the principal, together with the undistributed income therefrom to DENNIS MASAKI ENOMOTO.

The case considered various possible beneficial interests. Footnote 1 suggested:

> For a more thorough discussion of beneficiary rights in trust assets for purposes of the federal tax lien, see 4 William D. Elliott, *Federal Tax Collections, Liens & Levies* ¶ 9.09[3][j] (2016 update) and sources cited therein.

Determining his bundle of rights:

> Trusts of this nature—directing payment under a general standard while leaving specific calculations to the trustee—are sometimes referred to as discretionary support trusts or hybrid trusts. *See* Evelyn Ginsberg Abravanel, *Discretionary Support Trusts*, 68 Iowa L. Rev. 273, 277-80 (1983). As with traditional support trusts, the trustee must pay Dr. Enomoto in accordance with an ascertainable standard. But as with traditional discretionary trusts, the trustee's determination of exactly how much payment is required is reviewable only for abuse of discretion. The result is essentially a traditional support trust, but with deferential judicial review. That is, a trustee applying the payment standard in Ms. Enomoto's testamentary trust has more leeway than a trustee applying the equivalent standard in a traditional support trust. *See id.* at 290. Thus, Dr. Enomoto's right to the trust funds is a *right to payments the withholding of which would constitute an abuse of discretion in applying an ascertainable standard*.

Although state laws might indicate that an interest in a trust is not a property interest because they want to avoid creditor attachment, this court reasoned:

> The question whether a state-law right constitutes 'property' or 'rights to property' is a matter of federal law. *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 727 (1985). The statute itself provides little guidance on the matter. It merely imposes a lien on all property and rights to property, whether real or personal, belonging to the delinquent taxpayer. 26 U.S.C. § 6321. It does not define the terms property or rights to property.

….

The Supreme Court has provided some limited direction. In determining whether a federal taxpayer's state-law rights constitute 'property' or 'rights to property,' '[t]he important consideration is the breadth of the control the [taxpayer] could exercise over the property.' *Drye v. United States*, 528 U.S. 49, 61 (1999) (quoting *Morgan v. Com'r of Internal Revenue*, 309 U.S. 78, 83 (1940)) (alterations in original).

The court held:

… although Dr. Enomoto is the trust's sole beneficiary, the parties have not adequately briefed the trust consequences of his death[4] and the trust does not permit him to unilaterally terminate the trust and retain all assets. Therefore it is less clear whether Dr. Enomoto's right extends to all the trust funds.

[4] The only relevant assertion from either party is a sentence in Dr. Enomoto's Reply brief: Pursuant to A.R.S. § 14-2604(A), at Dr. Enomoto's decease, the remaining Trust assets would pour back into the residuary under the Will, to be distributed to the other two beneficiaries (Dr. Enomoto's sisters). (Doc. 74 at 4.) The sentence is not followed by any citation to authority.

For this reason, the IRS' summary judgment motion will be (1) granted to the extent it seeks a judgment that the federal tax lien attaches to Dr. Enomoto's right to the trust funds but (2) denied without prejudice to the extent it seeks a transfer of those funds to the United States. More evidence would be necessary to justify the latter conclusion. *See Taylor*, 254 F.Supp. At 758 (allowing additional hearings or proceedings to effectuate foreclosure of federal tax lien); *accord Magavern*, 415 F.Supp. at 221 (holding federal tax levy valid but stating determination of the actual amount of trust income and/or principal reached by the levy must await trial).

Admittedly, this outcome is somewhat unsatisfactory. Both parties have advanced simpler, more practicable positions: the IRS says it is entitled to all the trust funds, and Dr. Enomoto says it is not entitled to any. But both of these positions oversimplify the facts and the law. In reality, Dr. Enomoto's right to the trust funds gives him enough control to trigger tax lien attachment, but it is too circumstance-dependent to allow enforcement of the lien as to any specific amount on the current record.

The IRS asked the court to amend its judgment in light of the court's comments about the consequences of death not having been adequately briefed, but in an order dated June 6, 2016 (docket no. CV-14-01771-PHX-NVW), the court rejected the request, saying, The mention of inadequate briefing was not an invitation for more briefing, any more than a D on a student's report card is an invitation for extra-credit work. However, the court appeared receptive to additional enforcement action:

On the last page of its reply in support of its present motion, the IRS refers to evidence of Dr. Enomoto's current needs and living demands. (Doc. 100 at 11.) This is a step in the right direction. As the Court noted in its judgment, the IRS's lien is enforceable as to the amount to which [Dr.] Enomoto's right extends, i.e., the amount the trustee's withholding of which would be an abuse of discretion in applying the trust's standard of payment. (Doc. 96 at 1.) Evidence of Dr. Enomoto's overall financial situation is the sort of evidence that might show that the trustee's withholding of payment would be an abuse of discretion. Such evidence might support a separate motion to order one or more distributions to the United States. (*Id.* at 2.) That motion would be a motion to enforce the judgment, not a motion to alter or amend the judgment.

Note that the Arizona statute, http://www.azleg.state.az.us/FormatDocument.asp?inDoc=/ars/14/10504.htm&Title=14&DocType=ARS, states that a creditor may not compel distribution that is subject to a trustee's discretion but does not state that a beneficial interest does not constitute an interest in property or an enforceable right. Whether a federal court would respect the latter declaration or would disregard it and look to the beneficiary's rights was not discussed.

In an earlier iteration of the case, 116 A.F.T.R.2d 2015-6788, the IRS asked the court to attach funds in an estate before the estate had distributed them to the testamentary trust in which the debtor had an interest. The court refused, because the testamentary trust had not yet been funded (emphasis in the original):

> The IRS summary judgment motion does not fully appreciate the fact that the funds are not yet held in trust. Instead, the IRS claims this case is on point with *United States v. Delano*, 182 F.Supp.2d 1020, 1023 (D. Colo. 2001). (Doc. 48 at 11.) But the issue in *Delano* was whether a testamentary trust beneficiary's interest in the trust constituted property for federal tax purposes. 182 F.Supp.2d at 1021. Here, the issue is whether a testamentary trust beneficiary's interest in funds *designated to the trust but held by the personal representative* constitutes property for federal tax purposes. Whatever Dr. Enomoto's interest in the Trust, it does not extend to funds outside the Trust.

Delano, also found at 88 A.F.T.R.2d 2001-7071, found an interest in a discretionary trust:

> The court rejects the argument that the sole and absolute discretion given the Co-Trustees permits discretion to make no payments. See Co Trustees' Mot. At 5. In this trust instrument, the word shall directly precedes the word pay while the sole and absolute discretion follows so much of the income or principal, or both. Accordingly, the court concludes that the settlor intended the trustees' discretion to relate only to the amount of the payment and whether it came from trust income, principal, or both. The court finds nothing in this interpretation which is either internally inconsistent or contrary to law or public policy. Furthermore, this interpretation is in accord with the construction applied by other courts. See *Magavern v. United States*, 550 F.2d 797, 801 (2nd Cir. 1977) (concluding that the language Trustee shall pay over or use, apply and expend whatever part or all of the net income or principal creates a property right, not a discretionary trust, because it does not give [the trustee] the authority to deny a particular beneficiary anything at all); *La Salle Nat'l Bank v. United States*, 636 F.Supp 874, 876 (N.D. Ill. 1986) (concluding that the word shall indicated the settlor's intent that the trustee was obligated to pay); *United States v. Taylor*, 254 F.Supp. 752, 755-56 (N.D. Cal. 1966)(determining that the discretionary language related only to the trustees' determination of the amounts to be payed); *State ex rel. Sec'y of Soc. Rehab. & Servs. v. Jackson*, 822 P.2d 1033, 1038-39 (Kan. 1991) (concluding that the instrument which contained both mandatory and discretionary language did not create a discretionary trust because the mandatory language controlled the distribution and the discretionary language controlled only the amount and timing of the payments).
>
> The Co-Trustees further argue that when discretion is tied to a determination of need, a trustee may, in his discretion, determine that no funds are needed. See *Myers v. Kansas Dep't of Soc. & Rehab. Servs.*, 866 P.2d 1052, 1057 (Kan. 1994) (determining that where disbursement is tied to a discretionary determination of need, the trustee has no duty to pay a specific sum or any sum at all). And see *Texas Commerce Bank Nat'l Ass'n v. United States*, 908 F.Supp 453, 458-59 (S.D. Tx 1995) (interpreting similar language as creating a discretionary trust). Although the court finds the *Myers* analysis compelling, the court is not persuaded that Anna Delano intended her trust provision be so construed. The language of the Anna Delano Trust is distinguishable from the trust in *Myers* in two important ways. First, the Anna Delano Trust expressly authorizes the Trustee to disregard the beneficiary's financial need. See Will at Art. IV 4.2(a) (My Trustee may, but need not, consider all funds known to my Trustee to be available to him.) (Ex. A to Co-Trustees' Mot.) Based upon this language and the entire will instrument, the court concludes that Anna Delano did not intend her Trustee to withhold all payments if he determined that the beneficiary did not need the funds. Second, the court notes that the *Myers* Trustee was an independent professional entity. Where, as here, the settler names the sole beneficiary as Co-Trustee, it is far less compelling that a discretionary determination of need would result in no payment at all. *Cf. Jones*, 812 P.2d at 1156-57 (reasoning that a beneficiary's satisfaction is highly speculative because he can not force the trustee to pay income or principal); *Texas Commerce Bank Nat'l Ass'n*, 908 F. Supp. at 458 (finding a pure discretionary trust based on the reasoning that where property is given to trustees to be applied, in their discretion, to the use of a third person, no interest

The Internal Revenue Manual provides guidance to its personnel about liens, Part 5, Collecting Process, found at https://www.irs.gov/irm/part5/index.html, which includes subpart 5.5, Decedent Estates and Estate Taxes, including:

- 5.5.8 Estate Tax Liens, found at https://www.irs.gov/irm/part5/irm_05-005-008.html (last revised June 1, 2010 when I checked November 30, 2016).

- 5.5.9 Administrative and Judicial Actions for Estate Taxes, found at https://www.irs.gov/irm/part5/irm_05-005-009.html (last revised September 16, 2013 when I checked November 30, 2016).

The concepts of "nominee", "transferee", and "alter ego" are independent bases for attaching the property of a third party in satisfaction of a delinquent taxpayer's liability.[5419] If the government asserts that a trust in which the settlor had no legal rights

goes to the third person until the trustees have exercised this discretion) (emphasis added). Where a Trustee exercises discretion for his own benefit rather than that of a third party, the beneficiary's satisfaction is no longer highly speculative.

[5419] *Oxford Capital Corp. v. U.S.*, 211 F.3d 280 (5th Cir. 2000), explaining:

A nominee theory involves the determination of the true beneficial ownership of property. An alter ego theory focuses more on those facts associated with a piercing the corporate veil analysis. In contrast, a transferee theory requires (1) an intent to defraud the Internal Revenue Service as a creditor or (2) a transfer without consideration which rendered the taxpayer insolvent. These issues are fact-intensive and involve imprecise legal rules. William D. Elliot, *Federal Tax Collections, Liens and Levies* 6 9.10[2] (2nd Ed. 2000). Specific property in which a third person has legal title may be levied upon as a nominee of the taxpayer if the taxpayer in fact has beneficial ownership of the property. See, *e.g.*, *Towe Antique Ford Foundation v. Internal Revenue Service*, 791 F.Supp. 1450, 1454 (D. Mont. 1992), *aff'd* w/o opinion, 999 F.2d 1387 (9th Cir. 1993).[2] Under the alter ego doctrine, however, all the assets of an alter ego corporation may be levied upon to satisfy the tax liabilities of a delinquent taxpayer-shareholder if the separate corporate identity is merely a sham, i.e., it does not exist independent of its controlling shareholder and that it was established for no reasonable business purpose or for fraudulent purposes. See *United States v. Jon-T Chemicals*, 768 F.2d 686 (5th Cir. 1985).[3] Cause to believe that a third party is holding particular property of the taxpayer as a nominee, without cause to believe alter ego status, justifies a levy upon the property of the third party only with respect to that specific property held as a nominee.

[2] The court in *Towe* listed the following factors that are generally considered in determining nominee status: (a) No consideration or inadequate consideration paid by the nominee; (b) Property placed in the name of the nominee in anticipation of a suit or occurrence of liabilities while the transferor continues to exercise control over the property; (c) Close relationship between transferor and the nominee; (d) Failure to record conveyance; (e) Retention of possession by the transferor; and (f) Continued enjoyment by the transferor of benefits of the transferred property. *Towe Antique Ford Foundation*, 791 F.Supp. at 1454 (citing *United States v. Miller Bros. Constr. Co.*, 505 F.2d 1031 (10th Cir. 1974)).

[3] While adopting a totality of the circumstances test, this circuit has developed a non-exhaustive list of factors to consider: (1) the parent and subsidiary have common stock ownership; (2) the parent and subsidiary have common directors or officers; (3) the parent and subsidiary have common business departments; (4) the parent and subsidiary file consolidated financial statements; (5) the parent finances the subsidiary; (6) the parent caused the incorporation of the subsidiary; (7) the subsidiary operated with grossly inadequate capital; (8) the parent pays salaries and other expenses of subsidiary; (9) the

was really a nominee for the settlor, the nominee issues– "the taxpayer has engaged in a legal fiction by placing legal title to property in the hands of a third party while actually retaining some or all of the benefits of true ownership" - is a question of fact, especially where the trust lacked a bank account, the settlor paid expenses from his personal account, and the settlor used the trust's property.[5420] The nominee theory applies when a debtor transfers his residence to a joint revocable trust.[5421]

For more information, see "The Devil is in the Details: Important Tax Administration and Procedural Rules for Estate Planners," Chapter 9 of the 2015 Heckerling Institute on Estate Planning,[5422] as well as a 2009 law review article on tax liens' applications to trusts,[5423] an AICPA Tax Section presentation April 30, 2015,[5424] and the IRS' web page.[5425]

III.B.5.d.iv.(a). Imposition of the Estate Tax Lien

The estate tax lien has some surprising aspects that affect not only probate and trust lawyers but also real property lawyers who represent buyers of property subject to this (generally unrecorded) lien. These surprises extend to lenders who rely on such property as collateral.

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subsidiary receives no business except that given by the parent; (10) the parent uses the subsidiary's property as its own; (11) the daily operations of the two corporations are not kept separate; (12) the subsidiary does not observe corporate formalities. See *Century Hotels*, 952 F.2d at 110 n.5 (5th Cir. 1992).

Fourth Inv. LP v. United States, 720 F.3d 1058, 1069–70 (9th Cir. 2013) provides the following factors for nominee status:

(1) whether inadequate or no consideration was paid by the nominees;
(2) whether the properties were placed in the nominees' names in anticipation of a lawsuit or other liability while the transferor remains in control of the property;
(3) whether there is a close relationship between the nominees and the transferor;
(4) failure to record the conveyances;
(5) whether the transferor retained possession; and
(6) whether the transferor continues to enjoy the benefits of the transferred property.

U.S. v. Acacia Corporate Management, LLC, 119 A.F.T.R.2d 2017-1931 (9th Cir. 5/23/2017), confirmed that the Ninth Circuit still uses that test.

5420 *U.S. v. Kimball, Jr.*, 117 A.F.T.R.2d 2016-2234 (D. Me. 6/24/2016). The court was looking to applicable local law – that of Maine. The quote was the court quoting *Berkshire Bank v. Town of Ludlow*, 708 F.3d 249, 254 (1st Cir. 2013), which in turn was quoting *Holman v. United States*, 505 F.3d 1060, 1067-68 (10th Cir. 2007). The court further said that the nominee issue is fact-intensive and involves the totality of the circumstances, quoting *Dalton v. Commissioner*, 682 F.3d 149, 158 (1st Cir. 2012).

5421 *U.S. v. Peeler*, 118 A.F.T.R.2d 2016-XXXX (D. MS 11/29/2016), citing *Oxford Capital* (fn. 5419).

5422 See Thompson Coburn LLP document number 6141610.

5423 Much of this is from Gorin and Reynolds, Estate Tax Liens: The Surprising Truth That Estate Planning and Real Estate Lawyers Often Ignore, *Probate & Property* (January/February 2007). Jonathan Blattmachr made some useful suggestions when we wrote the article, including referring to the Code § 6324 lien as the secret estate tax lien.

5424 See http://www.aicpa.org/InterestAreas/Tax/CPEAndEvents/DownloadableDocuments/2015-04-30-Advanced-Tax-Quarterly-Understanding-the-IRS-IRM-and-Collection-Process-Presentation-Slides.pdf, which is saved as Thompson Coburn LLP document number 6174129.

5425 Understanding a Federal Tax Lien, found at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Understanding-a-Federal-Tax-Lien.

If assets pass on a person's death and are included in the decedent's gross estate for federal estate tax purposes ("included property"), and the total of the included property (that is, the gross estate), reduced by certain debts, expenses, and losses, exceeds a threshold, federal estate tax is required to be paid within nine months of the decedent's death. To ensure that the entire estate tax is paid, Code § 6324(a) provides for an estate tax lien on the included property for 10 years after the decedent's death. The lien automatically attaches to all included property not used to pay charges against the estate and its administrative expenses.[5426]

More important, this estate tax lien need not be recorded to be effective and enforceable, and no record need be kept of an estate tax lien's release.[5427] This estate tax lien (sometimes called the "secret estate tax lien") differs from the Code § 6321 general tax lien. The general tax lien attaches only when the taxpayer neglects or refuses to pay tax after demand.[5428] The general tax lien arises on assessment and is

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[5426] A similar lien applies for gift tax purposes, Code § 6324(b), capping the principal of the donee's liability at the value of the gift. The donee is also liable for interest, which the Eleventh Circuit says is not capped at the gift's value but the Third, Fifth, and Eighth Circuits say is capped at the gift's value. *U.S. v. Marshall*, 798 F.3d 296 (5th Cir. 2015); *Baptiste v. Commissioner*, 29 F.3d 1533 (11th Cir. 1994), *Baptiste v. Commissioner*, 29 F.3d 433 (8th Cir. 1994), and *Poinier v. Commissioner*, 858 F.2d 917 (3rd Cir. 1988). *Marshall* also held that the gift tax lien applies to the income beneficiary but not the remaindermen. Code § 6324(b) uses different language than Code § 6324(a), the latter imposing a lien on the trustee, not the beneficiaries.

[5427] Internal Revenue Manual § 5.5.8, Estate Tax Liens.

[5428] Reg. § 301.6321-1. The priority of Code § 6321 lien is discussed by Freyermuth, Does a Federal Tax Lien Take Priority over a Mortgagee's Lien on Rents? *Bloomfield State Bank v. United States*, *Probate & Property* (p. 58, Sept./Oct. 2011); the case is at 644 F.3d 521 (7th Cir. 2011). Code § 6321 imposes a lien upon all property and rights to property, whether real or personal, belonging to the taxpayer. A disclaimer cannot frustrate this lien. *Drye v. U.S.*, 528 U.S. 49 (1999), which included a far-reaching footnote 7:

> In recognizing that state-law rights that have pecuniary value and are transferable fall within § 6321, we do not mean to suggest that transferability is essential to the existence of property or rights to property under that section. For example, although we do not here decide the matter, we note that an interest in a spendthrift trust has been held to constitute 'property' for purposes of § 6321 even though the beneficiary may not transfer that interest to third parties. See *Bank One*, 80 F.3d, at 176. Nor do we mean to suggest that an expectancy that has pecuniary value and is transferable under state law would fall within § 6321 prior to the time it ripens into a present estate.

Code § 6321 also reaches assets held as tenants by the entirety, *U.S. v. Craft*, 535 U.S. 274 (2002); Notice 2003-60 explains how the IRS enforces liens in light of *Craft*. Update on *Craft* and Litigation of Tenancy by Entirety Property, presented at the ABA Tax/RPTE 2014 Joint Fall Meeting, explained that, on foreclosure of TBE property to satisfy a tax lien, generally the sale proceeds are divided evenly, but the non-debtor spouse can argue that TBE gave her the right to use the property for the rest of her life and that she should obtain a settlement based on actuarial values; see Thompson Coburn LLP document no. 6091970.

Whether the tax lien would automatically be extinguished when the debtor dies is a matter of state law. *NPA Associates, LLC, v. Estate of Cunning*, 114 A.F.T.R.2d 2014-6400 (D. V.I. 2014) (lien extinguished); *U.S. v. Mattox*, 113 A.F.T.R.2d 2014-444 (E.D. Wis.) (lien continued).

For more on foreclosure when more than one person has an interest, see part III.B.3.c.iv Effect of Liens on Dealings with Third Parties, especially fn. 5471.

The lien may also attach to both halves of community property. See Code § 66 and *U.S. v. Smith*, 117 A.F.T.R.2d 2016-663 (D. Wash. 2016). In *U.S. v. McGrew*, 118 A.F.T.R.2d 2016-

effective until the assessed taxes are paid or the lien becomes unenforceable because of a lapse of time.[5429] The IRS is required to give notice and an opportunity for a hearing.[5430] In contrast, the secret estate tax lien need not be recorded and the estate need not be given notice; therefore, an executor or other persons receiving included property, either by sale, distribution, or other transfer, might not be aware that an estate tax lien exists. On the other hand, administrative expenses, being enumerated as an exception to a Code § 6324(a) lien but not a Code § 6321 lien, are subject to the Code § 6321 lien, even if arising before the Code § 6321 lien was imposed.[5431]

Also, if the estate does not have the capacity to pay the estate tax or for other reasons would like to delay payment of the tax, the executor may request an extension under Code § 6161 by filing IRS Form 4768. This extension is granted for reasonable cause for an initial period of 12 months, but additional 12-month extension requests can be granted for up to 10 years. If the estate has an interest in a closely held business and the interest exceeds 35% of the adjusted gross estate, the estate may elect to pay the estate tax on such business in installments under Code § 6166. Section 6166 extensions may lead to liens recorded under Code § 6324A.

In any event, consider that an executor who distributes assets before all tax liabilities of the estate (or includible trust) are satisfied, the executor may be personally liable for paying the estate tax.[5432]

6149 (9th Cir. 10/17/2016), the IRS was able to satisfy ex-husband's tax debt by foreclosing on community property awarded to wife in their divorce:

> McGrew asserts that the liens which the United States seeks to foreclose do not cover the residence at this time. We disagree. The residence was the community property of McGrew and Kenneth, although it is now hers alone. In general, the whole of the community estate is liable for a debt incurred by either spouse before or during marriage. Cal. Fam. Code § 910(a); see also *Lezine v. Sec. Pac. Fin. Servs., Inc.*, 14 Cal.4th 56, 63–64, 925 P.2d 1002, 1006, 58 Cal. Rptr.2d 76, 80 (1996). That means that the community estate is liable for debts incurred by either spouse for the period preceding their separation. See Cal. Fam. Code § 910(b); *McIntyre v. United States* (*In re McIntyre*), 222 F.3d 655, 658 (9th Cir. 2000); *Babb v. Schmidt*, 496 F.2d 957, 959–60 (9th Cir. 1974).

The lien applies only to property rights at the time this tax lien becomes effective. If the debtor transferred property before the lien became effective, the government cannot enforce the lien against that property unless the government first obtains a judgment that the conveyance constituted a fraudulent transfer under applicable state law. *U.S. v. Baker*, 114 A.F.T.R.2d 2014-6158 (D.C. N.H. 2014) (under local law, divorce decree transferred all of the transferor's rights to the subject real estate). In *Baker*, the government complained that the transferor had not recorded the deed before the Code § 6321 lien was filed. Citing a First Circuit case, the court held that:

> any effect that an unrecorded property transfer has on a subsequent bona fide purchaser or creditor has no bearing on whether a grantor retains any rights to property previously conveyed for purposes of 26 U.S.C. § 6321.

The judge later awarded attorney fees to the taxpayer, holding that the government had no justification for its position. 115 A.F.T.R.2d 2015-379 (D.C. N.H. 2015).

[5429] Code § 6322.

[5430] Code § 6320.

[5431] *U.S. v. Spoor*, 118 A.F.T.R.2d 2016-6018 (11th Cir. 10/4/2016).

[5432] See fn. 5446.

III.B.5.d.iv.(b). Exceptions to the Estate Tax Lien

A lien will not apply the following types of purchasers or transactions:[5433]

- a purchaser of stock, bonds, or other securities who had no actual notice or knowledge of the lien at the time of the purchase;
- a purchaser of a motor vehicle who has no actual notice or knowledge of the lien at the time of the purchase and taking possession;
- a purchaser of tangible personal property sold at retail in the ordinary course of business (which might be relevant to an executor who continues to operate
- a business owned by the decedent as a sole proprietor); and
- a purchaser of household goods, personal effects, or certain other tangible personal property at a "casual sale" (and not for resale) for less than $1,000, if the purchaser has no actual notice or knowledge of the lien, or that the sale is one of a series of sales.

III.B.5.d.iv.(c). Priority of the Estate Tax Lien

Liens attaching before decedent's death have priority over the estate tax lien. The estate tax lien has priority over liens that attach to included assets after the date of death (other than liens for much personal property and certain other items excluded under Code § 6323(b)).[5434] If the estate has a Code § 6166 election in place to defer estate tax on closely held business interests, and a Code § 6324A lien is recorded, the Code § 6324A lien releases the secret estate tax lien and is subordinate to all liens that attached before the Code § 6324A lien attached.[5435] Thus, included property might be subject to liens that start out junior (or subordinate) to the secret estate tax lien but are senior (that is, take priority) to the Code § 6324A lien.

However, the Code § 6324A lien is subject to the following liens, even if they would otherwise be junior to the Code § 6324A lien:[5436]

(A) Certain real property tax and special assessment liens.[5437]

[5433] Code § 6324(c), incorporating by reference certain important exceptions found in Code § 6323(b).

[5434] However, if real estate was subject to a mortgage at the decedent's death and a bona fide purchaser buys the property after death with knowledge of the secret estate tax lien, the purchaser steps into the senior secured creditor's shoes to the extent that the purchase price discharged the senior debt, if the state law principle of equitable subrogation applies. *Spear v. U.S.*, 111 A.F.T.R.2d 2013-1064 (D. Ariz.).

[5435] See part III.B.3.c.iv Liens: Selected Internal Revenue Manual Materials.

[5436] Code § 6324A(d)(3).

[5437] Referring to Code § 6323(b)(6), which refers to:

> With respect to real property, as against a holder of a lien upon such property, if such lien is entitled under local law to priority over security interests in such property which are prior in time, and such lien secures payment of—

(B) Certain real property subject to a mechanic's lien for repairs and improvements, unless the mechanic's lien came into existence after the IRS accelerated the deferred amount under Code § 6166(g).

(C) Certain real property construction or improvement financing agreement giving rise to a security interest, whether such security interest came into existence before or after the tax lien was filed, unless the security interest came into existence after the IRS accelerated the deferred amount under Code § 6166(g).[5438]

Note that the above exceptions are more narrow than the exceptions to a Code § 6324(a) lien. Administrative expenses, being enumerated as an exception to a Code § 6324(a) lien but not a Code § 6324A lien, are subject to the Code § 6324A lien, even if arising before the Code § 6324A lien was imposed.[5439]

As described further below, the estate tax lien has a 10-year duration. After it expires, the IRS must rely on the general tax lien. The general tax lien's priority is not based on date of death; instead, its priority is based on notice required under Code § 6323. As to Code § 6323, I.R.M. 5.17.13.3(1) provides:

> The Federal Priority Statute does not apply if, before the insolvency proceeding begins, another person has obtained an interest in the property that would prevail over the federal tax lien under IRC § 6323. *United States v. Estate of Romani*, 523 U.S. 517 (1998).

(A) a tax of general application levied by any taxing authority based upon the value of such property;
(B) a special assessment imposed directly upon such property by any taxing authority, if such assessment is imposed for the purpose of defraying the cost of any public improvement; or
(C) charges for utilities or public services furnished to such property by the United States, a State or political subdivision thereof, or an instrumentality of any one or more of the foregoing.

[5438] Code§ 6323(c)(3), which provides:
For purposes of this subsection—
(A) *Definition*. The term real property construction or improvement financing agreement means an agreement to make cash disbursements to finance—
(i) the construction or improvement of real property,
(ii) a contract to construct or improve real property, or
(iii) the raising or harvesting of a farm crop or the raising of livestock or other animals.
For purposes of clause (iii), the furnishing of goods and services shall be treated as the disbursement of cash.
(B) *Limitation on qualified property*. The term qualified property, when used with respect to a real property construction or improvement financing agreement, includes only—
(i) in the case of subparagraph (A)(i), the real property with respect to which the construction or improvement has been or is to be made,
(ii) in the case of subparagraph (A)(ii) , the proceeds of the contract described therein, and
(iii) in the case of subparagraph (A)(iii), property subject to the lien imposed by section 6321 at the time of tax lien filing and the crop or the livestock or other animals referred to in subparagraph (A)(iii).

[5439] *U.S. v. Spoor*, 118 A.F.T.R.2d 2016-6018 (11th Cir. 10/4/2016).

a. If the interest of a creditor prevails over the federal tax lien under IRC § 6323(a), (b), (c), or (d), then the federal claim does not have priority over the creditor's interest.

b. Under IRC § 6323(a), the following creditors prevail unless the IRS has filed a Notice of Federal Tax Lien: (a) purchasers, (b) holders of security interests, (c) mechanic's lienors, and (d) judgment lien creditors. Generally, creditors meeting the requirements in IRC § 6323(a), (b), (c), or (d), will have a higher priority claim than the IRS if the creditor's interest arises prior to the insolvency proceeding and prior to the filing of the Notice of Federal Tax Lien. See Note, below.

c. In *Estate of Romani*, the Supreme Court held that a judgment lien creditor who recorded its liens on real property before the IRS filed its Notices of Federal Tax Lien prevailed over the IRS's tax claims in an insolvent decedent's estate case.

d. The general rule is that if the creditor would prevail against the IRS under IRC § 6323 outside of an insolvency, it will also prevail against the IRS in the insolvency.

e. Under *Estate of Romani*, many priority disputes in insolvency proceedings will be resolved by determining lien priorities under IRC § 6323.

Note: The *Romani* case applies only where the Government is relying on a claim for which a lien arose under IRC § 6321 and the competing interest is one identified in § 6323. In *Law Offices of Jonathan A. Stein v. Cadle Company*, 250 F.3d 716 (9th Cir. 2001), the Service levied the compensation of the president and CEO of an insolvent company. The company ignored the levy and continued to pay the president. The Service then sued the company to enforce the levy, and obtained a judgement under IRC § 6332(d). A third party also obtained a judgement against the company. The company then received a damages award to which the Service and the third party both claimed priority. In the ensuing interpleader proceeding, the Government claimed priority under 31 USC § 3713. The third party claimed priority by virtue of a judgement lien under IRC § 6323. The district court held for the Government under 31 USC § 3713, and the appellate court affirmed, finding that under *Romani*, the judgement lien would have priority if the United States were relying on claim for which a tax lien arose under IRC § 6321. However, in this case, the IRS did not have a federal tax lien claim against the company, so section 6323 did not apply. The Government won because section 3713 gave its claim priority over the third party's judgement lien.

In re: Estate of Frederick Alan Simmons[5440] held that, even though administrative expenses had higher priority under applicable state law, Code § 6323 did not give administrative expenses priority, so the Code § 6323 tax lien came first.

[5440] 120 A.F.T.R.2d ¶ 2017-5109 (D. IN 7/31/2017).

III.B.5.d.iv.(d). Ten-year Duration

Code § 6324(a) provides that the estate tax lien applies for 10 years from the date of death, unless estate tax is paid in full sooner or becomes unenforceable by reason of the lapse of time. Most courts follow the reasoning of *United States v. Cleavenger*,[5441] which held that litigation concerning enforceability of the lien must be completed within 10 years of the decedent's death or the IRS loses the ability to enforce the secret estate tax lien. The court held that the IRS should process a general tax lien if it wants to maintain a lien on unpaid estate taxes. Courts generally follow the *Cleavenger* case.[5442]

But, in *United States v. Saleh*,[5443] the court sharply disagreed with *Cleavenger*'s analysis of the secret estate tax lien and held that the IRS could extend the estate tax lien by suing for payment of taxes, even if that required the lien to run past the 10 years. Similarly, in *United States v. Warner*,[5444] the court reasoned that if Code § 6502, which states that an assessed tax may be collected by levy or court proceedings as long as the proceedings or levy is instituted within 10 years after the assessment, is satisfied, the IRS can enforce the lien even if the proceedings extend beyond 10 years after the decedent's death.

Thus, depending on the jurisdiction, an estate may become encumbered by the secret estate tax lien for a period well past the 10-year time frame expressed in the literal language of Code § 6324.

III.B.5.d.iv.(e). Which Estates Are Affected by the Estate Tax Lien?

Code § 6324 applies to all included property, whether passing through probate or otherwise. But whether a property is held in a probate estate or passes outside of probate is an important distinction.

<u>Probate Assets</u>

Under Code § 6324(a)(2), the estate tax lien automatically attaches to any included property that is transferred from a probate estate, whether to a beneficiary or purchaser. As a result, if a person purchases probate property that is subject to the secret estate tax lien, whether or not that person is aware of it, the purchased or transferred property is still subject to the lien in that person's possession. Moreover, as described above, the secret estate tax lien is superior to the interests of the purchaser or lender if the lender's security interest arises after the decedent's death. The government may seize the encumbered property and sell it to recover any unpaid taxes.[5445]

Under 31 U.S.C. § 3713(b), the executor of a decedent's estate is liable for paying a creditor or making a distribution before paying any claim of the U.S. government,

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[5441] 325 F.Supp. 871 (N.D. Ind. 1971), *aff'd* 517 F.2d 230 (7th Cir. 1975).

[5442] See *New England Acceptance Corp. v. United States*, 35 F.Supp.2d 53, 55–56 (D.N.H. 1997).

[5443] 514 F.Supp. 8 (D.N.J. 1980).

[5444] No. 83-CIV3717 (LBS), 1985 WL 2575 (S.D.N.Y. 9/18/1985).

[5445] Treas. Reg. § 301.63311(a).

including estate taxes, unless the payment is permitted under another federal law.[5446] The executor, however, would not be liable for a bona fide sale, because the sale proceeds are subject to the same rules.

[5446] *U.S. v. Estate of Reitano*, 114 A.F.T.R.2d 2014-5919 (D. Mass. 2014), citing *United States v. Renda*, 709 F.3d 472, 480 notes 9–10 (5th Cir. 2013), and *United States v. Coppola*, 85 F.3d 1015, 1020 (2nd Cir. 1996), held that the following three elements are required to prosecute a 31 U.S.C. § 3713(b) claim:

(1) A fiduciary of the debtor or the debtor's Estate transferred assets of the debtor or the Estate;
(2) At the time of the transfer, the debtor or the Estate was insolvent or was rendered insolvent by the transfer; and
(3) Before making the transfer, the fiduciary knew of a debt due the United States, or had notice of facts that would lead a reasonably prudent person to inquire as to the existence of such a debt.

The executor, McNicol, essentially admitted that these elements were present. The court described her defense:

> McNicol does not contest the elements, but instead argues that family allowances and funeral and administrative expenses take priority over plaintiff's claim. The trouble with this argument, however, is that the statute penalizes the transfer of the assets. Had McNicol left the assets in the estate and paid family allowances and expenses therefrom, this might be a different case.[8] But that did not happen. McNicol transferred the shares of stock to herself, and at that moment, she violated the statute. Summary judgment is proper on Count 2.[9]
>
> [8] Of course, I take no position on whether the allowances and expenses McNicol identifies do, in fact, take priority over a federal tax debt.
>
> [9] Plaintiff requests an award of prejudgment interest on McNicol's liability in Count 2, a matter which, it agrees, is left to my discretion… (citing *United States v. Golden Acres, Inc.*, 702 F.Supp. 1097, 1109 (D. Del. 1988)). I decline to award interest.

In affirming *Reitano*, *U.S. v. McNicol*, 118 A.F.T.R.2d 2016-5150 (1st Cir. 2016), *cert. denied* 1/9/2017, acknowledged that family allowances and administrative expenses may take priority over federal tax obligations but held that any such expenditures were not substantiated:

> We do not gainsay that a personal representative of an estate that is indebted to the United States for unpaid taxes may nonetheless use estate assets to defray certain types of expenses without contravening the statutory priority. The IRS itself acknowledges that there are exceptions to the priority created by section 3713(a) for family allowances and administrative expenses (such as expenses incurred for the general welfare of creditors, expenses incurred to collect and preserve assets, court costs, and funeral expenses). See *Internal Revenue Manual*, 34.4.1.7 (Aug. 11, 2004). The case law reinforces this view. See *Estate of Jenner v. C.I.R.,* 577 F.2d 1100, 1106 (7th Cir. 1978); *Schwartz v. C.I.R.*, 560 F.2d 311, 314 n.7 (8th Cir. 1977); *Abrams v. United States*, 274 F.2d 8, 12 (8th Cir. 1960).
>
> Despite this promising provenance, however, the appellant's argument for an equitable exception fails. Even if we assume that an equitable exception to the priority statute may exist — a matter on which we take no view — the appellant's prospects would not improve.
>
> As a threshold matter, the summary judgment record flatly contradicts the appellant's assertion that she transferred the stock to herself for the purpose of paying administrative expenses of the estate.

Administrative expenses, being enumerated as an exception to a Code § 6324(a) lien but not a Code § 6321 or 6324A lien, are subject to the Code § 6321 or 6324A lien, even if arising before the Code § 6321 or 6324A lien was imposed. *U.S. v. Spoor*, 118 A.F.T.R.2d 2016-6018 (11th Cir. 10/4/2016).

If an executor makes a written request to be discharged of personal liability for payment of estate taxes under Code § 2204 and the IRS does not respond within nine months or if the discharge is granted, the executor or personal representative is no longer personally responsible for payment of the tax.[5447] The release of the executor does not release the estate tax lien on the estate's assets, but the lien will not apply to property transferred to a purchaser or holder of a security interest. Instead, the lien will apply to the consideration received from the purchaser or holder.[5448]

Nonprobate Assets

Trustees of trusts included in the decedent's estate and other recipients of nonprobate included property may have personal liability under not only 31 U.S.C. § 3713(b)[5449] but also Code § 6324(a)(2).[5450] Under the latter, the estate tax lien does not continue to apply to included property that is transferred by the trustee or other recipient if the transfer is to a purchaser or holder of a security interest, but a lien is then imposed on the personal assets of the trustee or other nonprobate recipient. A recipient of includible life insurance is also liable under Code § 6324(a)(2).[5451]

Following *Coppola*, *United States v. Read*, 2016 WL 310721, 117 A.F.T.R.2d 2016-541 (D. Conn. 2016), awarded prejudgment interest from the dates on which the trustee made distributions, knowing of the tax debt to the United States.

The IRS has the burden of proving all three elements, and the fiduciary may use equitable apportionment contribution rights as assets in determining insolvency. *Singer v. Commissioner*, T.C. Memo. 2016-48.

[5447] Treas. Reg. § 20.2204-1.

[5448] Code § 6324(a)(3).

[5449] See text accompanying fn. 5502. See fn. 5446 for the requirements to make a claim under 31 U.S.C. § 3713(b).

[5450] Code § 6324(a)(2) applies to property included in the gross estate under sections 2034 to 2042. Relying on Rev. Rul. 75-553, *U.S. v. Johnson*, 118 A.F.T.R.2d 2016-6781 (D.C. UT 12/1/2016), reversing under a motion for reconsideration its prior decision under 112 A.F.T.R.2d 2013-5474 (D.C. UT), held that assets held in a revocable trust at death pass under Code § 2033, not Code §§ 2036-2038. Rev. Rul. 75-553 held that the trustee of a revocable trust, which trust passed to the grantor's estate at death, was not subject to Code § 6324(a)(2):

> Although sections 2036, 2037, and 2038 of the Code include in a decedent's gross estate the value of any interest in property transferred by the decedent, in trust or otherwise, where a life estate, reversionary interest, or power to alter, amend or revoke is retained by the decedent, these provisions of the Code do not become operative unless someone other than the decedent receives a beneficial interest in the transferred property. The transfer of property to a trustee acting as agent for the transferor, without a third party receiving any interest in the property, would not fall within the scope of sections 2036, 2037, and 2038. In the instant case the trust corpus is payable to the decedent's estate and is property of the decedent within the meaning of section 2033 and is includible in the gross estate only under that section.

Query whether a revocable trust pouring into the grantor's estate should be treated the same as a revocable trust that does not pour into the decedent's estate or a revocable trust that receives assets from the estate.

[5451] *Baptiste v. Commissioner*, 29 F.3d 1533 (11th Cir. 1994) (life insurance beneficiary liable and must pay interest), *aff'g* T.C. Memo. 1992-198 (life insurance beneficiary liable) and 100 T.C. 252 (1993) (recipient also liable for interest).

Furthermore, proceeds from the sale of included property are subject to the estate tax lien as if the proceeds were included property (a "like" lien).[5452]

III.B.5.d.iv.(f). Divestment of Lien Property and Release of Liens

A seller cannot give clear title to property encumbered by the secret estate tax lien until the lien is discharged or released. A taxpayer may request that certain property be discharged from the lien by filing IRS Form 4422[5453] with the IRS if:[5454]

- the remaining property in the estate has a value that is double the amount owed to the IRS,
- the government receives a payment equal in amount to the value of the property requested to be discharged,
- the government does not have a valuable interest in the specific property, or
- the sale proceeds are to be substituted for the discharged property.

In all of these cases, the property that is discharged is no longer subject to the secret estate tax lien. A like lien, however, may attach to any proceeds from the sale or transfer of the discharged property.

Also, Code § 6325(a) mandates that a lien must be released when:

- the liability assessed has been fully satisfied,
- the liability has become legally unenforceable (the time has expired within which the IRS can enforce the lien, for example), or
- a bond has been furnished by the payee guaranteeing payment.

If any of these conditions is met and the lien is released, the property is no longer subject to the lien. Note that, unlike the situation in which certain property has been discharged, when the estate tax lien is released under Code § 6325(a), the entire estate (not just certain items) is free of the secret estate tax lien.

Thus, if the estate tax is unpaid, generally four ways exist to divest included property of the estate tax lien even though the estate is subject to the estate tax:

- Included property that is used to pay for estate expenses and other amounts owed by the estate will not be subject to the lien.[5455]

[5452] Code § 6324(a)(2).
[5453] For the time frame for filing Form 4422, see text accompanying fn. 5461, found in part III.B.5.d.iv.(g) How to Avoid the Pitfalls of the Estate Tax Lien.
[5454] Code § 6325(b).
[5455] Code § 6324(a)(1).

- Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien, although a like lien attaches to all of the transferor's property.[5456]

- The lien is divested from included property that is probate property and has been transferred to a purchaser of probate property if the personal representative has been discharged of personal liability under Code § 2204, although a like lien attaches to the proceeds of the sale.[5457]

- Property that has been discharged under Code § 6325(a) is no longer subject to the lien.

III.B.5.d.iv.(g). How to Avoid the Pitfalls of the Estate Tax Lien

Ideally, an executor or trustee should not distribute or sell property included in the gross estate until the IRS has issued a "closing letter" stating that the estate tax has been satisfied and the matter is closed.[5458] At this point, the estate tax lien is removed if the estate tax has been paid,[5459] although no official record verifies its release.

Although it will not release the estate tax lien, an executor (and a trustee who is an executor within the meaning of Code § 2203) should ordinarily submit a written request to the IRS for an assessment of the estate tax due and to be discharged of personal liability under Code § 2204. Filing IRS Forms 4810 and 5495 will help discharge the executor from liabilities relating to not only estate tax but also gift and income tax. Although Form 5495 could also include income tax returns, that applies for purposes of Code §§ 2204, 6905 and not necessarily for purposes of 31 U.S.C. § 3713(b); filing Form 4810 lets the executor know whether any outstanding tax liabilities are owed. As to the latter, if the executor knows that some amount of tax is due, the executor needs to find out the finally determined amount of liabilities to make sure that they are paid in full;

[5456] Code § 6324(a)(2).

[5457] Code § 6324(a)(3).

[5458] Notice 2017-12 states:

> Estates and their authorized representatives may request an account transcript by filing Form 4506-T, Request for Transcript of Tax Return. Currently, Form 4506-T can be filed with the IRS via mail or facsimile (per the instructions on the form). Although account transcripts for estate tax returns are not currently available through the IRS's online Transcript Delivery System, the IRS website, www.irs.gov, will have current information should an automated method become operational. To allow time for processing the estate tax return, requests should be made no earlier than four months after filing the estate tax return.
>
> For those who wish to continue to receive estate tax closing letters, estates and their authorized representatives may call the IRS at (866) 699-4083 to request an estate tax closing letter no earlier than four months after the filing of the estate tax return.

See also https://www.irs.gov/irspup/Businesses/Small-Businesses-%26-Self-Employed/Transcripts-in-Lieu-of-Estate-Tax-Closing-Letters. However, when I checked on January 6, 2017, it did not include the information that the IRS's online Transcript Delivery System is not yet operational regarding estate tax returns.

[5459] The executor may request a duplicate receipt as an official record that an estate tax payment was made. Code § 6314(b) and Reg. § 301.6314-1. I am unaware of any form, so presumably a letter to the IRS would suffice.

the executor cannot just assume that the executor's lawyer (even one who has received all IRS notices) would let the executor know about any tax liabilities that are due.[5460]

If the estate tax has not been paid in full, included property needs to be sold, and none of the exceptions described in Code § 6323(b) will apply, the executor or trustee should request that the lien be released and applied to substituted property. IRS Publication 783 instructs us how to file IRS Form 4422 to apply for a discharge of an estate tax lien (or IRS Form 14135 for other tax liens); submit Form 4422 at least 45 days before the transaction date that the certificate of discharge is needed.[5461] As discussed above, however, the remaining assets are still encumbered by the lien.

Finally, if for compelling reasons an executor or trustee decides to make distributions before discharge or release under Code § 6325, the executor or trustee probably should seek indemnification from the beneficiaries.

III.B.5.d.iv.(h). Liens: Selected Internal Revenue Manual Materials

IRM 5.1.19.1 points out:

> [Code §] 6502 provides that the length of period for collection after assessment of a tax liability is ten years. The collection statute expiration ends the government's right to pursue collection of a liability.

IRM 5.5.7.2 explains:

> (1) The key to successfully collecting delinquent estate tax is a thorough understanding of the estate tax lien under [Code §] 6324(a)…. [T]he estate tax lien arises immediately upon the death of any United States citizen or resident, and attaches to all assets that comprise the gross estate of the decedent, i.e., those assets which must be reported on Form 706 and, the value of which on date of death, are the basis for the estate tax liability.
>
> (2) The [Code §] 6322015-65364(a) lien has an absolute life of 10 years beginning on the date of death. Although the lien may be foreclosed if accomplished within the 10-year period, no event can extend the lien. Notice of the lien cannot be recorded nor is any recording necessary in order for it to become choate. The lien has priority over all subsequent interests in the assets of the gross estate but for the exceptions detailed at IRM 5.5.8.2.

IRM 5.5.7.4(1) explains how strong the Code § 6324(a) lien is:

> The estate tax lien comes into existence upon death. No recording is necessary in order to perfect the estate tax lien, nor is recording possible since no form exists for this purpose. (See Revenue Ruling 69-23). Locally authored notices purporting to be notices of the estate tax lien should not be recorded.

[5460] *U.S. v. Shriner*, 2014 WL 992300, 113 A.F.T.R.2d 2014-1360 (D.C. MD) (holding executors liable under 31 U.S.C. § 3713(b) for making distributions before all debts owed the U.S. have been fully repaid). See fn. 5446 for the requirements to make a claim under 31 U.S.C. § 3713(b).

[5461] The time framework is from the Instructions for Completing Form 4422 (Rev. 9-2016).

When estate tax might be due, executors of probate estates cannot grant clear title when selling assets. As mentioned earlier above (but more briefly), IRM 5.5.7.5.2 provides some information that is shocking when one first learns of it:

(1) But for the exceptions detailed at IRM 5.5.8.2, probate assets distributed without having been discharged from the estate tax lien, are subject to administrative levy or seizure and/or litigation to foreclose the lien.

Example: An estate owes unpaid tax in the amount of $100,000. 5 years remain on the [Code §] 6324(a) lien. An asset check reveals that the decedent's residence, which was titled in her name at time of death and valued at $150,000, was sold 3 years after death. The purchaser obtained a mortgage for $140,000 to finance the purchase. The sale was not done at the direction of a court and the executor had not received a discharge of liability under [Code §] 2204 prior to the sale. The estate tax lien has priority over the interests of both the purchaser and the mortgagee and can be administratively seized from the purchaser and sold.

Note: This example is common. Unless the seller of the property is the estate, and sometimes even then, title insurers frequently do not consider the possibility that an unrecorded estate tax lien may be attaching to the property for which the purchaser is paying them to insure title. When title to property is conveyed by the personal representative to an heir who then sells the property, the chance that the title insurer will not recognize the presence of the lien is greatly increased. In practice, a title insurer can only indemnify itself against an unrecorded estate tax lien by performing a 10-year deed search, looking to see if an estate conveyed the property during that period. If so, the title insurer should contact the representative of the estate that conveyed the property and obtain verification that any estate tax that may have been due has been paid, or that the personal representative transferred title to an heir only after first receiving a discharge of liability. As an alternative, some title insurers have a clause in their title insurance policies excluding coverage for unrecorded liens. Because of the cost involved in performing a 10-year deed search, title insurers normally perform searches only as far back in the chain of title as the last occasion when a title company insured title. If seizure of property from a purchaser is proposed, it is usually necessary for the purchaser to file a claim with the title insurer before the title company will pay over the government's lien interest. Direct contact by the Revenue Officer with the title company informing them of the existence of the estate tax lien and demanding payment, is rarely effective.

(2) Under [Code §] 6324(a)(3), if a personal representative has received a discharge from liability under [Code §] 2204 and then distributes property to an heir who subsequently sells the property to a valid purchaser, the property is divested of the [Code §] 6324(a) lien. However a "like lien" then attaches to the consideration received from the purchaser and the consideration is subject to enforcement action. This lien does not attach to any other property of the heir unless it can be shown that the property was acquired with the consideration.

> Note: This provision for sale of property free of the [Code §] 6324(a) lien after the personal representative has been discharged from liability, does not apply if the personal representative, in that capacity, is the seller of the property.

This description is consistent with case law as well.[5462]

Nonprobate assets are not subject to the same hazards. However, those who receive nonprobate assets, including the trustees of revocable trusts, are in peril. IRM 5.5.7.6.1 explains:

> (1) [Code §] 6324(a)(2) provides that when estate taxes are not paid when due, any recipient of non-probate assets becomes personally liable for the taxes to the extent of the value at the time of the decedent's death, of such property. If the recipient transfers any of the non-probate property to a purchaser or holder of a security interest, the property is divested of the [Code §] 6324(a) estate tax lien. However, a like lien, in other words a lien with all of the attributes of the [Code §] 6324(a) estate tax lien, then attaches to all property owned by the recipient except that which is subsequently transferred to a purchaser or holder of a security interest.
>
> (2) The like lien remains in effect until the estate taxes are paid or until the [Code §] 6324(a) estate tax lien expires.
>
> (3) As with the [Code §] 6324(a) estate tax lien, no recording is necessary in order to perfect the like lien, nor is recording possible since no form exists for this purpose. Locally authored notices purporting to be notices of the like lien should not be recorded.
>
> (4) It is not necessary to obtain a separate assessment against the recipient of the non-probate property in order to enforce the like lien.

Let's take a moment to compare liens resulting from Code § 6166 to Code § 6324(a) liens:

- The Code § 6324(a) lien is very strong. However, as an unrecorded lien, it is not likely to impair assets as a practical business matter until creditors request a representation that no liens are on property included in the decedent's gross estate. When switching from a lender who made a loan before death to refinance with a new lender after death, one should have the first lender assign its loan to the new lender, hoping that the underlying security interest's priority over the Code § 6324(a) will survive the change.

- Code § 6324A liens on Code § 6166 property cause the Code § 6324(a) lien to be released from that particular property.[5463] Procedurally, this occurs when the property is listed on a recorded IRS Form 668-J.[5464] Recording the § 6324A lien also

[5462] *United States v. Vohland*, 675 F.2d 1071 (9th Cir. 1982); *United States v. Estate of Young*, 592 F.Supp. 1478 (E.D. Pa. 1984); *Metz v. United States*, 933 F.2d 802 (10th Cir. 1991).
[5463] Code § 6324A(d)(4); IRM 5.5.8.5(4)(d).
[5464] IRM 5.5.8.1(4)(b).

discharges the executor or other fiduciary.[5465] Code § 6324A liens are not valid against a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice of the lien is filed.[5466]

A TIGTA report on Code § 6166 liens made the following general comment:[5467]

> The IRS needs to enhance its current process to ensure a bond or an I.R.C. § 6324A special lien is obtained and filed in all I.R.C. § 6166 installment cases in which the IRS determines that there is a credit risk to the Federal Government and all special liens are appropriately monitored and tracked. Where an estate has elected to pay the estate tax attributable to its interest in a closely held business in installments over a period of up to 14 years under I.R.C. § 6166, the IRS could be left without lien protection for 4 years or more if a bond or an I.R.C. § 6324A special lien is not obtained and recorded with the appropriate local government office before the 10-year period of the general estate tax lien expires.

TIGTA acknowledged the *Roski* case:

> As a result of the Treasury Inspector General for Tax Administration's prior report, the IRS began instituting procedures to require a bond or an I.R.C. § 6324A lien from all estates making I.R.C. § 6166 elections. However, in *Estate of Roski v. Commissioner*, 128 T.C. No. 10 (April 12, 2007), the Tax Court held that the IRS may not require a bond or I.R.C. § 6324A special estate tax lien in every case but may determine on a case-by-case basis whether credit risks justify requiring security to protect the Federal Government's interest in the deferred estate tax. Accordingly, a bond or special lien may no longer be required in every case.

Note that the emphasis is on being unprotected after the Code § 6324 10-year lien has expired. Since the 10-year lien is unrecorded, it poses less of a problem regarding adverse publicity - third parties who see a Code § 6324A recorded tax lien might jump to the unwarranted conclusion that the business is in trouble.

IRM 5.5.8.1.1 offers the following comparison of federal estate tax liens:

Code Section	**How Created**	**Attributes**	**Form Title**
6321	Assessment, balance owed, notice and demand	Attaches to all right, title and interest of the decedent in any probate property undistributed at time lien arises - 10 year life can be extended.	Form 668 Notice of Federal Tax Lien

[5465] Reg. § 20.2204-3; IRM 5.5.8.5(4)(e).
[5466] Reg. § 20.6324A-1(c)(2). Once filed, the notice of lien remains effective without being refiled. *Id.*
[5467] http://www.treas.gov/tigta/auditreports/2007reports/200730174fr.pdf.

Code Section	How Created	Attributes	Form Title
6324(a)	At death	Attaches to estate assets listed on the F706 the value of which are the basis of the tax liability; recording not required to be choate; absolute life of ten years; follows the probate assets if transferred or liquidated, a lien of comparable value arises upon any property of the party who received proceeds from sale or encumbrance of non-probate property.	No form
6324A	Upon election by the estate and signed agreement by all parties with an interest in the property on the lien	Attaches the specific property shown on the lien; must be recorded. Recorded notice lists all parties of interest and the specific property that is subject to the lien.	Form 668J, Notice of estate Tax Lien under Internal Revenue Laws
6324B	Upon election by the estate of the special use 2032A or qualified family owned business interest 2057	Pertains to farm or business real estate only (2032A) or family owned business property. Notice must be recorded. Recorded notice lists all qualified heirs and has a complete legal description of the subject real property.	F668H, Notice of Federal Estate Tax Lien under Internal Revenue Laws

Notice 2007-90 announced that procedural changes would be made regarding liens securing Code § 6166 elections. These were integrated into the Internal Revenue Manual on June 1, 2010.

For Code § 6166 elections, IRM 5.5.8.1 provides:[5468]

(3) A limitation of the general estate tax lien is that it has an absolute life of 10 years. It cannot be extended. Estate tax attributable to an estate's interest in a closely held business may be paid over a 14-year period if an extension of time to pay under IRC § 6166 is in effect which could potentially leave the Service without lien protection for four years if a notice of lien is not recorded before the 10 years have elapsed.

(4) The filing of Form 668-J (the special IRC § 6423A lien for taxes deferred under IRC 6166) will secure the deferred taxes for the duration of the extension. The collection statute of limitations under IRC § 6502 is suspended during the period of the extension.

a. The lien attaches only the property specified on the recorded lien and in the IRC § 6166 agreement. A lien on property with equivalent value can be substituted for the actual IRC § 6166 property upon agreement between the Service and all parties with an interest in the property.

b. When estate property is listed on the recorded Form 668-J, it is automatically released from the effects of the general IRC § 6324(a) estate tax lien.

c. The IRC § 6324A lien is a negotiated lien that is created only when both the Service and all persons and/or entities with an ownership interest in the property listed on the notice of lien agree to its recording.

The taxpayer can choose the security to be offered.[5469] IRM 5.5.8.5(4) provides:

(4) Key elements of the lien include:

a. A lien describing the agreed upon property is recorded using Form 668-J, Notice of Federal Estate Tax Lien Under Internal Revenue Laws (see Exhibit 5.5.8-2).

b. An agreement to the lien under IRC § 6324A is filed with the Internal Revenue Service on Form 13925, IRC Section 6324A Lien Agreement Form. The agreement must be signed by all of the persons having an interest in the designated property (whether or not in possession) described on the lien.

c. Although real property is preferred, any property, either real or personal, with equity equal to the deferred taxes plus interest, and that can be expected to survive the deferral period, may be designated in the agreement. Property, other than property that was part of the gross

[5468] See F.A.A. 20070801F regarding how the IRS expects this security interest to be established with respect to a partnership or LLC interest. Also note that a protective election does not toll the statute of limitations under Code § 6502 mentioned in paragraph (4) if the taxpayer does not finalize the Code § 6166 election on audit; see fn. 5395.

[5469] See part III.B.3.c.iv Effect of Liens on Dealings with Third Parties.

estate, may be used to secure the lien. If at any time the value of the property covered by the agreement becomes less than the deferred taxes plus interest, the IRS can require the addition of property to the agreement.

Note: Even though the property offered by the estate as security for the lien may be, if necessary, difficult to enforce against (such as stock in a closely held corporation), distrainability is not a factor in determining the adequacy of the value of the property offered. As long as the requirements under IRC § 6166A(b) as to the value of the property are met, and there are no indications that the property will not survive the deferral period, whatever property the estate offers as security for the lien is acceptable.

d. Any property that is part of the decedent's gross estate that is part of the agreement and described on the recorded lien is no longer subject to the unrecorded IRC § 6324(a) estate tax lien.

e. Recording of the lien acts as a discharge of the executor and/or or fiduciary under IRC § 2204. See Treas. Reg. 20.2204-3.

IRM 5.5.8.5.1 provides:

(2) The Estate & Gift (E&G) Exam group will be responsible for sending lien packages to Advisory when the case has been assigned to the group for examination. When returns are accepted as filed or surveyed during classification, Campus will be responsible for preparing and forwarding the lien package to Advisory. E&G Campus will hold the original tax return for 90 days once the lien package is sent to Advisory, in case additional information is needed.

(3) Advisory shall contact the estate's executor or representative within 60 days of receipt of lien package and request the estate voluntarily provide a bond, or in the alternative an IRC § 6324A lien, to secure the deferred estate tax. If the executor or representative agrees to provide the bond or lien, proceed with processing procedures to get the bond or lien recorded. Send a copy of the lien agreement to E&G Campus for association with the IRC § 6166 file. Encumbrances must be checked to determine adequacy of collateral. The advisor may utilize sources such as Accurint, Secretary of State, UCC filings, etc. to verify encumbrances. It may be necessary to request the estate representative provide encumbrance information. Document the above action in the case history.

(4) If the estate declines to provide a bond or lien, Advisory shall review all information available to it before requesting any information from the taxpayer. Advisory shall review the following:

a. The lien package provided by E&G Exam,

b. Any information that the IRS may have such as extension requests (Form 4768), compliance with current installment/interest payments, tax returns or tax compliance information with respect to the decedent (1040), the estate or trust (1041) and closely held business (1040, 1041, 1120, 1120S, 1065, 941's),

c. Any information available by public record or on the Internet, such as filings with the Secretary of State.

……

(7) Advisory shall determine whether a bond or lien should be required in a case based on a review and analysis of applicable factors listed below and any other pertinent information. This is not an exclusive list and no single factor will be determinative of whether to require security in any particular case.

a. Duration and stability of the business: This factor considers the nature of the closely held business and of the assets of that business, the relevant market factors that will impact the business's future success, its recent financial history, and the experience of its management, in an effort to predict likelihood of its success and survival through the deferred payment period. This information may be found in the appraisal, financial statements, and SEC filings. Facts relevant to this factor are information regarding any outstanding liens, judgments, or pending or anticipated lawsuits or other claims against the business, if any; age of business; and continuity and stability of management. The estate may use a sworn affidavit or other probative documents to provide this information. When considering this factor, determine whether the decedent owned a majority interest in the business. If the decedent owned a minority interest, the financial information pertaining to the business may not be as relevant because the estate may not force distributions to pay the estate tax. In this case, consider whether other assets in the estate or other income are available to pay the estate tax.

b. Ability to pay the installments of tax and interest timely: This factor considers how the estate expects to be able to make the annual payments of tax and interest as due, and the objective likelihood of realizing that expectation. Facts relevant to this factor may include the nature of the business's significant assets and liabilities, type of debts (subordinated, related party, guaranteed, payment terms), and the business's cash flow (both historical and anticipated). An appraisal, the business' tax return, or SEC filings may provide this information.

c. Compliance history: This factor addresses the business's, estate's and decedent's history regarding compliance with all federal tax payment and tax filing requirements, in an effort to determine whether the business, its management and the executor respect and comply with all tax requirements on a regular basis. The relevance of the closely held business's filing and payment compliance is proportional to the estate's ownership interest and control of the business. This factor also addresses the estate's compliance history with respect to federal tax payment and filing requirements. Review frequency of requests for extension of time to pay, amount, and ultimate payment.

IRM 5.5.8.5.1 and 5.5.8.5.2 provide various deadlines for this process, as well as rights to appeal and the IRS' enforcement policy.

IRM 5.5.8.5.3 describes monitoring during the Code § 6166 deferral period. All Code § 6166 accounts are to be re-evaluated six years into the deferral period. In addition to the factors Advisory uses to determine whether a bond or lien should be required, IRM 5.5.8.5.3(4) provides that Advisory:

> should also look at subsequent actions below to determine if additional action should be taken to protect the Government's interest:
>
> a. What assets have been distributed?
>
> b. Has the estate distributed, sold, exchanged, or otherwise disposed of 50 percent or more of the value of the estate's interest in the closely held business?
>
> c. What assets have been discharged or subordinated?
>
> d. Has the estate made installment payments timely and in the full amount due?
>
> e. Has the estate requested extensions to pay installments?
>
> f. Has the estate defaulted on other financing?
>
> g. Has the estate made additional payments toward the tax liability?
>
> h. Does the closely held business appear to be financially stable and able to make future installment payments?
>
> i. Is the estate in compliance with filing and paying requirements?

As the 10-year period for Code § 6324(a) liens nears expiration, IRM 5.5.8.5.3(5) requires annual monitoring:

> Each year that Advisory conducts a review, the Advisor must document their analysis and recommendations to adequately protect the Government's interest. As the Service gets closer to expiration of the IRC § 6324(a) lien, the advisor must consider securing a "replacement lien" (IRC § 6324A lien or bond) to cover the additional deferral period and the amount of deferred tax due in order to protect the Government's interest.

IRM 5.5.8.5.3 further explains the monitoring process:

> (8) In consideration of accounts where the estate has been in compliance with timely payment of installments, as the Service gets closer to expiration of the IRC § 6324(a) lien, the advisor must consider securing a "replacement lien" (IRC § 6324A lien or bond) to cover the additional deferral period and the amount of deferred tax due in order to protect the Government's interest.

(9) Advisory must ensure annually that the value of the collateral securing the lien is equal to the outstanding IRC § 6166 balance on the account. In accordance with the Form 13925, the designated agent is required to send current valuation information annually with respect to the pledged property listed in the agreement. If the executor has provided an IRC § 6324A lien, Advisory must review the annual valuation information report from the designated agent to confirm that the value of the collateral securing the lien is equal to the outstanding IRC § 6166 balance on the account. If the financial information is not received from the designated agent, the Advisor may contact the designated agent to request that information.

When negotiating with the IRS, one might consider requesting a delay in recording a Code § 6324A tax lien until closer to when the 10-year period expires, if publicity is a concern. Sometimes, however, a recorded Code § 6324A lien is more favorable for the taxpayer - unlike the Code § 6324 lien, it is junior to post-mortem liens placed on property before the Code § 6324A lien.

Also, if imposing an IRS lien would impair the business' ability to earn the money necessary to pay the tax, the IRS must consider whether imposing the lien is penny-wise and pound-foolish.[5470]

III.B.5.d.iv.(i). Effect of Liens on Dealings with Third Parties

Lenders might not be very happy if ownership of one's business is suddenly subjected to an IRS lien. Also, franchise agreements tend to restrict transfer of ownership and might look unfavorably upon liens. Also, generally the IRS may force the sale of real property a debtor owns as a co-tenant, even if the co-tenant is innocent;[5471] if property is held as

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[5470] *Alessio Azzari, Inc. v. Commissioner*, 136 T.C. 178 (2011) (Code §§ 6159, 6320, 6323, and 6325).

[5471] *U.S. v. Adent*, 821 F.3d 911 (7th Cir. 2016), in allowing such a sale, held:

> The United States Supreme Court addressed the issue of an innocent third-party interest in the context of a forced sale in *United States v. Rodgers*, 461 U.S. 677 (1983). There, the Supreme Court found that the plain language of § 7403 contemplates the sale of the entire property, including innocent third-party interests in that property, and that the Supremacy Clause precludes protection of innocent third-party interests via state law. *Id.* At 693–94, 703–04. Further, § 7403 protects an innocent third party's interest by providing for distribution of the proceeds from the court-ordered sale to the innocent third party to compensate them for their interest. *Id.*
>
> ….
>
> Additionally, the Supreme Court provided a non-exhaustive list of four factors to consider when an innocent third party has an interest in the property to be sold, recognizing that financial compensation may not always be a completely adequate substitute for a roof over one's head. *Id.* At 704. These factors include: (1) the prejudice to the government's interest as the result of a partial, rather than a total, sale; (2) whether the third party with a non-liable separate interest in the property would, in the normal course of events ... have a legally recognized expectation that that separate property would not be subject to forced sale by the delinquent taxpayer or his or her creditors; (3) the prejudice to the third party as the result of a total sale; and (4) the relative character and value of the non-liable and liable interests held in the property. *Id.* at 710–11.
>
> ….

tenants by the entirety, the innocent party should consider whether she is entitled to more than half of the property.[5472] However, a court may consider imposing a rent obligation rather than requiring a sale.[5473]

As described above, the estate tax lien is imposed automatically as of the owner's death on the assets that the owner holds. One might consider placing the assets in a holding company so that the lien will be imposed on the holding company rather than the business assets. On the other hand, using a holding company may reduce or eliminate the estate's ability to obtain an automatic deferral of estate tax under Code § 6166.[5474]

When the IRS seeks to obtain an express lien under Code § 6324A to secure Code § 6166 payments, the estate can select the security to be provided.[5475] When doing so, the estate might consider which property causes the least disruption with existing lenders or others with whom one does business and also reduces the cost of keeping the IRS updated.

III.B.5.d.iv.(j). Wrongful Levy

If a levy has been made on property or property has been sold pursuant to a levy, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in or lien on such property and that such property was wrongfully levied upon may bring a civil action against the U.S. in a federal district court.[5476] This action may be brought without regard to whether such property has been surrendered to or sold by the IRS.[5477] If the IRS sold the property, a junior lienholder may sue the U.S. to receiver any surplus sale proceeds.[5478]

If a person whose account was levied for the debt of another person seeks a Taxpayer Assistance Order through the Taxpayer Advocate Service, that process tolls the statute of limitations for suing the IRS (5th Cir. divided panel).[5479]

> The other *Rodgers* factors also weigh in favor of the government. Derek, the non-delinquent co-owner of Parcel B, has no legally recognized expectation that his interest would not be subject to a forced sale due to Leonard's delinquency. Also, the prejudice to Derek as the result of a sale is minimal; Derek does not reside in Parcel B, so dislocation is not a consideration. After the sale, Derek will be compensated for his half interest. Further, Derek may bid on Parcel B at the foreclosure auction, either to gain the property outright or to attempt to increase the final sale price. Finally, the relative character and value of the non-liable and liable interests does not weigh in any party's favor. The non-liable interest of Derek is equal to the liable interest of Leonard.

5472 See article on procedures developed in light of *Craft*, cited in fn. 5428 in part III.B.3.c.iv Imposition of the Estate Tax Lien.

5473 *U.S. v. Cardaci*, 119 A.F.T.R.2d 2017-1735 (3rd Cir. 5/08/2017).

5474 See Code § 6166(b)(8), (9) and part III.B.5.d.ii Code § 6166 Deferral.

5475 For the taxpayer's choices, see part III.B.3.c.iv Liens: Selected Internal Revenue Manual Materials, especially the text accompanying and following fn. 5469.

5476 Code § 7426(a)(1). See Langstraat, Coyne, and Palmer, Third parties' right to sue on erroneous levies, 125 *Journal of Taxation* 30 (July 2016).

5477 Code § 7426(a)(1).

5478 Code § 7426(a)(2).

5479 *Rothkamm v. U.S.*, 802 F.3d 699 (5th Cir. 2015).

III.B.5.d.v. Transferee Liability

For information beyond what is in my materials below, see "The Devil is in the Details: Important Tax Administration and Procedural Rules for Estate Planners," Chapter 9 of the 2015 Heckerling Institute on Estate Planning.

III.B.5.d.v.(a). General Rules Regarding Transferee Liability

Generally, income tax, estate tax, and gift tax liabilities are assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred.[5480]

The IRS may assess an initial transferee's liability within one year after the expiration of the period of limitation for assessment against the transferor.[5481] The IRS may assess the liability of a transferee of a transferee, within one year after the expiration of the period of limitation for assessment against the preceding transferee, but not more than three years after the expiration of the period of limitation for assessment against the initial transferor.[5482] However, if, before the expiration of the period of limitation for the assessment of the liability of the transferee, a court proceeding for the collection of the tax or liability in respect thereof has been begun against the initial transferor or the last preceding transferee, respectively, then the period of limitation for assessment of the liability of the transferee shall expire one year after the return of execution in the court proceeding.[5483]

The IRS may assess a fiduciary not later than one year after the liability arises or not later than the expiration of the period for collection of the tax in respect of which such liability arises, whichever is the later.[5484]

"Transferee" includes donee, heir, legatee, devisee, and distributee, and with respect to estate taxes, also includes any person who, under Code § 6324(a)(2), is personally liable for any part of such tax.[5485] "Distributee" includes the distributee of an estate of a deceased person, the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in Code § 368, and all other classes of distributees.[5486] When assets pass in trust by reason of death, the trustee has Code § 6324(a)(2) personal liability, and the beneficiaries do not.[5487]

[5480] Code § 6901(a)(1).
[5481] Code § 6901(c)(1).
[5482] Code § 6901(c)(2).
[5483] Flush language at the end of Code § 6901(c)(1) and (2).
[5484] Code §6901(c)(3).
[5485] Code § 6901(h).
[5486] Reg. § 301.6901-1(b).
[5487] See fn. 5450, found in part III.B.5.d.iv.(e) Which Estates Are Affected by the Estate Tax Lien? Thus, trustees of revocable trusts need to do everything in their power to make sure estate taxes are paid, because they are personally on the hook.

Whether a person is liable under state law is determined independently of whether the person is a transferee under federal law.[5488] Similarly, fraudulent transfer remedies under Code § 6901 are based on state law fraudulent transfer remedies.[5489]

[5488] *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013); *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012); *Diebold Foundation, Inc v. Commissioner*, 736 F.3d 172 (2nd Cir. 2013); *Salus Mundi Foundation v. Commissioner*, 776 F.3d. 1010 (9th Cir. 2014) (shareholders had constructive knowledge of the fraudulent tax avoidance scheme at issue; series of transactions collapsed; shareholders made a fraudulent conveyance under state law), following *Diebold* and *rev'g* T.C. Memo. 2012-61. On remand, *Frank Sawyer Trust of May 1992 v. Commissioner*, T.C. Memo. 2014-59, held that, under Massachusetts law, a good-faith transferee of a fraudulent transfer was liable only to the extent that the fair market value of what it received exceeded the price that it paid; the taxpayer obtained additional relief (that did not change the reasoning of that case) at T.C. Memo. 2014-128.
All the sparring described in this footnote is described by *Alterman Trust v. Commissioner*, T.C. Memo. 2015-231 (12/1/2015):

> The fact patterns of these cases are similar. Someone sells an interest in a corporation for a good price; the corporation doesn't pay its taxes; and the Internal Revenue Service (IRS) goes after the former shareholder for the taxes.
>
> The outcomes of these cases vary. Many taxpayers have prevailed at the trial court, but many of those taxpayers have seen their victories turned to defeat on appeal.[2] The IRS has likewise prevailed at the trial court, and its victories have uniformly survived appeal.[3] Rarest of all is the taxpayer victory that survives appeal.[4]
>
> [2] *Slone v. Commissioner*, ___ F.3d ___, 2015 WL 5061315 (9th Cir. Aug. 28, 2015), vacating and remanding T.C. Memo. 2012-57; *Salus Mundi Found. v. Commissioner*, 776 F.3d 1010 (9th Cir. 2014), *rev'g and remanding* T.C. Memo. 2012-61; *Diebold Found., Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013), *vacating and remanding Salus Mundi Found. v. Commissioner*, T.C. Memo. 2012-61; *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013), *rev'g and remanding* T.C. Memo. 2011-298.
>
> [3] For a recent example, see Feldman v. Commissioner, 779 F.3d 448 (7th Cir. 2015), *aff'g* T.C. Memo. 2011-297.
>
> [4] *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012), *aff'g* T.C. Memo. 2011-63.
>
> But each case stands on its own. Outcomes are determined by the facts of each specific case and what is established by the record.[5]
>
> [5] See, *e.g.*, *Holden v. Commissioner*, T.C. Memo. 2015-83, at *2 n.2; *Holden v. Commissioner*, T.C. Memo. 2015-131, at *2 n.1 (noting that separate cases involving the same taxpayer and issues each turn on the facts established by the record in each separate case); see also *Feldman v. Commissioner*, T.C. Memo. 2011-297, 2011 WL 6781006, at *17 (noting different outcomes in *Midco* cases because of the distinct facts and circumstances of each case).

Slone v. Commissioner, 788 F.3d 1049 (9th Cir. 8/29/2015), set forth the Ninth Circuit's test:

> The question before us is whether the Slone Broadcasting shareholders can be held liable for taxes on Slone Broadcasting's sale of assets to Citadel because the shareholders were transferees of the proceeds of that sale.
>
> Under 26 U.S.C. § 6901, the Commissioner can assess tax liability against a taxpayer who is the transferee of assets of a taxpayer who owes income tax. *Salus Mundi Found. v. Comm'r*, 776 F.3d 1010, 1017 (9th Cir. 2014). Tax liabilities on transferred assets shall, with certain exceptions, be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the cases of taxes with respect to which the liabilities were incurred. 26 U.S.C. § 6901.
>
> While federal law provides the procedure for collecting tax liabilities from a transferee, state law answers the question whether the alleged transferee is substantively liable for

the tax. *Comm'r v. Stern*, 357 U.S. 39, 44–45 (1958). Therefore, in order to impose tax liability on a transferee, a court must engage in a two-pronged inquiry, see *Salus Mundi*, 776 F.3d at 1018 (citing *Stern*, 357 U.S. at 42, 44–45), which is sometimes called the *Stern* test. The first prong asks: is the party a transferee under § 6901 and federal tax law? *Id.* Under federal law, a transferee is defined as including a donee, heir, legatee, devisee, [or] distributee. 26 U.S.C. § 6901(h). Treasury regulations further define the term transferee to include the shareholder of a dissolved corporation. 26 C.F.R. § 301.6901-1(b).

The second prong of the *Stern* test asks: is the party substantively liable for the transferor's unpaid taxes under state law? *Salus Mundi*, 776 F.3d at 1018. The test for this second prong depends on the law of the state where the transfer occurred. See, *e.g.*, *id.* (Under the [New York Uniform Fraudulent Conveyance Act], a party seeking to recharacterize a transaction must show that the transferee had actual or constructive knowledge of the entire scheme that renders [its] exchange with the debtor fraudulent.) (alterations in original) (quoting *Diebold Found., Inc. v. Comm'r*, 736 F.3d 172, 184–85 (2d Cir. 2013)). The two *Stern* test prongs are separate and independent inquiries. *Salus Mundi*, 776 F.3d at 1012.

Slone continued, Although we have not previously considered how a court should analyze a transaction for purposes of transferee liability under § 6901, both the Supreme Court cases, and our own precedent, require us to look through the form of a transaction to consider its substance. *Slone* concluded:

We cannot resolve this dispute because the tax court failed to apply the correct legal standard for characterizing the stock sale transaction for the purposes of federal transferee liability. The court did not address either the subjective or objective factors we apply in characterizing a transaction for tax purposes, as it failed to make any finding on whether the shareholders had a business purpose for entering into the stock purchase transaction other than tax avoidance, or whether the stock purchase transaction had economic substance other than shielding the Slone Broadcasting shareholders from tax liability. Instead, the tax court focused its factual inquiry and analysis on factors that might be relevant to the second prong of the Stern test for assessing transferee liability, whether a party is substantively liable for the transferor's unpaid taxes as a matter of state law. For instance, the tax court's findings that the shareholders had not orchestrated the asset sale and the stock sale as a single scheme for tax evasion purposes, that Fortrend and its third-party service provider were legitimate players in the debt collection industry, and that the shareholders had no reason to believe that Fortrend was using illegitimate tax evasion methods and had no duty to inquire further all relate to the question whether the shareholders lacked actual or constructive knowledge of the entire tax evasion scheme that rendered their transaction with Fortrend fraudulent under state law. See *Salus Mundi*, 776 F.3d at 1020. But the tax court did not use these factual findings to analyze the shareholders' liability under the applicable state law; it instead concluded, based on these findings, that the form of the stock sale should be respected for the shareholders' transferee status under the first prong of the *Stern* test. This was an error.

Because the tax court applied the wrong legal standard to the question of transferee liability, it failed to make findings relating to the relevant factors for determining whether the Commissioner could properly disregard the form of the transaction. The tax court should make these determinations in the first instance. See *Lewis v. Comm'r*, 560 F.2d 973, 978 (9th Cir. 1977) (reversing and remanding when the tax court did not make proper factual findings). On remand, the tax court should make the findings necessary to apply the Stern test correctly. Under the first prong of this test, the tax court should apply the relevant subjective and objective factors to determine whether the Commissioner erred in disregarding the form of the transaction in order to impose tax liability on the shareholders as transferees under § 6901. Under the second prong of the Stern test, the tax court should analyze whether the shareholders are liable under state law for Slone Broadcasting/Arizona Media's unpaid tax liability. See *Salus Mundi*, 776 F.3d at 1018, 1020. The tax court may begin its analysis with either prong. The Commissioner may hold the shareholders liable as transferees under § 6901 only if both prongs of the Stern test are satisfied. See *id.* [5]

[5] Costs are awarded to the Commissioner.

On remand, *Slone v. Commissioner*, T.C. Memo. 2016-115, addressed the second prong to determine whether the taxpayers were substantively liable for the transferor's unpaid taxes under state law. The court held that Arizona law required the IRS to prove that the taxpayers had actual or constructive knowledge of the entire scheme, and the IRS proved neither. After determining that the form of the stock sale must be respected, the court applied the UFTA to the transaction to determine whether the taxpayers may be held substantively liable for the corporation's unpaid taxes under Arizona law. The court held that the taxpayers did not commit either constructive or actual fraud under Arizona fraudulent transfer law.

Swords Trust v. Commissioner, 142 T.C. No. 19 (2014), rejected the IRS' proposed approaches:

> Respondent urges the Court to adopt the following two-step analysis to determine whether petitioner trusts, as transferees from Davreyn, are liable for Davreyn's unpaid tax: (1) analyze whether the subject transactions are recast under Federal law, here primarily the Federal substance over form doctrine, and then (2) apply State law to the transactions as recast under Federal law. One or more transactions are recast or otherwise disregarded under the Federal substance over form doctrine where the transactions, taken as a whole, show that the transactions are shams or have no purpose, substance, or utility apart from their anticipated tax consequences. … The effect of this doctrine is that the substance and not the form of the transactions determines their tax consequences…. Alternatively, respondent contends, petitioner trusts, as transferees from Davreyn and without regard to the Federal law characterization of the transactions, are liable for Davreyn's debts under applicable State law or State equity principles. Petitioner trusts argue that they are not liable for Davreyn's tax liability because, they contend, (1) the transactions may be recast only under applicable State law, which does not provide for any such recast, and (2) respondent failed to show that they are liable for Davreyn's debts under applicable State law or State equity principles….
>
> In the setting at hand, respondent bears the burden of establishing that the … State's highest Court, would apply a substance over form doctrine to recast the series of transactions as a transfer between each of petitioner trusts and Davreyn.
>
> Respondent has failed to establish that an independent basis exists under applicable State law or State equity principles for holding petitioner trusts liable for Davreyn's unpaid tax. Accordingly, we hold that section 6901 does not apply to these cases.

These cases seem inconsistent with *Slone v. Commissioner*, which held that form over substance applies to Code § 6901 and held that:

> when the Commissioner claims a taxpayer was the shareholder of a dissolved corporation for purposes of 26 C.F.R. § 301.6901-1(b), but the taxpayer did not receive a liquidating distribution if the form of the transaction is respected, a court must consider the relevant subjective and objective factors to determine whether the formal transaction had any practical economic effects other than the creation of income tax losses.

Following this evolution of case law, *Tricarichi v. Commissioner*, T.C. Memo. 2015-201 (10/14/2015):

> In performing this substance over form inquiry, the Ninth Circuit does not engage in a rigid two-step analysis. Rather, it focuses holistically on whether the transaction had any practical economic effects other than the creation of income tax losses. *Id.* (quoting *Reddam*, 755 F.3d at 1060). Following a commonsense review of the transaction, if the court concludes that the transaction lacks a nontax business purpose, has no economic substance, and was entered into solely to generate illegitimate tax benefits, the Commissioner may disregard the form the parties have selected and tax the transaction on the basis of its underlying economic substance. *Id.* at __, 2015 WL 5061315, at *5-*6.

The IRS is not required to pursue collection efforts against one transferee before seeking to collect from another transferee.[5490]

III.B.5.d.v.(b). Transferee Liability Extends Past Original Estate Tax Lien

In *United States v. Kulhanek*,[5491] the decedent died in 1991, and the estate tax return was due in 1992. The estate tax return made a Code § 6166 election to defer estate tax. In 1999, the closely-held business sold all of its assets, making all of the estate tax due upon the IRS' notice and demand.[5492] The IRS sued the transferees in 2008. The transferees argued that the action was for collection of estate tax and was untimely, because it was brought more than ten years after date of death.[5493] The U.S. District Court held that the collection action was timely, because it was a transferee liability

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> For the reasons discussed previously, we find that the transaction by which Nob Hill purchased petitioner's West Side stock relied on sham transactions, had no economic substance, had no bona fide business purpose, and was entered into solely to evade West Side's Federal and Ohio tax liabilities. See *supra* p. 40 and note 11 and pp. 41-55. We therefore disregard the form of the transaction and find that petitioner in substance was a direct recipient of West Side's cash, *i.e.*, as a distributee, the shareholder of a dissolved corporation, or the assignee *** of an insolvent person. Sec. 6901(h); sec. 301.6901-1(b), Proced. & Admin. Regs. In any of those capacities, he was a transferee of West Side within the meaning of section 6901.

Stuart v. Commissioner, 144 T.C. 235 (2015), followed *Swords Trust* in rejecting the IRS' two-step approach but nevertheless found a fraudulent transfer under state law and upheld imposition of transferee liability. The Eighth Circuit reversed, holding that the Tax Court should have considered whether the stock sale should be recharacterized under state law, 118 A.F.T.R.2d 2016-XXXX (11/14/2016). The Eighth Circuit remanded to the Tax Court for consideration of whether the IRS is entitled to a full recovery from the former shareholders as transferees under Nebraska law.

[5489] *Schussel v. Werfel*, 758 F.3d 82 (1st Cir. 2014); *Alterman Trust v. Commissioner*, T.C. Memo. 2015-231. In *Alterman Trust*, based on detailed analysis of Florida's Uniform Fraudulent Transfer Act, the court held:

> The Commissioner seeks to impute transferee liability to petitioners for taxes that went unpaid by a corporation in which they previously owned an interest. Petitioners took steps to ensure those taxes would get paid. The corporation itself remained solvent even after the shareholders sold their interests, leaving the Commissioner to argue that petitioners should be liable under a transferee of a transferee theory. But the Commissioner failed to show that any of the transferors were insolvent at any of the relevant times.

[5490] *Tricarichi v. Commissioner*, T.C. Memo. 2015-201 (10/14/2015) held:

> Transferee liability is several under section 6901. *Alexander v. Commissioner*, 61 T.C. 278, 295 (1973); *Cullifer v. Commissioner*, T.C. Memo. 2014-208, at *74 (same). It is well settled that a transferee is severally liable for the unpaid tax of the transferor to the extent of the assets received and other stockholders or transferees need not be joined. *Estate of Harrison v. Commissioner*, 16 T.C. 727, 731 (1951) (citing *Phillips v. Commissioner*, 283 U.S. 589 (1931) (construing predecessor statute)). In the event that one transferee is called upon to pay more than his pro rata share of the tax, he is left to his rights of contribution from the other transferees. *Id.*

[5491] 106 A.F.T.R.2d 2010-7263 (W.D. Pa.).

[5492] Code § 6166(g)(1)(A).

[5493] Relying on Code § 6324(a)(1).

case,[5494] not an estate tax collection case, and was brought less than ten years[5495] after the event that accelerated payment of the estate tax.[5496]

Thus, transferees of estates that have made Code § 6166 elections might be liable until as long as 24 years and 9 months after death (ten years after the fourteen year deferral under Code § 6166 of taxes due nine months after death).

Similarly, in *Mangiardi v. Commissioner*,[5497] the IRS gave an estate six annual Code § 6161 extensions of time to pay estate tax on the grounds of hardship. Concerned that the ten-year statute of limitations under Code § 6324(a)(1) was coming up, the IRS granted the seventh request of time, but only for a couple of months, explaining:

> The extension to pay is only being allowed until 12/5/2004 because, if the liability is not paid in full by that date, the IRS will begin making transferee assessments against the heirs of the estate that received assets and have not paid to the IRS their portion of the estate tax and interest owed. We can not provide any additional time because we must ensure that the transferee assessments are made prior to the assessment expiration date to make those assessments.

The IRS sent a notice of intent to levy to the estate when the estate did not meet the deadline. When appealing the notice of intent to levy, the estate claimed that the IRS was precluded from collecting the estate tax liability from beneficiaries because the time for making a transferee assessment under Code § 6901 had expired. Thus, the estate suggested an offer-in-compromise in which the estate would offer a reduced amount based on doubt as to collectability of the remaining assets in the revocable trust.

Although the IRS originally thought it needed to make transferee assessments against the beneficiaries, before the Code § 6901 assessment expiration date, it never made those assessments and later asserted that a Code § 6901 assessment against transferees was not required before personal liability could be imposed under Code § 6324(a)(2).

The Tax Court ruled that it could not evaluate the legitimacy of the IRS' denial of the Code § 6161 extension, although it seemed to view the IRS' actions as pretty lame. However, that issue was moot because the court issued its judgment after the latest date for a Code § 6161 extension, so the court did not further address that issue.

The court pointed out that the Third and Tenth Circuit Courts of Appeals have held that the IRS may collect estate tax from a transferee pursuant to Code § 6324(a)(2) without a prior assessment against the transferee under Code § 6901[5498] and that the Tax Court

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[5494] Relying on Code § 6324(a)(2).
[5495] Relying on Code § 6502(a)(1).
[5496] Citing *United States v. Botefuhr*, 309 F.3d 1263, 1277 (10th Cir. 2002), *United States v. Degroft*, 539 F.Supp. 42, 44 (D. Md. 1981), and *United States v. Bevins*, 2008 WL 5179099, 102 A.F.T.R.2d 2008-7268 (E.D. Cal. 2008).
[5497] T.C. Memo. 2011-24.
[5498] Citing *United States v. Geniviva*, 16 F.3d 522, 525 (3d Cir. 1994) and *United States v. Russell*, 461 F.2d 605, 607 (10th Cir. 1972).

has found those cases to be persuasive and well-reasoned.[5499] However, the court noted, "We also sympathize with the beneficiaries of decedent's estate in that years later they find themselves at risk of forfeiting their inheritance without prior notice, especially after respondent had ample opportunity to make assessments against them." Nevertheless, the court sustained the levy as lawful.

Regarding the offer-in-compromise:

> Petitioner offered the remaining assets in the estate (approximately $700,000) as an offer-in-compromise; however, respondent determined petitioner's reasonable collection potential to be at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions. Because petitioner did not offer an acceptable amount, respondent did not abuse his discretion in rejecting petitioner's offer-in-compromise.

Thus, the court sustained the IRS' proposed collection actions. Then, when a beneficiary of the IRA challenged the IRS' collection efforts against her, a U.S. District Court upheld the IRS' action.[5500]

Another Code § 6166 case gave the following explanations:[5501]

> Upon an initial reading, section 6901 appears to mandate how the IRS may assess and collect taxes from those personally liable under section 6324(a)(2). The Tenth Circuit, however, has stated that section 6901 is only one method of collecting against transferees because "the collection procedures of § 6901 are cumulative and alternative—not exclusive or mandatory." [citing *Russell* - see fn. 5498]. As a result, "an individual assessment under 26 U.S.C. § 6901 is not a prerequisite to an action to impose transferee liability under 26 U.S.C. § 6324(a)(2)." [citing *Geniviva* - see fn. 5498]
>
> ….
>
> …. Tenth Circuit precedent is clear that as long as the period of time is open for collecting against an estate, it is open for collecting against a section 6324(a)(2) Distributee.

That case also held that refunding agreements (agreements with beneficiaries to pay estate tax) do not relieve the executor from liability for having made a distribution before estate tax is paid:[5502]

> One of section 3731's purposes is to provide a clear path for recourse when a representative distributes assets of an estate before paying estate taxes. Were

[5499] Citing *Ripley v. Commissioner*, 102 T.C. 654, 659 (1994).
[5500] *U.S. v. Mangiardi*, 112 A.F.T.R.2d ¶ 2013-5108 (S.D. Fla. 2013).
[5501] *U.S. v. Johnson*, 109 A.F.T.R.2d 2012-2253 (D.C. UT).
[5502] In an amended opinion at 112 A.F.T.R.2d 2013-5474, the court reaffirmed its holding, In this case, the individuals who distributed the Estate's assets accepted the risk that the Heirs may fail to pay the tax. Now that the risk has been realized, the Government may proceed on its claim against the Personal Representatives. See fn. 5446 for the requirements to make a claim under 31 U.S.C. § 3713(b).

courts to excuse personal representatives from liability when they secure contribution agreements, the Government would have to bring an action in contract, prove it is a third-party beneficiary of the agreement, and then establish its right of contribution. Section 3713(b) is designed to avoid such complications. It provides a straightforward way to collect unpaid taxes from the very individuals who dispersed the estate's assets without having satisfied the tax liability. In this case, the individuals who distributed the Estate's assets accepted the risk that the Heirs may fail to pay the tax. The Personal Representative, rather than the Government, is in the best position to seek reimbursement from the individuals who accepted the assets with a deferred obligation to pay the tax. The court therefore concludes the Government has stated a cognizable claim under section 3713(b) and denies the motion to dismiss this cause of action.

For more information, see "The Devil is in the Details: Important Tax Administration and Procedural Rules for Estate Planners," Chapter 9 of the 2015 Heckerling Institute on Estate Planning.

III.B.5.d.v.(c). Transferee's Inability to Contest the Merits of the Assessment

Collection due process (CDP) rights do not apply to a transferee of a taxable estate when the IRS seeks to levy or seize property to enforce either the general estate tax lien arising under Code § 6324(a)(1) or the "like lien" described in Code § 6324(a)(2).[5503]

[5503] Program Manager Technical Assistance (PMTA) 2013-014 (7/10/2013). This was a change from the IRS' previous position. The IRS' reasoning explains various parties' rights in proceedings:

> …the section 6324(a)(2) like lien is for the in rem collection of the estate tax from property subject to the lien, and not for collection of the transferee's personal liability. The estate tax lien shifts to other property, but the estate remains the only taxpayer. The transferee under section 6324(a)(2) is not the taxpayer, but is holding property subject to the tax lien for collection of another person's (the estate's) taxes. Under the CDP regulations, the transferee would not be a taxpayer entitled to CDP rights.
>
> We recognize that the section 6324(a)(2) like lien is different from other types of tax liens because it attaches to property other than that transferred by the taxpayer estate, including wages, bank accounts and after-acquired property. It is true that the transferor, if given CDP rights, would be able to propose alternatives to collection from certain types of property. However, although not entitled to CDP rights, such party would be entitled to collection appeal program (CAP) rights to propose collection alternatives and raise any other issues pertaining to the levies or proposed levies. IRM 8.24.1.2 (10-01-2012). For other issues that could be raised in CDP, such as the underlying tax liability, it would be counterintuitive to offer CDP rights to a non-taxpayer. If the estate tax were assessed from the estate tax return, for example, nothing would preclude the transferee given CDP levy rights from contesting that estate tax liability. See section 6330(c)(2)(B). Furthermore, a transferee has the ability to prevent imposition of the like lien by not selling or encumbering the estate assets prior to satisfaction of the estate tax.
>
> It is possible that a party in possession of non-probate property subject to the estate tax lien may not be aware of this unrecorded lien and may, therefore, also be unaware of the imposition of the like lien upon the sale or further encumbrance of the non-probate property. In this respect, the party whose property is subject to a like lien is really no different than a purchaser of or holder of security interest in probate property encumbered by an unrecorded estate tax lien who is unaware of that lien. See section 6324(a)(3); *United States v. Vohland*, 675 F.2d 1071, 1075 (9th Cir. 1982) (estate

Only the estate itself, and not an interested third party, may contest the tax assessment.[5504]

For more information, see "The Devil is in the Details: Important Tax Administration and Procedural Rules for Estate Planners," Chapter 9 of the 2015 Heckerling Institute on Estate Planning.

III.B.6. Marital Deduction Considerations and Related Planning

III.B.6.a. Qualifying for the Marital Deduction

In most cases, a marital trust should authorize the surviving spouse to direct the trustee to make the property productive.

Buy-sell agreements can ruin the marital deduction if they have the effect of transferring property away from the surviving spouse for less than adequate and full consideration.

The spouse must be entitled to income for life and must be the sole person who may receive principal during the spouse's life (subject to the surviving spouse having an inter vivos power of appointment for a general power of appointment marital deduction trust under Code § 2056(b)(5)). "Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust" is "the power to apply the income or corpus for the benefit of the spouse."[5505] Thus, to provide asset protection from creditors (to the extent available) and for distributions upon the spouse's incapacity, a marital deduction trust may provide language authorizing payments to or for the benefit of the spouse.[5506]

> tax lien remained attached to probate property sold to purchaser without notice of lien when fiduciary of estate had not received a section 2204 discharge at time of sale). It is not disputed that a purchaser or security interest holder under those circumstances would not be entitled to CDP rights prior to or after levy.
>
> For these reasons, a transferee of non-probate property is not entitled to a CDP notice or hearing prior to or after levy upon property subject to either the section 6324(a)(1) estate tax lien or the section 6324(a)(2) like lien. Under the CDP regulations, parties holding property subject to a federal tax lien are not taxpayers entitled to CDP rights.

[5504] *U.S. v. Cowles-Reed*, 114 A.F.T.R.2d 2014-5612 (9th Cir. 2014) (designated not for official publication) (surviving joint tenant from whom the IRS seeks to collect estate tax as a transferee); *Greenoak Holdings Limited v. Commissioner*, 143 T.C. 170 (2014) (offshore trust), the latter holding:

> We hold that a person, other than the taxpayer, who alleges an ownership interest in property which the Commissioner seeks to levy upon is not entitled to receive a notice of intent to levy and is not able to seek judicial review in this Court pursuant to a notice of determination issued to a delinquent taxpayer. Accordingly, we lack jurisdiction under section 6330(d) to hear petitioners' appeal.

[5505] Reg. § 20.2056(b)-5(f)(4).

[5506] Rev. Rul. 85-35 approved a marital deduction for the following situation:

> State X has a statute that provides that the trustee has the discretion to pay any sum distributable to a beneficiary under legal disability, without liability to the trustee, by paying the sum to the beneficiary or by paying the sum for the use of the beneficiary either to a legal representative appointed by the court, or if none, to a relative.

III.B.6.b. Discount Planning Related to Marital Deduction Trusts

Marital trusts are included in the surviving spouse's gross estate at the surviving spouse's death. A QTIP trust is included under Code § 2044; however, their assets are not aggregated with the surviving spouse's other assets.[5507] For example, suppose a QTIP trust owned 30% of the voting stock of a corporation, and the surviving spouse owned 40% of the voting stock outright. Even though 70% of the voting stock is included in the surviving spouse's gross estate, each block is valued separately as stock that lacks control.

Contrast this with a general power of appointment trust, which is included in the surviving spouse's gross estate under Code § 2041. Assets included under Code § 2041 <u>are</u> aggregated with other assets. In the example above, if the marital trust were a general power of appointment trust instead of a QTIP trust, the surviving spouse's gross estate would be deemed to own a controlling 70% voting block.

If the spouses have a high degree of trust in each other, the author tends to include in a QTIP trust a 5% withdrawal right exercisable only during a limited duration each year (two weeks, for example). The enables the surviving spouse to withdraw stock and make gifts without having to justify a principal encroachment. If the surviving spouse dies during the period in which the surviving spouse can withdraw 5%, the withdrawal right is considered a general power of appointment, with all the negative consequences described above, but only with respect to 5% of the trust. If the withdrawal right lapses, the lapse is not treated as a release of a general power of appointment, and the entire trust retains its QTIP segregation for estate valuation purposes.

Another strategy a surviving spouse can use is to sell a voting interest to a credit shelter trust. If the surviving spouse is a beneficiary of the credit shelter trust, consider having the trust overpay for the voting stock, documenting the transaction as part sale, part distribution. This should preclude the IRS from successfully arguing that the surviving spouse made a gift to the trust (if the IRS were to successfully revalue the stock as worth more than what the surviving spouse thought it was worth); such a gift could create future Code § 2036 inclusion issues.

> A similar provision relating to trustee powers appeared in the trust instrument, which also specifically requires the trust income to be paid at least annually to the spouse, legal representative, or relative of the spouse. Further, the fiduciary standards imposed by state X prevent the abuse of the powers by the trustee and constrain the conduct of any third party distributee.

Estate of Whiting v. Commissioner, T.C. Memo. 2004-68, held that, although a disability clause permitted accumulation of income, that clause was superseded by the marital deduction savings clause. Letter Ruling 201117005 approved a marital deduction in which the trustee could pay or apply for the benefit of the spouse, as well as having some elaborate unitrust options. Letter Ruling 8901008 45 denied a marital deduction when the trustee was to distribute as much income as the trustee deemed necessary and prudent. Thus, all of the income must be distributed annually, but distributions may be in the form of paying the spouse's bills or paying to others who must spend it for the spouse's benefit. Highlighted excerpts of all of the above are in Thompson Coburn LLP doc. no. 6507787.

[5507] See part II.O.2, Spousal Issues in Buy-Sell Agreements and Related Tax Implications, footnote 2713.

III.B.6.c. Irrevocable Inter Vivos QTIP Trust

An irrevocable inter vivos QTIP trust can also come in handy when one spouse wants to leave the business directly to children instead of to the other spouse. Suppose Husband has $1 million in cash or marketable securities, and Wife owns the closely-held business. Husband transfers that to an irrevocable inter vivos QTIP trust for wife where Wife is the trustee and has a special power of appointment. After recapitalizing the corporation into voting and nonvoting stock, Wife sells voting stock with an estimated fair market value for $600,000 to the trust in exchange for $1 million. The sale should not be not subject to income tax.[5508] The $400,000 excess of value over purchase price is a distribution from the trust to Wife. If the IRS audits the transfer, it can increase the voting stock's value to as much as $1 million before considering any adverse estate tax consequences under Code §§ 2036 and 2038.[5509]

An inter vivos QTIP trust can also come in handy when transferring assets shortly before death. Code § 1014(e) prevents a basis step-up when one spouse gives assets to another within one year of the donee's death. Whether an outright sale from the surviving spouse to the almost-deceased spouse works depends on whether the treatment of a sale between spouses as a transfer by gift under Code § 1014 applies for purposes of Code § 1014(e)(1)(A). However, a sale to an inter vivos QTIP trust for the benefit of the soon-to-be-deceased spouse, which trust is deemed owned by the grantor who is the soon-to-be surviving spouse, can convincingly prevent Code § 1014(e) from applying:

- If Code § 1014(e)(1)(A) looks to transfers for income tax purposes, then nothing has happened at the time of the sale (disregarded transaction rather than transfer by gift), so Code § 1014(e)(1)(A) would not apply. Disregarding the sale for income tax purposes is founded on Rev. Rul. 85-13 and confirmed by Letter Ruling 200408015.[5510]

- If Code § 1014(e)(1)(A) looks to transfers for state law purposes, then Code § 1041 would not apply because that is an income tax rule and does not change the status for state law purposes. For state law purposes, the sale to the QTIP trust is a sale, not a gift. Therefore, Code § 1014(e)(1)(A) would not apply.

Also, after the donee spouse dies, if the property passes back to a trust for the grantor, then the trust is deemed owned by the grantor for income tax purposes; if this trust is outside of the estate tax system at that time, then one has a powerful tool – a trust outside of the estate tax system that is taxed to the original grantor (so long as the

[5508] For more details on the tax treatment, see part III.B.2.i.xiv Alternative Way to Have a Trust Benefitting Client: Sale to Trust Created by Spouse.

[5509] An adverse tax consequence could occur if wife did not receive adequate and full consideration for the stock she transferred to the trust.

[5510] Letter Ruling 200408015 is discussed further in fn. 5650, found in part III.B.7.d Code § 2702 Overview.

donee spouse did not exercise a general power of appointment,[5511] which is unlikely to be present in a QTIP trust).[5512]

When an inter vivos QTIP trust holds stock in an S corporation, consider making an ESBT election while both spouses are living.[5513]

III.B.6.d. Divorce as an Opportunity to Transfer

Code § 2516 protects certain transfers that are solely between spouses from gift tax consequences, but including children or others as transferees generates a gift from the spouse whose marital rights are foregone in exchange for including the children or other transferees.[5514]

Code § 2702 has complementary rules.[5515]

The resulting legal obligation can be a deductible claim against the estate of an owner who was legally bound to make such a transfer.[5516]

See also part III.B.7.b.iv Divorce Planning to Avoid Code § 2701.

When a client sells property to a spouse, as described below, Code § 1041 would cause nonrecognition of the gain on sale.[5517] The interest income and expense would be recognized for income tax purposes;[5518] however, for income tax purposes, interest is not required to be charged between spouses.[5519]

5511 Reg. § 1.671-2(e)(5).

5512 See Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trust," 21 *Prob. & Prop.* 52 (July/Aug. 2007).

5513 See part III.A.3.a.iii Steps an S Corporation Might Take to Avoid a Trust Falling Short, especially fns. 4386-4387.

5514 Rev. Ruls. 68-379 and 79-363.

5515 Regs. §§ 25.2702-1(c)(7) (no consequences if only the spouses are involved), 25.2702-4(d), Example (5) (remainder to children not protected by this exception); Letter Ruling 9235032 (giving spouse a qualified retained interest ascribes value to it for purposes of Code § 2516).

5516 I have been told that support for this position is in *Estate of Kosow v. Commissioner*, 45 F.3d 1524 (11th Cir. 1995).

5517 If the sale is for a loss, the basis would not be decreased to fair market value for purposes of calculating a loss. See Reg. § 1.1041-T(d), Q/A 11, expressly distinguishing Code § 1015(a).
Also, the possible interaction between Code § 1041 nonrecognition and Code § 897 taxing the gain of a nonresident alien from the disposition of a U.S. real property interest. Thompson Coburn doc. no. 6236395 describes these issues and why an expert believes that Code § 1041 nonrecognition should prevail.

5518 Code § 1041 provides that sales between spouses are not taxable. However, Code § 1041 does not provide for the exclusion of income; it merely provides for the nonrecognition of gain or loss. *Gibbs v. Commissioner*, T.C. Memo. 1997-196 (recognizing interest income), followed by *Craven v. U.S.*, 70 F.Supp.2d 1323 (D.C. Ga. 1999); *Seymour v. Commissioner*, 109 T.C. 279 (1997) (rebuffed IRA argument that interest expense was per se nondeductible personal interest and required looking at the use of the loan proceeds based on the interest tracing rule; allowed an interest deduction based on tracing); *Armacost v. Commissioner*, T.C. Memo. 1998-150 (followed Seymour; interest was deductible to the extent that loan proceeds were used for taxable investments); *Yankwich v. Commissioner*, T.C. Memo. 2002-37 (interest income recognized); TAM 200624065. The *Gibbs* court pointed out that, although under certain circumstances

Code § 1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or a former spouse, but only if the transfer is incident to the divorce. For purposes of the latter , a transfer of property is incident to the divorce if such transfer occurs within one year after the date on which the marriage ceases, or is related to the marriage's cessation.[5520]

If Code § 1041(a) applies, the property shall be treated as acquired by the transferee by gift for income tax purposes,[5521] and the transferee's basis in the property shall be the transferor's adjusted basis.[5522]

Code § 1041(a) nonrecognition does not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.[5523]

Code § 1041(a) nonrecognition also does not apply to the transfer of property in trust to the extent that the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred.[5524] Any gain recognized by reason of the preceding sentence affects basis.[5525] For transfers directly between spouses, liabilities in excess of basis do not generate recognition.[5526] Presumably grantor trusts are disregarded for purposes of this rule.[5527]

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specific statutes (such as Code §§ 104(a)(2) and 1033) control the Federal income tax consequences of certain awards, judgments, or payments, the statutes do not necessarily control the Federal income tax consequences of interest paid to the taxpayer in connection with such awards, judgments, or payments.

[5519] Prop. Reg. § 1.7872-11(c), under the authority of Code § 7872(f)(7).

[5520] Code § 1041(c).

[5521] This reference to treatment as a gift can be confusing. To clarify, Reg. § 1.1041-1T, A-11 includes:

> This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than its fair market value at the time of transfer (or the value of any consideration provided by the transferee) and applies for purposes of determining loss as well as gain upon the subsequent disposition of the property by the transferee. Thus, this rule is different from the rule applied in section 1015(a) for determining the basis of property acquired by gift.

[5522] Code § 1041(b).

[5523] Code § 1041(d).

[5524] Code § 1041(e).

[5525] Code § 1041(e).

[5526] Reg. § 1.1041-1T includes:

> Q-12. Do the rules described in A-10 and A-11 apply even if the transferred property is subject to liabilities which exceed the adjusted basis of the property?
>
> A-12. Yes. For example, assume A owns property having a fair market value of $10,000 and an adjusted basis of $1,000. In contemplation of making a transfer of this property incident to a divorce from B, A borrows $5,000 from a bank, using the property as security for the borrowing. A then transfers the property to B and B assumes, or takes the property subject to, the liability to pay the $5,000 debt. Under section 1041, A recognizes no gain or loss upon the transfer of the property, and the adjusted basis of the property in the hands of B is $1,000.

[5527] See part III.B.2.d Income Tax Effect of Irrevocable Grantor Trust Treatment.

III.B.7. Chapter 14

Congress enacted much of Chapter 14 to avoid perceived abuses in valuing transfers of family-controlled business entities. Below this portion considers how retained equity interests are valued (and how to avoid such valuation), and the circumstances under which agreements to require or restrict transfers are considered in determining the value of what is transferred. We will focus on how Chapter 14 might affect the beneficial equity structures and deferred compensation techniques described in part II Income Tax Flexibility. After focusing on this interaction, the portion further below after this one brings the Code §409A overlay into play and tries to find some "sweet spots" which one might seek in structuring businesses.

Running the gift tax statute of limitations for Chapter 14 transfers requires filing a gift tax return that provides:[5528]

(i) A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each;

(ii) The identity of, and relationship between, the transferor, transferee, all other persons participating in the transactions, and all parties related to the transferor holding an equity interest in any entity involved in the transactions; and

(iii) A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before the valuation date.

III.B.7.a. Overview of Chapter 14 Rules Regarding Family-Controlled Business Entities

Generally, Code § 2701 values transfers from older family members to younger family members. Code § 2703 allows the IRS to disregard buy-sell and transfer restrictions in many situations. Code § 2704 allows the IRS to disregard restrictions on liquidating an entity in certain situations.

Does Chapter 14 apply to interests in family-controlled business entities when they are transferred as compensation for services rendered by a family member? The regulations governing transfers in the ordinary course of business are expressly subject to Chapter 14.[5529] Furthermore, those regulations generally apply to protect transactions made between unrelated parties from gift tax scrutiny, whereas transactions between

[5528] Reg. § 301.6501(c)-1(e)(2). Reg. § 301.6501(c)-1(e)(1) prevents us from relying on the income tax return exception that Reg. § 301.6501(c)-1(f)(4) provides for transactions in the ordinary course of business.
[5529] See the last sentence of Reg. § 25.2512-8.

related parties are subjected to the usual scrutiny even if the business is an operating business.[5530]

III.B.7.b. Code § 2701 Overview

Code § 2701 applies for gift tax purposes.[5531]

Rev. Rul. 83-120 provides general rules for valuing preferred stock (or presumably an interest in a preferred partnership). Also, if a recapitalization of a closely held corporation causes a shift in the value of the interests of the beneficiaries of trusts that own stock in the corporation, the shift is treated as a transfer for estate and gift tax purposes.[5532] With these general rules as background, consider that Code § 2701 imprints an additional layer of rules when preferred stock or an interest in a preferred partnership is involved.

[5530] See Rev. Ruls. 68-558 (no gift tax on citizens' contributions to company to entice it to invest to create jobs in the community), 72-583 (ignore subjective intent), 77-131 (ignore subjective intent), 80-196 (no gift tax when shareholders transferred stock to unrelated key employees; note that Reg. § 1.83-6(d)(1) treats such transactions for income tax purposes as a contribution to the capital of the corporation followed by compensation paid by the corporation to the employees) (see part II.M.4.c.i When a Gift to an Employee Is Compensation and Not a Gift), and 81-54 (transaction that had legitimate business purpose was done in a manner that constituted a taxable gift to children, with ongoing annual gifts to the extent of profits paid to the children); *Estate of Cullison v. Commissioner*, T.C. Memo. 1998-216 (applying the following standards in holding for the IRS: Transfers of property in the ordinary course of business … are not subject to gift tax. …. To qualify, the transaction must be bona fide, at arm's length, and free from donative intent. …. As we further noted in *Harwood v. Commissioner*…: 'Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift.), *aff'd* 221 F.3d 1347 (9th Cir. 2000); *Estate of Ellie B. Williams v. Commissioner*, T.C. Memo. 1998-59 (transfers were gifts, not compensation for services, in light of (a) the fact that decedent did not agree to transfer property to petitioner as part of their business relationship, (b) decedent's personal relationship with petitioner, (c) her history of making gifts to him, and (d) the estate's signing of the gift tax returns); Letter Rulings 9117035 (ESOP transaction that indirectly benefited son deemed gift), 9253018 (applying Code § 2701 in a different ESOP transaction), 199928013 (bonuses to son were not gifts because they were part of a larger plan that primarily benefited employees not related to the principal shareholder), and 200014004 (excess compensation for services rendered as trustee was a gift); and *Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005) (when an ESOP and decedent were the only shareholders in the company, the estate would have been required to pay estate taxes for having made a bargain sale to the ESOP; however, requirement to use death benefit to buy stock offset that difference), *aff'g in part and rev'g in part* T.C. Memo. 2004-116; but see *Estate of Pearl I. Amlie v. Commissioner*, T.C. Memo. 2006-76 (Code § 2703(b)(1) business purpose was also a business purpose under Reg. § 25.2512-8; business purposes included hedging the holdings of a conservatorship estate and planning for future liquidity needs of the decedent's estate).

[5531] See fn. 1404, found in part II.H.2.j Effect of Chapter 14 on Basis Step-Up.

[5532] Rev. Rul. 86-39.

Furthermore, it treats as held by an individual any equity interest "to the extent the interest is held indirectly through a corporation, partnership, estate, trust, or other entity."[5533]

Also note that Code § 2701 does not apply for purposes of the tax on generation-skipping transfers.[5534]

Practical uses of preferred partnerships include:

- Part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

- Migrating from a corporation into the structure described in part II.E Recommended Structure for Entities. See parts II.E.7.c Flowcharts: Migrating Existing Corporation into Preferred Structure and II.Q.7.h Distributing Assets; Drop-Down into Partnership, the latter including part II.Q.7.h.viii Value Freeze as Conservative Alternative.

Code § 2036 should not apply to a transaction covered by Code § 2701.[5535]

III.B.7.b.i. Code § 2701 Definitions

Code § 2701(a)(1) values "transfers" when a transferor or "applicable family member" (the older generation) holds an "applicable retained interest" (a preferential distribution or liquidation right) after making a transfer of an interest in a corporation or partnership[5536] to a "member of the transferor's family" (a younger generation); an example of such a transfer is a preferred stock or preferred partnership freeze.[5537] Let's examine the meaning of these quoted terms and consider exceptions to these rules.

[5533] Reg. § 25.2701-6(a)(1), which goes on to say, If an equity interest is treated as held by a particular individual in more than one capacity, the interest is treated as held by the individual in the manner that attributes the largest total ownership of the equity interest.

[5534] See part II.H.11.e Using Preferred Partnership that Intentionally Violates Code § 2701, especially fn. 1480

[5535] See fn. 1466.

[5536] Prop. Reg. § 25.2701-2(b)(5)(i) would provide:

> For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of § 301.7701-2(a) of this chapter controlled, immediately before a transfer, by the transferor, applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse. The form of the entity determines the applicable test for control. For purposes of determining the form of the entity, any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B) is a corporation. For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. In the case of any business entity that is not a corporation under these provisions, the form of the entity is determined under local law, regardless of how the entity is classified for federal tax purposes or whether it is disregarded as an entity separate from its owner for federal tax purposes. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under whose laws the entity is created or organized.

[5537] For more information on preferred partnerships, see part II.H.11 Preferred Partnership to Obtain Basis Step-Up on Retained Portion.

"Transfer" generally includes a contribution to capital, a capital structure transaction such as redemption, recapitalization, or other change in the capital structure of a corporation or partnership, or certain terminations of an indirect holding in the entity.[5538] However, it does not include:[5539]

- A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[5540]

- A shift of rights due to a Code § 2518 qualified disclaimer.

- A shift of rights occurring upon the release, exercise, or lapse of a nongeneral power of appointment, except to the extent the release, exercise, or lapse would otherwise be a transfer for gift tax purposes.

For most purposes of Code § 2701, "applicable family member" means "the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor."[5541] ***Multigenerational partnerships can be quite tricky, in that every transfer the second generation makes needs to consider the interests retained by not only the second generation but also the first generation.***

[5538] See Code § 2701(e)(5) and Reg. § 25.2701-1(b)(2)(i), the latter providing:

In general. Except as provided in paragraph (b)(3) of this section, for purposes of section 2701, transfer includes the following transactions:

(A) A contribution to the capital of a new or existing entity;

(B) A redemption, recapitalization, or other change in the capital structure of an entity (a capital structure transaction), if-

(1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

(2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a subordinate interest) and receives property other than an applicable retained interest; or

(3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased; or

(C) The termination of an indirect holding in an entity (as defined in § 25.2701-6), (or contribution to capital by an entity to the extent an individual indirectly holds an interest in the entity), if-

(1) The property is held in a trust as to which the indirect holder is treated as the owner under subchapter J of chapter 1 of the Internal Revenue Code; or

(2) If the termination (or contribution) is not treated as a transfer under paragraph (b)(2)(i)(C)(1) of this section, to the extent the value of the indirectly-held interest would have been included in the value of the indirect holder's gross estate for Federal estate tax purposes if the indirect holder died immediately prior to the termination.

[5539] Reg. § 25.2701-1(b)(3).

[5540] See part III.B.7.b.iii Capital Structure Transaction, If Each Individual Holds Substantially The Same Interest After The Transaction As That Individual Held Before The Transaction.

[5541] Code § 2701(e)(2); see Reg. § 25.2701-1(d)(2).

"Member of the family" means "the transferor's spouse, a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant."[5542]

"Applicable retained interest" includes the following:

- A "distribution right," but only if, immediately before the transfer, the transferor and applicable family members "control" the entity:[5543]
  - A "distribution right" is a right to distributions from an entity with respect to stock in a corporation or a partner's interest in a partnership.[5544] However, it does not include:[5545]
    - a right to distributions with respect to an interest that is of the same class or subordinate to the transferred interest,
    - an extraordinary payment right (a liquidation, put, call, or conversion right), or
    - a right to receive guaranteed payments from a partnership of a fixed amount.
  - "Control" means:
    - In the case of a corporation, at least 50%, by vote or value, of the corporation's stock.[5546] To be considered, voting rights must extend beyond the right to vote in liquidation, merger, or a similar event.[5547] A person is considered to own a voting right if that person can exercise that right alone or in conjunction with another person.[5548] Permissible recipients of income from the equity interest and other beneficiaries, rather than the trustee, are considered to hold voting rights that are in trust.[5549] Voting rights subject to a contingency that has not occurred do not count unless the holder of the right can control the contingency.[5550]
    - In the case of a partnership:[5551]
      - At least 50% of the capital or profits interests, or
      - In the case of a limited partnership, any interest as a general partner.[5552]

[5542] Code § 2701(e)(1); see Reg. § 25.2701-1(d)(1).
[5543] Code § 2701(b)(1)(A); Reg. § 25.2701-2(b)(1)(ii).
[5544] Code § 2701(c)(1)(A).
[5545] Code § 2701(c)(1)(B); Reg. § 25.2701-2(b)(3).
[5546] Code § 2701(b)(2)(A).
[5547] Reg. § 25.2701-2(b)(5)(ii)(B).
[5548] Reg. § 25.2701-2(b)(5)(ii)(B).
[5549] Reg. § 25.2701-2(b)(5)(ii)(B).
[5550] Reg. § 25.2701-2(b)(5)(ii)(B).
[5551] Code § 2701(b)(2)(B). See Letter Ruling 9639054 for one limited partnership scenario, involving ownership of the corporate general partner. Jonathan Blattmachr said that he obtained it after bringing in the author of the regulations and holding four meetings.
[5552] Reg. § 25.2701-2(b)(5)(iii).

- Under proposed regulations,[5553] for any other entity:

  - Holding at least 50% of either the capital interests or the profits interests in the entity or arrangement, or

  - Holding any equity interest with the ability to cause the liquidation of the entity or arrangement in whole or in part.

  The above excludes any Code § 707(c) guaranteed payment of a fixed amount.[5554]

  Solely for purposes of this "control" test, "applicable family member" includes any descendant of any parent of the transferor or the transferor's spouse.[5555]

- An extraordinary payment right.[5556] Generally, an extraordinary payment right includes a liquidation, put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the transferred interest's value.[5557] A "call right" includes any warrant, option, or other right to acquire one or more equity interests.[5558]

Notwithstanding the above, certain rights are not applicable retained interests:[5559]

- A mandatory payment right.[5560] This is a right to receive a payment at a specific time (including a date certain or the holder's death) for a specific amount.

- A liquidation participation right.[5561] This is a right to participate in a liquidating distribution. However, generally the right to ***compel*** liquidation is treated as if it did not exist if the transferor, members of the transferor's family, or applicable family members have the ability to compel liquidation.

- A right to a guaranteed payment of a fixed amount under Code § 707(c).[5562] The time and amount of payment must be fixed. The amount is considered fixed if determined at a fixed rate, including a rate that bears a fixed relationship to a specified market interest rate.

5553 Prop. Reg. § 25.2701-2(b)(5)(iv).
5554 Reg. § 25.2701-2(b)(5)(iii). See text accompanying footnote 5562. For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.
5555 Code § 2701(b)(2)(C).
5556 Reg. § 25.2701-2(b)(1)(i), (b)(2); see Code § 2701(b)(1)(B).
5557 Reg. § 25.2701-2(b)(1)(i), (b)(2).
5558 Reg. § 25.2701-2(b)(2).
5559 Reg. § 25.2701-2(b)(4).
5560 Reg. § 25.2701-2(b)(4)(i). Letter Ruling 9535026 conditioned the non-application of Code § 2701 to a sale for a note on the note not being characterized as equity; however, the ruling did not address that notes would be excluded from Code § 2701 as mandatory payment rights.
5561 Reg. § 25.2701-2(b)(4)(ii).
5562 Reg. § 25.2701-2(b)(4)(iii). For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.

- A non-lapsing conversion right.[5563] This is a non-lapsing right to convert an equity interest:
  - Into a fixed number or fixed percentage of shares in a corporation that are the same class as the transferred interest.
  - Into a specified interest in the partnership (not represented by a fixed dollar amount) that is the same class as the transferred interest.

In both cases:

- Differences in voting rights are ignored.
- The conversion right must be subject to proportionate adjustments:
  - For a corporation, such adjustments must be made with respect to splits, combinations, reclassifications, and similar changes in capital stock.
  - For a partnership, the equity interest must be protected from dilution resulting from changes in partnership structure.

In testing who holds an applicable retained interest, consider the broad attribution rules of Reg. § 25.2701-6, which attribute an interest held indirectly through a corporation, partnership, estate, trust, or other entity,[5564] even to the extent of attributing an interest held through a grantor trust in which the grantor holds no beneficial interest.[5565] Grantor trust attribution takes first priority in determining who owns applicable retained interest but takes a back seat to the actual transferee in determining who owns subordinate interests.[5566]

[5563] Reg. § 25.2701-2(b)(4)(iv).

[5564] Reg. § 25.2701-6(a)(1).

[5565] Reg. § 25.2701-6(a)(4)(ii)(C). And, if one has a beneficial interest in a trust, one must assume maximum exercise of the trustee's discretion in the beneficiary's favor. See the text accompanying fn 5644, found in part III.B.7.d Code § 2702 Overview, but also see fn. 5566 for limitations on that.

[5566] Reg. § 25.2701-6(a)(5) provides:

(i) *Applicable retained interests*. If this section attributes an applicable retained interest to more than one individual in a class consisting of the transferor and one or more applicable family members, the interest is attributed within that class in the following order—

(A) If the interest is held in a grantor trust, to the individual treated as the holder thereof;

(B) To the transferor;

(C) To the transferor's spouse; or

(D) To each applicable family member on a pro rata basis.

(ii) *Subordinate equity interests*. If this section attributes a subordinate equity interest to more than one individual in a class consisting of the transferor, applicable family members, and members of the transferor's family, the interest is attributed within that class in the following order—

(A) To the transferee;

(B) To each member of the transferor's family on a pro rata basis;

III.B.7.b.ii. Certain Exclusions from Code § 2701

Code § 2701 does not apply to:

- Transferred interests that are marketable securities.[5567]

- Applicable retained interests that are marketable securities.[5568]

- A capital structure transaction, if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[5569] Letter Ruling 9321046 held that this exception did not apply to an irrevocable trust that was deemed owned by the grantor, because attribution rules deem the grantor to own any senior interests and the trust to own any subordinate interests.[5570]

- A retained interest that is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest.[5571]

- A transfer by an individual to a member of the individual's family of equity interests to the extent the transfer by that individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer.[5572]

> (C) If the interest is held in a grantor trust, to the individual treated as the holder thereof;
>
> (D) To the transferor;
>
> (E) To the transferor's spouse; or
>
> (F) To each applicable family member on a pro rata basis.

[5567] Reg. § 25.2701-1(c)(1).

[5568] Reg. § 25.2701-1(c)(2).

[5569] Reg. § 25.2701-1(b)(3)(i).

[5570] See fn. 5566. Zaritsky & Aucutt, ¶ 2.02[4] Indirect Transfers, *Structuring Estate Freezes: Analysis With Forms* (WG&L), refer to the Letter Ruling as a fascinating and informative application of the indirect-holdings and indirect-transfer rules. Note that the ruling held, The taxpayer is treated as making a gift to the extent that the value of her life estate in the common stock held by her prior to the recapitalization exceeds the value of her life estate in the preferred and common stock received in the recapitalization, not mentioning the possible application of Code § 2702 to the transferor's retained interest in the trust. However, Code § 2702 might be unnecessary to protect the government's interest in a Code § 2701 case. See the text accompanying fn 5644, found in part III.B.7.d Code § 2702 Overview, but also see fn. 5566 for limitations on that.

[5571] See Reg. § 25.2701-1(c)(3), reproduced in the text accompanying fn. 5607 and further analyzed in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

[5572] Reg. § 25.2701-1(c)(4), which further provides:

> Thus, for example, section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P's child in a manner that reduces each interest held by P and any applicable family members, in the aggregate, by 10 percent even if the transfer does not proportionately reduce P's interest in each class. See § 25.2701-6 regarding indirect holding of interests.

III.B.7.b.iii. Capital Structure Transaction, If Each Individual Holds Substantially The Same Interest After The Transaction As That Individual Held Before The Transaction

Among various exceptions, a capital structure transaction is not subject to Code § 2701 if the transferor, each applicable family member, and each member of the transferor's family holds substantially the same interest after the transaction as that individual held before the transaction.[5573] For this purpose, common stock with non-lapsing voting rights and nonvoting common stock are interests that are substantially the same.

Letter Ruling 9427023 invoked this exception when partners in a straight-up partnership made additional capital contributions in proportion to their then-current interests. Letter Ruling 200026011 invoked this exception when an S corporation underwent a Code § 368(a)(1)(E) recapitalization in which the shareholders received one share of voting and ten shares of nonvoting common stock for every share of voting common stock currently held. Letter Rulings 9414012 and 9414013 invoked this exception when an S corporation issued nonvoting stock and when the senior generation gave nonvoting stock (with identical distribution and liquidation rights) to the next generation. None of the above letter rulings sheds any light on this exception, because all of these entities were straight-up: each ownership interest had identical distribution and liquidation rights, so Code § 2701 really did not apply anyway.

In Code § 355 spin-offs involving applicable retained interests, Letter Ruling 9843010 invoked this exception because "the shareholders will have substantially the same interests, rights, and limitations in the new entities and in Corporation, and with respect to the underlying assets of each, as each shareholder had before the transaction."

Letter Ruling 9309018 invoked this exception to approve a reverse split intended to avoid Delaware franchise tax:

> In the instant case, each preferred stockholder would hold the same percentage of the issued and outstanding preferred stock and the same overall percentage interest in the equity of the corporation after the proposed recapitalization as he or she would prior to the proposed recapitalization. In similar fashion, each common stockholder would hold the same percentage of the issued and outstanding common stock and the same overall percentage interest in the equity of the corporation after the proposed recapitalization as he or she would prior to the proposed recapitalization. Thus, each stockholder of [the corporation] would hold substantially the same interest in the corporation after the proposed transaction as he or she did prior to the proposed transaction.

Letter Ruling 199947034 invoked this exception to approve a Code § 368(a)(1)(F) reorganization of a C corporation, that had a complicated capital structure, from corporate form to an LLC so that:

> Taxpayer and the other shareholders of Corporation will exchange their shares in Corporation for an identical number of units in LLC with rights, preferences, and

[5573] Reg. § 25.2701-1(b)(3)(i).

> restrictions identical to the rights, preferences, and restrictions each shareholder held in Corporation before the transfer.

In ruling that Code § 2701 did not apply, the IRS reasoned:

> In this case, each share of stock held by Taxpayer carries the same rights and restrictions as every other share of stock held by Taxpayer including voting rights that will lapse if that share is transferred. Thus, because Taxpayer's entire interest in the Corporation is an interest in one class, if Taxpayer transfers less than Taxpayer's entire interest in the Corporation, the retained interest will be of the same class as the transferred interest.

The Conference Committee Report on which this exception presumably is based said:

> The conference agreement provides, however, that the provision would not apply to a change in capital structure other than a contribution to capital if the interests held by the transferor, applicable family members, and family members are substantially identical before and after the change. The provision would not apply, for example, to a recapitalization not involving a contribution to capital if all shareholders held substantially identical interests both before and after the recapitalization. Nor would it apply to a change in corporate name. In addition, the conferees intend that the addition of capital to an existing partnership or corporation would result in the application of these rules only to the extent of such contribution.

This exception is in some ways similar to the exception invoked when the retained interest that is of the same class of equity as the transferred interest, which is described in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

III.B.7.b.iv. Divorce Planning to Avoid Code § 2701

The lack of family relationship between former spouses can create planning opportunities. Consider this example:[5574]

> If two individuals who are married to each other want to use this planning device for the benefit of their children, a divorce prior to implementing the plan would avoid the disadvantages of § 2701. For example, if spouse A owns preferred and common stock in corporation X, a divorce from spouse B would enable him or her to sell the preferred stock to B while simultaneously giving the common to their children because B will no longer be a family member of A.

See also part III.B.6.d Divorce as an Opportunity to Transfer.

III.B.7.c. Code § 2701 Interaction with Income Tax Planning

How does Code § 2701 inform the discussion further above on ways to plan for entity transfers? Below is a qualitative analysis; quantifying these amounts using the

[5574] C. McCaffrey & J. McCaffrey, *Obergefell* and the Authority of the IRS to Challenge Valid Marriages and Divorces, *Steve Leimberg's Estate Planning Email Newsletter*, No. 2345 (9/21/2015).

complicated subtraction method[5575] is beyond the scope of these materials, although an application is described in part III.B.7.c.i.(b) CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer.

Our discussion begins with profits interests, which are favorable treated for income tax purposes and are not subject to the restrictions that Code § 409A places on deferred compensation.[5576] When we discover the Code § 2701 problems they present, we will discuss alternatives, which themselves can present challenges of Code § 409 or 2703.

III.B.7.c.i. Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer

Some take the position that Code § 2701 would not apply to the issuance of profits interests.[5577] In planning, I would rather explore the IRS' possible arguments and work around the problem than argue which approach is correct.

III.B.7.c.i.(a). General Discussion of Implications of Profits Interest in a Partnership that Was a Straight-Up Partnership before the Transfer

Suppose a parent transfers a profits interest to a child and retains the parent's capital account. The IRS would argue that the parent's capital account would be an applicable retained interest, valued at significantly less than its face amount, so that the transfer to the child will be treated as a transfer of much of the parent's capital account as well.[5578] However:

- This rule will not apply if the following, added together, are less than 50% of the partnership's income and less than 50% of the partnership's capital:
  - The parent's and child's interests, and
  - Interests of any combination of:
    - Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor), and

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5575 Reg. § 25.2701-3(b). The lack of family attribution under the *Bright* case, which the IRS conceded in Rev. Rul. 93-12, was decided after this regulation was issued, so presumably that trumps certain aspects of the subtraction method. The person who pointed this out to me said that he has prepared Form 8275-R taking this position one time, and the tax return was not audited.
5576 See part II.M.4.f Issuing a Profits Interest to an Employee.
5577 Dees, Profits Interests Gifts under Section 2701: 'I Am Not a Monster,' *Tax Notes* 5/11/2009, also found at http://www.mwe.com/info/pubs/profits.pdf. For a less optimistic view, see Wendel and Hatcher, How to Profit without Getting Carried Away: Carried Interests, Profits Interests, Or Black Holes? 2009 *ACTEC Annual Meeting* (paper dated 1/14/2009).
5578 In determining the value of the payment of the retained capital account, one must ignore the family's right to compel liquidation. See text accompanying footnote 5561.

- Descendants of the parents of the parent or the parent's spouse (in other words, the parent's and parent's spouse's siblings and the descendants of the parent, of the parent's spouse, or of such siblings).

- The parent may reduce the gift based on the discounted present value of the right to receive the capital account if either:

  - The partnership must pay the capital account to the parent at a "specific time," such as a specific date or the parent's death, or

  - One does not rely on liquidation (at which time the capital account would be paid to the parent) being compelled by any combination of:

    - The parent,

    - Members of the parent's family (the parent's spouse, a descendant of the parent or the parent's spouse, and the spouse of any such descendant), and

    - Applicable family members (the parent's spouse, an ancestor of the parent or of the parent's spouse, and the spouse of any such ancestor).

The parent can enhance the retained capital account's present value by retaining a cumulative distribution right with respect to the capital account. For example, if the partnership were required to pay the parent annually 7% of the parent's capital account and that right either was not contingent on profits[5579] or was cumulative,[5580] then the parent could also reduce the gift on account of the present value of that payment right.

The value of a junior equity interest cannot be valued at less than 10% of the sum of the total value of all equity interests in the partnership and the total amount of the partnership's indebtedness to the parent and other applicable family members.[5581] In a

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[5579] Thereby constituting a guaranteed payment right under Reg. § 25.2701-2(b)(4)(iii). Instead of using 7% (arbitrarily selected for this example), one could use the prime rate or some other market rate.

[5580] Thereby constituting a qualified payment under Code § 2701(c)(3)(C)(i) (first sentence) and Reg. § 25.2701-2(b)(6)(ii). The transferor or an applicable family member who holds a distribution right that does not qualify may nevertheless treat the right as a qualified payment if he or she makes a special election under Code § 2701(c)(3)(C)(i) (second sentence) and Reg. § 25.2701-2(c)(4). Finally, additional gift tax may be imposed under Code § 2701(d) if the qualified payment is not made within the four-year grace period allowed under Code § 2701(d)(2)(C).

[5581] Code § 2701(a)(4); Reg. § 25.2701-3(c). Such indebtedness does not include short-term indebtedness incurred with respect to the current conduct of the entity's trade or business (such as amounts payable for current services); indebtedness owed to a third party solely because it is guaranteed by the transferor or an applicable family member; amounts permanently set aside in a qualified deferred compensation arrangement, to the extent the amounts are unavailable for use by the entity; or a qualified lease. Reg. § 25.2701-3(c)(3). A lease of property is not indebtedness, without regard to the length of the lease term, if the lease payments represent full and adequate consideration for use of the property. Lease payments are considered full and adequate consideration if a good faith effort is made to determine the fair rental value under the lease and the terms of the lease conform to the value so determined. Arrearages with respect to a lease are indebtedness.

partnership, "junior equity interest" means any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests.[5582] Although a profits interest typically would be junior with respect to capital, generally it would not be junior with respect to income.[5583] Thus, generally the 10% minimum value rule would not apply to profits interests. However, as a practical matter, often appraisers of qualified retained interests require junior interests to be worth at least 20% of the entity to give full valuation effect to the stated payments, so avoiding the 10% minimum value rule would not necessarily be helpful.

On the other hand, if one needs to go through all of this complexity, one might consider abandoning the profits interest idea and instead using a GRAT.[5584] If the parent wants to transfer only a small portion, the parent could transfer a vertical slice (described further below) of what the parent owns and place a ceiling on the amount that is ultimately transferred to the child. If the parent's goal in transferring a profits interest is to incentivize the child, the GRAT's ceiling could be based on objective business performance measures.

- The issuance of a pure profits interest[5585] does not have Code § 409A implications.[5586] The Code § 409A analysis is not affected by whether the profits interest is junior to another interest.

- Suppose the partnership issues the interest to the child, instead of the parent transferring the interest. Code § 2701 applies to a "change in the capital structure" of a partnership or corporation in certain situations.[5587] However, Code § 2701 applies to a change in capital structure only if:[5588]

    (1) The transferor or an applicable family member receives an applicable retained interest in the capital structure transaction;

    (2) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest that is junior to the applicable retained interest (a "subordinate interest") and receives property other than an applicable retained interest; or

    (3) The transferor or an applicable family member holding an applicable retained interest before the capital structure transaction surrenders an equity interest in the entity (other than a subordinate interest) and the fair market value of the applicable retained interest is increased.

[5582] Code § 2701(a)(4)(B); Reg. § 25.2701-3(c)(2).
[5583] However, if the parent retained a cumulative distribution as recommended above, then the profits interest would be junior as to income, and presumably the 10% minimum value rule would apply.
[5584] The author remembers the late Mil Hatcher for his creativity in suggesting the GRAT alternatives described here.
[5585] By pure profits interest the author means a partnership interest that would be allocated nothing if liquidation were to occur at the time of transfer of such interest.
[5586] See II.M.4.f Issuing a Profits Interest to an Employee.
[5587] Code § 2701(e)(5).
[5588] Reg. § 25.2701-1(b)(2)(i)(B).

In this variation, the parent does not hold an applicable retained interest before the transaction. Thus, we look to paragraph (1) and not to paragraphs (2) or (3). Because the parent has retained the capital account that he had before the transaction, rather than receiving a capital account,[5589] has the parent "received" an applicable retained interest in the transaction?

Suppose a client has acquired a preferred interest in a partnership controlled by the next generation, but lots of others have invested in the partnership? Although Code § 2701 applies, the transaction might not constitute a gift, because it was done in the ordinary course of business.[5590] I would not plan a partnership assuming that exception applied, because the facts-and-circumstances nature makes the result uncertain, but it can provide relief when taxpayers business-motivations predominate.

III.B.7.c.i.(b). CCA 201442053 Discusses Profits Interest in a Partnership That Was a Straight-Up Partnership before the Transfer

Code § 7872 generally does not apply to transactions between partnerships and partners. See part II.G.3.a.i Loans to Businesses – Whether AFR Is Required.

CCA 201442053[5591] was essentially an attempt to make a 20-year interest-free loan to children using a partnership. The CCA applied Code § 2701 to fulfill the role of Code § 2701 in backstopping Code § 7872. After reviewing what the IRS said, this memo will discuss why this attempt was such a bad idea and that the taxpayers would have been better off simply loaning the money instead of messing around with a partnership structure.

In CCA 201442053, after forming and operating a straight-up partnership:

> …at a time when Donor held an X percent ownership interest, Child A and Child B each held a Y percent ownership interest and Donor's grandchildren collectively held the remaining Z percent ownership interest, Company was recapitalized. In exchange for the agreement of Child A and Child B to manage Company, the operating agreement was amended to provide that henceforth all profit and loss, including all gain or loss attributable to Company's assets, would be allocated equally to Child A and Child B. After the recapitalization, Donor's and the grandchildren's sole equity interest in Company was the right to distributions based on their capital account balances as they existed immediately prior to the recapitalization.
>
> The gift tax liability of the grandchildren is not at issue herein, and will not be further discussed.

[5589] This approach cannot be taken if done in conjunction with a contribution to capital. Reg. § 25.2701-1(b)(2)(i)(A).
[5590] See text accompanying fns. 5529 (ordinary course of business exception is subject to Chapter 14) and 5530 (when the exception has or has not been applied).
[5591] I have heard that, although this is designated a CCA, it really was an informal legal memorandum, without any input from the taxpayer or other procedural safeguards.

The CCA concluded that the shifting of the profits interests constituted a gift:

> For purposes of § 2701, a transfer includes a recapitalization or other change in the capital structure of an entity if the transferor holding an applicable retained interest before the capital structure transaction surrenders a subordinate interest and receives property other than an applicable retained interest. Section 25.2701-1(b)(2)(B)(2).[5592] An applicable retained interest is an interest in a family-controlled entity with respect to which there is a distribution right. Section 25.2701-2(b)(1)(ii). A subordinate interest is an interest as to which an applicable retained interest is a senior interest. Section 25.2701-3(a)(2)(iii). A senior interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Section 25.2701-3(a)(2)(ii). The term "property" includes every species of right or interest protected by law and having an exchangeable value.
>
> Here, at all relevant times, Donor and her family controlled Company. On Date 3, Company was recapitalized and Donor surrendered her right to participate in future profit and loss, including future gain or loss attributable to Company's assets. Both before and after the recapitalization, Donor held an applicable retained interest, an equity interest in Company coupled with a distribution right.[5593] Donor's interest, which carried a right to distributions based

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[5592] [my footnote, not the CCA's:] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), argues that the regulations exceed their statutory mandate by applying Code § 2701 to this recapitalization. Judge for yourself by reading Code § 2701(e)(5), which provides:

> Except as provided in regulations, a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership shall be treated as a transfer of an interest in such entity to which this section applies if the taxpayer or an applicable family member—
>
> (A) receives an applicable retained interest in such entity pursuant to such transaction, or
>
> (B) under regulations, otherwise holds, immediately after such transactions, an applicable retained interest in such entity.
>
> This paragraph shall not apply to any transaction (other than a contribution to capital) if the interests in the entity held by the transferor, applicable family members, and members of the transferor's family before and after the transaction are substantially identical.

[5593] [my footnote, not the CCA's:] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), criticizes the CCA for referring to Donors' equity interest as an applicable retained interest. His analysis correctly points out that the CCA's fails to discuss extraordinary payment rights (EPRs) in its shorthand description of the definition an applicable retained interest (ARI). However, let's look past that sloppy shorthand and apply the definition of an ARI to the original interest and to the retained interest; refer to the analysis in part III.B.7.b.i Code § 2701 Definitions.

ARI means an equity interest with respect to which there is either an EPR ***<u>or</u>*** a distribution right, so all the CCA needed to find was either an EPR or a distribution right. Reg. § 25.2701-2(b)(1). Key to his analysis regarding the original rights is Reg. § 25.2701-2(b)(3)(i), which says that distribution right does not include any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest. In this case, the original interest was a right to receive a capital account on liquidation, coupled with a right to profits. The transferred interest was a right to profits. Using the same reasoning as in fn. 5594, the original interest is not subordinate to the transferred interest. Thus, the remaining question in

> upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and gain. Donor received property in the form of the agreement of Child A and Child B to manage Company. Accordingly, the recapitalization constitutes a transfer by Donor for purposes of § 2701.

The statement, "Donor's interest, which carried a right to distributions based upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and gain," is an incorrect conclusion. Although the original interest had more rights than the transferred interest, the original interest had no rights that entitled it to payment earlier (higher in priority) than the transferred interest.[5594]

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determining whether the original interest included a distribution right is whether it is the same class as the transferred interest. Dees views them as the same class, presumably because both interests have rights in the same assets and have no payment preferences. However, the IRS might argue that Dees' approach is too narrow, because Reg. § 25.2701-1(c)(3) seizes on any differences whatsoever other than voting rights and limitations on liability:

> A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).

Presumably, the IRS would argue that the rights to the original and transferred interests were not identical, and that they were not proportional because the zero capital account associated with the transferred interest did not bear the same relationship to profits as the capital account of the original interest had to profits. Dees has a lot of background and experience with Code § 2701 and the regulations and, upon audit, would make a persuasive argument for the approach he takes. However, at the planning stage, I would not assume that they are the same class.

The donor retained no rights to ongoing distributions after the recapitalization, so I agree with Dees that the CCA erred in calling the retained interest a distribution right and that the only analysis of it is as an EPR. See Reg. § 25.2701-1(a)(2)(ii) (an example of a distribution right is a right to receive dividends), combined with the exclusion of EPRs from the definition of distribution rights. Dees argues that bells and whistles need to attach to a set of rights to make them constitute EPRs. He does not view the retained capital account as an EPR. His view would be correct if the capital account was not required to be paid by a date certain and therefore would, absent any distribution tights, have a value for regular gift tax purposes approaching zero. However, in the CCA, the LLC had a fixed 20-year term. The IRS might have been thinking that the donor retained the right to compel liquidation in 20 years, and the retained bare capital account was an EPR. On the other hand, the LLC's fixed terms could also be viewed as a mandatory payment right, which I view as being more correct. Weighing these two approaches, presumably the IRS would argue that an abuse that Code § 2701 wanted to prevent is saying that the entity had a term of a period of years, getting value ascribed to the retained right to payments on that liquidation, and then extending the term, claiming that the extension was not a gift; therefore, the IRS would argue, the right to receive the capital account at the end of the stated term is an EPR.

Thus, although Dees' arguments would be good ones to make in an audit and the IRS' view is probably wrong, for planning purposes one might be very conservative and assume that the CCA is correct in its conclusion that the original interest and the retained interests are ARIs.

[5594] Dees, Is Chief Counsel Resurrecting the Chapter 14 'Monster'? *Tax Notes* (12/15/2014 at p. 1279), criticizes the CCA for referring to the original interest as senior to the transferred interest. Let's compare this to Reg. § 25.2701-3(a)(2)(ii), which provides:

The CCA calculated the gift applying the subtraction method of Reg. § 25.2701-3(b):

> If § 2701 applies to a transfer, the amount of the transferor's gift, if any, is determined using a subtraction method of valuation. Under this method, the amount of the gift is determined by subtracting the value of any family-held applicable retained interests and other non-transferred equity interests from the aggregate value of the family-held interests. In determining the value of any applicable retained interest held by the transferor or an applicable family member, any distribution right in a controlled entity (*e.g.*, a right to receive dividends) is generally valued at zero.
>
> Step 1 - Determine the fair market value of all family-held equity interests in the entity immediately after the transfer assuming that the interests are held by one individual, using a consistent set of assumptions. Here, all equity interests are held by Donor, her children, and her grandchildren, all of whom are members of Donor's family. The result of Step 1 is an amount equal to the fair market value of 100 percent of the Company interests valued as if they were held by a single holder.
>
> Step 2 - Subtract: (A) the sum of the fair market value of all family-held senior equity interests determined after the transfer as if all interests were held by a single holder; and (B) the value determined under § 25.2701-2 of all applicable retained interests held by the transferor and any applicable family members. A senior equity interest is an interest that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest. Section 25.2701-3(a)(2)(ii). The interests of Child A, Child B and the grandchildren are senior to the transferred interests in that each carried a right to distributions based upon an existing capital account balance, whereas the transferred interests did not. Accordingly, the amount determined in Step 1 is

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> Senior equity interest means an equity interest in the entity that carries a right to distributions of income or capital that is preferred as to the rights of the transferred interest.

The original interest and the transferred interest had identical rights to distributions of income, so the only distinction was a right to capital. Nowhere do the regulations define preferred. However, they refer to preferred stock in various places, and traditionally preferred stock carries the right to receive dividends before any dividends are paid to the holders of common stock. Therefore, I believe that the better reading is looking to see whether one interest in capital receives its payment of capital before another interest does. The CCA leaps to the conclusion that an interest that includes a current capital account balance is senior in capital to an interest that has a zero capital account, a conclusion that ignores the timing assumption that appears to be inherent in the word preferred. The CCA's facts state, "No member has priority over any other member as to … the return of capital contributions." Furthermore, the CCA inherently assumes that a profits interest never has a capital account. Although the pure profits interest transferred here had a zero initial capital account (see part II.M.4.f Issuing a Profits Interest to an Employee), a partnership is required to maintain a capital account for each partner. Reg. § 1.704-1(b)(2)(iv)(a). When a partner is allocated profits, the allocation increases the partner's capital account. Reg. § 1.704-1(b)(2)(iv)(b)(3). Distributions of those profits decrease the partner's capital account. Reg. § 1.704-1(b)(2)(iv)(b)(4). It is not uncommon for a partnership to reinvest part of its earnings for contingencies or to expand its capital base (to grow the business or to create economies of scale in investing marketable securities). Thus, Dees correctly criticizes the CCA for calling the original interest senior.

> reduced by the fair market value of Child A's, Child B's and the grandchildren's interests. The amount determined in Step 1 is further reduced by the value of Donor's postrecapitalization applicable retained interest. In valuing Donor's interest, the distribution right, which does not constitute a qualified payment right, is valued at zero, and the liquidation participation right is valued as if the family's ability to compel liquidation did not exist.

The sentence, "The interests of Child A, Child B and the grandchildren are senior to the transferred interests in that each carried a right to distributions based upon an existing capital account balance, whereas the transferred interests did not," is incorrect (because there are no senior interests).[5595] Therefore, subtracting the value of the interests of Child A, Child B, and the grandchildren's interests is incorrect, and the CCA understates the value remaining to which Step 3 would apply.

The CCA continues:

> Step 3 - Allocate the remaining amount among the transferred interest and other non-transferred subordinate equity interests held by the transferor, applicable family members, and members of the transferor's family. A subordinate equity interest is an interest as to which an applicable retained interest is a senior interest. Section 25.2701-3(a)(2)(iii). Here, all applicable retained interests carried a distribution right based upon an existing capital account balance, whereas the interest transferred by the grandchildren did not. This interest, which was not transferred by Donor, is a subordinate equity interest. Based on Donor and the grandchildren's relative ownership percentages immediately prior to the recapitalization, X / X+Z percent of the Step 2 amount is allocated to the transferred interest. Donor is treated as transferring one-half of this amount to Child A and one-half to Child B.

Again, the CCA errs by viewing certain interests as subordinate.[5596] Therefore, all of the remaining amount would be allocated to the retained interest.

> Step 4 - If the value of the transferred interest determined without regard to § 2701 would be determined after application of a minority discount, the Step 3 amount is reduced by a pro rata portion of the fair market value of the family-held interests of the same class determined as if they were held by one person, over the fair market value of a transferred interest. The Step 3 amount is also reduced by the amount, if any, of any consideration in money or money's worth received by the transferor. Here, Donor transferred an interest to each of two transferees, implicating a minority discount. The reduction for each gift is the excess, if any, of a pro rata portion of the fair market value of the transferred interests determined as if all voting rights were held by a single holder over the fair market value of a single transferred interest. In the event that Donor establishes the value in money or money's worth of any consideration provided by either Child A or Child B, a further reduction may be appropriate.

[5595] See fn. 5594.
[5596] See fn. 5594.

The analysis of Step 4 appears correct and introduces an element not discussed in previous rulings. Let's read together the highlighted parts in the facts[5597] and in Step 4:

- Donor received property in the form of the agreement of Child A and Child B to manage Company.

- In the event that Donor establishes the value in money or money's worth of any consideration provided by either Child A or Child B, a further reduction may be appropriate.

These statements suggest to me that the fair market value of the children's services to be performed over the LLC's life will be subtracted at the end, if the Donor can prove that value. However, in this particular case, the children are benefitting only themselves by managing the partnership, so query how much value will be assigned to their services. This case represents an extreme example. Generally, a service provider in a venture capital arrangement receives a 2% management fee and then, after the investors have recovered their investment and a threshold rate of return, 20% of the profits.[5598]

Note in Step 2 that the Donor's right receive the Donor's capital account – referred to as a "liquidation participation right" - is properly valued as if the family's ability to compel liquidation did not exist. However, if, contrary to the CCA's approach, the partnership's fixed term were construed as a mandatory payment right, it would set an outside date at which the partners would receive their capital accounts – in this case, 20 years. If an appropriate discount rate for equity were 8%, the right to receive $100.00 in 20 years would be worth $21.45.[5599] Thus, whether or not the CCA's valuation approach applies, if Code § 2701 applies then the Donor has made a substantial gift.

Going through the complex subtraction method, obtaining the requisite appraisals, and using an equity rate of return to discount the Donor's interest might very well provide a much less favorable result than if the Donor had simply done a loan to the children at the AFR.

CCA 201442053 appears to shut the door on a potentially abusive transaction. It also illustrates how the IRS approaches the subtraction method. However, it is full of errors (and my understanding is that the IRS showed a lower Code § 2701 gift than one computed using the gift tax principles that would normally apply), making one wonder how the IRS will next attempt to apply Code § 2701. Profits interests do not fit neatly with the scheme of Code § 2701, so issuing them in a family-controlled partnership can generate uncertain results.

[5597] Donor received property in the form of the agreement of Child A and Child B to manage Company.

[5598] Arrangements vary from deal to deal. To determine what is market, one should talk with a corporate lawyer who advises in a large number of venture capital cases or consult an online service, such as Thompson Reuter's *Practical Law* (formerly known as the Practical Law Company).

[5599] As of October 2014, a typical preferred return would be 8% or 9%. That assumes an annual distribution. Where no distribution is made for 20 years, presumably the discount rate would be higher. Thus, the illustration of $21.45 value for every $100 probably overstates the value of the Donor's retained interest.

Partnerships play an important role in our economy, particularly in the venture capital/private equity area. However, for family transactions, they require applying a complex regime. Therefore, first try using AFR loans; then see whether a GRAT works; and, if those do not suffice, then perhaps consider using a partnership with commercially reasonable terms, making sure that the donor retains a preferred partnership interest, makes a Code § 2701(c)(3)(C) election, or retains Code § 707(c) guaranteed payments[5600] so that the donor can get credit for the donor's retained stream of payments.

III.B.7.c.ii. Profits Interest in a Partnership in Which Transferor and Applicable Family Members Initially Hold Only a Profits Interest

Suppose a parent is buying a partnership owned by an unrelated third party. The unrelated third party retains all of his capital interest and receives preferred payments of income in liquidation of the value of his interest in excess of his capital account. The parent is entitled to 100% of the profits in excess of the preferred payments. As discussion further above, preferred payments of income to the third party can be very beneficial to the parent who is buying the business, if the preferred payments are taxed to the third party as a distributive share of income under Code § 736(a) so that the parent is using pre-tax dollars to buy out the third party.

- Initially establishing this capital/income structure will not have Code § 2701 implications, because the parent is not a member of the third party's family.

- The partnership's capital/income structure could have Code § 2701 implications if the parent transfers an interest to his child or any other member of the parent's family.

  - Does the parent own at least "50% of the profits interests" that would be required for Code § 2701 to be considered (since the parent has no capital account yet) if the partnership is a general partnership? The statute and regulations do not clearly answer the question.[5601] If the partnership is a limited partnership and the parent is a general partner, then Code § 2701 must be considered no matter what the parent's economic interests are.[5602] If the partnership is a manager-managed limited liability company, and the parent is a manager, would that be the same as being a general partner in a limited partnership?

  - Even if one assumes that the parent's partnership interest is sufficient to make one consider Code § 2701, if the parent transfers a vertical slice of the parent's right to income and the same vertical slice of the parent's right to capital to his child, Code § 2701 should not apply to that transfer.[5603] Suppose, for example, that the parent owns 60% of the income and 10% of the capital and wants to give a vertical slice of 1/10 of his interest to his child.[5604] In that case, the parent

[5600] For details on Code § 707(c), see part II.C.8.a Code § 707 - Compensating a Partner for Services Performed, which focuses on guaranteed payments for services rather than for capital even though Code § 707 covers both.
[5601] Code § 2701(b)(2)(B)(i); Reg. § 25.2701-2(b)(5)(iii).
[5602] Code § 2701(b)(2)(B)(ii); Reg. § 25.2701-2(b)(5)(iii).
[5603] See Reg. § 25.2701-1(c)(3), (4).
[5604] In the example, the parent starts with a pure profits interest and no capital. However, the parent is likely to leave some income in the partnership, especially since the reinvested income

would give the child a 6% income (60% multiplied by 1/10) and 1% capital interest (10% multiplied by 1/10) and would retain a 54% income and 9% capital interest. The vertical slice should be structured so that the child succeeds to 1/10 of every item of the parent's rights to distributions and financial obligations. For example, if the parent is obligated to leave a portion of his share of income in the partnership, the child should have a proportionate obligation to leave income in the partnership; the parent's leaving profits in the partnership might[5605] constitute a contribution to capital, triggering Code § 2701,[5606] in which case one needs to find an exception to Code § 2701, such as transactions involving proportionate vertical slices.

III.B.7.c.iii. Same Class Exception - Possible Application to Profits Interests and Other Situations

Not much guidance explains how to implement the regulations under Code § 2701. The "same class" exception provides:[5607]

> Section 2701 does not apply if the retained interest is of the same class of equity as the transferred interest or if the retained interest is of a class that is proportional to the class of the transferred interest. A class is the same class as (or is proportional to the class of) the transferred interest if the rights are identical (or proportional) to the rights of the transferred interest, except for non-lapsing differences in voting rights (or, for a partnership, non-lapsing differences with respect to management and limitations on liability). For purposes of this section, non-lapsing provisions necessary to comply with partnership allocation requirements of the Internal Revenue Code (*e.g.*, section 704(b)) are non-lapsing differences with respect to limitations on liability. A right that lapses by reason of Federal or State law is treated as a non-lapsing right unless the Secretary determines, by regulation or by published revenue ruling, that it is necessary to treat such a right as a lapsing right to accomplish the purposes of section 2701. An interest in a partnership is not an interest in the same class as the transferred interest if the transferor or applicable family members have the right to alter the liability of the transferee.

Relying on Reg. § 25.2701-1(c)(3), the IRS has ruled that a merger that did not change the parties' economic rights did not cause Code § 2701 valuation to apply "because the

might be used to buy the third party's capital account. The cumulative effect would be to decrease the third party's capital account and increase the parent's capital account until the third party's capital account and income interest have decreased to zero.

[5605] The next paragraph of text suggests a difference between the parent transferring a partnership interest and the partnership issuing a partnership interest. Therefore, the author's concern about leaving profits in the partnership could be creating an issue where there is none, because the parent is not transferring property to the child. Thus, this recommendation is an attempt to be very conservative.

[5606] Reg. § 25.2701-1(b)(2)(i)(A).

[5607] Reg. § 25.2701-1(c)(3).

transaction involves a mere change in the form of Taxpayer's holdings in the business activity."[5608]

Private Letter Ruling 9451051 applied this exception to a corporate arrangement that seems very much like a profits interest. The preferred stock did not have any preferences on dividends. The only preference was as follows:

> Upon liquidation, dissolution, or winding up of Corporation, the holders of the Class A preferred stock are entitled to be paid out of the assets of Corporation then available for distribution an amount equal to a liquidation preference of $10 per share. If after the payments have been made there remain assets available for distribution, then all of the assets are to be distributed pro rata among the holders of the common stock and the convertible preferred stock as if each share of convertible preferred had been converted into common stock. However, there shall be subtracted from any residual distribution to the holders of the Class A preferred an amount equal to the liquidation preference received by each holder.

The IRS ruled that the preferred stock was "substantially the same" as the transferred common stock.

This exception is in some ways similar to the exception described in part III.B.7.b.iii Capital Structure Transaction, If Each Individual Holds Substantially The Same Interest After The Transaction As That Individual Held Before The Transaction.

It has been suggested that profits interest are analogous to common stock in this letter ruling and therefore are not subject to Code § 2701.[5609] However, in the letter ruling, after the preferred owners receive their preferred liquidation payment, the common would receive the proportionate make-up payments; whereas the holder of a profits interest would not receive make-up payments, absent a capital account. It might be possible to make up this difference by specially allocating to the holders of profits interests:

- Gain on liquidation to the holder of the profits interests. Whether that would make the profits interests close enough is unclear; presumably it would depend on the likelihood of that gain occurring.

[5608] Letter Ruling 9352012 approved a merger of Corporation B into Corporation A under the following facts, in which the taxpayer held only preferred stock (and all the preferred stock):

> The rights with respect to Corporation B common and preferred stock are identical to the rights of the common and preferred stock of Corporation A except that the Corporation B preferred stock is entitled to receive 85 percent of par value upon liquidation and is redeemable by the corporation at 85 percent of par.
>
> Under the proposed merger, Taxpayer will exchange her Corporation B preferred stock for an equal number of shares of new Class C preferred stock to be issued by Corporation A. The rights of the Class C shareholder will be identical to those of the Corporation B preferred shareholders, and the Class C shares will be redeemable for 85 percent of par value. The common stockholders of Corporation B will exchange their stock for common stock of Corporation A of equal value.

[5609] Robinson, Business Succession Planning, Profits Interests and § 2701, *ACTEC Journal* (Spring 2009).

- Current income first, then to gain on liquidation. That would certainly increase the likelihood of the capital accounts increasing until they are proportionate to those of the original partners. That would make the profits interests be preferred as to current income, but presumably the holders of the profits interests would be in a lower generation and therefore Code § 2701 would not apply to this reverse freeze.

One should also consider an earlier technical advice memorandum that refused to apply the same class exception:[5610]

> Underlying the statute and regulations, the legislative history states that a "retained interest is valued under present law if it is of a class which is proportionally the same as the transferred interest but for nonlapsing differences in voting power (or, in the case of a partnership, nonlapsing differences with respect to management and limitations on liability)." H.R. Rep. No. 101-964, at 1133 (1990). Further, the legislative history notes that section 2701 generally does not affect the valuation of a gift of a partnership interest if all interests in the partnership share equally in all items of income, deduction, loss and gain in the same proportion (i.e., straight-up allocations). See 136 Cong. Rec. 515681 (daily ed. October 18, 1990) (1990 Senate Report on Proposed Revision of Estate Freeze Rules). However, the legislative history also notes that the exception to the valuation rules of section 2701 "would not apply to a partnership with both a general and limited partner if one partner had a preference with respect to distributions." H.R. Rep. No. 101-964, at 1133 (1990). Thus, if either the transferred or applicable retained interest in Partnership enjoy a preference as to distributions, the applicable retained interest in Partnership will be valued under the rules of section 2701. See *Id.*
>
> In the present case, the Partnership Agreement provides that proceeds from capital transactions shall be distributed first to the limited partners until their Adjusted Capital Contributions are reduced to zero, then to the general partner until its Adjusted Capital Contribution is reduced to zero. The balance of any proceeds, if any, shall be distributed to the partners in proportion to their partnership interests. On its face, this provision in the Partnership Agreement is a preference enjoyed by the limited partner (Trust) with respect to distributions of proceeds from capital transactions. Thus, the transfers at issue are not excluded from the special valuation rules of section 2701(a)(1) because Donor's applicable retained interest is not of the same class of equity as the transferred interest, nor is Donor's applicable retained interest of a class that is proportional to the class of the transferred interest.

With this contrast, I would want to have a special allocation of profits to the holder of the profits interest as soon as possible, to try to make it look more like the letter ruling and less like the TAM, so long as that did not constitute an unacceptable change to the business deal.

I would still rather avoid the issue altogether, by using a loan to the service provider at the AFR so that the service provider could simply start with a proportionate capital

[5610] TAM 199933002.

account. The service provider could then have compensation incentives to enable him or her to repay the loan.

III.B.7.c.iv. Transfers When Owner Holds Profits Interest/Carried Interest and Other Interests

How might one deal complexities of planning with profits interests discussed in part III.B.7.b Code § 2701 Overview and the discussion in the previous parts of this part III.B.7.c Code § 2701 Interaction with Income Tax Planning? (Generally, a "carried interest" is a profits interest that provides an interest in profits only after the partners who provided the capital have received cash as part of an agreed-upon return.)

One method would be transferring all of the person's interest into a single entity, such as an LLC, so that the person's interest is held as a single package. Then one might transfer an interest in that single entity, to satisfy the vertical slice exception described in part III.B.7.c.iii Same Class Exception - Possible Application to Profits Interest.

An owner can combine this vertical slice planning with transfers that include more than just a straight gift. For example, an owner might place the LLC into a GRAT[5611] or transfer it in exchange for a note or an interest in preferred partnership.[5612]

III.B.7.c.v. Income Tax Dynamics of Using Deferred Compensation Instead of Profits Interest

Suppose that the moneyed partners – who we will call the service recipient (SR) – agree to pay compensation to the partner who is providing the services – the service provider (SP), instead of giving the SP a profits interest.

The SR would receive any capital gain treatment from the SP's portion of the profits. However, they would be able to use the tax benefits from an ordinary deduction to gross-up the SP's payment.

Suppose, for example, that ordinary income were taxable at a 40% rate and capital gain at a 20% rate. For every $100 the SP would receive, the SP would have expected to net $80, after subtracting $20 capital gain tax. Instead, the partnership pays the SP $133. The SP receives the same $80, which consists of $133 minus $53 (40% of $133) ordinary income tax. The SR receives a $133 ordinary income tax deduction, which costs the SR only $80 ($133 minus $53 ordinary income tax benefit); this $80 cost to the SR matches the $100 sale proceeds the SR receives less the $20 capital gain tax that the SR pays.

Thus, the lack of capital gain treatment to the SP should not an obstacle to the transaction. This assumes that the SR has other ordinary income against which to deduct the payment to the SP. If that is not the case, the benefit of the deduction might

[5611] The late Mil Hatcher suggested this idea to me. For information on GRATs, see part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

[5612] See Angkatavanich and Stein, Going Non-Vertical with Fund Interests - Creative Carried Interest Transfer Planning When The 'Vertical Slice' Won't 'Cut It,' *Trusts and Estates* (11/2010), saved as Thompson Coburn LLP document no. 6174249.

be at capital gain rates that are less than the ordinary income tax that the SP would be required to pay.

One would also want to compare whether the deduction to the SR is against the SR's self-employment income and whether the payment to the SP is subject to self-employment tax.

Because changes to deferred compensation plans must meet certain requirements or trigger significant tax consequences, using a profits interest is much more flexible than paying deferred compensation.

III.B.7.c.vi. Deferred Compensation

Although deferred compensation is not equity, it reduces the entity's value for many purposes and makes it easier to sell; it also creates an income stream for the older generation without constituting an asset subject to estate tax (assuming that the deferred compensation payments are spent and do not promote the recipient's other assets to grow to exceed the recipient's unused estate tax exemption).[5613] It is realistically available only if the entity earns sufficient income. For draconian rules that apply to deferred compensation, see part II.M.4.d Introduction to Code § 409A Nonqualified Deferred Compensation Rules.

Suppose a parent is 55 years old and wants to retire in 10 years. The business entity (same analysis whether partnership or corporation) agrees to make the following series of payments:

- Retirement Payment. $100,000 per year for life,[5614] but only if the parent continues to work for the entity until the parent attains age 65.[5615] This should not violate Code § 409A; of course, to satisfy other tax issues, the retirement payment must, when combined with other compensation, constitute reasonable compensation for future services.[5616] Similarly, as a payment that is fixed in amount at a specific time, it is not subject to Code § 2701,[5617] whether or not the IRS attempts to classify it as equity.

- Disability Payment. The parent receives $100,000 for life if the parent becomes disabled before attaining age 65. If disability is defined consistent with Code § 409A(a)(2)(A)(ii) & (a)(2)(C) and the pronouncements thereunder, the

[5613] For a married couple, the survivor's interest in the deferred compensation automatically qualifies for the marital deduction. Code § 2056(b)(7)(C).

[5614] If instead the payment were for a fixed period of years instead of for life, more planning opportunities are available if the arrangement provides at all times that the right to the series of installment payments is to be treated as a right to a series of separate payments. Reg. § 1.409A-2(b)(2)(iii).

[5615] When the parent reaches 65, the present value of the retirement payments vests for FICA purposes, and a lump-sum FICA tax payment is due. Reg. § 31.3121(v)(2)-1(c)(2). Although this might sound onerous, it is actually quite beneficial. See discussion at part II.Q.1.d Nonqualified Deferred Compensation

[5616] In this example, the requirement that the parent work for 10 years is an attempt to spread the period of earning the compensation for the purposes of determining reasonable compensation.

[5617] Reg. § 25.2701-2(b)(4)(i) (in the case of a corporation) or (iii) (in the case of a partnership).

payment would not violate Code § 409A. Unfortunately, this definition is more stringent than most good disability policies, and one might consider paying a bonus to the parent so that the parent can buy disability insurance instead.[5618]

- Death Benefit. A death benefit to replace the disability and retirement payments would not violate Code § 409A.

The discussion below of creative bonus arrangements convinces the author that none of the above would constitute an equity interest. Therefore, such arrangements would not constitute an "applicable retained interest" that would taint a transfer by the parent to a child.[5619]

III.B.7.c.vii. Stock Options

Stock options exercisable at a price that is at least the underlying stock's value on the date of grant generally are not subject to Code § 409A.[5620] Similar rules apply to partnerships.

In addition to being subject to FICA, nonqualified stock options are subject to tax under the Railroad Retirement Tax Act.[5621]

For purposes of Code § 2701, the IRS tends to view options as compensation, not equity:[5622]

[5618] A good disability policy will provide benefits if the disabled person cannot work in his or her ***own occupation***. Contrast this with Code § 409A(a)(2)(C), which provides (emphasis added):

For purposes of subparagraph (A)(ii), a participant shall be considered disabled if the participant—

(i) is unable to engage in ***any substantial gainful activity*** by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, or

(ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than 3 months under an accident and health plan covering employees of the participant's employer.

[5619] Code § 2701 applies only when the parent or a member of the parent's family holds an applicable retained interest. An applicable retained interest includes only a right to equity. See Code § 2701(b), (c)(1), (c)(2).

[5620] See part II.M.4.f.iv Alternative If a Prospective Partner Wants a Capital Interest Instead of a Profits Interest.

[5621] *Wisconsin Central Ltd. v. U.S.*, 118 A.F.T.R.2d 2016-XXXX (N.D. Ill. 7/8/2016), in holding that nonqualified stock options are subject to the RRTA, stated:

> Similar suits have been filed in recent years. See *BNSF Ry. Co. v. United States*, 775 F.3d 743 (5th Cir. 2015); *Union Pac. R.R. Co. v. United States*, No. 8:14-cv-00237, slip op. (D. Neb. Jul. 1, 2016) (reproduced at Doc. 35-1); *CSX Corp. v. United States*, No. 3:15-cv-00427 (M.D. Fla. filed Apr. 3, 2015). In the two judgments issued thus far, the Fifth Circuit in *BNSF Railway* and the District of Nebraska in *Union Pacific* both upheld the Treasury Department's interpretation of any form of money remuneration to include non-qualified stock options. For the following reasons, this court reaches the same result.

> Until the options are exercised, the holder of the option has no right to receive dividends and no right to vote shares of the corporation. The holder has only the right to purchase an equity interest (i.e., shares of stock). In purchasing the shares of stock, the holder would then obtain an equity interest in which he would have these rights. The holder of the options, thus, does not hold an equity interest in the corporation and a transfer of the options is not subject to section 2701 of the Code.

Income tax cases have held than an option to acquire a partnership interest does not constitute an equity interest in the partnership.[5623] The author has not discovered Code § 2701 cases addressing that question.

However, options are subject to Code § 2703, which deals primarily with buy-sell agreements.[5624]

Code § 1014(a) applies to a testamentary option to buy stock for less than fair market value, so that the option has basis and any stock bought in exercising it receives basis equal to the option's basis and exercise price.[5625] However, a lapse of the option is treated as having been disclaimed or renounced.[5626] This treatment would also apply to real estate.[5627]

III.B.7.c.viii. Creative Bonus Arrangements

Suppose an employee who is a family member is entitled to receive a bonus based on the entity's profitability. If the bonus is required to be paid on March 15 following the calendar year the results of which are being measured, the bonus plan generally would not be subject to Code § 409A. If this bonus is based on the entity's income, would the bonus plan constitute an equity interest?

The author is not aware of Code § 2701 cases addressing this issue, so the author has summarized selected income tax cases.

[5622] Letter Ruling 199952012 and CCA 199927002; see Letter Ruling 9616035. The IRS also compares the stock with respect to which the option is granted with the stock that the transferor retained. See Letter Ruling 9725032 (option related to publicly traded stock, and such stock is not subject to Code § 2701) and 9722022 (stock subject to option was same class as stock the transferor retained, so Code § 2701 did not apply).

[5623] *Dorman v. U.S.*, 296 F.2d 27 (9th Cir. 1961) (option was a capital asset but not a partnership interest); *Vestal v. U.S.*, 498 F.2d 487 (8th Cir. 1974) (option was neither a capital asset [because its value was too speculative] nor a partnership interest); *Mayhew v. Commissioner*, T.C. Memo. 1992-68 (option and right to bonus did not constitute a profits interest).

[5624] See text accompanying footnotes 3253-3259.

[5625] Rev. Rul. 67-96.

[5626] Rev. Rul. 67-96.

[5627] Letter Ruling 200340019 applied Rev. Rul. 67-96 to a testamentary option to buy a house. Regarding options involved in Code § 1031 tax-free exchanges of real estate, see Rev. Rul. 84-121, discussed in fn. 1084 in part II.G.15 Like-Kind Exchanges.

As in other areas, state law determines rights, but tax law determines the effect of those rights; whether a partnership exists depends on a weighting of several factors.[5628]

Some very entrepreneurial taxpayers have been treated as employees and not as owners when they:

- Received salary plus 50% of the profits.[5629]

- Developed a new product line, not only thinking of the idea but also reducing it to practical application and sales to the general public, receiving a percentage of sales.[5630]

The above tests all assume that the service provider is an employee. In a corporate setting, a shareholder who works in the business has two different capacities: an owner and an employee. The author is aware of only one situation in which the IRS combined the two concepts, and that was a clearly abusive situation.[5631] The discussion further above about S corporations compensating employees with stock options provide insight about when, for income tax purposes, an option constitutes equity in the corporation. Absent guidance in a Code § 2701 setting, the author suggests relying on the income tax principles, possibly requesting a Letter Ruling in appropriate situations.

Contrast that with a partnership setting: For income tax purposes, all partner compensation is considered in conjunction with the partner's equity interest. See part II.C.8.a Code § 707 - Compensating a Partner for Services Performed. The author suggests the following guidelines for partnerships:

- If the service provider has a clearly-defined vested[5632] equity interest in the partnership, any additional compensation constituting a guaranteed payment will be reported on the service provider's Schedule K-1.[5633] If the IRS audits an applicable family member's estate tax return and obtains partnership income tax returns, an agent is likely to argue that the service provider's guaranteed payments are part of the service provider's total equity interest and might argue that a testamentary or prior transfer of equity to the service provider should have been valued considering this additional compensation. One should carefully consider the extent to which the

[5628] See part II.C.9 Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership.
[5629] *Friednash v. Commissioner*, 209 F.2d 601 (9th Cir 1954); *Duley v. Commissioner*, T.C. Memo. 1981-246.
[5630] *Luna v. Commissioner*, 42 T.C. 1067 (1964). This is one of many cases in which insurance agents unsuccessfully attempted to treat as the sale of a capital asset payments commuting their future commissions or similar contract rights.
[5631] In TAM 9352001, son-in-law was given an employment contract that paid him cash of at least three or four times the market value of his services, for a management position for which he was not qualified, as well as issuing him a control block of voting stock as part of his compensation. The IRS ruled that the stock was cumulative preferred stock, with the excess compensation constituting the preference.
[5632] See text accompanying fn. 2677 in part II.M.4.f.ii Tax Effects of Profits Interest for issues relating to a wholly unvested interest in partnership capital and profits.
[5633] See footnote 435.

service provider has the right as a partner to make these payments to himself/herself.

- Contrast this to a corporate setting, where these incentive payments are reported on Forms W-2. The IRS' main inquiry is likely to be whether the incentive payments constituted reasonable compensation. Although the IRS might argue that the payments were part of the service provider's rights as a shareholder, in most corporate settings the shareholder would need to elect a director to protect his/her interest, and then prove that the director would have conspired with the other directors to order the corporation's president to pay such compensation.[5634]

III.B.7.c.ix. Debt vs. Equity

Generally, for gift tax purposes courts look to income tax cases to determine when a transaction rises to the level of granting an equity interest. For income tax principles, see part II.G.19, Debt vs. Equity.

III.B.7.d. Code § 2702 Overview

Code § 2702 governs grantor retained annuity trusts (GRATs), among other strategies. See part III.B.2.b General Description of GRAT vs. Sale to Irrevocable Grantor Trust.

Regulations under Code § 2702 also might create unexpected gift tax issues when trusts are modified, decanted, or otherwise adjusted. Code § 2702 provides special rules to determine the amount of the gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family and the individual or an applicable family member retains an interest in the trust.[5635] If Code § 2702 applies to a transfer, the value of any interest in the trust retained by the transferor or any applicable family member is determined under Reg. § 25.2702-2(b).[5636] The amount of the gift, if any, is then determined by subtracting the value of the interests retained by the transferor or any applicable family member from the value of the transferred property.[5637] If the retained interest is not a qualified interest,[5638] the retained interest is generally valued at zero, and the amount of the gift is the entire value of the property.[5639]

A potential trap is that a "transfer in trust" includes "a transfer to a new or existing trust and an assignment of an interest in an existing trust."[5640] So the IRS might assert that a beneficiary makes a gift of the value of the beneficiary's entire interest in a trust if the beneficiary makes a gift of any part of the beneficiary's interest in a trust and retains any interest in the trust; also note that "an assignment of an interest in an existing trust" is not explicitly limited to a transfer of the beneficiary's interest to a new trust, so the IRS

[5634] Many states have statutory close corporation provisions allowing a corporation to abolish such formalities; see fn 776. Furthermore, a shareholders' agreement can purport to lock-in such arrangements; however, the general rule is that no agreement can legally bind future directors to a particular course of action.
[5635] Reg. § 25.2702-1(a).
[5636] Reg. § 25.2702-1(b).
[5637] Reg. § 25.2702-1(b).
[5638] As defined in Reg. § 25.2702-3.
[5639] Reg. § 25.2702-1(b).
[5640] Reg. § 25.2702-2(a)(2).

might argue that it applies to a distribution from a trust outright to another beneficiary. However, a "transfer in trust" does not include the exercise, release or lapse of a power of appointment over trust property that is not a transfer under the usual gift tax rules[5641] and does not include a Code § 2518 qualified disclaimer.[5642] Also, Letter Ruling 9321046 did not apply Code § 2702 when applying Code § 2701 to a freeze transaction engaged in by a trust, making the gift equal to the difference in the beneficiary's life estate before and after the freeze.[5643] On the other hand, if Code § 2701 applies, "A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person."[5644]

Code § 2702 does not apply to a transfer in trust if the transfer of an interest to a spouse is deemed to be for full and adequate consideration by reason of Code § 2516 (relating to certain property settlements) and the remaining interests in the trust are retained by the other spouse.[5645] However, a settlement that provides benefits to the persons other than the couple, such as their children, constitutes either a gift by the transferring spouse to the those other persons,[5646] a relinquishment by the transferee spouse of the transferee's marital rights,[5647] or some combination of those.[5648] In such a settlement

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[5641] Reg. § 25.2702-2(a)(2)(i).

[5642] Reg. § 25.2702-2(a)(2)(ii).

[5643] See fn. 5570. Whether the IRS overlooked the issue or decided that Code § 2702 did not apply is unclear. The ruling did not mention any consideration of Code § 2702.

[5644] Reg. § 25.2701-6(a)(4), but also see fn. 5566 for limitations on that.

[5645] Reg. § 25.2702-1(c)(7). Reg. § 25.2702-4(d), Example (5), provides:

> H and W enter into a written agreement relative to their marital and property rights that requires W to transfer property to an irrevocable trust, the terms of which provide that the income of the trust will be paid to H for 10 years. On the expiration of the 10-year term, the trust is to terminate and the trust corpus is to be paid to W. H and W divorce within two years after the agreement is entered into. Pursuant to section 2516, the transfer to H would otherwise be deemed to be for full and adequate consideration. Section 2702 does not apply to the acquisition of the term interest by H because no member of H's family acquired an interest in the property in the same transaction or series of transactions. The result would not be the same if, on the termination of H's interest in the trust, the trust corpus were distributable to the children of H and W rather than W.

[5646] Rev. Rul. 79-363.

[5647] Rev. Rul. 77-314, Situation 2.

[5648] Reg. § 25.2702-4(c) applies to joint purchases:

> Solely for purposes of section 2702, if an individual acquires a term interest in property and, in the same transaction or series of transactions, one or more members of the individual's family acquire an interest in the same property, the individual acquiring the term interest is treated as acquiring the entire property so acquired, and transferring to each of those family members the interests acquired by that family member in exchange for any consideration paid by that family member. For purposes of this paragraph (c), the amount of the individual's gift will not exceed the amount of consideration furnished by that individual for all interests in the property.

Thus, if a transferee spouse acquires a term interest in the trust, and the children also acquire an interest, Code § 2702 would apply. However, if the transfer involves children of the transferee spouse and not of the transferor spouse and occurs after the divorce but pursuant to the divorce decree, the transferee spouse and the transferee spouse's children are not considered members of transferor spouse's family, so perhaps Code § 2702 would not apply.

involving other persons, Code § 2702 applies,[5649] and the beneficiary spouse's rights must be a qualified interest in order for them to be valued.[5650]

[5649] See the last sentence of Reg. § 25.2702-4(d), Example (5), which fn. 5645 reproduces in full.

[5650] Letter Ruling 200408015 did not apply Code § 2702 when the transferee spouse had the right to annuity payments from the trust's income and principal and the remainder would pass to the transferor spouse's children. It ruled that that, to the extent of the transferee spouse's annuity interest, the transfer to the trust would constitute a transfer for full and adequate consideration under Code § 2516, and the only taxable gift transferor spouse Settlor will be the gift of the trust remainder's to the transferor spouse's children under Code § 2511. Letter Ruling 200408015 also held that creating the trust to discharge the transferor trust's support rights did not subject the transferor spouse to income tax:

> In this case, Settlor proposes to transfer funds to Trust pursuant to the Modification. In the event Trust is treated as a grantor trust, Settlor is treated as the owner of the Trust. Therefore, Settlor will not be considered to have made a transfer of property for federal income tax purposes and there is no section 1041 issue to consider. Thus, if Trust is a grantor trust, no gain or loss would be realized by Husband under section 1001.
>
> Alternatively, if Trust is not treated as a grantor trust, Settlor will be considered to have made a transfer of property, but no gain or loss would be recognized by Settlor under section 1001. To the extent that Settlor's proposed transfer of assets to the Trust is for the benefit of Wife, any realized gain on the transfer would not be recognized under section 1041(a). To the extent that Settlor's transfer of assets to the Trust is considered as a gift to Settlor's children, no gain or loss would be recognized.
>
> The transfer of property will be made pursuant to the Modification. Settlor's transfer of property to Trust for Wife's benefit is a transfer that is incident to the divorce within the meaning of section 1041(a)(2) and section 1.1041-1T, Q&A-7. The transfer is pursuant to a divorce or separation instrument and occurs not more than 6 years after the date on which the marriage ceased. Thus, no gain or loss is recognized on such transfer.

It also addressed the interaction of the transferor spouse's swap power (see part III.B.2.h.i Who Is the Grantor), which made the trust a grantor trust as to the transferor spouse, with Code § 682, which taxes the transferee spouse on amounts paid, credited, or required to be paid to the transferee spouse (see the paragraph accompanying fn. 4470, found in part III.A.3.e.i.(a) QSSTs Generally):

> The circumstances surrounding Trust's administration will determine whether the power of administration is exercisable in a fiduciary or a nonfiduciary capacity. This is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office with responsibility for such examination. Provided that the circumstances surrounding Trust's administration indicate that the power of administration held by Settlor over Trust *(i.e.*, the power to substitute assets for assets of equivalent value) is exercisable by Settlor in a nonfiduciary capacity without the approval or consent of a person in a fiduciary capacity, Settlor will be treated as the owner of Trust. We further conclude that while both Settlor and Wife are alive, section 682 governs the income taxation of Trust. Accordingly, distributions from Trust to Wife are deductible by Trust and includible by Wife in her gross income to the extent provided in sections 661 and 662. Under the terms of Trust, capital gains are not includible in the distributions to Wife. Accordingly, capital gains are not included in the distributions to Wife and are included in the gross income of Settlor under section 675(4) (subject to the conditions noted above regarding section 675(4)).
>
> We further conclude that if Wife predeceases Settlor, upon the death of Wife, section 682 would no longer apply and Trust will be treated as a grantor trust with Settlor as owner, provided that, after the death of Wife, Settlor retains the same powers of administration that cause Trust to be a grantor trust under section 675(4) (subject to the conditions noted above regarding section 675(4)). If Settlor predeceases Wife, section 682 no

III.B.7.e. Code § 2703 Overview

See discussion in part II.Q.4.h Establishing Estate Tax Values.

Code § 2703 applies for estate, gift, and generation-skipping transfer tax purposes.[5651]

III.B.7.f. Code § 2704 Overview

Code § 2704 applies for estate, gift, and generation-skipping transfer tax purposes.[5652]

III.B.7.f.i. Code § 2704 – Current Law

In a family-controlled business, Code § 2704(a) treats as a transfer the lapse of any voting or liquidation right in a corporation or partnership.[5653] When valuing transfers, Code § 2704(b) disregards restrictions on liquidation that are not commercially reasonable and are more restrictive than state law defaults. In other words, Code § 2704(a) values what is not transferred but rather goes away, and Code § 2704(b) values what is transferred; in both cases, the true economic value is modified by federal tax law.

If the entity is not family-controlled (using a combination of Code § 2701 and 2704 principles), then Code § 2704 does not apply.

Code § 2704(a) provides that, if there is a lapse of any voting or liquidation right in a corporation or partnership, and the individual holding such right immediately before the lapse and members of such individual's family hold, both before and after the lapse, control of the entity, the lapse is treated as a transfer by the individual by gift, or a transfer which is includible in the gross estate of the decedent, whichever applies.[5654] The amount of this transfer is the excess (if any) of (A) the value of all interests in the entity held by the individual immediately before the lapse (determined as if the voting and liquidation rights were nonlapsing), over (B) the value of such interests immediately after the lapse.[5655]

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longer applies and payments to Wife will be deductible to Trust under section 661 and includible in Wife's gross income under section 662. Income allocable to principal will be taxable to Trust. If neither Settlor nor Wife are alive, then the income taxation of Trust is also governed by the rules of subchapter J, other than the grantor trust rules and section 682.

[5651] See fn. 1405, found in part II.H.2.j Effect of Chapter 14 on Basis Step-Up.

[5652] See fn. 1406, found in part II.H.2.j Effect of Chapter 14 on Basis Step-Up.

[5653] The lapse of voting rights at death was includible in the decedent's gross estate in the *Estate of Rankin Smith v. U.S.*, 103 Fed. Cl. 533 (2012). Why the decedent did not do a voting/nonvoting right recap and plan accordingly is not mentioned. The bona fide business arrangement is an exception to Code § 2703, not Code § 2704.

[5654] Code § 2704(a)(1). Code § 2704(a)(3) authorizes regulations to apply Code § 2704(a) to rights similar to voting and liquidation rights.

[5655] Code § 2704(a)(2).

In the context of an affirmative transfer of an equity interest, existing regulations apply only regarding one's right to liquidate the entity.[5656] Proposed regulations would expand this to apply these rules to the ability to liquidate one's interest in the business.[5657]

Code § 2704(b) provides that, if there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any applicable restriction shall be disregarded in determining the value of the transferred interest:[5658]

- An "applicable restriction" is any restriction which effectively limits the ability of the corporation or partnership to liquidate, and with respect to which either:[5659]

  (i) the restriction lapses, in whole or in part, after the transfer, or

  (ii) the transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.

- "Applicable restriction" does not include:[5660]

  (A) any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or

  (B) any restriction imposed, or required to be imposed, by any Federal or State law.

- Regulations may disregard other restrictions "in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest" for estate, gift, and generation-skipping transfer tax purposes "but does not ultimately reduce the value of such interest to the transferee."[5661]

III.B.7.f.ii. 2016 Proposed Regulations (Withdrawn)

For many years, taxpayers have been placing nonbusiness assets in business entities. Because business entities that are not publicly traded are illiquid and certain ownership interests lack input into how the entities are run, the ownership interests are worth much less than a pro rata share of the entities' assets. The IRS has had only limited success increasing the value to a pro rata share of the entities' assets.

[5656] *Kerr*, 292 F.3d 490 (5th Cir. 2002); compare Reg. § 25.2704-2(b) (for a transferred interest, an applicable restriction is a limitation on the ability to liquidate the entity) with Reg. § 25.2704-1(a)(2)(v) (for a lapse, liquidation right means right to compel the entity to redeem the interest).
[5657] See part III.B.7.f.ii.(a) Prop. Reg. § 25.2704-1 Regarding .
[5658] Code § 2704(b)(1).
[5659] Code § 2704(b)(2).
[5660] Code § 2704(b)(3).
[5661] Code § 2704(b)(4).

Fourteen years after losing a case in which the court suggested that the government consider changing the relevant regulations, the government took action.

REG-163113-02 (10/17/2017) withdrew the proposed regulations.

Further below are discussions of the following parts of the withdrawn proposed regulations:

- III.B.7.f.ii.(a) Prop. Reg. § 25.2704-1 Regarding Value That Disappears Without Being Transferred, including value that permanently disappears because of a change in rights and value that, if one dies too soon after the transfer, is brought back into one's estate because it reduced the value of one's retained interest in the entity by reason of losing control.

- III.B.7.f.ii.(c) Prop. Reg. § 25.2704-2 Disregarding "Applicable Restrictions" That Later Lapse or Can Be Removed.

- III.B.7.f.ii.(d) Prop. Reg. § 25.2704-3 Disregarding Restrictions under Governing Documents and State Law that Could Have Been Removed All Along.

The latter is very controversial and would not apply until 30 days after being finalized. Code § 2704(b)(4) authorizes the government to promulgate regulations disregarding a restriction "if such restriction has the effect of reducing the value of the transferred interest … but does not ultimately reduce the value of such interest to the transferee." If, as generally is the case for operating businesses, cashing in an owner's interest or liquidating the entity would decrease the value of the owner's interest, a regulation that assumes greater liquidity than is actually the case would seem to violate the regulation's authority.

Note that any value that the latter treats as being transferred would not be taxed as gifts under the first two proposed rules, because the value never disappeared. Also, to the extent that other tax attributes of transferred property are derived from gifts, they would apply to what the transferee received under the latter but have uncertain application to value treated as disappearing under the first two.

III.B.7.f.ii.(a). Prop. Reg. § 25.2704-1 Regarding Value That Disappears Without Being Transferred

The new rules apply only if the entity is controlled by the holder and/or members of the holder's family immediately before and after the lapse.[5662]

[5662] Prop. Reg. § 25.2704-1(a)(1). Prop. Reg. § 25.2704-1(a)(2)(i) would add the following to the end of existing Reg. § 25.2704-1(a)(2)(i):

> For purposes of determining whether the group consisting of the holder, the holder's estate and members of the holder's family control the entity, a member of the group is also treated as holding any interest held indirectly by such member through a corporation, partnership, trust, or other entity under the rules contained in § 25.2701-6.

Prop. Reg. § 25.2704-1(a)(2)(i) would add the following before the third sentence of existing Reg. § 25.2704-1(a)(2)(iii):

For purposes of subtitle B (relating to estate, gift, and generation-skipping transfer taxes), the lapse of a voting or a liquidation right[5663] in a corporation or a partnership (an entity),[5664] whether domestic or foreign, is a transfer by the individual directly or indirectly holding the right immediately before its lapse (the holder) to the extent provided in the rules below.[5665]

A lapse includes a transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor, specifically including the transfer of a voting partnership interest to an assignee who cannot vote.[5666]

Notwithstanding the repeal of rules against transfers in contemplation of death and the limitation of a 3-year rule in Code § 2035, the new rule would impose Code § 2704 estate inclusion on the lapse of a voting or liquidation right as a result of the transfer of an interest within three years of the transferor's death.[5667]

Whether an interest can be liquidated immediately after the lapse is determined under the local law generally applicable to the entity, as modified by the governing documents of the entity, but without regard to any restriction (in the governing documents, applicable local law, or otherwise) described in Code § 2704(b) and the regulations thereunder.[5668] See part III.B.7.f.ii.(b) Prop. Reg. §§ 25.2704-2 and 25.2704-3 Increasing Value.

In the case of a limited liability company, the right of a member to participate in company management is a voting right.

[5663] Prop. Reg. § 25.2704-1(a)(4) provides:

Source of right or lapse. A voting right or a liquidation right may be conferred by or lapse by reason of local law, the governing documents, an agreement, or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs voting or liquidation rights.

[5664] Prop. Reg. § 25.2704-1(a)(1) provides:

For purposes of this section, a corporation is any business entity described in § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, an S corporation within the meaning of section 1361(a)(1), and a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). For this purpose, a qualified subchapter S subsidiary is treated as a corporation separate from its parent corporation. A partnership is any other business entity within the meaning of § 301.7701-2(a) of this chapter regardless of how that entity is classified for federal tax purposes. Thus, for example, the term partnership includes a limited liability company that is not an S corporation, whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

[5665] Prop. Reg. § 25.2704-1(a)(1).

[5666] Prop. Reg. § 25.2704-1(a)(5).

[5667] Prop. Reg. § 25.2704-1(c)(1).

[5668] Prop. Reg. § 25.2704-1(c)(2)(i)(B), which further provides:

The manner in which the interest may be liquidated is irrelevant for this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, revising the governing documents, merging the entity with an entity whose governing documents permit liquidation of the interest, terminating the entity, or otherwise. For purposes of making this determination, an interest held by a person other than a member of the holder's family (a nonfamilymember interest) may be disregarded. Whether a nonfamily-member interest is disregarded is determined under § 25.2704-3(b)(4), applying that section as if, by its terms, it also applies to the question of whether the

Transfers made within 3 years of death might also constitute a lapse,[5669] including transfers approved by Rev. Rul. 93-12.[5670]

The three-year period was purportedly to capture transfers in contemplation of death. However, it would apply if a very healthy person died accidentally and could have unfair results. For example, a young, healthy married person with a marital deduction designed to generate no estate tax transfers assets subject to this rule. The transferor is hit by a bus two years later. The phantom asset in the transferor's estate does not pass to the spouse and therefore might generate estate tax. My understanding is that comments would suggest that this be changed to whether, using Code § 7520 principles, the taxpayer is expected to live at least one year, which would still benefit the government more than current law.

The effective date of the lapse provision is unclear. If a transferor dies within three years, the lapse is treated as occurring at the date of death. If the transfer is made before the regulations' effective date and the transferor dies after the regulations' effective date, would the regulations capture the lapse? My understanding is that the final regulations are expected to clarify that the answer is no.

Note that selling one's interest to an unrelated third party in a sale that results in the transferor losing control may constitute a lapse that this provision reaches.

III.B.7.f.ii.(b). Prop. Reg. §§ 25.2704-2 and 25.2704-3 Increasing Value Transferred

III.B.7.f.ii.(c). Prop. Reg. § 25.2704-2 Disregarding "Applicable Restrictions" That Later Lapse or Can Be Removed

If an interest in an entity is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any applicable restriction is disregarded in valuing the transferred interest.[5671]

"Applicable restriction" means "a limitation on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder's interest in the entity), if, after the transfer,

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> holder (or the holder's estate) and members of the holder's family may liquidate an interest immediately after the lapse.

[5669] Prop. Reg. § 25.2704-1(f), Example (7), would revise the third and fourth sentences and add a new conclusion:

> More than three years before D's death, D transfers 30 shares of common stock to D's child. The transfer is not a lapse of a liquidation right with respect to the common stock because the voting rights that enabled D to liquidate prior to the transfer are not restricted or eliminated, and the transfer occurs more than three years before D's death. * * * However, had the transfer occurred within three years of D's death, the transfer would have been treated as the lapse of D's liquidation right with respect to the common stock occurring at D's death.

[5670] See the regulation reproduced in fn. 4767, which is accompanied by a paragraph explain Rev. Rul. 93-12 in part III.B.1.b Gifts Without Consideration, Including Restructuring Businesses or Trusts Before Gifts or Other Transfers.

[5671] Prop. Reg. § 25.2704-2(a).

that limitation either lapses or may be removed by the transferor, the transferor's estate, and/or any member of the transferor's family, either alone or collectively."[5672]

An "applicable restriction" may arise under an entity's governing documents or applicable law.[5673] Almost every law is subject to being disregarded.[5674]

"A restriction is an applicable restriction only to the extent that either the restriction by its terms will lapse at any time after the transfer, or the restriction may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family."[5675]

[5672] Prop. Reg. § 25.2704-2(b)(1), which further provides, See § 25.2704-3 for restrictions on the ability to liquidate a particular holder's interest in the entity.

[5673] Prop. Reg. § 25.2704-2(b)(2) provides:

> *Source of limitation*. An applicable restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(4)(ii) of this section.

[5674] Prop. Reg. § 25.2704-2(b)(4)(ii) provides:

> *Imposed by federal or state law*. An applicable restriction does not include a restriction imposed or required to be imposed by federal or state law. For this purpose, federal or state law means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction. A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in section 2704, is not a restriction that is imposed or required to be imposed by federal or state law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to the rules of section 2704 is an applicable restriction. In addition, a restriction is not imposed or required to be imposed by federal or state law if that law also provides (either at the time the entity was organized or at some subsequent time) an optional provision that does not include the restriction or that allows it to be removed or overridden, or that provides a different statute for the creation and governance of that same type of entity that does not mandate the restriction, makes the restriction
> n optional, or permits the restriction to be superseded, whether by the entity's governing documents or otherwise. For purposes of determining the type of entity, there are only three types of entities, specifically, the three categories of entities described in § 25.2701-2(b)(5): corporations; partnerships (including limited partnerships); and other business entities.

[5675] Prop. Reg. § 25.2704-2(b)(3), which further provides:

> For purposes of determining whether the ability to remove the restriction is held by any member(s) of this group, members are treated as holding the interests attributed to them

However, an "applicable restriction does not include a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity."[5676]

"An option, right to use property, or agreement that is subject to section 2703 is not an applicable restriction."[5677]

Also, a put right as described further below is not an "applicable restriction."[5678]

Some of the calculations in examples need clarification or correction.

III.B.7.f.ii.(d). Prop. Reg. § 25.2704-3 Disregarding Restrictions under Governing Documents and State Law that Could Have Been Removed All Along

For purposes of subtitle B (relating to estate, gift and generation-skipping transfer taxes), and notwithstanding Reg. § 25.2704-2, if an interest in an entity is transferred to or for the benefit of a member of the transferor's family,[5679] and the transferor and/or members of the transferor's family control the entity immediately before the transfer, certain restrictions are disregarded and the transferred interest is valued using special rules.[5680]

A "disregarded restriction" is a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described as follows, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to certain exceptions), either alone or collectively:[5681]

> under the rules contained in § 25.2701-6, in addition to interests held directly. The manner in which the restriction may be removed is irrelevant f or this purpose, whether by voting, taking other action authorized by the governing documents or applicable local law, removing the restriction from the governing documents, revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents, merging the entity with an entity whose governing documents do not contain the restriction, terminating the entity, or otherwise.

5676 Prop. Reg. § 25.2704-2(b)(4)(i), which further provides:

> An unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in section 267(b), provided that for purposes of this section the term *fiduciary of a trust* as used in section 267(b) does not include a bank as defined in section 581 that is publicly held.

5677 Prop. Reg. § 25.2704-2(b)(4)(iii).

5678 Prop. Reg. § 25.2704-2(b)(4)(iv), referring to Reg. § 25.2704-3(b)(6), which is described in the text accompanying fn. 5706 in part III.B.7.f.ii.(d) Prop. Reg. § 25.2704-3 Disregarding Restrictions under Governing Documents and State Law .

5679 Prop. Reg. § 25.2704-3(c) includes as family members descendants of the transferor's siblings when determining whether the entity is controlled by the transferor and the transferor's family but does not when determining family members otherwise.

5680 Prop. Reg. § 25.2704-3(a).

5681 Prop. Reg. § 25.2704-3(b)(1).

1. The provision limits or permits the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest.[5682]

2. The provision limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a minimum value (described further below).[5683]

3. The provision defers or permits the deferral of the payment of the full amount of the liquidation or redemption proceeds for more than six months after the date the holder gives notice to the entity of the holder's intent to have the holder's interest liquidated or redeemed.[5684]

4. The provision authorizes or permits the payment of any portion of the full amount of the liquidation or redemption proceeds in any manner other than in cash or property (described further below).[5685]

"Minimum value" means the interest's share of the net value of the entity determined on the date of liquidation or redemption:[5686]

- The net value of the entity is the fair market value, as determined under Code § 2031 or 2512 and the applicable regulations, of the property held by the entity, reduced by the outstanding obligations of the entity.

- Solely for purposes of determining minimum value, the only outstanding obligations of the entity that may be taken into account are those that would be allowable (if paid) as deductions under Code § 2053 if those obligations instead were claims against an estate.

- Subject to the above limitation on outstanding obligations, if the entity holds an operating business, the rules of Reg. § 20.2031-2(f)(2) or 20.2031-3 apply in the case of a testamentary transfer and the rules of Reg. § 25.2512-2(f)(2) or 25.2512-3 apply in the case of an inter vivos transfer. This proposed rule modifying the valuation under those regulations by taking into account only Code § 2053 deductions is heavily criticized. Sound valuation principles, as well as the fundamental Rev. Rul. 59-60, require considering various business risks across the continuum, many of which do not even rise to the level of a contingent liability. Although a regulation can certainly overrule a revenue ruling, this rule would seem punitive as applied to operating businesses.

- The minimum value of the interest is the net value of the entity multiplied by the interest's share of the entity. The interest's share takes into account any capital, profits, and other rights inherent in the interest in the entity. If the property held by the entity directly or indirectly includes an interest in another entity, and if a transfer of an interest in that other entity by the same transferor (had that transferor owned

[5682] Prop. Reg. § 25.2704-3(b)(1)(i).
[5683] Prop. Reg. § 25.2704-3(b)(1)(ii).
[5684] Prop. Reg. § 25.2704-3(b)(1)(iii).
[5685] Prop. Reg. § 25.2704-3(b)(1)(iv).
[5686] Prop. Reg. § 25.2704-3(b)(1)(ii).

the interest directly) would be subject to Code § 2704(b), then the entity will be treated as owning a share of the property held by the other entity, determined and valued in accordance with the provisions of Code § 2704(b) and the regulations thereunder.

- Note that the above rules do not describe how one defines "net value." Does it consider business risks, even though obligations other than Code § 2053 deductions are ignored? Does it consider whether the interest being valued is a minority interest that cannot control related-party transaction that reduce the entity's value as a going concern but that would be normalized if the whole business were sold to a controlling owner? Does it assume that the business is liquidated to satisfy the put rights that the proposed regulations encourage?

The prohibition against paying other than in cash or property referred to further above is subject to the following rules:[5687]

- For purposes of this prohibition, a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related to either the entity or any holder of an interest in the entity, is deemed not to be property. In this context, a related person is any person whose relationship to the entity or to any holder of an interest in the entity is described in Code § 267(b).[5688]

- However, if the entity is engaged in an active trade or business, at least 60% of whose value consists of the nonpassive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of Code § 6166(b)(9)(B), those proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See Reg. § 25.2512-8.

The above test seems harsh. If the note is from an unrelated party, shouldn't it be respected regardless of whether the entity is an active trade or business?

A disregarded restriction includes a restriction that is:[5689]

- imposed under:
    - the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents),
    - a buy-sell agreement,
    - a redemption agreement,

[5687] Prop. Reg. § 25.2704-3(b)(1)(iv).
[5688] However, in applying the related party rule, the term fiduciary of a trust as used in Code § 267(b) does not include a bank as defined in Code § 581 that is publicly held.
[5689] Prop. Reg. § 25.2704-3(b)(2).

- an assignment or deed of gift, or any other document, agreement, or arrangement; and
- a restriction imposed under local law, regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise:
  - For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, which governs the applicability of the restriction.
  - Mandatory restrictions under federal or state law.

Mandatory restrictions are those imposed or required to be imposed by federal or state law:[5690]

- "Federal or state law" means the laws of the United States, of any state thereof, or of the District of Columbia, but does not include the laws of any other jurisdiction.
- A provision of law that applies only in the absence of a contrary provision in the governing documents or that may be superseded with regard to a particular entity (whether by owners, managers, or otherwise) is not a restriction that is imposed or required to be imposed by law.
- A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in Code § 2704, is not a restriction that is imposed or required to be imposed by law. For example, a law requiring a restriction that may not be removed or superseded and that applies only to family-controlled entities that otherwise would be subject to Code § 2704 is a disregarded restriction.
- For purposes of determining the type of entity, the three categories of entities are corporations, partnerships (including limited partnerships), and other business entities.
- A restriction is not imposed or required to be imposed by law if that law also provides (either at the time the entity was organized or at some later time) an optional provision that:
  - does not include the restriction or that allows it to be removed or overridden, or
  - provides a different statute for the creation and governance of that same type of entity that:
    - does not mandate the restriction,
    - makes the restriction optional, or
    - permits the restriction to be superseded, whether by the entity's governing documents or otherwise.

[5690] Prop. Reg. § 25.2704-3(b)(5)(iii).

This last provision – that an optional provision is disregarded – proves too much. All states have rules for creating and terminating entities. All of the owners can get together to vote to liquidate. Thus, any restriction on liquidation can be overridden and is therefore disregarded. Many commentators view this as creating a deemed put right – a result that government representatives emphatically deny. My understanding is that the government intended for "provision" to apply to anything requiring more than a majority vote to liquidate. Of course, those representatives will not be looking over an IRS examiner's shoulder or whispering into a judge's ear, so that understanding is worthless until the government integrates it into final regulations.

Those who say that these concerns exaggerate the proposed regulations' impact argue that, even if one ignored these restrictions, the owners would need to negotiate with each other over the terms of that liquidation. However, as will be seen later, the very existence of some owners is ignored. Even those who are left would need to negotiate on the basis of their legal rights. If their legal rights to block liquidation are ignored, then what is the basis for these negotiations? All that would remain is a slight delay in marshalling assets. Again, government representatives assure the public that is not the case, but skeptics will continue to assume the worse until final regulations clearly rebut this concern.

Returning to the proposed regulation's rules, a restriction is disregarded only to the extent that the restriction either will lapse by its terms at any time after the transfer or may be removed after the transfer by any one or more members, either alone or collectively, of the group consisting of the transferor, the transferor's estate, and members of the transferor's family:[5691]

- For purposes of determining whether the ability to remove the restriction is held by any one or more members of this group, members are treated as holding interests attributed to them under the rules contained in Reg. § 25.2701-6,[5692] in addition to interests held directly. As described further below, the interests of nonfamily members will be disregarded because the proposed regulations provide unrealistic requirements for considering them.[5693] Thus, the transferor and the transferor's family members will be deemed to have the power to remove restrictions.

- The manner in which the restriction may be removed is irrelevant for this purpose, whether by:

    - voting,

    - taking other action authorized by the governing documents or applicable local law,

    - removing the restriction from the governing documents,

    - revising the governing documents to override the restriction prescribed under local law in the absence of a contrary provision in the governing documents,

[5691] Prop. Reg. § 25.2704-3(b)(3).
[5692] See fns. 5564-5566, found in part III.B.7.b.i Code § 2701 Definitions.
[5693] Prop. Reg. § 25.2704-3(b)(4).

- merging the entity with an entity whose governing documents do not contain the restriction,
- terminating the entity, or
- otherwise.

In the case of a transfer to or for the benefit of a member of the transferor's family, for purposes of determining whether the transferor (or the transferor's estate) or any member of the transferor's family, either alone or collectively, may remove a restriction under Prop. Reg. § 25.2704-3(b), a nonfamily-member's ownership is disregarded unless all of the following are satisfied:[5694]

(A) The interest has been held by the nonfamily member for at least three years immediately before the transfer;

(B) On the date of the transfer, in the case of a corporation, the interest constitutes at least 10% of the value of all of the equity interests in the corporation, and, in the case of a business entity[5695] other than a corporation, the interest constitutes at least a 10% interest in the business entity, for example, a 10% interest in the capital and profits of a partnership;

(C) On the date of the transfer, in the case of a corporation, the total of the equity interests in the corporation held by shareholders who are not members of the transferor's family constitutes at least 20% of the value of all of the equity interests in the corporation, and, in the case of a business entity[5696] other than a corporation, the total interests in the entity held by owners who are not members of the transferor's family is at least 20% of all the interests in the entity, for example, a 20% interest in the capital and profits of a partnership; and

(D) Each nonfamily member, as owner, has a put right as described in Reg. § 25.2704-3(b)(6).

In applying the 10% and 20% tests when the property held by the corporation or other business entity is, in whole or in part, an interest in another entity, the attribution rules of Reg. § 25.2704-3(d) (described further below) apply in:[5697]

- determining the interest held by a nonfamily member, and
- measuring the interests owned through other entities.

The three-year holding requirement of (A) above is not unreasonable, except that it should be the lesser of three years or since the entity's inception, to avoid prejudicing start-up businesses. The Reg. § 25.2704-3(b)(6) put right described further below in is totally unrealistic, as operating businesses cannot afford to set aside liquidity to cash out

5694 Prop. Reg. § 25.2704-3(b)(4)(i).
5695 Within the meaning of Reg. § 301.7701-2(a).
5696 Within the meaning of Reg. § 301.7701-2(a).
5697 Prop. Reg. § 25.2704-3(b)(4)(iii).

owners without impairing their ability to operate, grow, and hopefully fulfill The American Dream.

If a nonfamily-member interest is disregarded under the above rule, Reg. § 25.2704-3 applies as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.[5698]

The following are not applicable restrictions:[5699]

- An applicable restriction on the liquidation of the entity as defined in and governed by Reg. § 25.2704-2.[5700]

- A commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations whether in the form of debt or equity,[5701] and an unrelated person is any person whose relationship to the transferor, the transferee, or any member of the family of either is not described in Code § 267(b).[5702] Given that the restriction is being imposed by an unrelated person, one wonders why the proposed regulations regulate the use of the funds.

- A mandatory restriction under federal or state law.[5703]

- An option, right to use property, or agreement that is subject to Code § 2703.[5704]

- A put right (described immediately below).[5705]

"Put right" means a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption:[5706]

- For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs liquidation or redemption rights with regard to interests in the entity.

- For purposes of this definition, the term other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or to any holder of an interest in the entity. However, if the entity is engaged in an active trade or business, at least 60% of whose value consists of the non-passive assets of that

[5698] Prop. Reg. § 25.2704-3(b)(4)(ii).
[5699] Prop. Reg. § 25.2704-3(b)(5).
[5700] Prop. Reg. § 25.2704-3(b)(5)(i).
[5701] Prop. Reg. § 25.2704-3(b)(5)(ii).
[5702] As applied here, fiduciary of a trust under Code § 267(b) does not include a is publicly held bank under Code § 581.
[5703] Prop. Reg. § 25.2704-3(b)(5)(iii), as described in the text accompanying fn. 5690.
[5704] Prop. Reg. § 25.2704-3(b)(5)(iv).
[5705] Prop. Reg. § 25.2704-3(b)(5)(v).
[5706] Reg. § 25.2704-3(b)(6).

trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of Code § 6166(b)(9)(B), "other property" does include a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds. See Reg. § 25.2512-8.

- The minimum value of the interest is the interest's share of the net value of the entity, as described above.[5707]

As mentioned above in the text accompanying fn. 5694, failure to give a put right to an unrelated person means that the unrelated person is treated as not being an owner.[5708] Furthermore, if a restriction is disregarded under Reg. § 25.2704-3, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise.[5709]

When applying Code § 2704(b), if part of a decedent's interest in an entity includible in the gross estate passes by reason of death to one or more members of the decedent's family and part of that includible interest passes to one or more persons who are nonfamily members of the decedent, and if the part passing to the members of the decedent's family is to be valued as if the disregarded restriction does not exist in the governing documents, local law, or otherwise, then that part is treated as a single, separate property interest.[5710] In that case, the part passing to one or more persons who are not members of the decedent's family is also treated as a single, separate property interest.[5711]

Given that nonfamily members' interests will be disregarded because nobody will ever qualify and that which legal restrictions are given effect is unclear, one might argue that Prop. Reg. § 25.2704-3 treats the transferor and the transferor's family as if no restrictions on liquidating their interest existed. One might also argue that "provisions" of governing law that do not apply are a much more narrow range, so that most aspects of the governing are given effect and far-reaching liquidation rights are not assumed. In light of this uncertainty, one might want to hope for the best and plan for the worst.

Although the proposed regulations encourage a put right for minimum value, they do not deem that right to exist. They merely use it as benchmarks for determining whether various restrictions exist. Although disregarded obligations that are not Code § 2035 debts might cause minimum value to be much higher than fair market value, consider that, if the entity liquidated, its owners could not collectively obtain more than fair market value. One of the best appraisers in the country suggested that this fair market value

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[5707] Reg. § 25.2704-3(b)(1)(ii), described in the text accompanying fn. 5686.

[5708] Reg. § 25.2704-3(b)(4)(ii) provides:

> *Effect of disregarding a nonfamily-member interest*. If a nonfamily-member interest is disregarded under this section, the rules of this section are applied as if all interests other than disregarded nonfamily-member interests constitute all of the interests in the entity.

[5709] Reg. § 25.2704-3(f), which further provides, For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, under which the entity is created or organized.

[5710] Reg. § 25.2704-3(e).

[5711] Reg. § 25.2704-3(e), which references Reg. § 25.2704-3(g), Example 4.

maximum is itself a mandatory restriction under applicable law that would be respected. Other comments appraisers have made include:

- Does one consider tenancy in common or restricted management agreements? How about rights of first refusal?

- A history of redemptions would tend to affect value.

- For an at-will general partnership, examiners argue under current law no discounts. However, the process required to liquidate can cause delay and uncertainty and require valuation adjustments. Although that adjustment might be relatively low, one appraiser reported settling for 20% where the liquidation process was going to be cumbersome and lengthy.

- Scrutinize control premiums, because merely deriving them public market minority discounts does not tell the whole story. Fair value would have normalized expenses, whereas fair market value might not. Control means different things for different types of businesses or investment portfolios.

- Environmental liabilities, key man risks, agreements that lock in executive compensation, and other business risks need to be considered in valuing a business. These can be larger issues than discounts, and minimum value should not disregard them the way that they might be doing under the proposed regulations.

- Family members do not necessarily work together. Although the proposed regulations may require that one assumes that they act together when deciding whether to liquidate, they might not agree how to operate the business or how to liquidate.

- What happens to the business when it sells assets to fund a redemption? Consider the tax and other economic issues.

- For pass-through entities, consider owners bargaining with each other and Code § 336, 338(h)(10) elections.[5712]

- How much of the value is based on a particular owner's vision and skills? Consider personal goodwill and similar issues.[5713]

- How about a lender's restrictions on the ability to liquidate? Although the proposed regulations provide an exception, the exception is not necessarily available. Furthermore, even if the family member is deemed to have a liquidation right, would liquidating the family member's interest generate a fire sale, due to the lender's restrictions?

- The right to a minority oppression lawsuit adds value under current law, and disregarding minority discounts also disregards the value given to that premium.

[5712] See part II.Q.8.e.iii.(f) Code §§ 338(g), 338(h)(10), and 336(e) Exceptions to Lack of Inside Basis Step-Up for Corporations: Election for Deemed Sale of Assets When All Stock Is Sold.
[5713] See part II.Q.1.c Personal Goodwill and Covenants Not to Compete.

- If the family is cohesive, they might not let an unrelated party withdraw or might impose a withdrawal penalty.

- An owner who is difficult to deal with or imposes reputational risk to the business might reduce value.

- The proposed regulations' increasing the value in appraisals done for estate planning purposes might provide arguments for dissenting owners to argue to be bought out at a higher price.

- Complexity of corporate structure may reduce value.[5714]

- Be careful when comparing the business' value against hedge funds' values. Hedge fund managers have incentive to be fair, because they want to sell future hedge funds, whereas a family member might not have that incentive. Hedge fund restrictions on withdrawal allowed them to weather market downturns so that they didn't have to liquidate assets at depressed values.

- One would need to do a liquidity analysis regarding cashing out owners.

III.B.7.f.ii.(e). Practical Planning Implications of Controversial 2016 Proposed Regulations

Generally, practitioners assumed that the regulations would attack entities formed to hold nonbusiness assets. However, the proposed regulations apply to operating businesses. They would ignore any restrictions on an owner's ability to cash out in six months or to cause the business to liquidate if the family could remove those restrictions. Furthermore, they do not distinguish between restrictions under the entity's governing documents and restrictions imposed by "provisions" of state law. Consider that all state laws provide rules for forming and liquidating an entity, the latter of course having the effect of liquidating each owner's interest in the entity. Although the government agrees that it cannot create rights, disregarding restrictions on exercising rights might have the effect of granting rights. State law expressly prohibiting a limited partner from withdrawing and being cashed out absent a contrary provision in the partnership agreement is a "provision" that would be disregarded. Is a shareholder's inability to withdraw and cash out (including placing a term governing the entity's dissolution date) a "provision," given that this inability is implicit and not explicit? I have seen some of the top estate planning lawyers in the country lock horns on this issue. My understanding is that the government did not intend to eliminate all minority discounts or to impose a deemed put right. However, that intent is not clear from the proposed regulation. Thus one might hope that the government would clarify these positions, while at the same time one would prepare for the possibility that the final regulations might not sufficiently clarify this intent and that an examiner or a judge would take a different view.

Any person who owns, or whose family owns, at least half of the entity would be subject to these rules. In determining whether an owner of that entity can cash out, one must assume that the family will act together to remove a covered restriction on cashing out and that nonfamily members cannot vote unless together they own at least 20% and are

[5714] *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990).

qualified: To count a nonfamily member's ownership, the person must have been an owner for at least 3 years, own at least 10%, and have a right to cash out with six months' notice for "minimum value" in exchange for a note at market interest rates that is adequately secured and requires periodic payments on a non-deferred basis. As a practical matter, a business is not going to want to let its owners cash out whenever they wish, and the proposed regulations disregard any covered restrictions on a person who owns, or whose family owns, at least half of the entity. Furthermore, this "minimum value" would not respect any contingent liabilities, without any explanation how one would draw the line between business risks that affect the business' going concern value and contingent liabilities.

The proposed regulations also provide that, if a person transfers part or all of the controlling interest within 3 years of death, that person's estate is treated as holding that level of control at death. For example, a sale to an unrelated party could create a lapse, given that the unrelated party held the property for less than 3 years and therefore is disregarded. However, the estate would not receive a marital or charitable deduction for that level of control, because that level of control does not pass to the surviving spouse or charity.

The proposed regulations apply to restrictions created after October 8, 1990, occurring either one or after day that, or at least 30 days after, the proposed regulations are finalized, depending on the provision of the proposed regulation. Written comments are due November 2, and on December 1 the government will hold a hearing, granting each speaker 10 minutes. My understanding is that, as of October 18, 2016, the government had processed 200 comments and had received but not yet processed another 3,200 comments. The usual process is to cross-reference each comment to each provision it references, although many of the comments express general dissatisfaction with the proposed regulations and do not provide comments on any particular provision. My understanding is that regulations usually take a year to finalize and that comments of this complexity might take three years to finalize. That being said, the regulations under Code § 385 were quite complex (over 500 pages between preamble and final regulations governing international financing transactions) but took just over 6 months to finalize. Given that a political announcement accompanied the proposed regulations, the prospect of a change in Administration might affect the timing. My understanding is that the government could have given 60 days for comments but chose to provide 90 days, a sign that the government did not appear to want to rush comments. As Yogi Berra said, "It's hard to predict – especially the future."

Effective dates:

- The amendments to Reg. § 25.2701-2 are proposed to be effective on and after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

- The amendments to Reg. § 25.2704-1 are proposed to apply to lapses of rights created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register. My understanding is that the final regulations would clarify that the amendments to this regulation would apply to lapses if the transfer occurred on or after that publication, not if the death triggering the lapse treatment occurred on or after that publication.

- The amendments to Reg. § 25.2704-2 are proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring on or after the date these regulations are published as final regulations in the Federal Register.

- Prop. Reg. § 25.2704-3 is proposed to apply to transfers of property subject to restrictions created after October 8, 1990, occurring 30 or more days after the date these regulations are published as final regulations in the Federal Register.

Action items include:

1. Consider making transfers before the proposed regulations become final. These transfers might be gifts, sales, or perhaps using other estate planning tools. This might be of all of the client's interest, of enough to reduce the client's interest below 50%, or of enough to reduce the client's holding to below the liquidation right threshold. Revise the governing documents to require a level of consent for liquidation higher than whatever the client owns now.

2. Note that owning property 50/50 would cause the proposed regulations to apply. One lawyer suggested to me that each owner contribute an equal amount to a Code § 501(c)(4) organization.

3. Review buy-sell agreements to consider whether any additional estate tax would apply under these rules and plan for who should pay that tax. Exercise caution in changing any provisions that existed on October 8, 1990.

4. The proposed regulations respect "a commercially reasonable restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity," so consider documenting the extent of those restrictions. When reviewing commercial loan agreements, carefully review any covenants that affect the owners' ability to cash out and document the extent to which these covenants require buy-sell provisions to prevent cashing out.

5. Some planners have suggested holding real estate as tenants in common instead of in an LLC or other entity, to avoid the new rules that would apply to business entities. Active rental can cause a tenant-in-common arrangement to be treated for state law purposes and tax purposes as a general partnership. General partners are subject to joint and several liability and have rights to cash out of their arrangements that would undermine valuation discounts, so expert advice is required before delving into this area. See part II.C.9 Whether an Arrangement (Including Tenancy-in-Common) Constitutes a Partnership. Note, also, that the proposed regulations under Code § 2704 are vague as to what is an "arrangement" that constitutes a business entity.

Appraisers might need to do more than one appraisal per transfer.

When preparing gift tax returns reporting transfers after the August 2016 promulgation of the proposed regulations, consider whether to attach a statement describing any position taken that is contrary to any proposed regulations published at the time of the transfer.[5715] Given that the proposed regulations were not proposed to apply to that period, this does not appear necessary, but each person can develop his or her own comfort level.

Also see part II.H.2.j Effect of Chapter 14 on Basis Step-Up, suggesting that taxpayers file an estate tax return to take advantage of the basis step-up for this inflated value.

III.C. Fairness Within Families; Valuation

A succession plan can be one of the most important factors contributing to the long-term success of a family business, yet the importance of these plans is often overlooked until it is too late. In many cases, the plans are technically sufficient, but the drafters have failed to consider the relationships that drive the business itself – the family.[5716] While the technical issues underlying family business succession plans are usually similar from case to case, the family issues are unique in every case. No two families are the same, and successful business succession plans consider those differences. The stakeholders in the business have to be treated fairly for the plan to succeed; thus, the plan has to consider the interests of family, non-family owners, and the employees.

The starting point for any business succession plan is determining an accurate valuation of the business. If the plan involves keeping the business in the family, it is important to have an accurate determination of its value in order to allocate wealth fairly among family members involved in the business and those who are not involved. Or, if the plan involves some sort of sale, accurate valuation will ensure the sellers receive fair compensation for their interests. And, regardless of whether the business stays in the family or is sold, an accurate valuation can help parties estimate a significant expense of the succession process – the transfer tax cost of the succession. See part II.H.3 Valuation Discounts – Friend or Enemy.

The general principle underlying business valuation is the "willing buyer – willing seller test". Regulations define fair market value in the context of estate transfers as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[5717] The test is easy to apply when dealing with publicly traded stock - one simply takes the mean between the highest and lowest quoted sales prices on the valuation date. In the context of non-publicly traded securities, ready-made market for the stocks exists, so valuation is more challenging. The Code states that the value of such stocks should be determined by examining numerous factors, including the value of stocks of corporations "engaged in the same or a similar line of business which are listed on an exchange."[5718] Regulations expand on the factors to be considered, mentioning the company's net worth, prospective earning power and dividend paying capacity and list other relevant factors, including the good will of the business, the economic outlook in a particular industry, the company's position in the industry, the degree of control of the business represented by the block of stock to be

[5715] Reg. § 301.6501(c)-1(f)(2)(v).
[5716] The discussion in this section comes in large part from some materials provided by James D. Spratt, Jr. of The Bowden Spratt Law Firm, P.C., who is not responsible for whatever use this author made of his materials.
[5717] Reg. §§ 20.2031-1(b), 25.2512-1.
[5718] Code §2031(b).

valued, and the value of stock of other corporations engaged in similar lines of business which are listed on a stock exchange.[5719] Revenue Ruling 59-60 mirrors the Regulations and lists eight fundamental factors that should be considered in valuation cases: the nature of the business and the history of the enterprise; the general economic outlook and the business' specific industry outlook; the book value of the stock and the company's financial condition; the company's earning capacity; the company's dividend paying capacity; goodwill; sales of the stock and the size of the block of stock to be valued; and the market price of companies in similar lines of business with actively traded stock. If the business has a contingent claim against it, consider making a protective claim for refund to deduct the amount actually paid.[5720]

In applying these factors, three methods are commonly used in business valuations: the net asset method, the market value method, and the earnings method. These methods are often used in conjunction with one another to come up with the best possible valuation of the business.

The net asset method (or the "underlying asset" method) is based on the accounting concept of net book value. Net book value of a company is the historical cost of the company's assets less its liabilities. Under this method, each asset and liability must be analyzed to determine if the historical balance sheet treatment needs to be restated. This approach is not always accurate when valuing operating companies, since the method does not consider the company's goodwill, so this method is usually considered to give a picture of the minimum value of a company and may be useful where a company is in financial distress with liquidation in its future. However, this method can be quite useful in valuing companies with little goodwill, like holding companies.

The market value method involves an analysis of the value of similar, publicly traded companies or of similar companies that have been recently acquired in private transactions. The comparison values are based on stock prices or transaction prices, which are then divided by a specific earnings parameter or balance sheet parameter. That multiple is then applied to the subject company's same parameter to get an estimated company value. Because the valuation's accuracy depends on the level of similarity between the two companies, this valuation method becomes less appropriate as the subject company becomes more unique and will be hard to apply in many cases.

The earnings method bases valuation on a company's cash flow capacity and earnings to determine the present value of the future economic benefits the company will bring to its investors. This valuation can be determined two ways, either through the discounted cash flow method or through the capitalization of earnings method. When a company has a past earnings stream that is not expected to indicate future earnings prospects, the discounted cash flow method is used. This entails projecting the business' future cash flows and discounting them to present value using an appropriate discount rate, usually the weighted average cost of capital (WACC), the rate of return the company's capital providers require on their investment. When a company has consistent historical earnings and expects that trend to continue, the capitalization of earnings method is often used. This method entails multiplying a normalized level of earnings by a capitalization factor, the inverse of the company's WACC.

[5719] Reg. §20.2031-2(f)(2) and §25.2512-2(f)(2).
[5720] Notice 2009-84.

Once the company's value has been established using any combination of the valuation methods, the value of the particular interest in the company has to be determined. In many cases, the value of the particular business interest will not be the proportionate share of the entire business value. Instead, adjustments often need to be made to get an accurate value of the interest. For example, a 51% interest may be just two percentage points larger than a 49% interest, but the 51% interest has more than just a two percentage point value advantage over the 49% interest, since the 51% interest is a controlling interest. Thus, controlling interests often are increased by a control premium, while minority interests are decreased by a minority interest discount. Other examples of valuation adjustments include a key employee discount, a non-voting stock discount or a blockage discount. When making these adjustments it is important to consider whether the discount has already been taken into consideration in determining the company value as a whole. If it has, then the discount should be ignored for the particular business interest valuation. For example, a controlling interest valued using earnings will be based on the company's dividend paying capacity. On the other hand, a minority interest tends to be valued using dividends paid, since a holder of a minority interest may have difficulty forcing dividends to be paid and keeping compensation reasonable.

Restrictive agreements can also play a role in determining interest values. Buy-sell agreements, by definition, involve setting a price at which a particular business interest will be purchased or redeemed. Price can be set a number of ways: by using a formula, by agreement, or by an appraisal procedure.

The formula method usually involves applying some multiple to asset value or earnings, and the decision on whether to use asset value or earnings is usually dependent upon the particular business industry. The multiple applied to that factor will vary depending upon the company and the general business cycle, so finding the appropriate multiple can be challenging. Some of this difficulty can be eased if the company is similar to publicly traded companies, that would give the valuation expert a guideline in determining the multiple.

The agreed value method is exactly what one would assume – it involves the business owners agreeing to a buy-sell purchase price. The most important aspect of this method is the certificate of value itself. Owners must make sure the certificate is updated on a regular basis to ensure the agreed upon price is in fact fair. It is best if the agreement itself provides for an alternate method of valuation if the certificate is not kept up to date. Another potential problem with this approach comes into play where the relative bargaining power of the owners is not equal. In such a case, this method can lead to inequitable results.

The appraisal procedure is usually the most fair method of valuation, but many times it is not used because it can be very expensive. Additionally, because the method requires many judgment calls, no two appraisers are likely to come to the same conclusion about the company's value. Thus, results can be very uncertain, and a company and its owners need to be prepared to pay for multiple appraisals if the interested parties are not satisfied with the initial results.

Two other issues also need to be addressed in buy-sell agreements: whether the interest will be valued at fair market value or fair value, and whether contingent payments will be an option. These issues both address fairness to the parties involved in the transaction.[5721]

Fair value can be the appropriate measure to be used in buy-sell agreements. The goal of fair value is to reach a fair result for the party whose interest is being cashed out involuntarily. On the other hand, fair market value derives from the "willing buyer, willing seller" test, and involves the previously discussed valuation adjustments. But many business interest disposals are triggered by involuntary events, like a family death, meaning the seller is often not the "willing seller" referred to in the fair market value context and applying valuation adjustments could lead to inequitable results. A countervailing argument is that cashing out an owner disrupts the cash flow of a business or its owners, so paying fair market value provides some relief from that disruption. Ultimately, one might consider whether advance planning can provide the needed cash flow, whether the party who controls the event or the party whose wrongful conduct creates the event should bear the consequences, and who should bear the burden of events that are beyond everyone's control.

A buy-sell agreement also should include a contingent payment provision. Such a provision will come into play when a company undertakes a sale or merger after the triggering event of the buy-sell agreement. In many cases, the sale or merger will be based on a significantly different value than the one used in the buy-sell agreement. If this happens, the party who is bought out in the buy-sell agreement could end up receiving inequitable compensation for his interest. A contingent payment provision can correct this inequity by providing for additional consideration to be paid to those whose interests were retired under the buy-sell agreement within a certain amount of time before the sale or merger.

The valuation issue is so important in family business settings because of personal issues arising within a family business. These businesses' success can depend on how well the older generation plans and how clearly they delineate those plans to the younger generation. This is especially critical when family members actively participate in the business. It is highly unlikely that all of those members involved in the business participate equally in the success of the business; and, when a patriarch dies, arguments may quickly break out about those contributions. If the business owner does not deal with these issues, the business may fail. Family members involved in the business should take over, and other family members should receive other bequests. To divide assets fairly among family members, one has to know the assets' value. In funding bequests, a beneficiary who receives an interest to which discounts apply might argue strongly that they will bear the costs of any situation that requires agreements that are not easily achieved,[5722] whereas the other beneficiaries might argue that merely getting along with others allows the recipient to attain full value and the recipient should not be able to assume that bad things will happen and therefore should be charged with a fair value approach. Non-family owners and employees are also critical to a company's

[5721] See Cavendish and Kammerer, Determining the Fair Value of Minority Ownership Interests in Closely Held Corporations: Are Discounts for Lack of Control and Lack of Marketability Applicable? *The Florida Bar Journal*, Vol. 82, No. 2, at 10 (2/2008).

[5722] See *Zoldan v. Zohlman*, 11 So.3d 982 (Fla. App. 3rd D. 2009) (ACTEC Fellow David Pratt testified for the winning side that discounts applied).

success, and their needs are important to address so that they will continue to be productive.

In addition to the valuation process discussed previously, consider expansion of the professional and business team, employment agreements, compensation, life insurance, ways to reduce estate taxes, capital structure, voting control, and communication.

When developing a business succession plan, professionals might help deal with family dynamics. These professionals usually have training areas like cultural anthropology, psychology or organizational dynamics and can help the business owner prepare for situations he or she would otherwise fail to see coming.

A successful succession plan may also integrate increased depth at the management level. Common sense would tell you that a company is more likely to succeed when the managers taking over have business experience, and succession planning should take that into consideration. It can also be helpful to incorporate outside directors into the board of directors. These "neutral" parties can not only help family members make smart business decisions after the patriarch's death, but can also help reassure the employees. In addition to having non-family board members, it may also be helpful to have a board of advisors. These advisors would not assume any fiduciary duty to the company, but can provide an impartial review of the company's operations and can be a significant aide to new family members or outside management who take over the company after the patriarch's death.

Employment agreements can help ease the anxieties surrounding their futures after a business owner's death. Key employees may be concerned about being run out or demoted by new family members who take over the business. Employment agreements can help to lessen these concerns by including protection from "without cause" terminations and by allowing for compensation if the employee resigns for "good reason." These agreements may also include a clause similar to a "retention bonus" that gives the employee additional compensation for staying on after the death of an owner to help the business complete the transition period.[5723]

In addition to addressing compensation in employment agreements, a succession plan should address compensation decisions. All parties involved need to know and understand who will make compensation decisions in the new management scheme and how abuses of the compensation system will be prevented.

Life insurance can help with liquidity issues that may arise at the time of an owner's death in two ways. First, the proceeds can assist in achieving fairness in the estate distribution process if the estate does not hold sufficient liquid assets. The proceeds can provide assets for family members who are not involved in the family business (or can provide liquidity for those who are involved so that they have a cushion if the business declines), while the business itself passes to interested family members. Additionally, if the estate does hold liquid assets, then the proceeds can provide liquidity for the

[5723] Deferred compensation agreements are subject to Code §409A (added by the American Jobs Creation Act of 2004), which accelerates an employee's recognition of income and imposes a 20% penalty when such agreements do not satisfy its requirements. Payments contingent on future performance of services frequently satisfy its requirements.

business itself in the time of transition. Finally, life insurance payable to the company upon the death of key management can be used to help the company in retaining or recruiting management during the transition.

A business succession plan should include estate planning strategies to help preserve family wealth, thereby increasing the likelihood of continued success of the business. Some of these strategies are discussed elsewhere in these materials.

A business' capital structure can also be arranged to ensure fairness among owners. A plan needs to consider all owners' needs and determine what business structure gives the company and owners the most flexibility in meeting those needs. In addition, a business plan can use capital structure to segregate assets for estate planning purposes. For example, an LLC can be created to hold real estate, which it can lease to the operating company in exchange for rent. The real estate LLC can provide rental income to family members who are not active in the business. Long-term leases with inflation adjustments can provide stability for all interested parties.

Voting control allocation can also assist in the success of a fair business succession plan. A balance needs to be struck between giving the active family members enough power to fulfill their responsibilities and not giving them too much authority so as to enable abuse of power situations. A voting/non-voting interest dichotomy or a limited partnership structure can achieve this balance.[5724] In both cases, active family members can take control of the company, regardless of how much of the company they actually own themselves. Family members who are not in control also need rights that give them some input into major company issues or at least some way to get out of the company if they are not satisfied with how management is running it. This could be accomplished by setting a level of performance of management, and if management falls below that performance level, then minority or non-controlling members would have the right to cash out their interest.

Essentially all of these issues come together under one theme – communication. Business owners need to address as many potential issues as they can and make sure all interested parties know and understand how those issues are to be resolved. This can be achieved through a clearly delineated business succession plan that is communicated to family members, non-family owners, key employees and the board of directors or advisors. Finally, when the plan involves keeping the business in the family under the control of certain family members, the client needs to make sure the family knows the reasoning behind the decisions, to minimize future conflict.

III.D. Hypothetical

III.D.1. Facts

Harvey Decedent died in 2002, leaving four children by his first marriage and a second wife, Wanda.[5725] All four children (Angie, Bob, Cindy, and Dan) are in their late thirties,

[5724] State law often restricts a plan's ability to dictate corporate directors' actions. LLC statutes provide much more flexibility. Statutory close corporation rules can provide a fair amount of flexibility if a corporate form is essential; see fn. 776.
[5725] This hypothetical is based on a presentation done by Steve Salley, Jonathan Lander, Steve Kirkpatrick, and the author at the 2004 ABA RPPT/Tax Joint Fall Meeting.

and each has two children of his/her own. Harvey was diligent during his life in moving assets to his children, so that at his death all his business assets were held in family entities in which his children participated. Following estate administration virtually all the estate's assets ended up in a QTIP for Wanda with the remainder to Harvey's descendants per stirpes.

A) <u>The Trust</u>. The QTIP holds assets which include the following:

1) Approximately $5,000,000 in marketable securities.

2) An 80% interest in Cow Town LLC, an entity (taxable as a partnership) that owns the real estate and improvements of Cow Town Hotel, a well-known and valuable but aging urban hotel in Texas. The real estate is valued at $10,000,000 but is encumbered by a $4,000,000 mortgage that currently bears interest at 5% per annum. Payments are currently interest only for the next 3 years, until it balloons. The Hotel earns approximately $1.5 million per year in taxable income after management fees, but has been distributing only 50% of that amount to its members, the balance going to badly needed capital improvements. The remaining 20% of the LLC is owned in equal shares by the four children, two of whom are desperate for cash due to their wastrel ways and two of whom are the key employees of Cow Town, Inc., discussed below.

3) A 40% interest in Cow Town, Inc., an S corporation established by Harvey to manage the Hotel and, during his life, to provide cash flow to his kids from Hotel operations. The corporation has no assets other than a management agreement on the hotel which has 2 years to run before it must be renegotiated. The remaining 60% of the stock is held 15% each by the four children. To date the contract calls for a management fee equal to 50% of the Hotel's "profit," an amount deemed by dad to be equal to taxable income. Thus the corporation has enjoyed $1,500,000/year in management fees, which after salaries and expenses of $500,000 annually, was distributed pro rata to the shareholders. The two key employees of the corporation and, indirectly, of the Hotel are Angie and Bob Decedent who have received the same $100,000/year salary since Harvey died. They complain about doing all the work for the benefit of their brother, sister, and Wanda and are demanding significant salary concessions to continue managing the hotel.

B) <u>The Trustees</u>. The QTIP has three trustees, Sam Tortte (Harvey's long-time lawyer), Tom Penny (Harvey's CPA), and FiDuc., a nationally known commercial trust company first nominated to serve under Harvey's will with no prior experience with the family.

C) <u>The Problems</u>.

1) The mortgage holder on Cow Town LLC has offered to extend the mortgage to a 15-year term with straight amortization and a 4.5% interest rate but only if the Trust, as the largest equity holder and source of liquidity, guarantees the mortgage.

2) FiDuc is requesting that the management agreement and the compensation of Angie and Bob be reviewed by an outside "expert" to determine reasonability; but

the four kids threaten to stymie any efforts to change the ownership or cash flow for the benefit of Wanda, whom they believe is more than well taken care of from the trust's other assets.

3) The hotel is desperately in need of a new roof at a cost of $1,000,000, which will either have to come from the hotel's "profit" or a second mortgage. A second mortgage will require additional collateral beyond the guarantee of the Trust, including, perhaps, a pledge of a portion of the Trust's marketable securities.

4) FiDuc has demanded that any collateral or guarantee by the trust of Hotel debt must be accompanied by a loan agreement that assures the Trust control of the Board of Directors of Cow Town Inc. and the status of "sole managing member" of the LLC.

The trust is domiciled in a state that has adopted the most recent uniform trust-related laws. The trustees desire a "roadmap" of issues to be addressed in the upcoming negotiations.

III.D.2. Trust Accounting and Taxation

The QTIP trust holds an 80% interest in a partnership. As a QTIP trust, it must distribute all of its income. The partnership earns approximately $1.5 million in the current year, but distributes only 50% of that amount to its partners. Thus, the trust receives a K-1 with $1,200,000 of income (80% of $1,500,000), but receives only $600,000 in cash (50% of $1,200,000). Initially, one might think the entire $600,000 is distributable net income and must be distributed to the beneficiary, because under Uniform Principal and Income Act § 401, a trustee must allocate money received from an entity to income.[5726]

[5726] See also RSMo §469.423.2. Uniform Principal and Income Act § 401 is found at http://www.uniformlaws.org/Act.aspx?title=Principal and Income Amendments (2008) and provides:

(a) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 402 applies, a business or activity to which Section 403 applies, or an asset-backed security to which Section 415 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(c) A trustee shall allocate the following receipts from an entity to principal:
  (1) property other than money;
  (2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;
  (3) money received in total or partial liquidation of the entity; and
  (4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

(d) Money is received in partial liquidation:
  (1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or
  (2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as

However, if the trust does distribute the entire amount, it will be unable to pay the tax on the other $600,000 of "phantom" taxable income from the K-1 that it could not distribute. So the trust must retain some of the cash it received from the partnership. This withholding is supported by the language of § 505(c) of the Uniform Principal and Income Act,[5727] which states that taxes required to be paid by a trustee on a trust's share of an entity's taxable income are to be paid proportionately from income and principal based on the extent that receipts from the entity are allocated to each.

In this hypothetical, all $600,000 of cash received was properly allocated to income, so 100% of the tax due on the trust taxable income must come out of income. Thus, the trustee has to do a circular calculation to determine how much of the $600,000 must be withheld in order to cover the tax on that amount.

Assuming a 40% combined federal and state income tax rate, the trust will end up withholding $400,000 of the cash and distributing $200,000 to the beneficiary. This leaves the trust with $1,000,000 of taxable income ($1,200,000 K-1 income minus the $200,000 distribution deduction), resulting in a $400,000 tax due, which the trust will be able to pay with the $400,000 cash it retained. The beneficiary will receive $200,000 and pay $80,000 tax on that amount, leaving the beneficiary with $120,000.

Put another way, the K-1 income was $1,200,000, requiring $480,000 of tax to be paid by somebody, and $120,000 to be retained by the income beneficiary after tax ($600,000 cash distribution from the partnership minus $480,000 tax paid). Of the $480,000 tax to be paid, $400,000 is paid by the trust and $80,000 by the beneficiary (out of the beneficiary's $200,000 distribution).

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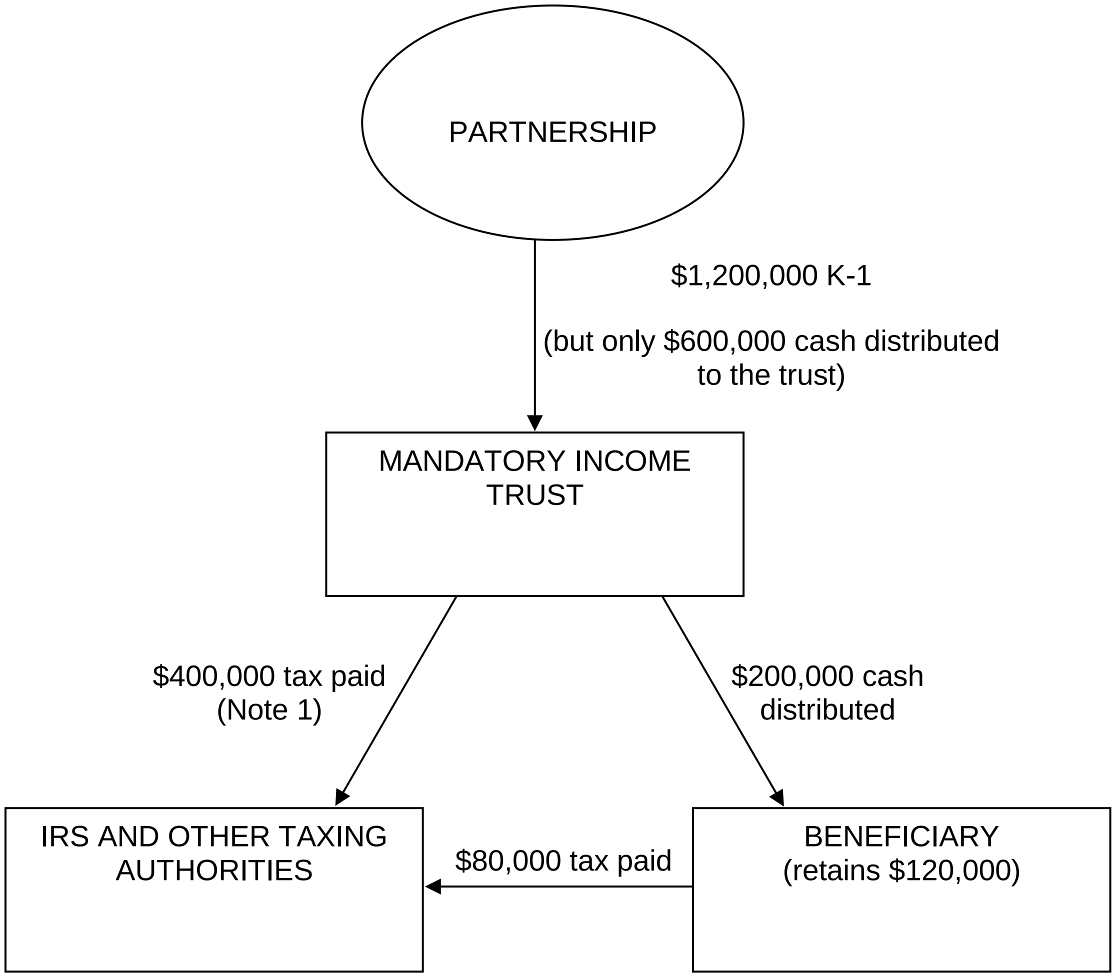
shown by the entity's year-end financial statements immediately preceding the initial receipt.

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

[5727] See part III.A.4 Trust Accounting Income Regarding Business Interests. See also RSMo § 469.459.3.



Note 1: $1,200,000 K-1 income minus $200,000 income distribution deduction equals $1,000,000 taxable income. This example assumes a combined federal and state tax rate of 40%.