The Texas Tax Lawyer

Spring 2012
Vol. 39, No. 3
www.texastaxsection.org

STATE BAR OF TEXAS

2012

Created in 1939

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CHAIR'S MESSAGE

This is my last Chair's Message, and what a great year this has been for the Tax Section! Thanks so much to the Officers, Council Members, Committee Chairs and Vice-Chairs, and you for all you've done to advance our goals – education, better laws, pro bono, enhanced profile, future leaders, outreach, and having fun! We have grown to more than 2000 members and are now a Big Section of the State Bar. Tina Green, the incoming Tax Section Chair, is primed and ready to keep up and build on our great momentum!

Education

24/7 Free CLE Library. As a Tax Section member, you may access the Tax Section's 24/7 library of free CLE Webcast programs at any time through the Tax Section website. Check out the programs from the recent Property Tax Conference that are coming soon:

- Case Law Panel – John Brusniak, Rick Duncan, Robert Mott, Matthew Tepper
- E-Discovery – Ian Davidson
- Post-Judgment Issues in Tax Litigation – The Honorable Kristen Brauchle, Jason Bailey, James Bellevue, Victoria Vonder Haar
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Thanks to Bill Elliott, you may now view videotaped interviews with Texas Tax Legends such as Buford Berry, Richard Freling, Ron Mankoff, Bob Davis, and former IRS Commissioner Larry Gibbs. If you have any questions, please contact J. Michael Threet, the head of our CLE Committee, at (214) 969-2795 or mthreet@akingump.com.

Live CLE. The Tax Section sponsors and conducts many live CLE programs.

- The Texas Society of CPAs Free CPE Day, May 4, 2012, at the Hilton Anatole in Dallas Texas
- The Texas Federal Tax Institute will be held at the Hyatt Hill Country in San Antonio on June 7 and 8, 2012. The Outstanding Texas Tax Lawyer presentation will take place during the lunch on June 8th.
- Tax Section Annual Meeting at the George R. Brown Convention Center in Houston, TX, from 8:30-1:30, with the following programs: (a) Effective Techniques to Resolve an LB&I Audit, with Richard Husseini of Baker Botts; (b) Creative Uses of LLCs with Steve Kuntz and Robert Phillpot of Fulbright & Jaworski; and (c) Practice Before the IRS: The Tightening Noose, with Trey Cousins of Meadows Collier.
- The 2012 Advanced Tax Law Course, August 16 and 17, 2012, at the Westin Hotel Galleria in Dallas, Texas, with Tax Law 101 on August 15

Tax App. The Tax Section has worked hard all year with the Computer & Technology Section to develop a "Tax App" to access Federal and Texas state tax materials on your IPhone, IPad, and IPod Touch. There will also be a web-based app. The Tax App will be

the first of its kind and will give you fingertip access to the Internal Revenue Code, Treasury Regulations, tax treaties, AFRs, IRS guidance, cases, Texas Tax Code, Texas Administrative Code, and much more. The long-awaited Tax App will be released very soon – really!

Texas Tax Lawyer. Thanks to the hard work of Lisa Rossmiller and Rob Morris, the Tax Section publishes three issues of *The Texas Tax Lawyer* each year. The *Texas Tax Lawyer* is distributed to members electronically and, upon request, in hardcopy. The issues include articles on hot topics, substantive outlines from Committee Webcasts, COGS submissions, and annotated forms. We have added a "Practitioners' Corner" to our website, which includes forms and other useful information from past issues of *The Texas Tax Lawyer*. We are working towards making the past issues of *The Texas Tax Lawyer* full-text searchable and hope to roll out this benefit to you soon! Please contact Lisa at lrossmiller@fulbright.com if you would like to submit an article.

Texas Bar Journal. Check out the Year in Review, Tax Law, in the January 2012 issue of the *Texas Bar Journal*. Many thanks to Heather Panick for preparing the article.

Better Laws

COGS Projects. The Section continuously seeks to improve the substance and administration of state and federal tax laws through its Committee on Government Submissions ("COGS") process. The COGS process also enhances the profile of our members within the tax community and furthers the national reputation of the Texas tax bar. Under the leadership of our COGS Chair, Stephanie Schroepfer, we have submitted four COGS projects this year regarding (i) IRS Notice 2011-62 proposed revisions to procedures relating to *ex parte* communications between Appeals and other IRS functions; (ii) the application of section 10101(d) of the Patient Protection and Affordable Care Act, P.L. 111-148, nondiscrimination standards to insured employer group health plans; (iii) the anti-churning rules of Section 197 of the Internal Revenue Code; and (iv) the proposed new definition of "governmental plan" for purposes of Section 414(d) of the Internal Revenue Code; and (v) the proposed amendments to the Rules of the United States Tax Court. Many thanks to the Tax Controversy Committee and Joel Crouch, Robert Probasco, Stephanie Mongiello, Elizabeth Copeland, and Emily Parker; the Employee Benefits Committee and Susan Wetzel, Henry Talavera, Stephanie Schroepfer, David D'Alessandro, Neal Thomas, and Felecia Finston; and the Corporate Tax Committee and Jeffrey M. Blair, Eric Larson, David S. Peck, and R. David Wheat. If you wish to get involved with on ongoing project or have ideas for leading one yourself, please contact Stephanie Schroepfer at (713) 651-5591 or sschroepfer@fulbright.com.

Pro Bono

- ***The Tax Court Program***. The Tax Section assists pro se taxpayers during Tax Court calendar calls in Dallas, Houston, Lubbock, El Paso, and San Antonio. Check the calendar on the Tax Section's website for the next calendar call in your city and contact our Pro Bono Chair Gerald Brantley at 512 -637-1045 or gerald@geraldbrantley.com or Bob Probasco at 214-969-1503 or robert.probasco@tklaw.com to assist.

- ***2012 Volunteer Income Tax Assistance (VITA) Program***. Many thanks to Vicki L. Rees (vrees@pittmanfink.com) for heading up the Tax Section's VITA Program and to all who volunteered.

Enhanced Profile

2012 Outstanding Texas Tax Lawyer Award. Congratulations to Emily A. Parker of Thompson & Knight L.L.P. for being selected as our Outstanding Texas Tax Lawyer for 2012! Please join us in San Antonio at the Texas Federal Tax Institute on June 7 in congratulating Emily Parker as the first woman to be awarded the Outstanding Texas Tax Lawyer!

Future Leaders

Leadership Academy. The first Leadership Academy for our inaugural class of 20 participants was held in San Antonio on March 22-23. The Leadership Academy will allow young tax lawyers to develop their leadership skills and network with other tax lawyers throughout the state. The remaining meeting dates and cities are as follows:

- June 14-15, 2012 – Houston (in conjunction with the State Bar of Texas Annual Meeting)
- September 20-21, 2012 – Austin, TX
- January 17, 2013 – Dallas, TX

Many thanks to David Colmenero for his efforts in spearheading the Leadership Academy, to Elizabeth Copeland for leading the meetings in San Antonio, and Tina Green, Alyson Outenreath, Christi Mondrik, and Ryan Gardner for their assistance. If you have any questions, please contact David at 214-744-3700 or dcolmenero@meadowscollier.com.

Outreach

Law School Outreach. We hold luncheons each year with students at the SMU Dedman, University of Texas, University of Houston, and Texas Tech University Schools of Law. Every other year, we hold luncheons at Baylor, LSU, and South Texas Law Schools. St. Mary's University, Texas Southern and Texas Wesleyan and will be visited every third year. If you wish to serve as a panelist, please contact the head of our law school student outreach program, Abbey B. Garber, at (972) 308-7913 or abbey.b.garber@irscounsel.treas.gov.

Law School Student Paper Competition Many thanks to Ron Adzgery for again running this year's paper competition. We have increased the prize money this year to $2,500 for first place. At the judges' discretion, second and third place winners may be selected and awarded prizes of $1,500 and $1,000. The deadline for submitting papers for the 2011-2012 competition is June 1, 2012. Please see the Tax Section's website for more details.

Having Fun!

Annual Meeting and Tax Legends Lunch. Register now to attend the Tax Section's Annual Meeting on June 15, 2012, in Houston, Texas, from 8:30 a.m. – 1:30 p.m.. The

Annual Meeting will include the CLE programs listed above and our Tax Legends Lunch honoring Charlie Hall of Fulbright & Jaworski. Many thanks to Matt Larsen for coordinating the Annual Meeting and to Bill Elliott for the time and energy he puts into spotlighting a Texas Tax Legend for us. Please plan on attending – the lunch is on us!

More information about all of these activities is available on our website: www.texastaxsection.org).

Nominating Committee and Tax Section Leadership for 2012-13

The Tax Section's Nominating Committee for 2011-2012 – Dan Micciche as Chair and Tyree Collier, Patrick O'Daniel, and me as an ex officio member – unanimously recommended the Officers and Council members listed below. Council approved the officers, who will join incoming Chair, Tina Green. The Council members will be voted on at the Annual Meeting on June 15.

Chair-Elect: Elizabeth Copeland

Secretary: Andrius Kontrimas

Treasurer: Alyson Outenreath

Incoming Members Of The Council:

Jeffry M. Blair

Lisa Rossmiller

Susan A. Wetzel

If elected, they will join Ron Adzgery, Christi Mondrik, and Ryan Gardner, whose terms end in 2013, and Matt Larsen, Bob Probasco, and Catherine Scheid, whose terms end in 2014. Many thanks to Robert Phillpot, David D'Alessandro, and Alyson Outenreath, whose terms are ending.

Get Involved!!

If you are not already involved in the Section's activities, please get involved. Contact one of the chairs of the above activities or join a committee. We have included the Committee Selection form in this issue of the *Texas Tax Lawyer* and have also posted it on the Tax Section's website. Mark one or more Committees that you would like to join and send the form to the Committee Chair listed on the form.

When you join a Committee, you become a member of that Committee's list serv. The list serv provides you with an email forum for sharing tips, concerns, referrals and other matters with your fellow Texas tax lawyers. If you wish to opt out of the list serv, please contact Brent Gardner at 214-999-4585 or bgardner@gardere.com.

If you are not sure who to contact and what would be the best fit for your skills, then email me at mary.mcnulty@tklaw.com. You will help us build an even stronger Tax Section and have some fun in the process!

Mary A. McNulty
2011-2012 Chair

COMMITTEE SELECTION FORM
Section of Taxation
State Bar of Texas

NAME: ______________________________ DATE: ____________________

FIRM: ____

ADDRESS: ____

CITY STATE ZIP CODE

TELEPHONE NO: (_____)______________________ E-MAIL: ____________________

BAR CARD.: ________________________

PLEASE CHECK THE BOX FOR EACH COMMITTEE YOU ARE INTERESTED IN JOINING:

	COMMITTEE	CHAIR
☐	**Corporate Tax**	Jeffry M. Blair Hunton & Williams LLP 1445 Ross Avenue, Suite 3700 Dallas, Texas 75202-2799 214-468-3306 214-468-3599 (fax) jblair@hunton.com
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	Committee	Chair
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☐	**Tax-Exempt Organizations**	Terri Lynn Helge Texas Wesleyan School of Law Associate Professor of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817- 429-8050 thelge@law.txwes.edu

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PLEASE COMPLETE THIS FORM AND FORWARD IT TO THE COMMITTEE CHAIR(S) FOR EACH COMMITTEE THAT YOU ARE INTERESTED IN JOINING.

For the Rates they are A-Changin'

By: *Jeffry M. Blair*[1]

In January 1964, singer-songwriter Bob Dylan released his third studio album entitled *The Times They Are A-Changin'*. The title track of that album was one of Dylan's most famous. The first verse of that song went as follows:

Come gather 'round people wherever you roam
And admit that the waters around you have grown
And accept it that soon you'll be drenched to the bone
If your time to you is worth savin'
Then you better start swimmin' or you'll sink like a stone
For the times they are a-changin.'

Nearly 50 years later, advice being provided to taxpayers has a similar ring. This tax advice may sound something like "if your money to you is worth savin', then you better start plannin' or sink like a stone for the rates they are a-changin.'"

The changes referred to above are significant increases in the federal income tax rates that are currently scheduled to become effective for taxable years beginning after December 31, 2012. These federal income tax rate increases are coming from two sources. First, income tax rate reductions that were put in place during the Presidency of George W. Bush and later extended during President Obama's administration are scheduled to lapse at the end of 2012. In addition, new taxes were enacted by the Obama administration as part of the Health Care and Education Reconciliation Act of 2010.[2] These new taxes will be imposed on certain individuals and trusts and are currently scheduled to take effect on January 1, 2013. Taken together, these changes could increase the highest marginal federal tax rate on individuals from 35% in 2012 to 43.4% in 2013, an increase in the rate of 8.4%.

At the same time that federal income tax rates on individuals are increasing, the proposed budgets for 2013 of both President Obama and the Republican party call for a reduction in the highest marginal federal income tax rate applicable to corporations.[3] If corporate income tax rates are reduced at the same time that individual tax rates increase, the combined effect could have an impact on some tax planning and choice of entity decisions.

Congress could take action before the end of 2012 to reduce or further delay these tax rate increases or implement corporate tax rate reductions. However, because 2012 is an election year, any Congressional action is not expected to occur until the lame duck session of Congress following the November elections. Even then, regardless of the outcome in the elections, there are no guarantees that the Democrats and Republicans will be able to agree on further delays of the scheduled increases in the income tax rates or that any such agreement would also be approved by President Obama. Therefore, taxpayers may want to have a plan in place in case there are significant changes in the federal income tax rates in 2013.

I. Federal Income Tax Rates that are A-Changin'

A. Tax Rates Imposed on Individuals' Taxable Income

Currently, the tax rate schedules for singles, married filing jointly/surviving spouses, married filing separately and heads of householders are divided into six tax brackets with marginal federal income tax rates of 10%, 15%, 25%, 33% and 35%.[4] Under current law, for taxable years beginning after December 31, 2012, the 10% bracket would be eliminated and the marginal federal income tax rates for individuals would increase to 15%, 28%, 31%, 36%, and 39.6%. As a result of the expiration of these tax cuts, the highest marginal federal income tax rate on individuals is scheduled to increase 4.6% in 2012 from 35% to 39.6%.

B. New HI Tax Imposed On High-Earning Workers and Self-Employed Taxpayers

In addition to the general increase in federal income tax rates, wage earners and self-employed taxpayers could be subject to additional hospital insurance taxes on their wages and self-employment income. For taxable years beginning after December 31, 2012, the hospital insurance tax on wages will increase from 1.45% to 2.35% for wages that exceed a certain threshold amount.[5] The threshold amount for employment wages is $200,000 for taxpayers filing individually, $250,000 for joint filers and $125,000 for married filing separately.[6] Combined with the general increases described above, the highest marginal federal income tax rate on wages and self-employment income would increase in 2012 by a full 5.5% from 35% to 40.5%.

The hospital insurance tax rate on self-employment wages for taxable years beginning after December 31, 2012 will also increase by 0.9% from 2.9% to 3.8% on self-employment wages in excess of a threshold amount.[7] The threshold amounts for self-employment income is the same as for employment wages described above (i.e., $200,000 in self-employment income for taxpayers filing individually, $200,000 for joint filers, etc.).

The threshold amounts applicable to wages and self-employment income are not indexed for inflation. In addition, no deduction is allowed for the additional 0.9% tax. Therefore, this addition to the hospital insurance tax functions like an addition to the income tax liability for wage earners and self-employed individuals.

C. Tax Rates Imposed on Dividend Income

"Qualified dividend income" is currently taxable to noncorporate shareholders at the same tax rate as net long-term capital gains.[8] In general, qualified dividend income includes dividends received during the taxable year from domestic corporations and qualified foreign corporations but only if the shareholder meets certain holding period requirements.[9] Under these rules, the highest marginal federal income tax rate on qualified dividend is only 15%.[10] For taxable years beginning after December 31, 2012, the reduced tax rate for qualified dividends will be eliminated and dividends will go back to being taxed under the tax rates for ordinary income. As a result, the highest marginal federal income tax rate on qualified dividend income

will increase from 15% to 39.6%. This represents an increase in the federal income tax rate on qualified dividend income of a staggering 264%!

D. Tax Rates Imposed on Net Long-Term Capital Gains

Individuals, estates and trusts are currently taxed on their net long-term capital gains at reduced rates ranging from 0% to 28%.[11] For most individuals, this results in the excess of that taxpayer's long-term capital gains over their long-term capital losses to be taxed at a maximum federal income tax rate of 15%.[12] For taxable years beginning after December 31, 2012, the reduced 15% tax rate will be eliminated and the maximum federal income tax rate for most long-term capital gains will revert to 20%.[13] In addition, for taxable years beginning after December 31, 2012, the federal income tax rate on qualified 5-year gains will again become relevant and will reduce the top rate on these gains from 20% down to 18%.[14] Qualified 5-year gain is defined as the aggregate long-term capital gain from property held for more than 5 years.[15] The 18% rate only applies to gain on property the holding period of which began after December 31, 2003.[16]

E. New Surtax on Net Investment Income of Higher Income Individuals and Trusts

For taxable years beginning after December 31, 2012, a new 3.8% surtax will be imposed on investment income of individuals earning more than a certain threshold amount of modified adjusted gross income.[17] The threshold amount is $200,000 for taxpayers filing individually, $250,000 for joint filers and $125,000 for married taxpayers filing separately.[18] The 3.8% surtax is imposed on the lesser of: (i) the taxpayer's net investment income or (ii) the excess (if any) of the taxpayer's modified adjusted gross income for that taxable year over the taxpayer's threshold amount.[19] Modified adjusted gross income is defined as the taxpayer's adjusted gross income increased by the amount excluded from income as foreign earned income under Section 911(a)(1) of the Internal Revenue Code net of deductions and exclusions disallowed with respect to foreign earned income.[20]

For purposes of this surtax, "net investment income" includes interest, dividends, annuities, royalties, and rents, as well as gross income from a trade or business that would be treated as a passive activity with respect to that taxpayer and gross income from a trade or business of trading in financial instruments or commodities.[21] Net investment income also includes net gain to the extent such net gain is taken into account in computing the taxpayer's taxable income and is attributable to the disposition of property (other than property held in a trade or business that is not a passive activity or a trading business with respect to that taxpayer).[22] Net investment income does not include distributions from IRAs or other qualified plans or any income taken into account for self-employment tax purposes.[23] Net investment income is gross investment income reduced by deductions allocable to such investment income.[24]

The 3.8% surtax also is imposed on estates and trusts on the lesser of (i) the undistributed net investment income for such taxable year; or (ii) the excess (if any) of the adjusted gross income (as defined in Code section 67(e)) over the dollar amount at which the highest tax bracket in Code section 1(e) begins for such taxable year.[25] This additional tax may be

particularly onerous to estates and trusts because these taxpayers reach the highest tax bracket very quickly. Currently, for 2012 the highest tax bracket for trusts and estates is only $11,650.

When combined with the general increase in the tax rates, the highest marginal tax rate on the net investment income of individuals and trusts with modified adjusted gross incomes over the applicable threshold amount is scheduled to increase 8.4% from 35% to 43.4%. Significantly, the threshold amount is not indexed for inflation, the tax is subject to estimated tax payment provisions and the new surtax is not deductible in computing income tax liability.

II. Planning Opportunities and Contingency Plans

With the potential for significant increases in federal income tax rates, taxpayers may want to keep in mind some tax planning opportunities for 2012 and 2013. Even though taxpayers may want to wait to pull the trigger on some of their plans, it still makes sense to have ideas in place that can be enacted quickly. Assuming that some or all of these income tax rate increases go into effect for taxable years starting after December 31, 2012, here are a few things taxpayers may want to consider:

A. Accelerating Income into 2012, Pushing Losses and Deductions into 2013

Many tax planning strategies are based on the deferral of the recognition of income based on the time value of money. Taxpayers faced with increasing tax rates in future years may find that the present value of paying a tax today can cost less than paying a higher amount of taxes in future years because the time value of the delaying the payment is more than offset by the increased amount of taxes. Taxpayers facing the currently scheduled increases in taxes may want to consider accelerating income into 2012 that would otherwise be paid in 2013. This would be especially true with respect to items such as qualified dividend income paid to individuals. The highest marginal federal income tax rate on qualified dividend income is currently scheduled to increase from 15% in 2012 to 39.6% in 2013. If the surtax on net investment income also applies, then the maximum 2013 federal income tax rate on this income could be as high as 43.4%. If these dividends are paid in December 2012 rather than January 2013, individuals receiving this income could save up to $28.40 for every $100 of dividends received.

Taxpayers that are individuals or other pass-through entities may also want to consider deferring deductions into 2013 that might otherwise have been paid in 2012. By decreasing deductions in 2012, the 2012 income would be increased and the 2013 income could be decreased. This would increase the income paid at 2012 rates and decrease the income paid at the increased 2013 rates. Although not as dramatic as the rate difference on qualified dividend income, the rates on income treated as net investment income (e.g. income from an S corporation that an individual taxpayer owns stock but is not treated as active) could go from a maximum rate of 35% to 43.4%.

B. Choice of Entity

Currently, the choice between a C corporation and a pass-through is fairly simple if the choice is based primarily on rate differential or potential tax deferral. The maximum federal income tax rate for both C corporations and individuals is currently 35%. This provides no rate difference. If the entity is a domestic entity, it also provides little or no tax deferral benefit because the initial federal income tax at the top rate would be the same in both cases. When combined with the additional shareholder level tax on dividends, C corporations are often not the "entity of choice" for closely held businesses.

The current rate changes combined with the potential decreasing income tax rates on C corporations could change some of that thinking. For example, if the maximum federal income tax rate on C corporations is reduced from 35% to 25% or lower, it would be significantly less than a 39.6% or 43.4% rate on individuals. Although C corporations will still have the problem of having two levels of tax (i.e., the corporate tax at the entity level and another tax on distributions treated as dividends made to the corporation's shareholders), there may be some deferral benefit if the C corporation rates drop significantly below the top individual rates. Taxpayers will once again have to actually evaluate whether the delayed taxation offered by the lower corporate rates, especially if the business wants to plow its earnings back into the business. As one commentator has put it, this could cause C corporations to be on the "verge of a renaissance."[26]

C. Adjust Agreements for Tax Distributions after 2012

Taxpayers that currently own interests in partnerships, S corporations and other flow-through entities will need to look at whether the entities need to increase the amount of their distributions to accommodate the additional taxes. For example, if a partnership agreement currently makes distributions equal to 35% of the federal taxable income allocated to each partner, that rate would need to be increased and reflected in the partnership agreement.

Even if the partnership or LLC agreement already has language that indicates that it will make tax distributions at the highest federal income tax rate, there could be a disagreement as to whether that rate should include the 3.8% surtax. This same issue could come up in credit agreements that permit tax distributions. Investors that are subject to the surtax on net investment income will likely prefer including the surtax in the calculation of the distributions, but other investors or lenders may prefer to not include the surtax permitting those funds to stay in the business and not be distributed.

Taxpayers and their tax advisors should review their current partnership, LLC and credit agreements to make sure that they will be permitted to distribute sufficient funds to pay their taxes. New agreements, including those being drafted in 2012, should contain language that will adjust for tax increases. These new agreements should also clearly state whether or not the 3.8% surtax is included in the calculation of the permitted tax distribution amounts.

D. Automatic Adjustments

Some rates automatically adjust to changes in the federal rates. For example, the tax rate imposed on back-up withholding will automatically increase from 28% back up to 31% as a result of the non-extension of the Bush tax cuts. These changes are like daylight savings time. Taxpayers will just have to remember it is going to happen and adjust their withholdings to accommodate the change.

III. Conclusion

As the old English proverb says, "forewarned is forearmed." Taxpayers will need to plan for the distinct possibility that these changes will take place as projected. Don't let the potential rate changes sneak up on you because as has been said, the rates may be a-changin.'

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1 Jeffry M. Blair is a partner with Hunton & Williams LLP.

2 Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152 (Mar. 30, 2010) (the "Reconciliation Act"). The Reconciliation Act modified the Patient Protection and Affordable Care Act, Pub. L. No. 111-48 (Mar. 23, 2010) (the "PPAC Act") that President Obama signed into law on March 23, 2010 (collectively, the Reconciliation Act and the PPAC Act are referred to as the "2010 Health Care Act").

3 *See* Budget FY 2913 -- The Budget Message of the President, p.38 *available* at www.gpo.gov; Naftali Bendavid, *GOP Budget Targets Taxes*, WALL ST. J., March 20, 2012, at A1.

4 §1(i). Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

5 §3101(b)(2).

6 *Id.*

7 §1401(b)(2).

8 §1(h)(11).

9 §1(h)(11)(B). For dividends to be treated as qualified dividends, the shareholder receiving the dividend with respect to a share of stock must have held such stock for more than 60 days during the 121 day period beginning 60 days before the ex-dividend date with respect to the dividend. §1(h)(11)(C)(iii). Certain dividends are excluded from the definition of qualified dividend income including: (i) dividends received as a nominee; (ii) payments received in lieu of dividends; (iii) any dividend on any share of stock to the extent the person receiving the dividend is under an obligation to make related payments with respect to positions held in substantially similar or related property; (iv) any dividend described in §404(k); and (v) any amount allowed as a deduction under §591.

10 §1(h)(1)(C) and §1(h)(11)(A).

11 §1(h)(1). The 28% tax rate is the rate placed on the sum of collectible held for more than one year and section 1202 gain.

12 §1(h)(1)(C).

13 §1(h)(1)(B) before amended by Sec. 301(b)(1)(A), PL 108-27, 5/28/2003.

14 §1(h)(2)(B) before amended by Sec. 301(b)(1)(A), PL 108-27, 5/28/2003.

15 *Id.*

16 *Id.* The reduced tax rate does not apply to collectible gains, unrecaptured section 1250 gains, or section 1202 gains. *See* §§1(h)(5)-(7). .

17 §1411(a)(1).

18 §1411(b).

19 §1411(a)(1).

20 §1411(d)(1).

21 §§1411(c)(1) - (2).

22 §1411(c)(1)(A)(iii). Gain from a disposition of an interest in a partnership or S corporation is included as net investment income only to the extent of the net gain that the partner or shareholder transferring the

interest would have taken into account if the partnership or S corporation had sold all of its property for fair market value immediately before the disposition. §1411(c)(4)(A). A similar rule will apply to a loss recognized from a disposition of an interest in a partnership or S corporation. §1411(c)(4)(B). Thus, only net gain or loss attributable to property held by an entity that is not property attributable to an active trade or business will be taken into account. For this purpose, a business of trading financial instruments or commodities won't be treated as an active trade or business. *See* Joint Committee, Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as Amended, in Combination with the "Patient Protection and Affordable Care Act" (Mar. 21, 2010), p.135.

[23] §1411(c)(6).

[24] §1411(c)(1)(B).

[25] §1411(a)(2).

[26] Robert Rizzi, *Corporations: Back in the Game*, 39 JOURNAL OF CORPORATE TAXATION 1 (Jan./Feb. 2012).

Choice of Entity Considerations for Charitable Organizations

By: *Terri Lynn Helge*[1]

I. Introduction. This article discusses choice of entity issues related to the formation, operation and governance of nonprofit organizations, highlighting the distinctions between charitable organizations formed as charitable trusts and charitable organizations formed as nonprofit corporations. In determining the legal structure for a new nonprofit entity, considerations that need to be taken into account include: (1) ease/speed of formation; (2) limitation of liability for members and directors; (3) financial resources; (4) type and scale of activities to be conducted; (5) governance requirements; (6) capacity to own property and contract; (6) capacity to sue and be sued; (7) liabilities to third parties; (8) permanence of the organization; and (9) ease of dissolution.

II. Formation.

A. Charitable Trust. The charitable trust is the oldest form of nonprofit entity. A charitable trust establishes fiduciary relationship with respect to property between the trustee and the charitable beneficiaries. Texas law defines a charitable trust as ~~"a~~ charitable entity, a trust the stated purpose of which is to benefit a charitable entity, or an inter vivos or testamentary gift to a charitable entity." TEX. PROP. CODE § 123.001(2). Assets contributed to a charitable trust are irrevocably dedicated to charitable purposes. A charitable trust is created by a settlor irrevocably transferring property to a person or entity as trustee with the intention of creating a trust, and is typically evidenced by a written trust agreement executed by the settlor and the initial trustee or a provision in the settlor's duly probated will. Charitable trusts are governed by the Texas Trust Code which includes provisions specifically directed at charitable trusts. *See* TEX. PROP. CODE § 123.001 et seq. Additionally, a large body of common law applies to charitable trusts.

B. Nonprofit Corporation. The nonprofit corporation is the predominant form of charitable organization in the United States. A nonprofit corporation is defined as a corporation that is prohibited from distributing its income to its members, directors or officers in the form of dividends or otherwise. TEX. BUS. ORG. CODE § 22.001(5). Nonprofit corporations are governed by the Texas Business Organizations Code which includes provisions specifically directed at nonprofit corporations under the Nonprofit Corporation Law. See Tex. Bus. Org. Code § 22.001 et seq. Formation of a nonprofit corporation begins with filing a Certificate of Formation with the Secretary of State of Texas. The Certificate of Formation generally contains the name of the corporation, the purposes of the corporation, the names of the initial directors, the name and address of the registered agent, and restrictions on distributions of assets of the corporation upon its dissolution if it is a charitable corporation. The Certificate of Formation may also contain other provisions permitted by state law such as indemnification of

directors and officers and limitation of liability provisions for directors and officers. The nonprofit corporation is incorporated when the Secretary of State issues a Certificate of Filing evidencing that the Certificate of Formation has been accepted for filing. Next, Bylaws for the corporation must be drafted. Bylaws are the set of procedures or internal rules governing the corporation. Bylaws typically contain provisions regarding meetings of the members and directors, election of directors and officers, duties of directors and officers, and committees of directors, and other miscellaneous matters, such as fiscal year and procedures for amending the Bylaws. Finally, the initial directors must hold an organizational meeting at which the Bylaws are adopted, the officers are elected and a number of other organizational resolutions are adopted, such as authorizing depository accounts and filing for tax exemption.

III. Governance Structure.

A. Charitable Trusts. Charitable trusts are managed by trustees who have the legal authority to do all things necessary to administer the trust. Texas law does not require the trustees to have periodic meetings or to keep minutes of any meetings held by the trustee. Title to trust assets is held in the individual names of the trustees. Accordingly, conveyance of the assets of a charitable trust generally requires the signature of all trustees. Under Texas law, a charitable trust may be managed by a single trustee, including the settlor of the trust. When more than one trustee is serving, the decision of a majority of the trustees serving controls. *See* TEX. PROP. CODE § 113.085. If a dissenting trustee believes that the action approved by the majority of trustees would result in a serious breach of trust, then the dissenting trustee must exercise reasonable care to prevent a co-trustee from committing a serious breach of trust or compel a co-trustee to redress a serious breach of trust.; otherwise the dissenting trustee is jointly liable for the action taken by the majority of trustees. *See* TEX. PROP. CODE § 114.006.

B. Nonprofit Corporations. Nonprofit corporations may be member organizations or non-member organizations. Typically, nonprofit corporations are managed by a board of directors (sometimes called the board of trustees). Texas law requires a minimum of three directors of a nonprofit corporation. TEX. BUS. ORG. CODE § 22.204(a). The approval of a majority of the directors present at a meeting at which a quorum is present generally is required to constitute the action of the board of directors. TEX. BUS. ORG. CODE § 22.214. The board of directors is ultimately responsible for the oversight of the nonprofit corporation. The board is the sole policy making authority of the corporation. The board of directors is required to have a minimum of one meeting annually and to keep minutes of all the meetings of the board. The board of directors elects the officers of the nonprofit corporation who are responsible for the day to day management of the corporation. *See* TEX. BUS. ORG. CODE § 22.232(b). If the nonprofit corporation has members, then the members typically elect the directors and have the authority to approve certain fundamental changes with respect to the organization, such as merger, dissolution, amendment to the Certificate of Formation or the Bylaws, or sale of substantially all of the corporation's assets. *See* TEX. BUS.

ORG. CODE § 22.164. In dealing with the membership, the board must act fairly. The board can curtail or abolish the members' rights, but the membership must have adequate notice, information and the right to vote upon such changes.

IV. **Fiduciary Duties of Directors and Trustees.** Regardless of the choice of form for the charity, all decision makers owe certain fiduciary duties to the organizations they serve. The fiduciary standards applicable to charitable directors and trustees include the duty of care, the duty of loyalty, and the duty of obedience. Additional standards may apply with respect to the investment of the charity's assets. These fiduciary standards vary somewhat depending on whether the charity is formed as a nonprofit corporation or a charitable trust. As a general observation, however, trustees of charitable trusts are normally held to stricter standards of fiduciary behavior than directors of nonprofit corporations. While some have argued for the higher trustee standard to apply to nonprofit directors, Texas law makes it clear that a director of a nonprofit corporation is not held to the fiduciary standards of a trustee of a charitable trust. *See* TEX. BUS. ORG. CODE § 22.223.

A. Duty of Care. All nonprofit managers are subject to a duty of care. At is most fundamental level, the duty of care requires a charity manager to act in good faith and with reasoned competence.

1. Charitable Trusts. To satisfy the duty of care, charitable trustees are required to exercise the care and skill that a person of ordinary prudence would exercise in dealing with their own affairs. *See* SCOTT, LAW OF TRUSTS § 174. More specifically, charitable trustees have a duty to make the assets of the trust productive while properly managing, supervising and safeguarding trust funds. *See* InterFirst Bank Dallas v. Risser, 739 S.W.2d 882, 900 (Tex. App.—Texarkana 1987, no writ). Charitable trustees must also administer the trust in good faith. *See* TEX. PROP. CODE § 113.051. Texas law does not define ―good faith" in the context of fiduciaries. However, contrasting good faith with ―bad faith" is illuminating – a fiduciary acts in bad faith when the fiduciary acts out of a motive of self-gain. *See* Bohatch v. Butler & Binion, 905 S.W.2d 597, 602 (Tex. App.—Houston [14th Dist.] 1995), *aff'd* 977 S.W. 2d 543 (Tex. 1998). One of the largest distinguishing factors between the duty of care for charitable trustees and the duty of care for nonprofit directors is that a charitable trustee is liable for simple negligence in the performance of the trustee's duties while a director of a nonprofit corporation generally is not.

2. Nonprofit Corporations. The duty of care requires a nonprofit director to discharge his responsibilities in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes is in the best interests of the organization. See TEX. BUS. ORG. CODE § 22.221(a). The degree of skill required is that of the ordinary prudent person, that is, the basic directorial attributes of common sense, practical wisdom, and informed judgment. If a director has special expertise, such as accounting,

legal or investment expertise, then that director must exercise the degree of skill that a prudent person with similar expertise would exercise in the same or similar circumstances. The duty of care also requires that directors make decisions they reasonably believe to be in the best interests of the corporation. *See* TEX. BUS. ORG. CODE § 22.221. A director can fail to discharge the duty of care in two ways: by failing to supervise or by failing to make an informed decision. Adequate supervision means that the director actively participates in the charity's governance, such as by regularly attending board meetings, reviewing minutes and other materials disseminated to board members, meeting periodically with senior management, periodically reviewing the charity's financial statements and annual information returns (IRS Form 990), and asking questions of outside experts such as accountants and attorneys when appropriate. To make an informed decision, a director must be adequately informed about the material aspects of a proposed transaction before approving it. In discharging the duty of care, a director may rely in good faith on information, opinions, reports or statements concerning the corporation that was prepared or presented by officers, employees, a committee of the board of which the director is not a member, or outside professional advisors to the corporation (e.g., auditors, legal advisors, and investment advisors). *See* TEX. BUS. ORG. CODE § 3.102. The business judgment rule protects nonprofit directors by providing that directors will not be liable for harm to the corporation for the exercise of their judgment so long as they exercised care in the decision making process. Thus more than simple negligence on the part of the director is required to hold the director liable for a breach of the duty of care. The business judgment rule applies only in the absence of fraud, illegality or a disabling conflict of interest.

In summary, the duty of care relates to the decision-making process. If a nonprofit director acts in good faith and satisfies the requisite standard of care, a court generally will not review the action, even if it proves disastrous to the charity. Accordingly, compliance with the duty of care protects a nonprofit director from liability for decisions that, with the benefit of hindsight, turn out to be wrong.

B. Investment Responsibility. Responsibilities with respect to the management of the charity's investment are a subsidiary of the duty of care. However, the Texas Uniform Prudent Investor Act (applicable to charitable trusts) and the Texas Uniform Prudent Management of Institutional Funds Act (―TUPMIFA") (applicable to nonprofit corporations and charitable trusts for which a charitable organization serves as trustee) contain specific provisions regarding the application of the duty of care in the management of a charity's investments. Therefore, the duties with respect to a charity's investments are discussed separately.

1. Charitable Trusts. A trustee has the duty to invest charitable funds as prudent investor would do in managing their own affairs, taking into account the purposes, terms, distribution requirements, and other circumstances of the trust. Tex. Prop. Code § 117.004(a). In satisfying this standard, the trustee must exercise reasonable care, skill and caution. *Id*. Prudence is measured principally through the process by which investment strategies and tactics are developed, adopted, implemented and monitored. Actual performance of the investments is a secondary concern. Evaluation of a particular investment is determined in the context of the portfolio as a whole, not in isolation. Tex. Prop. Code § 117.004(b). The trustee is allowed to consider overall return of the investment and not focus on traditional distinctions of income and principal. Diversification of investments is generally required unless the trustee reasonably determines that the purposes of the trust are better served without diversification due to special circumstances. Tex. Prop. Code § 117.005. A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise. Tex. Prop. Code § 117.004(f). Delegation of investment authority to an agent is permitted if exercise proper diligence in selecting agent, establishing criteria for agent, and periodically monitoring agent. See Tex. Prop. Code § 117.011

2. Nonprofit Corporations. The Nonprofit Corporation Law does not provide for specific duties of directors with respect to the investment of the charity's assets. However, TUPMIFA prescribes specific standards regarding the investment of charitable funds held as "permanent endowment" – funds which the donor requires in writing to be held in perpetuity or for a specified period of time – by a nonprofit corporation. *See* Tex. Prop. Code § 163.003. The TUPMIFA standard of investment provides "each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." Tex. Prop. Code § 163.004(b). A person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds. Tex. Prop. Code § 163.004(e)(6). In managing and investing an institutional fund, the following factors, if relevant, must be considered: general economic conditions; the possible effect of inflation or deflation; the expected tax consequences, if any, of investment decisions or strategies; the role that each investment or course of action plays within the overall investment portfolio of the fund; the expected total return from income and the appreciation of investments; other resources of the institution; the needs of the institution and the fund to make distributions and to preserve capital; and an asset's special relationship or special value, if any, to the charitable purposes of the institution. Tex. Prop. Code §

163.004(e)(1). Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution. TEX. PROP. CODE § 163.004(e)(2). An institution is required to diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification. Tex. Prop. Code § 163.004(e)(4).

C. Duty of Loyalty. The duty of loyalty generally requires the charity manager to place the interests of the organization ahead of his own personal interests. Common forms of interested transactions that may pose duty of loyalty issues include: (1) use of the organizations property on a more favorable basis than available to outsiders; (2) usurpation of corporate opportunity; (3) use of material nonpublic organizational information or position; (4) insider advantages and corporate waste; and (5) competing with the organization. A breach of the duty of loyalty not only gives rise to a tort claim under state law, but may also implicate penalties under federal tax law such as the excess benefit transaction excise tax or the prohibited self-dealing excise tax.

1. Charitable Trusts. The duty of loyalty mandates that the trustee administer the trust property solely for the benefit of the beneficiaries. *See* TEX. PROP. CODE § 117.007. Under the trust standard of the duty of loyalty, the charitable trustee generally is prohibited from engaging in any act of self-dealing with the trust, no matter how fair or reasonable the transaction may be to the charity, unless the self-dealing was specifically authorized by the settlor in the trust instrument or the trustee made full disclosure of the transaction and obtained the consent of the trust beneficiaries. *See* TEX. PROP. CODE § 113.052; 113.053; 114.005. In the context of a charitable trust in which the beneficiaries are an unascertainable group of individuals, obtaining beneficiary consent for the proposed self-dealing transaction is not possible, and perhaps could be accomplished by receiving approval from the Texas Attorney General.

2. Nonprofit Corporations. In general, nonprofit directors are subject to a less exacting standard with respect to the duty of loyalty than charitable trustees. To satisfy the duty of loyalty, a nonprofit director must act in the best interests of the corporation, but does not need to avoid personal gain at all costs.

a. Conflict of Interest Transactions and Self-Dealing. In the nonprofit corporate setting, a conflict-of-interest or self-dealing transaction is not flatly prohibited, but should be carefully scrutinized. The only exception is a blanket prohibition on loans to directors of a nonprofit corporation; any director who votes for or assents to the making of the loan is jointly liable for the amount of

the loan until it is repaid. *See* TEX. BUS. ORG. CODE § 22.225. Before engaging in a self-dealing or conflict-of-interest transaction with a charitable organization, the director should disclose all material facts relating to his personal interest in the transaction to the board of directors or a committee of the board comprised of disinterested directors, and a majority of disinterested directors or committee members should approve the transaction only after concluding that it is fair and reasonable to the charity. *See* TEX. BUS. ORG. CODE § 22.230. If this procedure is followed, then the transaction is not void or voidable solely because of the director's interest in the transaction. If the transaction occurred prior to obtaining approval from a majority of disinterested directors, then the transaction may be ratified by a majority of disinterested directors or a committee of the board comprised of disinterested directors provided the transaction is fair to the nonprofit corporation. *Id*.

b. Corporate Opportunity. A nonprofit director is prohibited from usurping corporate opportunities for personal gain. *See* Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 577 (Tex. 1963). If the nonprofit director learns of an opportunity that is closely related to the operations of the charity the director serves, the director has an obligation to disclose the opportunity to the charity and allow the charity a chance to accept or reject the opportunity. If the charity rejects the opportunity, then the director is free to pursue the opportunity for herself. However, if the director fails to disclose the opportunity to the charity, then the director will be held liable for the harm caused to the charity unless the director can show that the opportunity was not in the same line of business as the charity's operations, that the charity abandoned the opportunity, or that the charity did not have the necessary financial resources to pursue the opportunity.

D. Duty of Obedience. The duty of obedience requires a director to adhere to the governing documents of the organization and to faithfully adhere to its mission, and to follow restrictions imposed by donors on contributions of charitable funds. Essentially, the duty of obedience requires directors and trustees to refrain from transactions and activities that are *ultra vires*.

1. Charitable Trusts. A charitable trustee has a duty to administer the trust in a manner faithful to the wishes of the settlor. *See* TEX. PROP. CODE § 113.051. If the trustee desires a modification to the administrative terms of the trust instrument, the trustee must generally seek court approval and show one of the following: (1) because of unforeseen circumstances, the proposed modification will further the purposes of the trust; (2) modification of administrative terms of the trust is necessary to prevent waste or avoid impairment of the trust's administration; (3) the proposed

modification is necessary to achieve the settlor's tax objectives; or (4) the proposed modification is not inconsistent with a material purpose of the trust, and all the beneficiaries consent to the proposed modification or termination. TEX. PROP. CODE § 112.054(a).

If the trustee desires to change the fundamental purposes of a charitable trust, then the trustee must seek court approval of the change through a *cy pres* proceeding. *Cy pres* is an equitable procedure that is used to reform a charitable trust to prevent the trust from failing. The theory of *cy pres* is that when a charitable purpose becomes impossible, inexpedient, or impracticable of fulfillment or is already accomplished, equity will permit the trustee to substitute another charitable object which reasonable approaches the designated purpose as closely as possible. In order to reform a charitable trust's fundamental purpose under *cy pres*, the trustee must show (i) a valid charitable trust exists; (ii) the settlor's specific charitable object is frustrated, necessitating *cy pres* reform to carry out the settlor's wishes; and (iii) the settlor's general charitable intent is not limited to the precise purpose identified in the trust instrument. *See Scott v. Sterrett*, 234 S.W.2d 917, 920-21 (Tex. Civ. App.—Dallas 1950, writ ref'd n.r.e.); s*ee also* RESTATEMENT (THIRD) OF TRUSTS § 67. In addition, the trustee must show that the proposed modification to the trust purpose is as near as possible to the settlor's original purpose. *See Inglish v. Johnson*, 95 S.W. 558, 560-61 (Tex. Civ. App. 1906, writ ref'd). If the named charitable beneficiary of a trust ceases to exist or no longer qualifies as a charitable entity, a *cy pres* proceeding is not necessary to change the charitable beneficiary. Rather, the trustee is authorized to name a new charitable entity as the beneficiary of the trust. TEX. PROP. CODE § 113.026.

In any proceeding involving a charitable trust, the Texas Attorney General must be given notice and the opportunity to intervene. TEX. PROP. CODE § 115.011. If proper notice is not given, then the judgment in the proceeding is voidable by the Texas Attorney General. TEX. PROP. CODE § 123.004.

2. Nonprofit Corporations. If the board of directors desires to alter the fundamental objectives of a nonprofit corporation, it must first amend its Certificate of Formation and Bylaws. Normally, these amendments can be made with only the approval of the board of directors. TEX. BUS. ORG. CODE §§ 22.102(c); 22.107. If the nonprofit corporation has voting members, then the members will also need to approve any amendments to the Certificate of Formation and Bylaws. TEX. BUS. ORG. CODE §§ 22.102(c); 22.105. However, court approval of the amendments generally is not required. The Texas Attorney General has the authority to supervise charitable organizations formed as nonprofit corporations and may intervene if the Texas Attorney General believes that the amendment of the charitable corporation's fundamental purposes is improper. Even if

the Texas Attorney General intervenes, generally courts are more lenient in allowing amendment of purposes to the Certificate of Formation of a nonprofit corporation that modification of the purposes of a charitable trust.

V. Liability of Directors and Trustees.

A. Limitation of Liability. Texas law allows for a nonprofit corporation to limit the liability of its directors to the organization or its members for monetary damages for an act or omission by the director in the person's capacity as a director by including appropriate provisions in its Certificate of Formation. *See* TEX. BUS. ORG. CODE § 7.001(b). However, the elimination or limitation of the liability of a director is not allowed to the extent the person is found liable under applicable law for: (1) a breach of the director's duty of loyalty; (2) an act or omission not in good faith that: (A) constitutes a breach of duty of the director to the organization; or (B) involves intentional misconduct or a knowing violation of law; (3) a transaction from which the director received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the director's duties; or (4) an act or omission for which the liability of a director is expressly provided by an applicable statute. TEX. BUS. ORG. CODE § 7.001(c). Similarly, the Texas Trust Code allows the settlor of a charitable trust to exculpate the trustee from liability for breach of trust by including appropriate provisions in the trust instrument. Such exculpation from liability will not apply when the breach of trust was committed in bad faith, intentionally, or with reckless indifference to the interest of the beneficiary. TEX. PROP. CODE § 114.007 (a). Additionally, the trustee may not be relieved of liability for any profit derived by the trustee from a breach of trust. *Id*.

B. Indemnification. Texas law allows for indemnification of directors of nonprofit corporations for costs and liabilities incurred in connection with a lawsuit filed against the director in her capacity as director of the nonprofit corporation. *See* TEX. BUS. ORG. CODE § 8.001 et seq. Such indemnification is provided by including appropriate provisions in the certificate or formation or bylaws of the nonprofit corporation. Both permissive and mandatory indemnification are authorized. Indemnification is not authorized, however, unless the director acted in good faith and reasonably believed that his conduct was in the best interests of the nonprofit corporation. TEX. BUS. ORG. CODE § 8.101. Furthermore, indemnification of a director who is found liable to the nonprofit corporation or is found liable because the director improperly received a personal benefit: (1) is limited to reasonable expenses actually incurred by the director in connection with the proceeding; (2) does not include a judgment, a penalty, a fine, and an excise or similar tax, including an excise tax assessed against the director with respect to an employee benefit plan; and (3) may not be made in relation to a proceeding in which the director has been found liable for: (A) willful or intentional misconduct in the performance of the director's duty to the nonprofit corporation; (B) breach of the director's duty of loyalty owed to the nonprofit corporation; or (C) an act or omission not committed in good faith that

constitutes a breach of a duty owed by the director to the nonprofit corporation. TEX. BUS. ORG. CODE § 8.102. The Texas Trust Code does not allow for similar indemnification of costs and liabilities of charitable trustees.

VI. Modification and Termination.

A. Charitable Trust. In general, modification or termination of a charitable trust requires court approval. *See* TEX. PROP. CODE § 112.054. Additionally, in any proceeding involving a charitable trust, proper notice must be given the Texas Attorney General and the Texas Attorney General may chose to intervene in the proceeding. *See* TEX. PROP. CODE § 123.002; 123.003. Modification of the purpose of a charitable trust requires the application of *cy pres*. *Cy pres* is an equitable procedure that is used to reform a charitable trust to prevent the trust from failing. The theory of *cy pres* is that when a charitable purpose becomes impossible, inexpedient, or impracticable of fulfillment or already accomplished, equity will permit the trustee to substitute another charitable object which reasonable approaches the designated purpose as closely as possible. If the trustee instead seeks modification of an administrative provision of a charitable trust, then the more permissive doctrine of deviation will apply. The doctrine of deviation allows the court to alter the administrative or distributive provisions of a charitable trust when (1) because of unforeseen circumstances, the proposed modification will further the purposes of the trust; (2) modification of administrative terms of the trust is necessary to prevent waste or avoid impairment of the trust's administration; (3) the proposed modification is necessary to achieve the settlor's tax objectives; or (4) the proposed modification is not inconsistent with a material purpose of the trust, and all the beneficiaries consent to the proposed modification or termination. TEX. PROP. CODE § 112.054(a).

B. Nonprofit Corporations. Generally, the purposes of a nonprofit corporation or other governance provisions may be changed by the board of directors approving an amendment to the relevant provisions in the nonprofit corporation's governing documents. TEX. BUS. ORG. CODE §§ 22.102(c); 22.107. If the nonprofit corporation has voting members, then member approval is also required. TEX. BUS. ORG. CODE §§ 22.102(c); 22.105. However, court approval is generally not required. If a nonprofit corporation receives an unrestricted gift, then the donation may be used for any of the corporation's enumerated purposes. If the gift is restricted for a specific purpose, then the nonprofit corporation must use it for that purpose or apply to the court to vary the use of the funds under the doctrine of *cy pres.* In such case, proper notice to the Texas Attorney General must be provided, and the Texas Attorney General may elect to intervene in the proceeding. *See* TEX. PROP. CODE § 123.002; 123.003.

VII. Other Considerations.

A. Public Disclosure of Information. In general, the public has a right to inspect all records, books and reports of financial activity of a nonprofit corporation for the

preceding three fiscal years at the corporation's principal office. *See* TEX. BUS. ORG. CODE § 22.353. Several important exemptions apply to this requirement, and generally only non-church charitable nonprofit corporations that solicit funds from the general public are subject to this requirement. *See* TEX. BUS. ORG. CODE § 22.355. In contrast, charitable trusts do not have an obligation to disclose its books and records to the general public other than the disclosure of its Form 990 or Form 990-PF in accordance with federal tax law.

B. Unrelated Business Income. If a charity has a significant amount of unrelated business taxable income, it will likely pay more tax if it is formed as a charitable trust than a nonprofit corporation. The tax rates that are applied to unrelated business taxable income are the rates that normally apply to the underlying form of entity. Thus, charitable trusts are subject to the trust tax rates, which currently reach the maximum rate of 35% when net taxable income exceeds $11,650. In contrast, nonprofit corporations are subject to the corporate tax rates, which currently do not reach the rate of 35% until net taxable income exceeds $10 million.

C. Change of Domicile. A relatively new provision in the Texas Trust Code prohibits a Texas charitable trust which benefits one or more charitable entities from transferring the administration of the trust to another state unless the trustee receives both court approval and approval from the Texas Attorney General. *See* TEX. PROP. CODE § 113.029. If a Texas nonprofit corporation desired to change its domicile, no approval is necessary by the court or the Texas Attorney General.

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EVALUATING AND CONFIRMING U.S. FEDERAL TAX-EXEMPT STATUS OF POTENTIAL GRANT RECIPIENTS

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On June 8, 2011, the Internal Revenue Service ("IRS") announced that approximately 275,000 organizations automatically lost their tax-exempt status because they failed to file legally required annual reports for three consecutive years. As of February 2012, approximately 125,000 organizations were added to the revocation list with 9,500 having asked for reinstatement of their tax-exempt status. Many more organizations will lose their tax-exempt status in 2012 as a result of engaging in prohibited political activities, conducting substantial business activities unrelated to their tax-exempt status, materially changing their character, purposes, activities or method of operation from those on which their ruling or determination letter was based, or failing to comply with applicable laws and regulations. Other organizations will continue to qualify for tax-exempt status, but have their qualification status change either automatically or as a result of a request for a change in type or reclassification.

I. EVALUATING A GRANT RECIPIENT

In order for charitable contributions to be tax-deductible for U.S. federal income tax purposes, the recipient organization must qualify as tax-exempt under applicable tax provisions **at the time of the contribution**. As a result, grantors and contributors (including donors) are generally not affected by reason of a subsequent revocation by the IRS of an organization's tax-exempt status until the date on which notice of change of status is made to the public, unless any of the following scenarios apply:

- The donor had knowledge of the revocation of the ruling or determination letter prior to publication of the revocation;
- The donor was aware that such revocation was imminent; or
- The donor was in part responsible for, or was aware of, the activities or deficiencies on the part of the organization that gave rise to the loss of qualification.

Due to the potential uncertainty with respect to evaluating the status of a recipient organization at a particular point in time, it is extremely important for donors to ensure that they are in compliance with all IRS requirements at the time of the contribution, compile documentation showing their research into the recipient organization's eligibility to receive charitable gifts, and consider the implications of what will happen if a contribution is given to an organization without conducting this due diligence or properly documenting the due diligence and contribution.

II. PRE-GRANT PROCEDURES AND CONSIDERATIONS

Revenue Procedure 2011-33[2] ("Rev. Proc. 2011-33") specifies which sources taxpayers may rely upon to determine whether the recipient organization of a charitable contribution or grant meets IRS requirements for a charitable deduction for U.S. federal income tax purposes or a qualifying distribution for grantmaking purposes. Effective June 20, 2011, Revenue Procedure 2011-33 modifies and supersedes Revenue Procedure 82-39[3] and Revenue Procedure 2009-32[4].

Specifically, Rev. Proc. 2011-33 is helpful to individual taxpayers and for-profit corporations to verify the sources upon which they may rely to obtain advance assurance that a contribution to a proposed recipient organization will qualify for a charitable income tax deduction under Section 170 of the Internal Revenue Code of 1986, as amended ("Code"). Moreover, private foundations and sponsoring organizations for donor advised funds may rely on the guidelines set forth in Rev. Proc. 2011-33 to determine whether certain recipient organizations are eligible to receive qualifying distributions under Section 4942 of the Code and whether they need to exercise expenditure responsibility under Sections 4945 or 4966 of the Code.

The following summarizes certain suggested best practices for taxpayers to confirm the U.S. federal income tax status of potential grant recipients as set forth in Revenue Procedure 2011-33 (along with certain supplemental procedures believed to be of best practice, as specifically noted):

1. **<u>Verify That Proposed Recipient Organization is Listed in Approved IRS Sources</u>.**

Under prior law, donors were required to rely on one source, IRS Publication 78, *Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1986*, to determine an organization's U.S. federal tax-exempt status. The IRS now permits donors to determine an organization's tax-exempt status using <u>either</u> Publication 78 or the Business Master File ("<u>BMF</u>"), another separate database maintained by the IRS.

Publication 78 was previously available both in written form and as a stand-alone searchable database. Beginning in February 2012, however, the IRS incorporated Publication 78 into Exempt Organizations Select Check, an on-line search tool that allows users to select an exempt organization and check certain information about its federal tax-exempt status and filings. Exempt Organizations Select Check is available at http://apps.irs.gov/app/eos/. Exempt Organizations Select Check consolidates three former search sites into one, providing expanded search capability and a more efficient way to search for organizations that are eligible to receive tax-deductible charitable contributions (Publication 78 data), have had their tax-exempt status automatically revoked because they have not filed Form 990 series returns or notices annually as required for three consecutive years (Auto-Revocation List), and have filed a Form 990-N annual electronic notice (e-Postcard). Exempt Organizations Select Check data is generally updated on the third Monday of each month for automatically revoked organizations and organizations eligible to receive deductible contributions, and weekly for Form 990-N (e-Postcard) filings. In addition to searching for a particular organization, donors may download a complete list of each of the three types of organizations through Exempt Organizations Select Check.

Donors may alternatively check the BMF which is available at http://www.irs.gov/taxstats/charitablestats/article/0,,id=97186,00.html. Due to its size, the BMF is only available as a downloadable Excel or ASCII Text file; however, this database contains significantly more information than Publication 78, including an organization's tax identification number (EIN), address, ruling date, affiliation code, Section 501(c) classification, deductibility code, foundation code (indicating whether the organization is a private foundation, private operating foundation, or Section 509(a)(1), (2), or (3) organization), and other information. The IRS expects to update this database monthly.

In addition to these databases, Revenue Procedure 2011-33 states that a donor may rely on third party sources, such as Guidestar, so long as the third party source provides the donor with a report including the following information: the recipient organization's name, EIN, foundation status, deductibility status, a statement that the information is from the current BMF extract and the date of such extract's last revision. Additionally, the third party report must include the date and time that it was generated, and the donor should retain a copy of the report, either electronically or in hard copy.

2. **Confirm That Recipient Organization's Tax-Exempt Status Has Not Been Revoked.**

Even if an organization is listed in an IRS-approved source, donors should confirm that such organization's tax-exempt status has not been revoked since such source was last updated. The IRS may revoke such status for various reasons including, an organization's failure to file required tax returns or notices, through publication in the Internal Revenue Bulletin, on the IRS's website (www.irs.gov), or by any other means to notice the public. Donors should search the Exempt Organizations Select Check (see Section II.1 above), the IRS website, the Internal Revenue Bulletin and other public sources prior to making a contribution to ensure that the potential recipient organization's U.S. federal tax-exempt status has not been revoked.

Further, although not explicitly mentioned in Rev. Proc. 2011-33, donors should confirm that a potential recipient organization is not on the "Specially Designated Nationals" (SDN) list published by the U.S. Department of the Treasury's Office of Foreign Asset Control (OFAC) . This list includes organizations with suspected ties to terrorism and can be found at http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx.

3. **Research Other Potential Limitations on Deduction or Qualification.**

Even if an organization is qualified to receive a charitable contribution under Section 170 of the Code, donors may not always receive a deduction for the entire value of the contribution. In general, an individual donor may receive a charitable deduction for up to 50 percent of his or her adjusted gross income for gifts made to public charities, private operating foundations, certain private foundations that distribute the contributions they receive to public charities and private operating foundations within 2½ months following the year of receipt, and certain private foundations the contributions to which are pooled in a common fund and the income and corpus of which are paid to public charities. An individual donor may, however, only receive a

charitable deduction for up to 30 percent of his or her adjusted gross income for gifts made to private foundations that do not qualify for the 50 percent limit. A for-profit corporation may deduct all contributions to Code Section 501(c)(3) organizations (regardless of foundation status) up to an amount normally equal to 10% of its taxable income. Various exemptions and exclusions to these rules may apply depending on the applicable facts and circumstances. In light of the above, donors should carefully consider their own situation in connection with the recipient organization's deductibility code to determine the extent to which a contribution would qualify the donor for an income tax deduction under Section 170 of the Code.

Besides deductibility, other restrictions relating to making grants may apply. For example, a non-operating private foundation must annually distribute a certain percentage of its income to qualified organizations to maintain its status as a charitable organization and avoid excise taxes under Section 4942 of the Code. Moreover, if such a foundation intends to make any such distribution to a supporting organization, the Pension Protection Act of 2006 requires the non-operating private foundation to check the foundation status (also known as Section 509(a)(3) status) of such potential recipient supporting organization to determine whether such organization is classified as Type I, II, or III, and if so, whether it is eligible to receive a qualifying distribution from such foundation. Because this information was not available in Publication 78, foundations previously had to conduct independent research. However, following Rev. Proc. 2011-33, non-operating private foundations may now rely on the BMF (which provides more detailed information regarding the status of a potential recipient organization for most entities), a qualified third party report, or the recipient organization's current IRS determination letter to make this determination.[5]

Moreover, when making grants and other distributions, all private foundations, operating and non-operating, must exercise expenditure responsibility with respect to grants to certain types of recipient organizations. This generally means that the foundation is "responsible to exert all reasonable efforts and to establish adequate procedures – (1) to see that a grant is spent solely for the purpose for which made, (2) to obtain full and complete reports from the grantee on how the funds are spent and (3) to make full and detailed reports with respect to such expenditures to the Secretary."[6] If a private foundation fails to do so, any such grants or other distributions may be treated as a taxable expenditure under Section 4945 of the Code and subject to excise tax. Sponsoring organizations for donor advised funds are subject to similar rules and

an excise tax may be imposed on a sponsoring organization if it fails to exercise expenditure responsibility with respect to grants or other distributions made by a donor advised fund under Section 4966 of the Code. The additional sources for determining an organization's U.S. federal tax-exempt status authorized under Rev. Proc. 2011-33 should make it easier and more efficient for such non-profit donors to conduct due diligence in order to determine whether and to what extent they need to exercise expenditure responsibility.

III. CONSEQUENCES OF VIOLATING THE RULES

Generally, a donation, grant, or other distribution to an organization that is in good standing as of the date of such contribution will be treated as either a charitable deduction or qualifying distribution, as the case may be, even if the recipient organization later loses its U.S. federal tax-exempt status or previous tax-exempt classification. Nevertheless, and as noted in Section I. above, the IRS may disallow such deduction or qualification if the donor (1) had knowledge of the revocation of the organization's exempt status prior to publication of the revocation, (2) was aware that such revocation was imminent, or (3) was in part responsible for, or was aware of, the activities or deficiencies on the part of the organization that gave rise to the loss of exemption. Moreover, for certain nonprofit organizations not only will a distribution to a non-qualifying organization or a failure to exercise expenditure responsibility potentially subject such organization and its management to excise taxes, but in some cases, it may cause the organization to lose its U.S. federal tax-exempt status.

With respect to contributions to an organization classified as a SDN, Executive Order 13,224, *Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism* allows the Executive Branch of the U.S. Government to freeze the assets of any individual or organization deemed to associate with, or support, terrorist organizations. Furthermore, the U.S. Patriot Act imposes significant fines and imprisonment for willful, knowing, or intentional contributions to such organizations.[7]

Finally, donors should be aware that even if an organization is listed in Publication 78 or the BMF and its U.S. federal tax-exempt status has not been revoked as of the date of a contribution, if a contribution to such qualifying organization was made with the understanding or based on a condition that such contribution may be made available to or for the use of another organization that is not listed in or covered by Publication 78 or the BMF, it may not necessarily

be a tax-deductible contribution or a qualifying distribution, as the case may be since it could be deemed made with the intent of circumventing these rules.

IRS CIRCULAR 230 DISCLOSURE:

TO ENSURE COMPLIANCE WITH REQUIREMENTS IMPOSED BY THE IRS, WE INFORM YOU THAT ANY U.S. FEDERAL TAX ADVICE CONTAINED IN THIS COMMUNICATION (INCLUDING ANY ATTACHMENTS) IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSE OF (I) AVOIDING PENALTIES UNDER THE INTERNAL REVENUE CODE OR (II) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY TRANSACTION OR TAX-RELATED MATTER[S].

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[2] 2011-25 I.R.B. 887.

[3] 1982-2 C.B. 759.

[4] 2009-28 I.R.B. 142.

[5] IRS Notice 2006-109. If a letter of determination is obtained, it is recommended that the donor also request a letter from an officer of the organization representing that such letter has not been revoked or modified by the IRS since its issuance.

[6] Code Section 4945(h).

[7] Exec. Order No. 13,244 § 3(c), 66 Fed. Reg. 49,.079 (Sept. 23, 2001); Uniting and Strengthening America by Providing Appropriate Tools to Intercept and Obstruct Terrorism Act ("Patriot Act") of 2001, Pub. L. No. 107-67, 115 Stat. 272 (2001).

Canada Revenue Agency Releases "New" Treaty Eligibility Forms – Are there New Canadian Compliance Obligations to be Met Before Applying a Treaty Reduced Rate of Withholding Tax?

By: Michael Friedman and Ashley Palmer, McMillan LLP[1]

Certain amounts that are paid or credited by a Canadian resident to a non-resident of Canada, including dividends, royalties, and income from certain estates or trusts, are generally subject to Canadian tax under Part XIII of the *Income Tax Act* (Canada) (the "**Act**").[2] Although the ultimate liability for Canadian Part XIII tax (commonly referred to as "**withholding tax**") rests with the relevant non-resident, it is the Canadian-resident payer of an amount that is subject to Part XIII tax that generally has the obligation to withhold and remit the tax on behalf of the non-resident. The general rate of withholding tax under the Act is 25 percent, but the applicable rate may be reduced by the terms of a bilateral tax treaty. For instance, under the *Canada-United States Income Tax Convention* (the "**Canada-US Treaty**"),[3] royalties paid by a Canadian resident to a resident of the United States may be subject to a reduced withholding tax rate of 10 percent (or a complete exemption, under certain circumstances).

In the spring of 2011, prompted by recent changes to the Canada-US Treaty, such as the addition of the new, bilateral "limitation on benefits" clause, the Canada Revenue Agency (the "**CRA**") released a new set of declaration forms that, in concept, are similar to Form W-8BEN. The stated purpose of the new declaration forms is to help Canadian residents determine whether it is appropriate to apply a reduced rate of withholding tax to payments made to non-residents.

Forms NR301, NR302 and NR303 (the "**Forms**")[4] are declarations that are designed to be used by conventional non-resident taxpayers (*e.g.*, corporations, individuals), partnerships with non-resident partners, and hybrid entities, respectively, to substantiate eligibility to claim the benefits afforded by a particular tax treaty. While the Forms are not prescribed forms, and Canadian resident taxpayers are not required by statute to obtain a completed Form or equivalent information before applying a reduced rate of withholding tax on amounts paid or credited to non-residents, it is likely that, as a practical matter, the CRA will request such Forms or equivalent information during an audit of a taxpayer's cross-border tax affairs.

The Forms

Draft versions of the Forms were initially released in June 2009 and the CRA sought public comments on the Forms until September 30, 2009. Some of the concerns raised during the public consultation period were addressed in the most recent versions of the Forms and supplementary information thereto. For instance, the Forms now include an undertaking that non-residents will advise Canadian payers of any changes to the information provided in the Forms, and the supplementary information released by the CRA confirms that penalty and interest relief may be available under subsection 220(3.1) of the Act (*i.e.*, by way of a Taxpayer

Relief Request) (the "**Fairness Regime**") to Canadian payers who obtain completed Forms and whose withholdings are thereafter found by the CRA to be deficient. However, other concerns that were expressed during the public consultation period do not appear to have been addressed, such as whether a payer may accept a duly completed Form without undertaking additional due diligence with respect to the accuracy of the statements made in the Form.

The Forms require a non-resident to provide information, such as its name, mailing address, foreign tax identification number (and Canadian tax identification number, if any), country of residence for treaty purposes, the type of income for which the non-resident is making the declaration, and a certification and undertaking with respect to the accuracy of the information presented in the Form. In addition to the standard certification that the information given on the Form is correct and complete, a non-resident must also certify that (i) it is the beneficial owner of the income to which the Form relates, and (ii) to the best of the non-resident's knowledge, and based on the factual circumstances, the non-resident is entitled to the benefits of the tax treaty between Canada and its country of residence on the relevant income. Furthermore, as noted above, a non-resident undertakes to immediately notify the payer, or partnership or hybrid entity through which it derives the income and to whom it submits the Form, of any changes to the information in the Form. It is not clear what the consequences, if any, are to a non-resident who make a false certification or does not comply with its undertaking.

The Forms expressly provide that, for withholding tax determination purposes, they expire on the earlier of (i) a change in the non-resident's eligibility for treaty benefits, and (ii) three years from the end of the calendar year in which the Form is signed and dated.

Completion of the Forms should generally not be particularly burdensome, except in circumstances where the non-resident recipient of the subject payments is a partnership or hybrid entity that has a large number of non-resident partners or members, respectively.

Establishing Entitlement to Treaty Benefits

As indicated above, the information requested in the Forms is intended to assist Canadian residents in determining whether it is appropriate to apply a reduced rate of withholding tax to amounts paid or credited to non-residents. Historically, the CRA suggested that a payer could generally use a non-resident recipient's name and address when assessing whether the non-resident was entitled to claim the benefit of a reduced rate of withholding tax under a bilateral tax treaty, unless there was reasonable cause to suspect the beneficial owner resided in another jurisdiction. However, with the introduction of the new "limitation on benefits" clause in the Canada-US Treaty, the CRA is of the view that, in order to apply a treaty-reduced rate of withholding tax to an amount paid or credited to a non-resident, Canadian payers must have sufficient information to establish (i) the identity of the beneficial owner of such an amount, (ii) that the beneficial owner is resident in a country with which Canada has a tax treaty, and (iii) that the beneficial owner is eligible to claim the benefits afforded by the tax treaty on the income paid or credited.[5]

(i) Beneficial Ownership

The CRA has stated that, generally, a Canadian resident payer can accept the payee as the beneficial owner of a subject amount, unless there is reasonable cause to suspect that the payee is not the beneficial owner. The CRA has provided the following examples of situations in which there is reasonable cause for the payer to question whether the payee is, in fact, the beneficial owner of the amount paid:[6]

- the payee is known to act, even occasionally, as an agent or nominee (other than a Swiss agent or nominee);
- the payee is reported as "in care of" another person, or "in trust", or the address of the payee is a post office box;
- the mailing address provided for payment of interest or dividends is different from the registered address of the "owner";
- the payee is a flow through entity such as a partnership or limited liability company (that is not taxed on its worldwide income under the laws of another country); or
- there is reason to believe that a reduced rate of withholding will not apply due to the limitation on benefits provisions in the Canada-US Treaty.

Where the payer has any doubt as to the beneficial ownership of the subject payment, or when the payment is made to a partnership with non-resident partners or to a hybrid entity with members resident in the United States, the CRA is of the view that a declaration (*i.e.*, a Form) must be completed and forwarded to the payer.[7]

Payers may accept an insurance corporation or a pension trust as the beneficial owner of amounts paid to a non-resident if such corporation or trust invests solely for itself and includes the amount in the calculation of its revenue.[8]

(ii) Eligibility to Claim Treaty Benefits

Where a Canadian resident payer has reason to believe that the "limitation on benefits" clause in the Canada-US Treaty will restrict the application of treaty benefits, the CRA requires that the payer ask the non-resident recipient of the amount for certification that it is eligible for treaty benefits immediately or withhold tax at a rate of 25 percent.[9]

Amounts Payable to a Non-Resident Agent, Nominee or Registered Holder

Canadian resident payers have an obligation to withhold and remit withholding tax in respect of payments made to intermediaries, such as agents, nominees and registered holders, located in foreign jurisdictions. Under such circumstances, the CRA has asserted that a reduced rate of withholding tax under an applicable tax treaty should only be applied where the

Canadian payer has received, prior to the relevant payment, documentation from the agent or nominee that certifies the beneficial ownership of the payment, the country of residence of the beneficial owner(s) of the payment and their eligibility for treaty benefits. The CRA is of the view that the payer should receive a certification from the intermediary in the suggested form set out in the Pending Updates to IC76-12. The suggested form of the certification is similar to the suggested certification in paragraph 5(a) of the current version of Information Circular 76-12R6,[10] with modifications to include a certification that the beneficial owner is eligible to claim the benefits of a particular tax treaty and a reference to the Forms and the information in the Forms as examples of information that may be necessary to substantiate the accuracy of the information contained in the certification, which the agent, nominee or registered holder undertakes to provide to the CRA upon request.[11]

When should a non-resident complete a Form?

Despite the fact that, as noted above, there is no statutory requirement for a payer to obtain a completed Form prior to applying a reduced rate of withholding tax, each Form sets out the circumstances in which the CRA asserts a Form should be completed. Based on the information contained in the Forms, the CRA suggests that Forms should be completed and obtained in the following circumstances:

(a) a non-resident taxpayer, partnership with non-resident partners, or a hybrid entity receives a payment that is subject to withholding tax;

(b) a non-resident taxpayer, partnership with non-resident partners, or a hybrid entity is submitting a request for a compliance certificate under section 116 of the Act (*i.e.*, forms T2062 or T2062A);

(c) a non-resident taxpayer is asked by a partnership or hybrid entity through which it derives income to complete Form NR301 to support a declaration by the partnership or the hybrid entity;

(d) a partnership with non-resident partners or a hybrid entity is requesting a refund of withholding tax;

(e) a partnership with non-resident partners or a hybrid entity is submitting a waiver request for amounts required to be withheld under Regulation 105 of the *Income Tax Regulations*; and

(f) a hybrid entity is filing a Canadian income tax return and claiming a deduction relating to treaty benefits.

A cross border derivatives transaction is an example of a circumstance in which Canadian parties should consider obtaining completed copies of the applicable Form. It is common practice for parties to an ISDA Master Agreement (an "**ISDA Master**") that do not reside in the same jurisdiction to provide certain tax representations relating to their eligibility to claim the benefits afforded by an applicable income tax treaty. A party to an ISDA Master that

is resident in the United States for tax purposes may request the relevant counterparty, under certain circumstances, to execute and deliver certain Internal Revenue Service Forms, including Form W-8BEN, to substantiate any eligibility of the counterparty to claim the benefits afforded by a particular tax treaty. Canadian resident parties that are negotiating the terms of the Schedule to an ISDA Master should now consider whether it is necessary to expressly provide that a non-resident counterparty shall be required to deliver a properly executed Form, together with all required supporting documentation and worksheets.

The CRA has also set out the following circumstances, which it refers to as "exceptions", in which a payer need not obtain a Form or equivalent information from a payee:[12]

(a) where all of the following are true: (i) the payer knows that the payee is an individual, or the payee is an estate and the trustee has an address in the United States; (ii) the payer has a complete permanent address on file that is not a post office box or "care-of" address; (iii) the payer has no contradictory information; (iv) the payer has no reason to suspect the information is inaccurate or misleading;[13] and (v) the payer has procedures in place so that changes in the payee's information (*e.g.*, a change of address or contact information that includes a change in country, or returned mail) will result in a review of the withholding tax rate;

(b) a payer is applying an exemption or a statutory withholding tax rate specified in Part XIII or Part XIII.2 of the Act (*e.g.*, an exemption from withholding tax on interest payments to non-residents);

(c) where a payer pays or credits amounts to a Swiss address, withholding tax may be based on the tax rates in the *Canada-Switzerland Income Tax Convention*;[14]

(d) the payer has received a letter of exemption or written authorization issued by the CRA, which confirms that a treaty exemption or withholding tax rate reduction can be applied (*e.g.*, (i) a written authorization from the CRA in respect of the Doctrine of Sovereign Immunity exemption; or (ii) a letter of exemption issued by the CRA confirming that an organization or plan is exempt from tax under Article XXI of the Canada-US Treaty); and

(e) payments made to CDS Clearing and Depository Services Inc. on securities registered in the name of Cede & Co. without withholding tax.

Why should a Canadian resident payer obtain Forms from non-resident recipients?

There is no absolute statutory requirement for a Canadian resident payer to obtain a Form from a non-resident to whom it pays or credits amounts subject to withholding tax. The

Forms appear to be a tool to gather information that is relevant to the determination of whether a non-resident is eligible for benefits under a tax treaty. Ideally, the ability to demonstrate that completed Forms or equivalent information was previously obtained would be of assistance where there has been a deficiency in the amount of withholding tax and (i) the payer's directors wish to support a due diligence defence under subsection 227.1(3) of the Act, or (ii) the payer wishes to request penalty relief under the Fairness Regime in respect of such withholding deficiencies. However, the CRA has not published any definitive statements confirming that the possession of the Forms will be accepted as supporting such a due diligence defence or increase the likelihood that a taxpayer might be granted penalty relief under the Fairness Regime.

In fact, it arguably appears as though additional due diligence may be required in respect of the accuracy of the information contained in the Forms. In the supplementary information that accompanied the release of the Forms, the CRA advises that a Canadian resident payer should question information given by, and look at other information received from, the non-resident recipient or known about the non-resident where the payer "knows or has reasonable cause to believe that the information on the form:

- is incorrect or misleading;
- contradicts information in the payer's files; or
- is given without knowledge or consideration of the facts of a situation."[15]

The CRA also states that where it determines that an insufficient amount of withholding tax was withheld on a payment to a non-resident, "an assessment (including interest) can be issued to the payer, the non-resident recipient, or both. If the payer is issued an assessment of tax, a penalty applies on that amount."[16] The CRA notes that a taxpayer can seek penalty and interest relief under the Fairness Regime by making a request for taxpayer relief, but provides little additional detail as to the prospects of such a request being accepted under various circumstances.[17]

Based on such CRA statements, it appears as though obtaining completed copies of the Forms or equivalent information may not necessarily provide the payer or payee with any additional protection from liability where the amount of withholding tax withheld from payments to non-residents is subsequently determined by the CRA to be insufficient.

Transition Period

The CRA originally stated that it would permit a transition period until December 31, 2011 to allow payers to gather any additional information that was necessary to establish a non-resident's eligibility for a treaty-reduced rate of withholding tax under the CRA's new pronouncements. In late December 2011, the CRA extended the transition period to December 31, 2012 to allow payers further time to gather any additional information that is necessary to establish a non-resident's eligibility for a treaty-reduced rate of withholding tax and to perform

procedural changes and system upgrades that may be required to adapt to the increased informational requirements under the CRA's new pronouncements.[18]

The CRA has stated that, during the transition period, Canadian resident payers can accept the name and address of the payee of an amount as the beneficial owner of the amount and withhold at the applicable treaty rate, except in circumstances where there is reasonable cause to question the appropriateness of accepting such information as proof of beneficial ownership.

Generally, where the payer has any doubt as to the beneficial ownership of the subject payment, the CRA is of the view that a declaration (*i.e.,* a Form) (or similar information) must be completed and forwarded to the payer. However, an exception from the requirement to obtain Form NR301 where the payer has doubts as to the beneficial ownership of an amount may be available in certain circumstances where the payer, agent or nominee has on file a certificate of beneficial ownership as described in the CRA's Information Circular IC76-12R.[19]

The CRA's commentary with respect to the transition period further advises that payers cannot withhold at treaty-reduced rates where "information on file" reveals that the benefits of a particular treaty do not apply or that another rate is applicable. Presumably, "information on file" would include information relating to the ownership of the payer, or the payee's relationship with the payer, that would result in a treaty-reduced rate of withholding not being applicable, or another rate being applicable, in the circumstances. Payers must also await the issuance of a Letter of Exemption or written authorization from the CRA prior to applying a reduced rate of withholding tax where such documentation is required by the CRA.[20]

* * *

The introduction of the Forms represents the culmination of several years of internal study and consultation by the CRA. It is reasonable to expect that the CRA will request copies of all Forms relevant to cross-border payments when conducting withholding tax audits. On that basis, recipients of payments from Canadian resident taxpayers should expect that requests for completed Forms will become more commonplace in the future. The current ambiguities with respect to the protections afforded by obtaining completed Forms, and the required due diligence associated with obtaining such documentation, will hopefully be resolved by the CRA in due course.

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained in the context of a reader's own particular circumstances.

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[2] R.S.C. 1985 (5th Supp.), c.1.

[3] *Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital*, (26 September 1980), as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007.

[4] Accessible at http://www.cra-arc.gc.ca/E/pbg/tf/nr301/nr301-10e.pdf, http://www.cra-arc.gc.ca/E/pbg/tf/nr302/nr302-10e.pdf, http://www.cra-arc.gc.ca/E/pbg/tf/nr303/nr303-10e.pdf.

[5] CRA, Beneficial ownership and tax treaty benefits, online: CRA <http://www.cra-arc.gc.ca/tx/nnrsdnts/pyr/prtxiii/wthhldng/bnfclwnrshp-eng.html> [*Beneficial Ownership*]; and CRA, Pending updates to IC76-12, *Applicable rate of part XIII tax on amounts paid or credited to persons in countries with which Canada had a tax convention* related to forms NR301, NR302, and NR303, online: CRA <http://www.cra-arc.gc.ca/formspubs/frms/ic76-12r6-eng.html> [*Pending Updates to IC76-12*].

[6] See *Beneficial Ownership, ibid; Pending Updates to IC76-12, ibid;* and CRA, Procedures during the transitional period, online: CRA < http://www.cra- arc.gc.ca/tx/nnrsdnts/pyr/ prtxiii/wthhldng/prcdrtrstnl-eng.html> [*Transition Period*].

[7] *Pending Updates to IC76-12, ibid.* However, as noted above, there is no provision in the Act that requires a payer to obtain a Form or equivalent information.

[8] *Beneficial Ownership, supra* note 5; and *Pending Updates to IC76-12, ibid.*

[9] *Beneficial Ownership, ibid*; and *Pending Updates to IC76-12, ibid.*

[10] CRA, Information Circular IC76-12R6 *Applicable Rate of Part XIII Tax on Amounts Paid or Credited to Persons in Countries with which Canada has a Tax Convention* (2 November 2007), online: CRA <http://www.cra-arc.gc.ca/E/pub/tp/ic76-12r6/ic76-12r6-e.pdf>.

[11] *Pending Updates to IC76-12, supra* note 5.

[12] *Ibid.*

[13] Information published by the CRA on its website concerning "Beneficial ownership and tax treaty benefits" provides that the payer must have no reason to suspect that the payee is not entitled to the tax treaty benefits. This is not included in the Pending Updates to IC76-12. See, *Beneficial Ownership, supra* note 5; and *Pending Updates to IC76-12*, *supra* note 5.

[14] Additional Canadian withholding tax may be payable on such amounts where the beneficial owner of the amount resides outside of Switzerland. Such amounts are to be withheld and remitted by the agents or nominees to the Federal Tax Administration of Switzerland for the purposes of forwarding it to the Canadian tax authorities. See, *Pending Updates to IC76-12, ibid.*

[15] CRA, More information on forms NR301, NR302 and NR303, online: CRA <http://www.cra-arc.gc.ca/formspubs/frms/nr301-2-3-eng.html>.

[16] *Ibid.*

[17] A request for taxpayer relief may be made by submitting Form RC4288, *Request for Taxpayer Relief* to the CRA. See Information Circular IC07-1, *Taxpayer Relief Application*, which is available online at http://www.cra-arc.gc.ca/E/pub/tp/ic07-1/ic07-1-e.html, for additional information on making such a request.

[18] *Transition Period, supra* note 6.

[19] *Supra* note 10.

[20] *Transition Period, supra* note 18.

WHAT TO DO FOR A CLIENT WHO EXPECTS A WILL CONTEST

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I. SCOPE OF THIS ARTICLE

For most of our clients, their Will is the most important document they will sign during their lifetimes. Accordingly, our duties as estate planning attorneys are to prepare and carry out the execution of our clients' Wills in a manner that, first and foremost, will prevent or discourage a Will contest from being brought and, secondarily, if a contest is brought, to have taken the necessary steps so that the contest will be defeated. In exploring the measures that can be taken in fulfilling our duties, this article assumes that most of you are like this author, i.e. you're either an estate planning and probate attorney or, at the least, estate planning and probate is a substantial part of your practice - and you're not a litigator. The author further assumes that, if you're presented with a client situation where a Will contest is likely, you will take the minimum necessary steps to make sure that the Will is executed properly and appropriate measures will be taken to properly safeguard the Will so that it will not be altered, destroyed, etc. . . .

At the outset it should be pointed out that the preparation of this article included the review and reference to several excellent articles on the same or related topics cited in the bibliography prepared by some fine Houston lawyers, e.g. Mike Cenatiempo, Stephanie Donaho, John Hopwood, and Joe Horrigan.

II. COMMON GROUNDS FOR CONTESTING A WILL

A. Improper Execution.

1. Obviously, a Will that is not executed with the requisite formalities is not a valid Will and may not be probated. Section 59 of the Texas Probate Code contains three requirements for the proper execution of a Will: (i) it must be signed by the testator or for him at his direction and, except for holographic Wills (i.e. - entirely in the testator's own handwriting), (ii) the Will must be attested by two or more credible witnesses over 14 years of age who subscribe their names thereto, and (iii) the witnesses must sign the Will in the presence of the testator. Of course, a Will should normally have an "attestation clause" preceding the witnesses' signatures reciting that the execution requirements have been satisfied (e.g. - "The undersigned persons hereby sign

their names to the foregoing Will in the presence of the testator, etc."), but no such clause is required.

A "credible witness" is synonymous with a "competent witness", who is defined as "a witness competent under the law to testify to the fact of the execution of the Will. See *Moos v. First State Bank*, 60 S.W.2d 888 (Tex. Civ. App. 1933, writ dism'd w.o.j.)
The testator is not required to sign the Will in the presence of the witnesses; however, the witnesses must sign the Will in the presence of the testator. For these purposes, Texas cases interpret the term "in the presence of the testator" to mean actual presence or "conscious presence". In *Morris v. Estate of West*, 643 S.W.2d 204 (Tex. App - Eastland 1982, writ ref'd n.r.e.), the Court held that the witnesses were not in the presence of the testator when they signed the Will in a secretarial office while the testator remained in a conference room down the hallway.

B. Testamentary Intent.

1. In order to be a valid Will, it must be executed in accordance with the foregoing statutory requirements and, in addition, the testator must have "testamentary intent", which is not a statutory requirement, but a long standing principle of case law. Basically, a testator must intend to create a revocable disposition of his property to take effect after his death. Further, "it is essential, however, that the maker shall have intended to express his testamentary wishes in the particular instrument offered for probate". See *Hinson v. Hinson*, 280 SW.2d 731 (Tex. 1955). Accordingly, a testator with testamentary intent should not be questioned regarding an instrument in the general form of a Will and clearly labeled as such.

C. Testamentary Capacity

Section 57 of the Texas Probate Code requires that a testator must be "of sound mind" in order to have the right and power to make a Last Will and Testament. The sound mind requirement essentially means having "testamentary capacity." The five part test for testamentary capacity laid out in *Prather v. McClelland*, 13 S.W.2d 543 (Tex. 1890) is still the current rule, and essentially requires that the testator must have been capable of understanding the following:

a. The business he was engaged in;

b. The nature and extent of his property;

c. The persons who were the objects of his bounty;

d. The effect of his making the Will and thereby distributing his property among such persons; and

e. "Memory sufficient to collect in his mind the elements of the business to be transacted, and to hold them long enough to perceive, at least, their obvious relation to each other, and be able to form a reasonable judgment as to them."

More recent cases have consistently followed the test laid out in *Prather v. McClelland* and frequently repeated the text almost verbatim. See *Teiken v. Midwestern State University*, 912 SW.2d 878 (Tex. App.- Fort Worth 1995, no writ); *Oeschner v. Ameritrust*, 840 SW.2d 131 (Tex.App. - El Paso 1992, writ denied).

The testator's testamentary capacity on the day the Will is executed is all that is required for the Will to be valid. See *Croucher v. Croucher*, 660 S.W.2d 55 (Tex. 1983). However, evidence of incapacity at other times is generally relevant, but admissible only if it demonstrates that the condition persists and has some probability of being the same condition which obtained at the time of the Will's making. *Lee v. Lee*, 424 S.W.2d 609 (Tex. 1968).

Even though the general requirements of testamentary capacity listed above are satisfied, a Will may still be held invalid on the basis of an "insane delusion." In *Lindley v. Lindley*, 384 S.W. 2d. 676 (Tex.1964), the court indicated that a person who is entirely capable of attending to his business affairs may have his mind so warped by some false and unfounded belief that he is incapable of formulating a rational plan of testamentary disposition. Accordingly, even though a testator otherwise is of sound mind, a Will may be denied probate if it was the product of an insane delusion, which has been defined as " the belief of a state of supposed facts that do not exist, and which no rational person would believe." See *Knight v. Edwards*, 264 S.W.2d 692 (Tex. 1954). Further, the insane delusion must affect the provisions in the Will in order for the Will to be invalidated. See *Bauer v. Estate of Bauer*, 687 S.W. 2d. 410 (Tex. App.- Houston [14th Dist.] 1985, writ ref d n.r.e.).

D. Undue Influence

The Texas Supreme Court, in *Rothermel v. Duncan*, 369 SW.2d 917 (Tex. 1963), listed the following legal requirements for proving the existence of undue influence and thereby invalidating a Will: "(1) The existence and exertion of an influence; (2) the effective operation of such influence so as to subvert or overpower the mind of the testator at the time of the execution of the testament; and (3) the execution of a testament which the maker thereof would not have executed but for such influence . . . . It cannot be said that every influence exerted by one person on the will of another is undue, for the influence is not undue unless the free agency of the

testator was destroyed and a testament produced that expresses the will of the one exerting the influence."

While the elements needed to prove undue influence may be shown by circumstantial as well as direct evidence, evidence that merely shows the opportunity to exert influence, the testator's susceptibility to influence due to age and physical condition, and an unnatural disposition, do not establish that the testator's mind was in fact subverted or overpowered. See *Estate of Woods*, 542 SW.2d 845 (Tex. 1976).

To support a jury finding of undue influence, there must be some proof that influence was in fact exerted, and that the testator's mind was subverted and overpowered at the time the Will was executed. See *Estate of Davis*, 927 SW.2d 463 (Tex. App. - Amarillo 1996, writ denied).

E. Revocation

Section 63 of the Texas Probate Code essentially provides that there are two ways to revoke a Will, i.e. (i) "by a subsequent Will, Codicil, or declaration in writing, executed with like formalities" or (ii) "by the testator destroying or cancelling the same, or causing it to be done in his presence." Of course, the normal way to revoke a Will is by executing a new Will containing a standard revocation clause, e.g. - "I hereby revoke all previous Wills and Codicils."

The requirement that a written revocation of a prior Will must be "executed with like formalities" simply requires that the revoking instrument be executed with the same formalities that are required to probate a Will. See *Harkins v. Crews*, 907 SW.2d 51 (Tex. App. - San Antonio 1995, writ denied). Accordingly, to revoke a Will, the testator must have testamentary capacity at the time the subsequent instrument of revocation is executed. Otherwise the, attempted revocation is without effect. See *Lowery v. Saunders*, 666 SW.2d 226 (Tex. App. - San Antonio 1984, writ ref d n.r.e.).

Revocation of a Will by physical act requires both the act itself and the intent to revoke the Will. The physical act of revocation must be of the Will itself, not some other document. Thus, where a testator tore up an envelope and its contents, mistakenly believing that the Will was inside, the Will was not revoked. "The mere intention to destroy a Will, or the intention to have it destroyed, coupled with the belief that destruction has occurred, is insufficient to effect revocation." See *Morris v. Morris*, 642 SW.2d 448 (Tex. 1982). Further, a testator may not partially revoke certain provisions in an attested Will by erasure, cancellation or other obliteration of a specific clause. The strike out is ignored and the Will is admitted to probate as it was originally executed. See *Leatherwood v. Stephens*, 24 SW.2d 819 (Tex. Comm. App. 1930).

If a testator validly revokes a Will with a revocation clause with the intention of reviving or restoring an earlier Will,, Texas applies the common law "no revival" rule, meaning the earlier Will is not revived merely by destroying the later Will with its revocation language. In other words, the earlier Will was revoked when the later Will was executed. See *Hawes v. Nicholas*, 72 Tex. 48 1, 10 S.W. 558 (1889).

F. Mistake

Generally, a Will may be held invalid on the grounds that it was induced by a testator's mistake in the factum (i.e. - mistake in the execution) or a mistake in the inducement. A mistake in the factum by the testator occurs when (i) the testator mistakenly signs his Will when he thinks he is signing some other instrument or (ii) when there is a mistake in the contents of the document signed by the testator.

A mistake in the inducement occurs when the testator is induced to sign the Will by his mistaken belief as to an extrinsic fact, such as whether an intended beneficiary is alive, the occurrence of a particular event, etc. . . .

G. Fraud

A Will may be denied probate on the basis of fraud if the testator was induced to sign the Will by deception or misrepresentation. See *Vickery v. Hobbs*, 21 Tex. 570 (1858); *Stolle v. Kanetzky*, 259 S.W. 657 (Tex.Civ.App.- Austin 1924, no writ).

Fraud is similar to mistake and can involve a misrepresentation to the testator in the factum or in the inducement. For example, fraud in the factum occurs when the testator is deceived as to the identity or contents of the instrument being executed. Further, fraud in the inducement occurs when some extrinsic fact is intentionally misrepresented to the testator, who otherwise would not have executed the Will.

H. Forgery

Obviously, a Will which has been forged, in whole or in part, will be held as invalid and denied probate if the contestant to the Will can prove that forgery occurred. "Forgery" in the context of a Will contest is not limited to the forgery of the signature of the testator or one of the purported witnesses, but can also include an alteration or substitution of pages of the document.

I. Duress

Under Texas case law, duress appears to be a form of undue influence. For duress to be present, it would appear that there must be an exertion of unlawful threats or coercion sufficient to preclude a person from exercising his own free will, thus inducing the person to do an act which he would not have otherwise done. See *Lawler v. Speaker*, 446 SW.2d 888 (Tex. Civ. App. - Amarillo 1969, writ ref'd n.r.e.).

III. PROTECTING THE WILL AND ESTATE PLAN

The time for estate planning attorneys to begin thinking about measures to prevent or discourage a contest of our client's Will and estate plan is at the outset of our engagement. If a Will contest appears to be a possibility, then from that point forward we should be mindful of procedures that will discourage a contest from being brought. Perhaps a good rule of thumb in that situation is to adopt a litigator's mind set and be conscious of how various steps taken will appear to a judge and jury. One of the primary considerations is whether or not to include a no-contest provision in the client's Will and/or living trust agreement - and that subject is addressed in Part IV of this article. Other procedures to consider include the following:

A. Prior to Execution

After the initial estate planning meeting with a client, the attorney should have some indication of whether or not the client's estate plan may result in a Will contest following his or her death. For example, some of the factors likely to provoke a Will contest include (i) an unusual disposition of property, (ii) unequal treatment or omission of family member(s) from the Will and estate plan, (iii) the client's remarriage and second family, (iv) any unusual behavior by the client, and/or (v) the client's physical or mental illness. In any of these situations, if not in every client situation, the attorney should prepare a memorandum summarizing his initial and all subsequent estate planning conferences with the client. Further, it would be wise for the attorney to request that the client prepare a letter in his own handwriting addressed to the attorney summarizing the client's dispositive wishes regarding his Will and estate plan. In that letter, the client should also include his reasons for any omission of family members or any unusual testamentary dispositions; however, the attorney should caution the client to not include any possible slanderous statements.

B. Careful Selection of Witnesses

One of the most crucial considerations in preventing or defeating a possible Will contest will be the determination of the witnesses to the execution of the client's Will. Accordingly, careful

consideration should be given to the selection of the witnesses, keeping in mind the likelihood that they will also be called as witnesses in the event of a Will contest. Accordingly, bear in mind how the witnesses will come across to the judge and the jury in the event that a Will contest lawsuit is filed.

Generally, individuals who have known or been associated with the client for a long period of time will make the best witnesses. Examples include long time family friends, business associates, bankers, and professionals, such as CPAs. The attorney might also consider having an extra third witness at the Will signing ceremony.

C. Strict Observance of Will Execution Requirements

The attorney should carefully explain, conduct and supervise the Will signing ceremony. Further, the Notary should swear in the testator and the witnesses before asking them the questions called for in the self-proving affidavit. Obviously, this is not the time to take any shortcuts regarding the execution of the Will and compliance with the self proving affidavit - and do not even consider mailing the finalized instruments to the client with execution instructions.

D. Video Tape of Will Signing Ceremony

Obviously, if the client's physical appearance and mental state are satisfactory, a videotape of the Will signing ceremony can be a powerful deterrent to a Will contest or provide dramatic evidence for the proponent if a contest is brought. However, because taping the ceremony can sometimes backfire, the decision to videotape the ceremony in any client situation should be made by the attorney only after careful consideration of all the circumstances. As pointed out by Mike Cenatiempo in his excellent article which is cited in the bibliography, "serious thought should be given to the following factors: age, physical appearance, demeanor and any physical impairments of the testator, such as severe hearing loss or poor eye sight." Ultimately, the decision of whether or not to tape the Will singing ceremony is a judgment call that the attorney must make.

If the decision is made to tape the execution ceremony, then common sense dictates that the attorney should retain a professional firm who handles the taping of Will signing ceremonies on a regular basis.

As far as the ceremony itself, Mike Cenatiempo points out in his article that a rehearsal of the ceremony can be helpful to avoid any confusion or surprises. The attorney should conduct the ceremony and, in addition, have the client briefly explain any unusual disposition of his property pursuant to the client's estate plan. In explaining his reasoning or logic, the client should be

careful not to libel anyone. Further, before concluding the taping session, the attorney should also obtain the witnesses' impressions of the client's testamentary capacity.

E. **Transcription of Will Signing Ceremony**

If a client's physical appearance is not suitable for video tape, the attorney should consider hiring a court reporter to transcribe the Will signing ceremony. Unlike video tape, a typed transcription of the Will signing ceremony will not necessarily reveal the client's physical appearance and/or impairments at the time that the Will is signed. If the attorney chooses to hire a court reporter to transcribe the will signing ceremony, the attorney should follow the same suggested course of action which is recommended above for video taping the Will signing ceremony (e.g. - retain a professional court reporter to transcribe the ceremony, have the client briefly explain any unusual disposition of his property pursuant to the client's estate plan, have the witnesses share their impressions of the client's testamentary capacity with the court reporter so that the witnesses' impressions will be included in the transcript, etc...). Unlike a video tape of a will signing ceremony, a transcript of a will signing ceremony that is prepared by a professional court reporter will not record or reflect long pauses by the client or the witnesses as they share any or all of the information which is discussed above.

F. Follow-up Measures

Immediately following the Will signing ceremony, the attorney should consider having each of the witnesses prepare and sign a brief memorandum summarizing their observations and recollections of the ceremony, as well as the testator's competency, appearance and frame of mind. In addition, the attorney should prepare a memorandum to the client's file regarding the same matters.

G. Family Communication

In situations where a client desires to dispose of his or her property in an unequal manner, verbal communications from the client to the affected family member could go a long way toward preventing a potential Will contest after the client's death. However, as pointed out in Stephanie Donaho's excellent article which is cited in the bibliography, "most clients are highly reluctant to do this, preferring to let someone else clean up their mess. They wish to avoid controversy while they are alive." Nevertheless, the attorney should encourage the client to at least consider writing a letter to be opened after the client's death briefly summarizing the dispositive provisions of his or her estate plan, as well as the client's logic or rationale for any unequal treatment or omission of family members. Further, the client should indicate in the letter that he reached his decisions after long and careful consideration.

H. Disposition of personal Effects and Other Tangible Personal Property

Surprisingly, the division and allocation of a decedent's personal effects and other tangible personal property often creates controversy among the donees, especially where the decedent's Will provides for a class gift of these items. In those instances, the friction usually arises over (i) the manner of selection of the items among the class of donees, (ii) the valuation of the various items and (iii) questions over whether or not the decedent gifted any such items during lifetime to a particular donee. Various measures in a client's estate plan can be implemented to go a long way toward avoiding this type of controversy. For example, the client's Will can list the various items and their recipients or, alternatively, it can refer to a memorandum prepared by the client which lists the various items and their recipients. In addition, the Will could spell out the manner of selection of items among the class of recipients (e.g. the first item to be selected by the oldest child, the next item to be selected by the next oldest child, etc....). Further, the Will should provide that if the donees are incapable of making a division among themselves for any reason, then the executor shall determine the division of those items in some equitable manner.[3]

I. Gifts During Lifetime

Lifetime gifting while a client still has all of his or her mental capacity can reduce the potential for a Will contest by removing those assets from the client's testamentary estate. Further, a gift to a potential contestant of the client's Will sometime near the date the Will is signed can be significant in upholding the validity of the Will in the case of a later contest. As pointed out in Mike Cenatiempo's article, the potential contestant's acceptance of such a gift would serve at trial as evidence of his belief that the testator had capacity at that time. As further pointed out by Mike Cenatiempo, if such a gift is made with a check from the client, the cancelled check would be proof of the contestant's acceptance of the gift.

J. Mental Status Exam

Referring the client to a psychiatrist or neurologist for a mental competency exam is a measure sometimes taken in an attempt to prove a testator's competency. However, caution should be exercised before having a client undergo an exam because clearly a contestant in a later Will contest could argue that the mental competency exam clearly shows that there must have been doubts regarding the client's mental capabilities on the part of the estate planning attorney at or about the time that the Will was prepared. Whether or not to have this exam performed in an effort to thwart a potential Will contest is another judgment call that the attorney must make.

Obviously, if the decision is made for the client to have a mental status exam, it should be done as near as possible to the date that the client signs his estate planning documents.

If a client has serious physical problems but his or her mental capabilities are sound, then a competency exam could be an effective means of demonstrating the client's testamentary capacity.

K. Series of Wills

An effective technique to make a potential contestant's task more difficult is to have the client execute a series of Wills over time with fairly minor changes. By doing this, a contestant must successfully prevent the admission to probate of the latest and all prior Wills to reach intestacy or an earlier more favorable Will.

In Mike Cenatiempo's article, he suggests a shrewd variation of this technique combined with "baiting" the no contest provision. "Assuming the testator will agree to bait the in terrorem provision, the testator can embellish this idea with each successive Will by providing the contestant with a larger bequest or devise. If the most current Will is denied admission, the prior Will takes effect and grants the contestant even less." If the client is willing to make a small but nevertheless significant bequest to the potential contestant, a series of baited Wills might be sufficient to discourage the contestant from challenging the client's estate plan.

L. Revocable Living Trust

Perhaps the best protection against a potential Will contest is to have the client establish a revocable living trust, which provides that the trust assets will be used liberally for the benefit of the client during his or her lifetime, with the remainder interest to pass to the client's intended beneficiaries at death. The client could serve as the sole trustee or as a co-trustee. In such event, the trust should be fully funded with the client's entire estate. Obviously, the longer the trust is in existence prior to the client's death, the better it reflects on the client's mental capacity. However, there are a number of other advantages which are afforded by a revocable living trust. For example, the trust instrument will not be a part of the public records and, in addition, the trust property will pass directly to the beneficiaries outside of the probate process following the client's death. Further, existing law is not clear regarding who has standing to contest a living trust and, in addition, the statute of limitations for challenging the validity of a living trust is unclear as well. As opposed to a Will contest, generally only the grantor of a trust or his or her representative can challenge a trust.

A pourover Will should always be used in conjunction with a revocable trust in case some of the client's assets are not conveyed to the trust prior to death. In addition, the pour over Will should include alternative dispositive provisions in case the living trust is held to be invalid. For example, it is not clear under current Texas law whether a grantor must have a higher level of mental capacity (i.e.-contractual capacity instead of testamentary capacity) to create a valid living trust.

To further bolster a living trust arrangement in a potential Will contest situation, a no-contest clause should be included in the provisions of the trust agreement. Based upon the few courts in other jurisdictions that have addressed the issue and the *Conte* case here in Texas cited in part IV.C.3 of this article, it appears that a no-contest provision in a trust agreement would be treated the same as a similar provision in a Will.

At some point consideration might also be given to amending the trust to make it irrevocable; however, in such an event, to avoid gift tax consequences the client should retain at least a testamentary special power of appointment in favor of those beneficiaries who will receive the trust property at the client's death.

M. Allocation of Litigation Expenses

As pointed out in Stephanie Donaho's article, an additional disincentive or an alternative to a no-contest clause in a Will or trust agreement would be a provision allocating all litigation expenses against a contestant's share or bequest and further providing that the contestant cannot be reimbursed for such expenses from the estate or trust. Such a provision might not appear to be as extreme as a no-contest clause, but nevertheless would be a substantial deterrent against challenges to the validity of a Will or trust agreement.

N. Diffuse Marital Property Issues

Especially for those who have remarried, the characterization of the various properties comprising a deceased client's estate can result in major disputes among the beneficiaries. In her article, Stephanie Donaho suggests a couple of procedures or measures for diffusing this issue. The first is to create an estate plan that should negate any issues regarding property characterization from arising between children of a first marriage and a second spouse. As an example, in a situation where a client desires to split the marital estate, with half passing to his or her spouse and the other half passing to children from the first marriage, the client could simply leave half of his or her separate property to the surviving spouse, with the residue going to the children; thereby achieving an equal division of the estate.

Other procedures or measures suggested by Stephanie Donaho include partition agreements and/or transmutation agreements pursuant to the Texas Family Code, especially where there has been substantial commingling of assets.

IV. NO-CONTEST CLAUSES

As indicated above, one of the first or primary considerations an estate planning attorney should present to a client who faces a potential Will contest situation is whether or not to include a no-contest clause (also called an in terrorem clause) in the client's Will or trust agreement. Even where family disputes are likely, many clients will not want to include a no-contest clause in their Wills, either because (i) the client believes that doing so would be an extreme measure or (ii) the client is unwilling to make the potential contestant a significant beneficiary under the Will, which is required for the in terrorem provision to be effective. Nevertheless, if properly structured, a no-contest clause can be a strong incentive for a potential contestant not to challenge a client's estate plan.

A. Typical Clause

The typical no-contest clause or in terrorem clause included in a Will essentially provides that if any beneficiary under the Will contests any provision of the instrument, then any share or interest in the testator's estate given to that beneficiary is deemed to be void and, further, the testator's Will is to be construed as if the contesting beneficiary had predeceased the testator. Accordingly, in order for a no-contest clause to be operative and effective, the client must make the potential contestant a fairly significant beneficiary under the Will.

The attorney should point out to the client that if a no-contest provision successfully prevents a Will contest or if the potential contestant brings an action but is unsuccessful, then the contestant's share of the client's estate might very well pass to the descendants of the contestant. This result might not be what the client desires. Accordingly, in structuring a no-contest provision, the attorney must determine whether or not the client wants to disinherit the descendants of a potential contestant.

B. Enforceability

There appear to be basically three positions among the states regarding the enforceability of no-contest clauses in the United States. First, there are two states, i.e.-Indiana and Florida, having statutes rendering no-contest clauses invalid. IND. CODE ANN. § 29-1-62 (West 1979); FLA. STAT. ANN § 732.517 (West 1995).

Second, the Courts in several states have held that no-contest clauses are valid with no exceptions. See, for example, *Rosi v. Davis*, 133 SW2d 363 (Mo. 193 9); *Elder v. Elder*, 120 A.2d 8 f 5 (R.I. 1956); *Dainton v. Watson*, 658 P. 2d 79 (Wyo. 1983).

Third, quite a number of states have recognized an exception to the enforceability of a no-contest clause where the contest was brought in good faith and with probable cause. As pointed out in the excellent law review article by Professor Gerry Beyer, et al. cited in the bibliography, those states that have recognized this exception by judicial precedent include Iowa, Kansas, North Carolina, Oregon, Pennsylvania, South Carolina, Tennessee, Washington, West Virginia and Wisconsin. Even more states have adopted by statute the good faith/probable cause exception to the enforcement of no-contest clauses. As cited in the article by Professor Beyer, et al., those states that have adopted the exception by statute include Alaska, Arizona, Colorado, Hawaii, Idaho, Maine, Marilyn, Michigan, Minnesota, Montana, Nebraska, New Jersey, North Dakota and Utah. It appears that this exception, whereby a no-contest clause is unenforceable if an action is brought in good faith and with probable cause, is also the Texas position.

C. Texas Position

Until 2009, Texas had no statute governing no contest clauses. In 2009, Section 64 of the Probate Code codified the good faith/just cause exception to provide the following:

> A provision in a will that would cause a forfeiture of or void a devise or provision in favor of a person for bringing any court action, including contesting a will, is unenforceable if:
> (1) just cause existed for bringing the action; and
> (2) the action was brought and maintained in good faith.

TEX. PROB. CODE § 64. Since its enactment in 2009, there has been no case law construing Section 64 of the Texas Probate Code.

While it appears that a no contest clause can still be included in a Will, if the contestant shows just cause for contesting the will, and that the contest was brought and maintained in good faith, the no contest clause would be unenforceable. *See id.*

Prior to the adoption of Section 64 of the Texas Probate Code, many Texas courts have upheld the validity and enforceability of no-contest provisions where the contestant was challenging the dispositive provisions of the Will. See *Hammer v. Powers*, 819 SW2d 669 (Tex.App. - Fort

Worth 1991, no writ); *Massie v. Massie* 118 S.W. 219 (Tex. Civ. App. - 1909 no writ); and *Perry V. Rogers*, 114 S.W. 897 (Tex. Civ. App. - 1908, no writ).

1. **Good Faith/Just Clause Exception** – As stated above, the Texas Legislature codified the good faith/just cause exception in Section 64 of the Texas Probate Code. However, prior to the adoption of Section 64, no Texas case had ruled directly on the good faith/probable cause exception to enforcement of in terrorem clauses, but the exception has been mentioned favorably in dictum. See *Estate of Newbill*, 781 SW2d 727 (Tex.App. - Amarillo 1989, no writ); *Calvery v. Calvery*, 55 SW2d 527 (Tex. 1932).

   Even if the good faith/probable cause exception applies, thereby allowing an unsuccessful contestant to still receive the property bequeathed to the contestant under the Will, the contestant has the burden at trial to prove, and there must be a finding by the trial judge or jury, that the contest was brought in good faith and with probable cause. See *Gunter v. Pogue*, 672 SW2d 840 (Tex.App.- Corpus Christi 1984, writ ref'd n.r.e.). Further, absent any pleading or proof that the contest was made in good faith and with probable cause, enforcement of the in terrorem clause cannot be avoided. See *Hammer v. Powers*, 819 S.W.2d 669 (Tex. App. - Fort Worth 199 1, no writ).

2. **Strict Construction** - Texas law appears to be clear that no contest clauses in a Will are to be strictly construed, forfeiture is to be avoided if possible, and only where the act of a party comes strictly within the clause may breach of the forfeiture provision be declared. See the *Estate of Hodges*, 725 S.W.2d, 265 (Tex. App. - Amarillo 1986, writ ref d n.r.e.). Accordingly, the primary question Texas courts have considered when presented with the application of no contest clauses has usually been whether or not the contestant's action was a "contest."

   Texas Courts have strictly construed no-contest clauses and held that a contestant's actions did not trigger forfeiture pursuant to such clauses in the following cases:

   1. Filing an application to probate a 1993 Will and, in the alternative, a 1991 Will. See *Estate of Foster*, 3 S.W.3d 49 (Tex.App. - Amarillo 1999, no writ).

   2. Actions to construe a Will. *Calvery v. Calvery*, 55 SW.2d 527 (Tex. 1932) *Upham v. Upham*, 200 SW.2d 880 (Tex. Civ. App. 1947, writ refd n.r.e.).

   3. The filing of a Will contest, which was dismissed prior to the Court hearing on procedural grounds, because the clause at issue did not specifically prohibit the

mere filing of the contest. See *Sheffield v. Scott*, 662 S.W.2d 674 (Tex. App. - Houston [14th Dist.] 1983 writ ref d n.r.e.).

4. Challenge by a beneficiary of the suitability of the person named in the Will for appointment as the independent executor. See *Estate of Newbill*, 781 S.W.2d 727 (Tex. App. - Amarillo 1989, no writ).

5. An action for a declaratory judgment that a non-beneficiary executor had no standing to contest a family settlement agreement. See *Estate of Hodges*, 725 S.W.2d 265 (Tex.App. -Amarillo 1986, writ ref'd n.r.e.).

6. An action against an executor alleging mismanagement of the decedent's estate. See *McClendon v. McClendon*, 862 S.W.2d 662 (Tex. App. - Dallas 1993, writ denied).

7. An action against an executor seeking a final accounting, distribution and closing of an estate. See *Estate of Minnick*, 653 S.W.2d 503 (Tex. App. -Amarillo 1983, no writ).

3. **Application to Trusts.** –Section 112.038 of the Texas Trust Code was simultaneously amended in 2009 to codify the good faith/just cause exception relating to trusts. Section 112.038 contains language identical to Section 64 of the Probate Code relating to no contest clauses in Wills, and provides as follows:

> A provision in a trust that would cause a forfeiture of or void an interest for bringing any court action, including contesting a trust, is unenforceable if:
> (1) just cause existed for bringing the action; and
> (2) the action was brought and maintained in good faith.

TEX. PROP. CODE § 112.038.

There is generally a lack of case law dealing with the issue of no-contest clauses in trust agreements; however, those courts that have addressed the issue have generally treated no-contest clauses in trust agreements in the same manner as no-contest provisions in Wills. See, for example, *Poag v. Winston*, 241 Cal. Rptr. 330 (Ct. App. 1977); *Haynes v. First National State Bank of New Jersey*, 432 A.2d 890 (N.J. 1981). In a recent Texas case, the appellate court held that an action by a co-trustee to remove another co-trustee

did not violate the in terrorem provisions in the trust agreement. *See Conte v. Conte*, 56 S.W.3d 830 (Tex. App. -Houston [1st Dist.] 2001, no writ).

In the *Conte* case, a sister wanted to remove her brother as a co-trustee of an inter vivos trust established by their parents. The governing trust agreement included a no contest clause which provided for forfeiture "if any beneficiary or remainderman under this trust agreement in any manner, directly or indirectly, contests or challenges this trust or any of its provisions." The sister brought an action for a declaratory judgment to establish that her suit to remove her brother as a co trustee would not violate the in terrorem clause in the trust agreement. The trial court held that the sister's action would not violate the no contest clause and the appellate court affirmed. In so doing, the appellate court strictly construed the no-contest provision and held that it did not apply to the sister's anticipated suit to remove her brother as co-trustee because, first, the clause did not prohibit an action by a co-trustee and, second, the clause did not apply to actions for the removal of a trustee.

D. Drafting Considerations.

In light of the above considerations, in order for a no-contest clause to be effective in preserving the estate plan of a client, the following considerations should be taken into account in carefully drafting the in terrorem provision:

1. **Bequest to Potential Contestant** - The attorney should explain to the client that in order for a no-contest clause to be effective, a bequest must be made to the potential contestant in an amount that is large enough to discourage a Will contest, but small enough so that it does not disrupt the client's overall estate plan. For most clients this is a difficult decision, but it is a judgment call the client must make. However, if a contest is likely, then the potential contestant should be provided some type of incentive not to challenge the client's estate plan.

2. **Prohibited Actions** - As pointed out by John Hopwood in his excellent article cited in the bibliography, "one of the tactics frequently used to avoid the application of an in terrorem provision is to frame the litigation as being something other than a direct contest." These actions by a potential beneficiary/contestant might be in the form of a declaratory judgment action asking whether a contemplated lawsuit would cause forfeiture or, for example, a lawsuit against a favored beneficiary for tortious interference with inheritance rights. Accordingly, as John Hopwood suggests, the attorney should consider drafting the no-contest clause in a manner that it would be triggered if any such

disguised action is brought by a beneficiary. The attorney should also consider whether or not to attempt to cause forfeiture for actions brought by a beneficiary in good faith and with probable cause. However, it is not clear whether provisions drafted in this manner will be enforceable.

3. **Avoid Unduly Broad Provisions** - In drafting no-contest clauses, the attorney should be careful that the provisions are not so broad as to preclude beneficiaries from seeking relief for legitimate grievances, such as serious breaches of fiduciary duty by the executor, etc.... Unduly broad provisions of a no-contest clause might be held to be punitive and against public policy and therefore not enforceable.

4. **Additional or Alternative Provision** - As discussed in part III.L. of this article, consideration should be given to including a provision in the Will or trust agreement allocating all litigation expenses against any contestant's share or bequest and, in addition, providing that the contestant cannot be reimbursed for such expenses from the estate or trust. Such a provision could serve as an additional deterrent to a challenge of the instrument or as an alternative to a no-contest clause.

5. **Combine No-Contest and Arbitration Provisions** - In his article, John Hopwood discusses a suggested combination of a no-contest clause with arbitration or ADR provisions. "The general idea would be to require that any controversy within the scope of the in terrorem provision would be required to be submitted to the arbitration or ADR process before being filed in any court. Failure to file the arbitration/ADR procedure would be deemed a violation of the in terrorem provision regardless of the outcome of the litigation." John Hopwood points out a number of potential advantages of such a combined provision e. g.- could be as broad as the client desires, could include confidentiality requirements and limits on recovery, etc.); however, he also points out that it is unknown whether such a provision would be enforceable by a court.

V. CONCLUSION

In the litigious society we live in today with frequent second marriages, we, as estate planners, will be faced with more and more client situations where Will contests are likely. Accordingly, it is important for all of us to recognize those situations at the outset and to be able to implement effective measures to prevent and/or defeat actions taken by displeased beneficiaries or contestants to disrupt our clients' estate plans.

VI. PARTIAL BIBLIOGRAPHY

Beyer, Dickinson and Wake, “The Fine Art of Intimidating Disgruntled Beneficiaries with In Terrorem Clauses,” 51 SMU L. Rev. 225 (1998).

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Horrigan and Stanfield, “Preparing to Try a Will Contest,” State Bar of Texas 1994, Advanced Estate Planning and Probate Course, Tab M.

Johanson's Texas Probate Code Annotated, West Group Publishing Company, 2002 Edition.

EXHIBIT "A"

PERSONAL PROPERTY DIVISION AND DISTRIBUTION SCHEDULE

1. **Special Bequests**. Certain items of personal property have been enumerated by ________________ (hereinafter referred to as the "Decedent") in her letter to her children, dated August 9, 1979 (the "Special Bequests Letter"). A copy of the Special Bequests Letter is attached to this Schedule as Exhibit "A" and incorporated herein for all purposes. The items of personal property, which are specifically set forth in the Special Bequests Letter, shall be immediately distributed directly to the intended recipients in accordance with the terms of the Special Bequests Letter, and the monetary value of the foregoing items of personal property, if any, shall not be charged to such recipient(s). The items of personal property which are set forth in the Special Bequests Letter are identified as follows on the Appraisal Report of ______________________ or are otherwise described below:

(A) Special Bequest Item #1 for _____________ is located either (i) among the items of personal property which have not been inventoried or (ii) among items of personal property which have been grouped together with other items of personal property in a lot or is missing.

(B) Special Bequest Item #2 for _____________ is located either (i) among the items of personal property which have not been inventoried or (ii) among items of personal property which have been grouped together with other items of personal property in a lot or is missing.

(C) Special Bequest Item #3 for _____________ is located either (i) among the items of personal property which have not been inventoried or (ii) among items of personal property which have been grouped together with other items of personal property in a lot or is missing.

(D) Special Bequest Item #4 for _____________ is located among the items of personal property which have not been inventoried.

(E) Special Bequest Item #5 for _____________ is listed as Appraisal No. 31 (C).

(F) Special Bequest Items listed as #6 for _____________ were not individually inventoried and remain at the Decedent's house in ____________, Houston, Texas.

(G) Special Bequest Item #7 for _____________ is located either (i) among the items of personal property which have not been inventoried or (ii) among the items of personal property which have been grouped together with other items of personal property in a lot or is missing.

(H) Special Bequest Item #1 for _____________ is in _____________'s possession.

(I) Special Bequest Item #2 for _____________ is located either (i) among the items of personal property which have not been inventoried or (ii) among the items of personal property which have been grouped together with other items of personal property in a lot or is missing.

(J) Special Bequest Item #3 for _____________ is in _____________'s possession.

(K) Special Bequest Item #4 for _____________ is listed as Appraisal No. 120.

(L) Special Bequest Item #5 for _____________ is listed as Appraisal No. 33.

(M) Special Bequest Item #6 for _____________ is listed as Appraisal No. 26.

(N) Special Bequest Item #1 for _____________ is located either (i) among the items of personal property which have not been inventoried or (ii) among the items of personal property which have been grouped together with other items of personal property in a lot or is missing.

(O) Special Bequest Item #2 for _____________ is in _____________'s possession.

(P) Special Bequest Item #3 for _____________ is listed as Appraisal No. 142.

(Q) Special Bequest Item #4 for _____________ is listed as Appraisal No. 32.

(R) Special Bequest Item #5 for _____________ is in _____________'s possession.

(S) Special Bequest Item #6 for _____________ is listed as Appraisal No. 65.

2. **Photographs and Documents**. Estate photographs, slides ("Photos") and all original Documents shall be turned over to the Administrator on or before Wednesday, March 1, 2000, at the Administrator's office, which is located at 333 Clay Street, Suite 3300, Houston, Texas 77002-4499. Photos and Documents shall not be inventoried or appraised and any Photos

(including frames) which are listed in the Appraisal Report shall not be considered as part of the Appraisal Report for distribution purposes, but shall be divided among the Heirs as follows:

(A) Photos depicting a single Heir and/or the children and/or spouse of such Heir shall be given by the Administrator to such Heir (where no other Heir and no other Heir's children or spouse is depicted).

(B) All Photos not covered by paragraph A above and all original Documents shall be made available to the Heirs for viewing at the offices of the Administrator and each Heir shall be given a reasonable period of time (expiring Wednesday, March 22, 2000) to make selections. All such Photos and Documents shall be allocated and distributed among the Heirs by the Administrator as follows:

(1) Photos and Documents desired by only one Heir shall be given to that Heir.

(2) Photos and Documents desired by more than one Heir shall be distributed among the requesting Heirs so that each Heir receives an equal number of such original Photos and Documents (to the extent practicable); and as to such Photos and Documents, the Estate shall, at its expense, make and furnish quality reproduction copies of such Photos and Documents to each requesting Heir who did not receive the original and desires a copy.

3. Visitation & Selection

(A) Each Heir will be granted a reasonable period of time to inspect the items of personal property which belong to the Decedent's Estate, which are currently located at the Decedent's house in Houston, Texas; however, each Heir's inspection must be completed on or before Wednesday, March 15, 2000. Each Heir must contact the Administrator to schedule their respective inspection on or before Monday, March 13, 2000. Each Heir's inspection will be supervised by the Administrator or his agent.

(B) Each Heir will prepare a list of items of personal property that he/she desires to inherit ("Initial List") from the Decedent's Estate. This Initial List will include a complete description of the items of personal property, the item numbers (as used by the Appraisal Report), and any other tag numbers that may be required to uniquely identity items of personal property (see below). The Heirs may

photograph the items of personal property (at his/her expense) and include a copy of the photographs with his/her Initial List if he/she so chooses.

(1) If an Heir wishes to include an item of personal property in his/her Initial List which is not inventoried in either of the Appraisal Reports which was prepared by __________________, then the Heir must attach a tag which bears a unique number to that item of personal property which was not included in the foregoing Appraisal Report.

(2) If an Heir wishes to include a single item of personal property in his/her Initial List which is part of an appraised lot, then the Heir will attach a tag to the single item of personal property he/she wishes to receive that includes both the original appraisal number and a unique item number.

(3) If the desired item of personal property has been previously tagged by another Heir, the item should not be retagged. Instead, the Heir should use the tag number(s) appearing on the previously affixed tag.

(4) The Administrator will furnish each Heir with forms for the Initial List and uniquely numbered tags prior to his/her visit to the Decedent's house.

(5) The items of personal property appearing on the Initial List which is submitted by each Heir may appear in any order.

(6) The items of personal property which are specifically set forth in the Special Bequests Letter shall not be included in each Heirs' Initial List since these items of personal property will be distributed pursuant to the terms of that letter (which is attached hereto as Exhibit "A")(See section 1 above). If an Heir locates an item of personal property which is missing from the Appraisal Report which were prepared by _______________, he/she should promptly tag such item, notify the Administrator, and provide a photograph of such item to the Administrator, if possible.

(C) Each Heir shall submit his/her Initial Lists of desired items of personal property to the Administrator on or before Wednesday, March 22, 2000 at 5:00 p.m. Once the Administrator has received all Initial Lists of desired items of personal property, he shall prepare a Master List of all items of personal property desired by the three (3) Heirs and assign a value to each item of personal property requested by the Heirs. The Master List shall not specify which Heir selected the items of personal property appearing on the Master List.

(1) The items of personal property on the Master List will be valued based on the following procedures:

(a) If the value of a specific item of personal property is set forth in the Appraisal Report which has been prepared by __________________, then that value shall be used.

(b) If an item of personal property is part of a lot which was appraised by ________________, then the value shall be determined by taking the total value of the lot, as set forth in the foregoing Appraisal Report, and dividing by the number of items in the lot.

(c) If an item of personal property is not included in either of the Appraisal Report which was prepared by _________________________, then the Administrator shall in his sole discretion assign values to that item of personal property which is not listed in the Appraisal Report.

(2) The Administrator shall distribute the entire Master List to each Heir no later than three (3) business days following the date the Administrator receives an Initial List from each Heir.

(3) Items of personal property which are not enumerated in the Special Bequest Letter and items of personal property which are not included in the Master List shall be immediately disposed of by the Administrator pursuant to the provisions set forth in Paragraph 5 below.

(D) Each Heir shall prepare a Final List of items of personal property that he/she wishes to inherit by selecting items from the Master List. The Final Lists must be submitted to the Administrator within ten (10) business days of the date each Heir receives the Master List from the Administrator.

(1) Only items appearing on the Master List can be selected for the Final List; however, an item can be placed on an Heir's Final List even if it was not included in that Heir's Initial List.

(2) The items on each Heir's Final List must be ranked in order of preference (1st choice to last choice).

(3) Each Heir will choose two (2) numbers within the range of 0 - 99 and write these numbers on the spaces provided on the Final List form. One number will be designated first choice and the other as second choice. These numbers will be used to assign the order of selection.

(4) The form for preparing the Final List and selecting the two (2) numbers will be provided by the Administrator.

(5) Once the Administrator has received a Final List from each Heir, he will send copies of all three (3) Final Lists and "order of selection" numbers to each Heir.

(E) The Administrator shall select a Distribution Date and shall notify all heirs of this date at least three (3) business days prior to such Distribution Date.

(1) The method of distribution for items of personal property which belong to the Decedent's Estate shall be as follows:

(a) Any item of personal property which is selected by only one Heir shall be distributed to that Heir.

(b) All items of personal property which are selected by more than one Heir shall be distributed by a round robin process.

(c) In turn, each Heir will be awarded the item of personal property that appears highest on his/her Final List that has not already been distributed.

(d) This process will continue until all items of personal property appearing on the combined Final Lists have been distributed.

(2) No heir will be awarded an item of personal property that did not appear on his/her Final List.

(3) The "order for selection" will be as follows:

(a) The Heir choosing a number (first choice) closest to the final two (2) digits (to the left of the decimal point) of the Dow Jones Industrial Average ("DJA") for the business day preceding the Distribution Date shall select first, the Heir making the second closest choice shall select second; and the Heir selecting the number furthest away from the DJA number will select third.

For example, if X chooses 45, Y chooses 21, and Z chooses 88 and the DJA closes at 11,185.23, then Z chooses first because 88 is the closest number to 85. Conversely, X chooses second and Y chooses last.

(b) If numbers selected by two (2) Heirs tie, then their second choice of numbers will be used to break the tie. For example, if X and Y are tied for 2nd and 3rd choice, then the second number closest to the final two (2) digits of the DJA will be used. In this example, Z will still make the first selection regardless of his/her choice of a second number.

(4) Within five (5) business days following the date the selection process has been completed, the Administrator will inform each Heir of the items of personal property and corresponding values that he/she has inherited and the items of personal property and corresponding values that the other heirs have inherited.

4. **Removal of Personal Property**. All items of Personal Property allocated to an Heir shall be removed from their locations by such Heir within twenty-one (21) days following the date each Heir is informed by the Administrator of the items of personal property that he/she

has inherited from the Decedent's Estate. All expenses associated with the removal of personal property from the Decedent's house in Houston, Texas shall be paid solely by the party incurring the same. Under no circumstances shall the Estate be responsible for any Heirs' moving costs. The Heirs shall coordinate pick-up with the Administrator and the Heirs can only schedule one (1) day to pick up their personal property.

5. Unselected Items. All Items which are not selected during the process detailed above shall be disposed of in one of the following manners:

(A) The Administrator shall decide in his sole discretion which items will provide additional funds to the Estate by being consigned for sale. The Administrator shall decide in his sole discretion the location for such consignment sale.

(B) All remaining items not sold by consignment shall be donated in the name of the Decedent's Estate to the Salvation Army or any other charitable organization which both wants and has the facilities to process the amount of items to be donated. Donations can be split between charitable organizations at the Administrator's sole discretion.

6. Final Report of the Administrator. After the above distribution and allocation process has been completed, the Administrator shall issue a Final Report to each Heir. The Final Report shall contain the following information:

(A) A complete description of all items of personal property distributed to each Heir (e.g.-by tag number and appraisal amount) by the Decedent's Estate; and

(B) a list of the items of personal property consigned to and sold by or donated to the Salvation Army or any other charitable organization, including the total value of such sale or donation.

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[1] Mr. Walters is with Kormeier & Walters, L.L.P. in Houston, Texas
[2] Mr. McCulloch is with MacIntyre & McCulloch, L.L.P. of Houston, Texas
[3] For a real life example of just how contentious and ludicrous the division and distribution of nominally valued personal property can become in a situation where an unmarried decedent left her entire estate to her only three (3) children, please see the personal property distribution schedule which is attached to this article as Exhibit "A". To fully appreciate the attached Exhibit, please be advised that all three (3) of the decedent's children were represented by counsel.

FATCA and FBAR Reporting Obligations: Will the Benefits Outweigh the Burdens?

By: *Heather C. Panick*[1], *Esq.*

Motivated by the global initiative to identify monetary transactions facilitating terrorism and the bleak status of the U.S. economy, laws are being passed which are aimed at identifying and pursing areas of foreign monetary transactions and assets, and mechanisms for tax avoidance. Foreign accounts owned by U.S. citizens are one kind of target, as these accounts are perceived to be potential offshore tax evasion devices and mechanisms for potential terrorist activities. IRS Commissioner Doug Shulman has stated that the U.S. government is getting very serious about rooting out offshore tax evasion.

To demonstrate the government's push to eliminate offshore tax evasion, U.S. taxpayers now have two separate and distinct foreign account/asset reporting obligations: 1) the Foreign Bank Account Reporting ("FBAR") obligation; and 2) the Foreign Account Tax Compliance Act ("FATCA") obligation. FATCA was enacted as part of the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. 111-47) of 2010 and implements additional disclosure requirements for U.S. taxpayers and foreign financial institutions ("FFI"). With respect to foreign asset and account reporting, under the governing laws and regulations, it is possible for a U.S. taxpayer to have a filing obligation under both provisions, or to only have a reporting obligation under FATCA. Therefore, U.S. citizens, and tax advisors, need to tread carefully when determining what kind of filing obligations apply to them.

A FBAR disclosure is filed by a U.S. person using the Form TD F 90-22.1 and is filed with the Treasury Department by June 30 each year. This disclosure is generally required to be filed by a U.S. person with a financial interest, signatory authority or other authority over foreign

accounts, including bank, securities, cash value insurance policy, annuity, or other types of financial accounts in a foreign country, if at any point during the calendar year the aggregate value of all such foreign accounts over which such U.S. person had authority equaled or exceeded $10,000.

The definition of a U.S. person includes citizens, residents of the U.S. or an entity, including but not limited to a corporation, partnership, trust or limited liability company, created, organized or formed under the laws of the United States. The terms "financial interest" is defined as being the owner of record or holder of legal title and signature authority is defined as the authority of the individual (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account.

Individuals need to be aware that the reporting obligation is not only applicable to an individual who owns or has a financial interest in a foreign account, but also to an individual who has signature authority in a foreign financial account. Therefore, an employee who has signature authority over their employer's foreign financial account, i.e. bank account, retirement plan account, security account, etc., has a FBAR filing obligation, even though they do not have any ownership interest in the foreign financial account. These individuals need to be aware of the filing obligation or they will be vulnerable to the applicable failure to disclose penalties. The FBAR reporting obligation may extend for some period even after the employee has separated from employment.

Section 511 of FATCA created the new Internal Revenue Code section 6038D, which requires individual U.S. taxpayers with specified foreign accounts and assets with an aggregate value exceeding $50,000[2] on the last day of the tax year, or $75,000 at any time during the year, to report the asset values on Form 8938 and attach the form to their individual tax return.

Individuals are considered to have an interest in an account if any income, gains, losses, deductions, gross proceeds, or distributions from holding or disposing of the account are or would be required to be reported or otherwise reflected on the individual's tax return.

The individual reporting requirement applies to U.S. citizens, resident alien of the U.S. for any part of the year, a nonresident alien who elects to be treated as a resident alien for purposes of filing a joint tax return, and a nonresident alien who is a bona fide resident of American Samoa or Puerto Rico. Furthermore, a specified foreign asset is defined as any financial account maintained by a foreign financial institution, stock or securities issued by someone other than a U.S. person, any interest in a foreign entity, and any financial instrument or contract that has an issuer that is a non-U.S. person. This reporting obligation commences with the income tax return filed for the 2011 tax year. Employees who own stock options, restricted stock or phantom stock in a foreign parent corporation as a consequence of their compensation packages may be surprised to learn that they must disclose these types of interests on their individual tax returns.

FATCA further requires foreign financial institutions ("FFI")[3] to report information regarding financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest, to the Internal Revenue Service. FATCA imposes a 30% withholding requirement on all withholdable payments to FFIs from non-effectively connected U.S. source income, including gross proceeds from the sale of assets that produce U.S. source interest or dividends. This withholding rule applies to whether the beneficial owner is a U.S. or non-U.S. person, regardless of whether the payment is subject to U.S. tax and whether the foreign entity is the beneficial owner.

In order for FFIs to escape the 30% withholding requirements, the FFI must enter into an agreement with the IRS to identify and report on U.S. accounts, withhold payments to other FFIs that have not entered into an agreement with the IRS, and withhold on payments to account holders that may or may not be U.S. persons, but do not provide appropriate documentation.

Under the proposed regulations, FFIs must review new accounts upon opening and identify U.S. connections. Pre-existing accounts with a balance of $50,000 or less, and insurance contracts less than $250,000, are exempt from review. Accounts with a balance less than $1 million are permitted to have an electronic review, but accounts with a balance exceeding $1 million are subject to an electronic and paper audit.

Furthermore, the proposed regulations establish the following compliance deadlines: identification of accounts begins in 2014 (for calendar year 2013), reporting of income begins in 2016 (for 2015 income) and full reporting begins in 2017 (for 2016 calendar year).

In addition to the heightened reporting and disclosure obligations, the penalties for failing to make the necessary disclosures have also increased. The penalties for failing to file the Form TD 90-22.1, disclosing a foreign bank account, are intended to deter taxpayers from ignoring the foreign bank account reporting obligation. Civil penalties for a non-willful violation can reach up to $10,000 per violation and civil penalties for willful violations can range up to the greater of $100,000 or fifty- percent of the amount in the account at the time of the violation.

In addition to the steep civil penalties, there are also criminal penalties that may be imposed. These penalties can range from a $500,000 fine to 10 years in prison, or both. These penalties are not mutually exclusive, so taxpayers may fact civil and criminal penalties for failing to report a foreign bank account interest.

While not as severe as the penalties for failing to disclose an interest in a foreign bank account, the FATCA penalties can still be significant. In an effort to further increase compliance with FATCA, Section 511 of the Act amended IRC §6662 to add a 40% penalty on any portion of an underpayment attributable to an undisclosed financial asset that should have been reported under section 6038D. In addition, there is a minimum penalty of $10,000 for failing to submit the required disclosure with the tax return, and it increases by $10,000 for each 30 day period following notification from the Treasury Department. Taxpayers need to be aware that there is a presumption that a taxpayer will a "specified foreign financial asset" has a filing obligation for purposes of penalty assessment, if the IRS believes the taxpayer has a reportable interest and the taxpayer has not provided sufficient evidence to show that the aggregate value was less than the threshold.

The silver lining to the failure to disclose penalty is that there is a reasonable cause exception that is available if the taxpayer can demonstrate that they had reasonable cause for failing to disclose their accounts.

Taxpayers should be aware that they could be penalized under both the FBAR reporting obligations and FATCA obligations for the same transaction. Therefore, it is imperative that taxpayers take all steps necessary to ensure that all necessary disclosures have been made.

In addition to the heightened reporting requirement and additional penalties, FATCA also expands the applicable statute of limitations period. As a general rule, the IRS has three years from the filing of a return to audit a taxpayer and assess additional taxes. However, under FATCA, the period is increased to six years if the taxpayer omits 25% or more of gross income or omits more than $5,000 of income attributable to one or more assets required to be reported

under §6038D. See Code §6501(e), as amended. In addition, the statute of limitations period does not begin until the required information has been reported to the IRS.

Under this rule, if a U.S. taxpayer, who's foreign financial assets exceed the applicable threshold, fails to file their report under §6038D for tax year ended 2012 until 2018, the statute of limitations period does not begin to run until 2018. Therefore, the IRS would have until 2024 to audit and assess additional taxes and penalties against the U.S. taxpayer.

It is not hard to imagine the concerns and controversy that have arisen due to the passage and increase in enforcement of the FBAR and FATCA reporting obligations. Not only do these laws effect taxpayers living in the United States, but the laws impose onerous reporting obligations on U.S. citizens living abroad as well as foreign financial institutions.

There has been considerable outrage by U.S. citizens living abroad and foreign nationals working in the U.S. to the increased FBAR penalty enforcement as well as the passage of FATCA. U.S. citizens living abroad are concerned about the increased disclosure obligations, the cost of hiring an accountant or attorney to assist them with compliance efforts as well as the additional reporting burdens that are placed on their FFIs and whether the laws will impede the citizen's ability to open accounts in the foreign nation in which they are living. It is reported that these obligations have caused an increase in the number of U.S. citizens living abroad to renounce their citizenship to avoid the banking and disclosure issues. Foreign nationals are also concerned about the complex tax compliance obligations in the U.S., as well has the burden of having to disclose their personal bank accounts in their home country on U.S. tax returns.

In addition to the individual costs associated with the heightened disclosure and reporting obligations, it has been estimated that the costs for FFIs to become compliant with the FATCA will be in the hundreds of millions. It is this cost that has caused the IRS to propose regulations

that will implement each FATCA reporting requirement in stages. However, the imposition on FFIs is not only monetary, but in many cases also conflicts with the privacy laws of the foreign country. In this situation, FFIs are forced to either comply with FATCA or close the U.S. owned accounts. Critics of FATCA are concerned that the reporting obligations on FFIs will cause many FFIs to stop doing business with U.S. customers, and this will ultimately have a negative effect on our economy. Only time will tell whether this prediction will come true and FFIs will cease to do business with U.S. customers.

In order to work with foreign countries and their privacy laws, currently there are discussions among the U.S., France, Germany, Italy, Spain and the United Kingdom to possibly form an intergovernmental approach where the government would enter into an agreement to require FFIs to identify and report on U.S. accounts and pass the information on to the IRS. If this intergovernmental approach is developed then the need for FFI agreement with the IRS will be eliminated, FFIs won't have to withhold payment to FFIs in other countries, there will be no withholding on payments to account holders who do not provide identifying information and no obligation to close accounts where account holders are reluctant to disclose information.

It is too soon to tell whether the passage and enforcement of the FBAR and FATCA provisions will benefit the U.S. economy or ultimately be a significant burden to those with the requirements and cause a backlash in the economy.

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[1] Heather Panick is an attorney with the law firm of Jackson Lewis LLP, Houston, Texas.
[2] There are higher threshold amounts for married individuals filing jointly and individuals living abroad.
[3] FFI is defined as a foreign entity that accepts deposits in the ordinary course of the banking business; holds financial assets for the account of others as a substantial portion of its business; or is engaged or holds itself out as being engaged primarily in the business of investing, reinvesting of trading securities, partnership interests or commodities.

Overview of the Petroleum Industry Positions Relative to Oil Industry Tax Issues in the Federal FY2013 Budget Proposal

By: Bill Smalling, LL. M., Esq.[1]

Summary

The President’s FY2013 budget proposes to eliminate various tax exemptions and credits that benefit the oil and natural gas industries. Those backing these exemptions and credits view them as comparable to those affecting other industries. Opponents of the tax expenditures see them as subsidies to a profitable industry the government cannot afford. Also, opponents see the exemptions as impediments to the development of clean energy alternatives.[2]

The FY2013 budget proposal calls these proposals a termination of tax preferences, which would potentially increase the taxes paid by the oil and natural gas industries. Independent producers would share a large percentage increase of this tax burden. The specific actions include repeal of the enhanced oil recovery and marginal well tax credits, repeal of the current expensing of intangible drilling costs provision, repeal of the deduction for tertiary injectants, repeal of the passive loss exception for working interests in oil and natural gas properties, elimination of the manufacturing tax deduction for oil and natural gas companies, increasing the amortization period for certain exploration expenses, and repeal of the percentage depletion allowance for independent oil and natural gas producers. Also, a variety of increased fees and other charges that would generate more revenue for the Department of the Interior (―DOI”) are included in the budget proposal.[3] The American Petroleum Institute (―API”) recognizes a number of other proposed tax changes that would affect the oil industry. These changes include the repeal of the last-in-first-out (―LIFO”) accounting method, increasing the Oil Spill Liability Trust Fund taxes, reinstating Superfund taxes, and modifying the Dual Capacity Rule.[4]

The tax changes, as outlined in the President’s budget proposal, would provide $38.56 billion in additional total revenues over the period FY2013 to FY2022. If enacted, the changes would also reduce the tax advantage of independent oil and natural gas companies over the major oil companies and they would also raise the cost of exploration and production. Potentially the result would be higher consumer prices and a reduction in the current increasing domestic production.[5] Changing the LIFO provision could raise $78.3 billion in total revenues over the period FY2013 to FY2022, with $25.8 billion coming from the oil and natural gas industries.[6]

The tax changes proposed would increase tax collections from the petroleum industries. These proposals likely would decrease exploration, development, and production. Consumer prices and possibly the nation’s dependence on foreign oil would be increased. The changes would, on the other hand, eliminate some tax preferences that have favored the oil and natural gas industries over other energy sources. These tax exemptions have made petroleum products artificially inexpensive, with consumer cost held below the true cost. At the risk of oversimplification, companies headquartered outside the United States, such as BP, Shell and Total might consider the proposals ―revenue neutral”, because any revenue lost in the U.S. would be offset by revenue gains outside the U.S. In the author’s opinion, with gasoline hovering around four dollars a

gallon, the Administration and Congress will approach carefully anything that further raises gasoline prices.

<u>Discussion of the FY2013 Budget Proposal</u>

Repeal Enhanced Oil Recovery Credit

The enhanced oil recovery (―EOR”) credit is a credit of 15% of allowable costs associated with the use of oil recovery technologies, including the injection of carbon dioxide, to supplement natural well pressure. This enhances the production from older wells. However, the EOR credit is only available during periods of low oil prices, as determined on a year by year basis. Due to high oil prices, the EOR credit has not been in effect over the past several years. Therefore, elimination of the credit would have any effect on current oil production, because oil prices are predicted to remain high. The paradox of this credit is that during phases of low oil prices are usually caused by excess supply in the market. During excess supply periods, it is not likely that keeping up higher cost, low-production wells is an effective strategy for oil companies. While prices are low, revenues from these wells are unlikely to cover operating costs. Nevertheless, in periods of low prices, the credit could provide the margin that keeps these wells in production.[7]

Petroleum Industry Response to this Proposal: Section 43 of the Internal Revenue Code provides the EOR credit. Treasury Regulation guidelines for the Section 43 tax credit are very narrow, generally including only expensive EOR processes, many no longer in use. It excludes many EOR processes that are the result of technological advances now considered common in the industry. Additionally, the EOR credit phases out as the reference price of oil exceeds an annually adjusted threshold. For the 2008 tax year, the threshold price was $41.06 and the reference price was $66.52 based on 2007. The EOR tax credit has served the country well by encouraging the development of expensive oil reserves when prices would make them uneconomic. It can continue to do so as a safety net against low prices in the future. Additionally, one of the EOR technologies in use is carbon dioxide (―CO_2”) injection. This injection also serves as a mechanism to sequester CO_2 – a component of efforts to diminish atmospheric greenhouse gases. There is no budget benefit to repealing the EOR tax credit while the consequences could result in lost oil production and lost opportunities to sequester CO_2.[8]

Repeal Credit for Oil and Gas from Marginal Wells

In 2004, Congress enacted an Independent Petroleum Association of America (―IPAA”) advocated Marginal Well Production Tax Credit amendment to the Internal Revenue code that established a tax credit for existing marginal wells.[9] This provision’s purpose is to keep low producing oil and gas wells in production during periods of low prices. The tax credit helps to maximize U.S. production levels even during low world prices for oil and gas. Up to 20% of U.S. oil production and 12% of natural gas production might be generated from marginal wells. The credit has not been utilized because market prices have been high; therefore, application of the credit has not been required. If prices remain high or if the United States transitions to alternative energy sources, the credit is not likely to be a critical factor. High-cost wells that fall into the marginal category are likely to be eliminated anyway even if the credit were maintained.[10]

Petroleum Industry Response to this Proposal: The provision allows a $3per barrel tax credit for the first three barrels of daily production from an existing marginal oil well and a $0.50 per million cubic feet (―Mcf”) tax credit for the first 18 Mcf of daily natural gas production from a marginal well. The tax credit is in and out in equal increments as prices for oil and natural gas fall and rise. Prices triggering the tax credit are based on the annual average wellhead price for all domestic crude oil and the annual average wellhead price per 1,000 cubic feet for all domestic natural gas. The credit for the current taxable year is based on the average price from the previous year. The phase in and out prices are as follows:

Oil: Phase in/out between $15 and $18 per barrel.
Gas: Phase in/out between $1.67 and $2.00 per Mcf.

For producers without taxable income for the current tax year, the amendment provides a five year carryback provision allowing producers to claim the credit on taxes paid in those years. A principal recommendation of the National Petroleum Council's *Marginal Wells* report was the creation of a countercyclical marginal well tax credit. The Department of Energy has evaluated the benefits of a tax credit and believes that it could prevent the loss of 140,000 barrels per day of production if fully employed during times of low oil prices like those of 1998 and 1999. This countercyclical credit established a safety net of support for these critical wells. Eighty-five percent of all U.S. oil wells are marginal wells and provide 20 percent of U.S. oil production. Seventy-four percent of all U.S. natural gas wells are marginal wells. These well produce 12 percent of U.S. natural gas production. The API opposes removal of this important safety net for U.S. production.[11]

Repeal Expensing of Intangible Drilling Costs

Included in the federal tax code since 1913, intangible drilling costs (―IDC”) are necessary for the drilling of an exploratory well or the development of a well for production. IDCs cover the ground clearing, draining, surveying, wages, repairs, supplies, drilling mud, chemicals, and cement required to initiate drilling or to develop a well. Permitting the current-year expensing of these costs attracts capital to what has been a high risk investment. Expensing enables a faster return of invested funds through reduced tax payments. The risk associated with finding oil has been reduced by using advanced technology, including three-dimensional seismic analysis and advanced horizontal drilling techniques. These technological advances make expensive ―dry holes” less likely, while expanding the physical range of exploration and production activities available from a drilling rig.[12] Currently, the full expensing of IDCs is available to independent oil producers. Since 1986, major integrated oil companies have expensed 70% of their IDCs. The remaining IDCs are capitalized over a 60-month period. The FY2013 budget proposes to repeal both the direct expensing and the capitalization requirements. Generally applicable accounting procedures (―GAAP”) for cost recovery would be substituted for expensing.

The repeal of the expensing of IDCs provision is estimated to yield $13.9 billion in revenue over the decade from 2013 to 2022. Drilling budgets impacts are likely to be determined by the effect of increased taxes in conjunction with the price of oil. That is, if the price of oil were to be around the $40-per-barrel range, the burden of additional tax expense could reduce drilling

activity. However, if the price of oil remains above $100 per barrel, coupled with political unrest in the Middle East, the additional tax expense is likely to have little or no effect on oil development activity.[13]

Petroleum Industry Response to this Proposal: In response to a similar tax proposal in the FY2010 federal budget proposal, the IPAA estimated that the tax change would result in an initial year reduction in investment in U.S. oil development of about $3 billion.[14] IPAA's estimated reduction in oil development spending implied an almost dollar-for-dollar relationship between higher taxes and reduced investment. Little empirical evidence for the estimate was provided. The effect of the elimination of the expensing of intangible drilling costs in FY2012 was estimated by IPAA to result in an almost immediate one-third reduction in drilling budgets.[15]

According to the API, despite great advances in technology, drilling a well is the only means of determining with absolute certainty the presence of hydrocarbons in reservoir rock or sand. When companies drill they incur intangible drilling costs, which are costs that cannot be recovered, such as site preparation, labor, engineering and design. These intangible costs associated with drilling a well usually represent 60 to 80 percent of the cost of the well. Other businesses are able to expense the costs of creating potential new products and services (for example, research and development in the pharmaceutical industry). At the same time, Congress is considering completely repealing the expensing of IDCs only for the US oil and gas industry. These rules only apply to costs incurred in the US and therefore only impact US oil and gas production – thus making the US less competitive with foreign operations. IDC are a necessary and significant cost of oil and gas exploration and production. These costs represent the industry's research and development (―R&D") costs that must be spent in the pursuit of finding new business opportunities.[16]

According to a Wood Mackenzie study, repealing the deduction would discourage domestic investment and likely result in less revenue to the government and greater dependence on foreign oil. This, along with other proposed tax changes, could result in:

1. A potential loss of 600,000 barrels per day of domestic production,
2. Estimated $15 billion in capital is at risk in 2011 alone and almost $130 billion over the next ten years,
3. In the first year of tax changes, approximately 1% of oil and 5% of natural gas production is expected to be lost,
4. An estimated loss of 10 to 20% of expected total upstream spending in the US each year.

According to the Department of Energy, U.S. based oil and gas companies spend more than double to produce oil and gas domestically, compared to the cost of production overseas. Additionally, nearly half of the US offshore exploration wells drilled are classified as dry holes.[17]

API follows this up by stating that restrictions on expensing intangible drilling costs make domestic exploration more expensive. This discourages new domestic oil and natural gas exploration and undermines America's energy security. New investment in domestic energy is critical to meeting future energy demand, boosting U.S. energy security and protecting jobs.

According to the Department of Energy, U.S.-based oil and gas companies spend about $70 to explore for and produce each barrel of oil or equivalent of natural gas in the U.S. offshore. That compares with less than $30 a barrel spent to explore for and produce abroad. Favorable tax treatment for domestic exploration will help keep the cost of domestic projects competitive with foreign alternatives. Eliminating or further restricting the ability to expense intangible drilling costs would eliminate many marginal domestic projects and would render some of the costly by high yield domestic projects unattainable. Repealing the deduction would discourage domestic investment and likely result in less revenue to the government, fewer U.S. jobs and greater dependence on foreign oil.[18]

ExxonMobil contends that IDCs enable U.S. oil and natural gas companies to continue exploring for and producing domestic resources, which provide significant revenue to federal and state governments. In fiscal year 2010, the Department of the Interior's Office of Natural Resources Revenue (―ONRR") disbursed a total of $9.1 billion in royalties from onshore and offshore energy production. While the U.S. Treasury received $4.5 billion, more than $1.8 billion was distributed to 34 states, and 34 American Indian Tribes and 30,000 individual Indian mineral owners received $407 million. The current treatment for IDCs is hardly a special rule for oil and gas. It is consistent with the full deductibility of R&D expenses currently available to all taxpayers and is exactly how development costs for all other natural resources are treated. Repealing the deductibility of IDCs will necessarily force U.S. energy producers to curtail exploration budgets, leading to less domestic production, the loss of U.S. jobs, and increased imports.[19]

Repeal Tertiary Injectants Deduction

Tertiary injection expenses and material cost can be fully deducted in the current tax year. The favorable current tax treatment of these expenses assists the maintenance of the output of older wells. A less favorable tax treatment of the tertiary injection expenses would be likely to reduce oil output from older producing fields during periods when the profit margin of oil is low. During high oil price periods, the repeal is likely to have a smaller effect on production levels.[20]

Petroleum Industry Response to this Proposal: According to the API, changing how these costs are recovered could force producers to shut in older fields, which would significantly impact local economies. In addition, this deduction supports using carbon dioxide in enhanced oil recovery projects, one of the primary methods by which carbon dioxide is stored to prevent its release into the atmosphere.[21]

Repeal Passive Loss Exception for Working Interests in Oil Properties

Repeal of the passive loss exception for working interests in oil and natural gas properties is a relatively small item in terms of tax revenues, estimated at $82 million from FY2013 to FY2022. The provision exempts working interests, investments, in gas and oil exploration and development from being categorized as ―passive income (or loss)" with respect to the Tax Reform Act of 1986. This categorization permits the deduction of losses in oil and gas projects against other active income earned without limitation, and are believed to act as an incentive to induce investors to finance oil and gas projects.[22]

Repeal Percentage Depletion Allowance

The practice of deducting from an oil company's gross income a percentage value is percentage depletion (―depletion"). Depletion in the current law is 15% and represents, for tax purposes, the total value of the oil deposit that was extracted in the tax year. Depletion has a long history, dating back to 1926. Depletion's purpose is to provide for the oil industry equivalent to business depreciation of assets. Depletion's theory is that capital equipment in traditional manufacturing and oil deposits are ―wasting resources" in the sense that they both require capital investment to generate an income stream. The assets will eventually become nonproductive. Depreciation is applied against the investment in capital equipment, and depletion is applied to the value of oil deposits as a way to recover initial investments.

Currently, depletion is limited to domestic U.S. production by independent producers, on the first 1,000 barrels per day, per well, of production, and is limited to 65% of the producer's net income.

The net income limitation requires depletion to be calculated on a property-by-property basis. It prohibits depletion to the extent it exceeds the net income from a particular property. These limitations apply both for regular and alternative minimum tax purposes. Depletion in excess of the 65 percent limit may be carried over to future years until it is fully utilized. Depletion was eliminated for the major oil companies in 1975. Oil production within the U.S. remains attractive because ownership of the oil is allowed in this country. In most other nations, ownership of oil is vested in a national oil company. Therefore, the result is generally a lower share of revenues for private oil companies producing outside the United States. The FY2013 budget forecasts that the repeal of depletion would yield tax revenues of approximately $11.5 billion over the period FY2013 through FY2022.[23]

Petroleum Industry Response to this Proposal: The IPAA contends that despite these limitations, depletion remains an important factor in the economics of U.S. oil and natural gas production. Most independent producers do not exceed the 1000 barrel per day limitation. Yet, these producers are a significant component of America's oil production. For example, they are the predominant operators of America's marginal wells. Over 85 percent of America's oil wells are marginal wells – producing less than 15 barrels per day. Yet, these wells produce about 20 percent of U.S. oil production. About 75 percent of U.S. natural gas wells are marginal wells, producing approximately 12 percent of U.S. natural gas. Marginal wells are unique to the United States; other countries shut down these small operations. Once shut down, they will never be opened again, because it is too costly. Even keeping the wells operating is expensive. They must be periodically reworked, their produced water (around 9 of every 10 barrels produced) must be disposed properly, the electricity costs to run their pumps must be paid. The revenues retained by depletion are essential to meet these costs. For larger wells, percentage depletion provides more revenues to be used to find new oil and natural gas in the United States. Independent producers historically invest more than their cash flow back into projects.

The IPAA believes the loss of depletion would adversely affect U.S. oil and natural gas production. Lost U.S. production runs counter to America's energy security needs, America's

move toward cleaner energy and even the development of alternative energy sources like wind and solar that require natural gas backup when they cannot generate energy.[24]

Repeal Manufacturing Tax Deduction (§199)

The repeal of the domestic manufacturing tax deduction is a provision in the proposed budget for FY2013 that affects both independent and the major companies' oil and natural gas tax liabilities. The Administration estimates that the repeal of this deduction for the petroleum industries would contribute $16.49 billion in revenue for the period FY2013 to FY2022. This statute was enacted in 2004 as part of the American Jobs Creation Act to encourage the expansion of U.S. employment in manufacturing. The oil industry was categorized as a manufacturing industry; therefore, it is eligible for the deduction, which was to be phased in over several years. This phase-in begins at 3% in 2005, and rises to a maximum of 9% in 2010. The net income from domestic manufacturing activities is the base of the tax. This is capped by a limit related to the company's payroll size. The rate available to the oil and natural gas industries is limited to 6% under §199(d)(9) of the Tax Code. This tax deduction was intended to provide incentives for domestic firms to increase domestic employment in manufacturing. This percent deduction of net income effectively reduces the real cost of labor to the manufacturer. The intent of reducing net labor cost was to expand employment, increase output, and reduce prices. This should make domestically manufactured goods more competitive in the U.S. and world markets.[25]

The oil and natural gas industries are classified as manufacturing industries for data reporting and tax purposes. However, they differ from traditional factory manufacturing in a number of ways. One way is that the production of petroleum products at a refinery is only indirectly related to the level of employment. If wage costs go down due to the tax deduction, there is less chance that the result will be increased output due to higher employment. If employment did increase, because of the capital-intensive nature of the industry it would have little effect on national employment levels. The Bureau of Labor Statistics reports that oil and natural gas extraction industries employed approximately 185,500 workers in December 2011. The period since 2004 has been difficult for U.S. manufacturing as a whole. Conversely, the period has been one of high profits for the oil industry. The generally high prices for oil since 2004 have driven high profits for the oil industry. This is a critical factor in oil investment. Oil exploration increases when prices are expected to increase and remain high; investment declines when prices are expected to decrease and remain low. The expected oil and natural gas prices are likely to be the largest factor in determining capital investment budgets (meaning exploration and production development budgets). In other words, the repeal of a tax benefit that is capped by a relatively low wage bill for the companies will have little effect.[26]

Petroleum Industry Response to this Proposal: The API believes that Congress enacted the Section 199 deduction to encourage U.S. manufacturers to invest, expand and create jobs. Discriminatorily eliminating this deduction for the oil and natural gas industry will have the reverse effect, hurting U.S. workers and prospects for economic recovery. Repeal of the deduction would threaten about 1.8 million oil and gas worker jobs and nearly 4 million jobs producing goods and services used by the oil and gas industry. This would include well-paying

jobs held by petroleum geologists, refinery workers, rig builders, accountants, chemical engineers, environmental technicians and other categories of workers.

Disallowing the deduction would force the industry to pay more in taxes, which would depress investment in new projects that could contribute to the production of energy Americans will be demanding in the future. Eliminating the deduction would create special challenges for financing high-cost domestic projects. The United States is a mature producing region, which makes finding and producing oil and natural gas more expensive at home than abroad. Paying billions more in income taxes would make it harder to find the capital to build costly projects, such as a deep water production platform in the Gulf of Mexico or a major refinery expansion. It would also reduce the number of projects companies can afford to invest in and encourage the flow of capital overseas, taking with it jobs and potential tax revenues and royalties. By discouraging more oil projects at home, the repeal of the reduction would decrease domestic production, spurring an increase in oil imports. U.S. oil production has declined by nearly half since 1970. By reducing oil production, elimination of the deduction would limit supplies, threatening tightness in oil markets and could lead to higher consumer prices. That would make it harder for our economy to grow jobs and get stronger.[27]

ExxonMobil maintains that Section 199 of the Internal Revenue Code encourages all U.S. manufacturers and producers — including the oil and natural gas industry — to invest, expand and create jobs in the United States. The law, enacted in 2004, modestly reduces U.S. corporate tax rates for U.S. businesses. It applies broadly to everything from developing software, producing movies, and printing newspapers, to farming, coal mining and many other lines of business. Oil and natural gas producers should be treated no differently from these other U.S. industries. Proposals to repeal Section 199 for oil and natural gas activities would endanger some of the 2.1 million U.S. oil and natural gas jobs as well as the 7.1 million jobs supported by the industry. They would also likely discourage new investment in America's energy sector, precluding a significant boost to economic recovery and job growth. There is no defensible tax policy basis for discriminating against oil and natural gas producers.[28]

Increase Geological and Geophysical Amortization Period

Geological and geophysical (―G and G") expenses are incurred during oil and natural gas exploration. The best possible tax treatment of G and G costs would be to allow them to be deducted in the year they are incurred. Requiring amortization of these costs over several years is less favorable; the longer the amortization period, the less favorable the tax treatment. This is because a smaller amount is deducted each year, hence, more time is required to recover the entire cost. The major integrated oil companies now amortize geological and geophysical costs over a period of seven years. Independent producers amortize these costs over two years. Under the FY2013 budget proposal, independent producers would have their amortization period increased to seven years. The amortization period for integrated oil companies would remain seven years.. The extended amortization period for independent producers is projected by the Administration to yield $1.4 billion over the period FY2013 to FY2022. In 2010, the IPAA estimated that a similar proposal in the FY2011 budget proposal would likely reduce exploration and development activities on a dollar-for-dollar basis. If the spread of the market price over the full cost of oil exploration and development remains high, it is unlikely that oil producers would

reduce exploration investment on a dollar-for-dollar basis. Conversely, if prices decline, investment is likely to be curtailed even with the more favorable tax treatment of G and G expenses, which are currently in place.[29]

Petroleum Industry Response to this Proposal: API's position is that extending the period for recovering the domestic G and G costs of oil and natural gas production companies would further increase the cost of domestic exploration. This in turn would make foreign exploration more attractive, push investment overseas, jeopardize U.S. jobs and increase the nation's reliance on imported oil. A reduction in exploration activity due to increased domestic exploration costs would likely result in less supply. That later could be reflected in higher consumer costs. With America in a deep recession, now is not the time to increase energy costs for families who are struggling to make ends meet. According to the U.S. Department of Energy, U.S.-based oil and gas companies spend about $70 to explore for and produce each barrel of oil or equivalent of natural gas in the U.S. offshore. That compares with less than $30 a barrel spent to explore for and produce abroad. Favorable tax treatment for domestic exploration will help keep the cost of domestic projects competitive with foreign alternatives. Domestic exploration and drilling supports U.S. jobs. The oil and natural gas industry directly employs 1.8 million workers. Of those, 170,000 support oil and gas operations, the portion of the industry that includes contract geological and geophysical exploration.[30]

Discussion of Other Tax Policies

The API's response to President Obama's FY2013 budget proposal identifies a number of other proposed tax changes that would affect the oil industry. These changes include the repeal of the last-in-first-out (―LIFO") accounting method, increasing the Oil Spill Liability Trust Fund taxes, reinstating Superfund taxes, and modifying the Dual Capacity Rule.

Last In, First Out ("LIFO")

According to API, LIFO is not a tax loophole. It is an established accounting methodology to determine taxable earnings.[31] Under LIFO procedures, firms assume that the last unit of a good that the company acquires in its inventory is the first unit of the good that is sold. In periods of price inflation, LIFO is helps to reduce taxes by allowing the cost deduction of the most recent and expensive goods. It is irrelevant which goods were actually sold out of inventory. The period after 2004 has been a favorable period for the oil industry to be using LIFO. If current demand conditions and political unrest in oil exporting regions keep the price of oil rising, keeping LIFO would be a tax advantage for the oil industry. If the LIFO provision is changed it is projected to raise $78.3 billion over the period FY2013 to FY2022. About $25.8 billion would come from petroleum industries.[32]

Petroleum Industry Response to this Proposal: New taxes on business proposed in the administration's FY 2013 budget include those from proposed repeal of LIFO, a well-accepted accounting method used by U.S. industry and approved by the IRS since the 1930s. API's position is that Congress should not repeal LIFO. It would reduce jobs across U.S. industry, hurting workers and families everywhere already struggling with the economic downturn. It would reduce investments in domestic energy production. This would result in a greater reliance

on imports and cause money to leave the U.S. economy. LIFO more accurately reflects the finances of a business that has rising inventory costs since it pairs current income with the current higher cost of inventory (such as with supplies of crude oil used at a refinery). Repeal of LIFO accounting would result in a significant up-front tax increase for businesses, placing significant cash constraints on them and limiting their ability to manage inflation. With respect to the petroleum industry, the proposed change would represent a one-time, multi-billion dollar tax penalty on petroleum refiners. Congress has failed to advance any tax abuse problem or other policy reason for changing the LIFO rules. LIFO is not a gimmick. It is a useful tool to determine taxable income for companies that anticipate inflation or rising prices. Repealing LIFO would require companies to redirect cash or sell assets to cover tax payments, potentially destroying some businesses.[33]

Oil Spill Liability Trust Fund

The FY2013 budget proposal includes a proposed increase in the Oil Spill Liability Trust Fund financing. This would be accomplished by raising the tax on imported and domestic oil to 9 cents per barrel in 2013 and to 10 cents per barrel in 2017. The current tax rate is 8 cents per barrel; this is scheduled to rise to 9 cents per barrel in 2016. The *Deepwater Horizon* oil spill in the Gulf of Mexico is probably the driving factor behind these proposed increases to finance the fund at a higher rate.[34]

Petroleum Industry Response to this Proposal: API member companies understand the need to adequately fund the Oil Spill Trust Fund. However, recent legislative proposals have sought to use this fund as a resource to pay for special interest projects and other non-Oil Spill Trust Fund spending. This effort unfairly imposes a tax on the oil and gas industry and its' consumers under the guise of addressing a need that is not really there.[35]

Superfund

Superfund's, which finances cleanup of the nation's high risk contaminated sites for which the responsible parties cannot be found, or cannot pay, tax authority expired at the end of 1995. An excise tax of 9.7 cents per barrel on domestic and imported crude oil would be reinstated under the FY2013 budget proposal.[36] Also, other dedicated taxes on chemicals and corporate income have been proposed.[37] The Administration believe that reinstatement of Superfund taxes would reduce the reliance on general Treasury revenues.

Petroleum Industry Response to this Proposal: The API contends that Reinstatement of expired Superfund taxes is not necessary because responsible parties continue to pay for more than 70 percent of clean-ups, according to the U.S. Environmental Protection Agency. A wide range of individuals, businesses and government agencies are responsible for the pollution at the remaining 30 percent of so-called orphan sites. Congress has appropriately recognized the cost as a broad societal problem and provided general revenues for cleanups. Reinstating the expired Superfund taxes would be unfair. Prior to their expiration, the petroleum industry paid $7.5 billion, or 57 percent of the taxes even though its share of the liability was less than 10 percent, according to the EPA. Moreover, reinstating the Superfund taxes could result in higher energy costs to hard-working Americans who already struggle to make ends meet. Reinstating

Superfund taxes will not speed-up the program's cleanup activity. Revenues from Superfund taxes do not go directly to the EPA. Rather, the level of expenditures from the Superfund trust fund are appropriated annually by Congress regardless of whether taxes are reinstated.[38]

Dual Capacity Rule and Foreign Tax Credits

The foreign income taxes credit dates back to 1918. Corporations have been able to credit, from their U.S. income tax liabilities, income tax payments made to foreign governments. From 1945 to 1950, a new interpretation of this tax rule developed with respect to the oil industry. Before 1945, oil-producing countries like Saudi Arabia charged the oil companies operating in their countries royalties, which were based on the resources extracted. For U.S. tax purposes, the royalties were treated as costs of doing business; therefore they were an expense. They were not a direct credit against U.S. tax liabilities. In 1950, Saudi Arabia and the U.S. major oil companies operating therein began working to change royalty payments to income taxes. This allowed the companies to pay more to Saudi Arabia, increase their after-tax earnings. This had the effect of transferring funds from the U.S. Treasury to the Saudi government.[39] A modification of the dual capacity rules would inhibit companies from claiming all of their foreign income taxes as a credit against U.S. taxes. Oil companies would be limited to a credit of amounts equal to the general corporate tax rate applicable to other industries. Additional tax payments over this limit would be tax-deductible operating expenses. The proposed change in dual capacity rules would reduce after-tax revenues for the companies and would reduce profits from foreign investments.[40]

Petroleum Industry Response to this Proposal: The change is not needed as there is no problem. At one time, policymakers were concerned if tax payments to a foreign government were a business expense or income tax. But 30 years in the development of foreign tax laws have produced an effective and consistent set of rules. Eliminating foreign tax credits would subject companies to double taxation. They would be required to pay U.S. taxes on income that had already been taxed by another country. U.S. oil and natural gas companies must consider a higher tax burden when contemplating foreign projects. The additional cost would put U.S.-based companies at a competitive disadvantage. And when U.S. companies are outbid for a foreign project, it means fewer opportunities for U.S. businesses and workers. Many foreign oil companies, which are owned by their governments, seek the rights to petroleum reserves to be used for their own country. When U.S. companies cannot submit a winning bid because their tax costs are too high, that means less oil flowing to the United States, and that can lead to tighter supplies and increased price volatility.[41]

ExxonMobil weighed in by saying that U.S. tax rules have consistently allowed companies to offset U.S. income tax on foreign earnings with income taxes paid on those earnings abroad. Currently, the foreign tax credit enables all U.S. companies to operate and produce goods and services in other countries without taxing profits twice — once by the host country, and once again by the home country. U.S. companies benefit from a level playing field with foreign competitors. According to a recent IHS CERA study, if these rules were changed and the foreign income for select U.S. oil and gas companies, like ExxonMobil, were to be double taxed, our foreign-based competitors and the full range of foreign-government-owned oil companies would gain a significant competitive advantage abroad. Those government-owned oil companies and

other international competitors would continue to incur only one level of taxation in nearly every case, while U.S. companies were subjected to “double taxation.”[42]

ExxonMobil continues asserting that the dual capacity rule is not even considered a “tax expenditure” by the U.S. Treasury, nor by the Congressional Joint Committee on Taxation. Yet it’s repeatedly called an oil and gas “subsidy” by those who want to remove it. So what would happen if U.S. oil and gas companies were excluded from this rule (and therefore subject to double taxation)? A study of oil and gas company competitiveness in 10 major countries conducted by IHS-CERA found that “[P]otential new rules to restrict credits for foreign taxes already paid to a host government, currently under discussion in the United States, would make the United States the least competitive among the analyzed peer group, excepting India.” That means that companies headquartered outside the United States, such as BP, Shell and Total, as well as national oil companies like those in China or Venezuela, would have the upper hand on bidding for projects around the world and creating the jobs that go with them. Among the “least competitive” is not where this country should ever be. But that’s where we could be if our leaders continue to advocate punitive taxation for energy companies. If policymakers are truly serious about economic growth and deficit reduction, then there is an alternative to punitive energy taxes: Put our industry to work. Put the policies in place that let us safely develop U.S. energy resources for the benefit of U.S. consumers; contribute more government revenue through increased energy production; and compete for projects overseas that create jobs in the U.S. and produce returns for our shareholders, the vast majority of whom are in the United States.[43]

Department of the Interior Budget

The Department of the Interior (“DOI”) budget proposal contains changes in fees and other revenue items that would affect the oil and natural gas industries. The proposed budget includes:

1. Provisions to transfer the cost of drilling inspection,
2. Permit fees to the companies in the form of increased fees,
3. Fees would be established for new nonproducing oil and gas leases to encourage development and production,
4. Royalty rate adjustment and terminating the royalty-in-kind program are included in the budget proposal.

These fees and charges would increase the cost of exploring, developing, and operating oil and natural gas facilities under DOI’s management, and are likely to slightly reduce those activities as suggested by opponents of the proposals. The effects of the fee changes are likely to be small, as these fees represent only a fraction of the revenues, profits, or other taxes and fees paid to the government.[44]

Conclusion

The tax changes proposed (repeal of the enhanced oil recovery and marginal well tax credits, repeal of the current expensing of intangible drilling costs provision, repeal of the deduction for tertiary injectants, repeal of the passive loss exception for working interests in oil and natural gas properties, elimination of the manufacturing tax deduction for oil and natural gas companies, increasing the amortization period for certain exploration expenses, repeal of the percentage

depletion allowance for independent oil and natural gas producers, and the repeal of LIFO accounting method) would increase tax collections from the petroleum industries. These proposals likely would decrease exploration, development, and production. Consumer prices and possibly the nation's dependence on foreign oil would be increased.

The changes would, on the other hand, eliminate some tax preferences that have favored the oil and natural gas industries over other energy sources. These tax exemptions have made petroleum products artificially inexpensive, with consumer cost held below the true cost.

At the risk of oversimplification, companies headquartered outside the United States, such as BP, Shell and Total might consider the proposals ―revenue neutral", because any revenue lost in the U.S. would be offset by revenue gains outside the U.S.

In the author's opinion, with gasoline hovering around four dollars a gallon, the Administration and Congress will approach carefully anything that further raises gasoline prices.

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[2] Robert Pirog, *Oil and Natural Gas Industry Tax Issues in the FY2013 Budget Proposal,* at 1, (March 2, 2012).
[3] *Ibid.*
[4] American Petroleum Institute, ―FY2013 Budget Calls for Targeted Tax Increases on America's Oil & Natural Gas Producers," February 2012, http://www.api.org.
[5] Pirog, *Supra Note 1.* Also citing FY2013 federal budget request, Department of Energy, Cuts, Consolidations, and Savings, at 80.
[6] Pirog, *Supra Note 1,* at 7. Also citing American Petroleum Institute, *Supra Note 3*.
[7] Pirog, *Supra Note 1.*
[8] http://www.api.org/Policy-and-Issues/Policy-Items/Taxes/~/media/Files/Policy/Taxes/2009-03-EnhancedOilRecovery.ashx (Accessed March 18, 2012).
[9] Pirog, *Supra Note* 1, at 3. Marginal wells produce on average less than 15 barrels per day, produce heavy oil, or produce up to 25 barrels per day, but with 95% or more water content. 5 The credit is $3 per barrel (inflation adjusted), and/or $0.50 per thousand cubic feet of natural gas (inflation adjusted) from a marginal well. The credit phases out once threshold prices are reached.
[10] Pirog, *Supra Note* 1, at 3.
[11] http://www.api.org/~/media/Files/Policy/Taxes/2009-04-MarginalWellTaxCreditFactSheet.ashx, (Accessed March 19, 2012).
[12] Pirog, *Supra Note* 1, at 3.
[13] Pirog, *Supra Note* 1, at 4.
[14] Pirog, *Supra Note* 1, at 4. Also citing Independent Petroleum Association of America, ―New Natural Gas and Oil Taxes Would Crush America's Clean Energy and Energy Security," http://www.ipaa.org/news/docs/ObamasNewtaxes2009.pdf.
[15] Pirog, *Supra Note* 1, at 4. Also citing Independent Petroleum Association of America, ―Increasing Taxes on America's Independent Natural Gas and Oil Producers—A Bad Idea," http://www.ipaa.org.
[16] http://www.api.org/policy-and-issues/policy-items/taxes/~/media/Files/Policy/Taxes/Eliminating_Ability_to_Expense_Tax_IDC.ashx (Accessed March 19, 2012).
[17] Ibid.
[18] http://www.api.org/policy-and-issues/policy-items/taxes/~/media/Files/Policy/Taxes/Repeal_Expensing_of_Intangible_Drilling_Cost.ashx (Accessed March 19, 2012).
[19] http://www.exxonmobil.com/Corporate/about_issues_taxes_current.aspx (Accessed March 18, 2012).
[20] Pirog, *Supra Note* 1, at 4.
[21] http://www.api.org/policy-and-issues/policy-items/taxes/api-key-tax-issues.aspx (Accessed March 19, 2012).
[22] Pirog, *Supra Note* 1, at 4.
[23] Pirog, *Supra Note* 1, at 5.
[24] http://www.ipaa.org/issues/factsheets/tax_capital/2009-04-PercentageDepletion.pdf (Accessed March 19, 2012).
[25] Pirog, *Supra Note* 1, at 5-6.
[26] Pirog, *Supra Note* 1, at 6. Also noting the refinery can attain different utilization rates and product mixes with no, or minor, variations in labor utilization.

[27] http://www.api.org/policy-and-issues/policy-tems/taxes/~/media/Files/Policy/Taxes/Repeal_Section_199_for_Oil_and_Natural_Gas_Companies.ashx (Accessed March 18, 2012).
[28] http://www.exxonmobil.com/Corporate/about_issues_taxes_current.aspx (Accessed March 18, 2012).
[29] Pirog, *Supra Note* 1, at 6-7.
[30] http://www.api.org/~/media/Files/Policy/Taxes/Increase_G_G_Amortization_Period.ashx (Accessed March 18, 2012).
[31] Pirog, *Supra Note* 1, at 7. Also citing American Petroleum Institute, ―FY2013 Budget Calls for Targeted Tax Increases on America's Oil & Natural Gas Producers," February 2012, http://www.api.org.
[32] *Ibid.*
[33] http://www.api.org/policy-and-issues/policy-items/taxes/~/media/Files/Policy/Taxes/LIFO_021411.ashx (Accessed March 18, 2012).
[34] Pirog, *Supra Note* 1, at 8. Also citing National Pollution Trust Fund Center, U.S. Coast Guard, for details on the Oil Spill Liability Trust Fund. Available at http://www.uscg.mil/npfc/About_NPFC/osltf.asp.
[35] http://www.api.org/policy-and-issues/policy-items/taxes/api-key-tax-issues.aspx (Accessed March 18, 2012).
[36] Pirog, *Supra Note* 1, at 8. Also citing the section on the ―Hazardous Substance Superfund Trust Fund" in CRS Report R41039, *Comprehensive Environmental Response, Compensation, and Liability Act: A Summary of Superfund Cleanup Authorities and Related Provisions of the Act*, by David M. Bearden.
[37] Pirog, *Supra Note* 1, at 8. Also citing the 112th Congress, see H.R. 1596, H.R. 1634, H.R. 3638 (Subtitle G of Title II), and S. 461.
[38] http://www.api.org/policy-and-issues/policy-items/taxes/~/media/Files/Policy/Taxes/Reinstate_Superfund_Taxes.ashx (Accessed March 18, 2012).
[39] Pirog, *Supra Note* 1, at 8-9. Also citing Daniel Yergin, *The Prize*, Simon & Schuster, New York, 1991, p. 446.
[40] Pirog, *Supra Note* 1, at 8-9.
[41] http://www.api.org/policy-and-issues/policy-items/taxes/~/media/Files/Policy/Taxes/Raising_Foreign_Income_Taxes.ashx (Accessed March 18, 2012).
[42] http://www.exxonmobil.com/Corporate/about_issues_taxes_current.aspx (Accessed March 18, 2012).
[43] http://www.exxonmobilperspectives.com/2012/02/15/another-year-another-energy-tax-hike-proposal/ (Accessed March 18, 2012).
[44] Pirog, *Supra Note* 1, at 9.

ISSUES IN COLLECTION OF DELINQUENT AD VALOREM TAXES

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I. DEFENSES TO A DELINQUENT AD VALOREM TAX COLLECTION SUIT

A. Defenses Limited

The Texas Tax Code creates a scheme of administrative remedies designed to limit litigation on property taxes. Various sections provide for appraisal districts to notify taxpayers of appraisal district actions that would affect the taxes assessed on their property. Chapter 41 of the Code sets out a system for taxpayers to protest such actions to an appraisal review board ("ARB"). Chapter 42 provides a limited window of time for appeal to state district courts of ARB decisions. A detailed discussion of these procedures is outside the scope of this paper. But it is critical to note the consequences of a taxpayer's failure to timely utilize these procedures. After the administrative deadlines pass, taxpayer remedies during delinquent tax collection suits are quite limited.

Section 42.09 of the Texas Tax Code states:

> (a) Except as provided by subsection (b) of this section, procedures prescribed by this title for adjudication of the grounds of protest authorized by this title are exclusive, and a property owner may not raise any of these grounds:
>
> > (1) in defense to a suit to enforce collection of delinquent taxes; or
> >
> > (2) as a basis of a claim for relief in a suit by the property owner to arrest or prevent the tax collection process or to obtain a refund of taxes paid.
>
> (b) A person against whom a suit to collect a delinquent property tax is filed may plead as an affirmative defense:
>
> > (1) if the suit is to enforce personal liability for the tax, that the defendant did not own the property on which the tax was imposed on January 1 of the year for which the tax was imposed; or
> >
> > (2) if the suit is to foreclose a lien securing the payment of the tax on real property, that the property was not located within the boundaries of the taxing unit seeking to foreclose the lien on January 1 of the year for which the tax was imposed.

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(c) For purposes of this section, “suit” includes a counterclaim, cross-claim, or other claim filed in the course of a lawsuit.

In *Cameron Appraisal District v. Rourk,* 194 S.W.3d 501, 502 (Tex. 2006), the Texas Supreme Court stated:

> The Texas Tax Code provides detailed administrative procedures for those who would contest their property taxes. *See* [Texas Tax Code] §§ 41.01-.71. Administrative decisions are final if not appealed to the district court within 45 days. *Id.* § 42.21(a). The administrative procedures are “exclusive” and most defenses are barred if not raised therein. *Id.* § 42.09.

The Court continued:

> Thus, we have repeatedly held that a taxpayer’s failure to pursue an appraisal review board proceeding deprives the courts of jurisdiction to decide most matters relating to ad valorem taxes.

Id. at 502. When defendants try to raise in tax collection suits issues that should have been addressed administratively, these “defenses” are subject to pleas to the jurisdiction.

B. Defense of Non-Ownership

The one defense specifically allowed by Section 42.09(b)(1) is non-ownership of the property subject to taxation. Section 42.09(b)(1) applies only to efforts to enforce personal liability for taxes. Generally, under Section 32.07(a) of the Texas Tax Code, taxes are the personal obligation of the person who owns or acquires the property on January 1 of the tax year. Often, defendants asserting non-ownership will seek dismissal from the suit. This ignores the limiting language of Section 42.09(b)(1). Even if a court is inclined to find no personal liability, the defendant claiming non-ownership should often remain a defendant for purposes of the foreclosure of the tax lien, to provide a clear chain of title to the buyer at the tax sale.

The defense of non-ownership is generally a straight-forward question of what appears in the title records. Trial may require testimony by title examiners or surveyors. But some non-ownership defenses are more complex.

(1) —I sold the property, but the buyer hasn’t recorded the deed”

This is a frequent defense in delinquent tax collection cases. Many such defendants cannot produce a copy of the deed which they claim to have delivered to a buyer. Instead they simply testify that they sold the property at some time in the past. The taxing jurisdiction’s lawyer may have difficulty disproving that such a sale occurred—particularly if the defendant does not now occupy the property. If the court believes that a sale took place before January 1 of the tax year, it may relieve the record title owner of personal liability.

The Texas recording statute does not provide much guidance in such cases. Section 13.001 of the Texas Property Code states:

(a) A conveyance of real property or an interest in real property or a mortgage or a deed of trust is void as to a creditor or to a subsequent purchaser for a valuable consideration without notice unless the instrument has been acknowledged, sworn to, or proved and filed of record as required by law.

(b) The unrecorded instrument is binding on a party to the instrument, on the party's heirs, and on a subsequent purchaser who does not pay a valuable consideration or who has notice of the instrument.

(c) This section does not apply to a financing statement, a security agreement filed as a financing statement, or a continuation statement filed for record under the Business and Commerce Code.

Since Section 42.09(b)(1) of the Texas Tax Code provides that non-ownership is a defense only to personal liability, it should not affect the lien's foreclosure. Under the recording statute, the unrecorded instrument is void as to the creditor taxing jurisdiction. *See United States of America vs. Key,* 308 F.Supp.2d 727 (U.S.D.C.—Dallas, 2004). But if the holder of the unrecorded interest has taken visible, open and exclusive possession of the property, this interest may be superior to that acquired by a purchaser at a tax sale, if he is not made a party. *See Apex Financial Corp. vs. Garza,* 155 S.W.3d 230 (Tex. App.—Dallas, 2004, writ denied). While the alleged unrecorded sale should not preclude a tax lien, it may require adding the purported grantee as a party to the suit.

(2) —I was only a Trustee"

The word "trustee" sometimes appears after the grantee's name in a deed. If sued for delinquent taxes, these grantees may argue that they were acting only as a trustee and have no personal liability. Section 101.001 of the Texas Property Code addresses the effect of a designation of trustee in a deed:

> If a property is conveyed or transferred to a person designated as a trustee but the conveyance or transfer does not identify a trust or disclose the name of any beneficiary, the person designated as trustee may convey, transfer, or encumber the title of the property without subsequent question by a person who claims to be a beneficiary under a trust or who claims by, through, or under any undisclosed beneficiary or by, through, or under the person designated as trustee in that person's individual capacity.

While providing that the "trustee" has full authority to convey the property, this section does not appear to answer the question of the trustee's liability for taxes. But case law suggests that the designation of "trustee," without more, has no legal effect. A Houston Court of Appeals stated:

> The use of the word "trustee" in a deed, in and of itself, does not create a trust, it is merely a description and of no legal effect.

Fred Rizk Construction Company v. Cousins Mortgage & Equity Investments, 627 S.W.2d 753, 757 (Tex. App.—Houston [1st District], 1981, writ ref'd n.r.e.). The Texas Supreme Court agrees:

> The term "trustee" appears in conjunction with Ann's name on the note and deed of trust, but the mere designation of a party as "trustee" does not create a trust.

Nolana Development Association v. Corsi, 682 S.W.2nd 246, 248 (Tex. 1984). Thus, at least, the "trustee" must testify to facts which support a trust for the benefit of some other party. Those other parties should be added as defendants to the suit. Even then, taxing units may argue that the "trustee" bears personal liability for the tax. An agent acting for an undisclosed principal can have personal liability. *See, Posey v. Broughton Farm Company,* 997 S.W.2d 829 (Tex. App.—Eastland, 1999, pet. denied); *Wynne v. Adcock Pipe and Supply,* 761 S.W.2d 67 (Tex. App.—San Antonio, 1988, writ denied).

(3) Heirs

Other issues arise when a record title owner is deceased. Texas Probate Code Section 37 (regarding passage of title upon intestacy and under a will) provides that a decedent's estate shall vest immediately in his/her heirs. The Texas Supreme Court holds that heirs are not personally liable while an estate is under administration. *Bailey v. Cherokee County Appraisal District,* 862 S.W.2d 581 (Tex. 1993). When an estate's administration is pending, heirs can avoid personal liability. *Bailey* also discusses whether probate courts or district courts have jurisdiction of an estate's property tax matters. After the *Bailey* decision, in 1999, the legislature added Section 5C of the Probate Code, which altered the jurisdictional provisions.

(4) Strips and Gores

Another non-ownership defense arises where a defendant once owned a much larger tract in a chain of title, and later sold most of the property while retaining a small part which is not included in the legal descriptions in the later deeds. In this circumstance, a defendant may argue that she no longer owns the remaining smaller tract under the strip and gores doctrine. This doctrine requires the strip of land to be: (1) small in comparison to the land conveyed, (2) adjacent to or surrounded by the land conveyed, (3) owned by the grantor at the time of conveyance, and (4) of insignificant or little practical value at the time of the conveyance and in comparison to the value of the larger tract. *Glover vs. Union Pacific Railroad Company,* 187 S.W.3d 201 (Tex. App.—Texarkana, 2006, writ denied). The grantor is presumed to have intended to convey such a strip unless it clearly appears in the deed, by plain and specific language, that the grantor intended to reserve the strip. *Strayhorn vs. Jones,* 300 S.W.2d 623 (Tex. 1957). If a defendant asserts this in a tax collection suit, the taxing unit may need to name as an additional defendant the adjoining property owner who is alleged to own the property under the strips and gores doctrine.

(5) Leasehold Improvements

Leasehold improvements assessed under a separate tax account present special issues in tax collection. Section 25.08(c) of the Texas Tax Code provides:

> When a person other than the owner of an improvement owns the land on which the improvement is located, the land and the improvements shall be listed separately in the name of the owner of each if either owner files with the chief appraiser before May 1 a written request for separate taxation on a form furnished

for that purpose together with proof of separate ownership. After an improvement qualifies for taxation separate from land, the qualification remains effective in subsequent tax years and need not be requested again. However, the qualification ceases when ownership of the land or the improvements is transferred or either owner files a request to cancel the separate taxation.

Under this provision, separate tax accounts are frequently created for leasehold improvements. Where the owner of the underlying land is not the owner of the improvements on January 1 of a tax year, he escapes personal liability for that year's taxes on the improvements. But he may not escape the attachment of a lien to his land, if the estates later merge.

If the owner of the leasehold improvements does not pay the taxes on the account established in his name, the lien created by Section 32.01 of the Tax Code attaches to the improvements. But if the lease has terminated, and the ownership of the improvements reverts to the landlord under the lease terms, the leasehold estate has merged into the fee simple ownership of the land. The lien on the improvements then becomes a lien on the land. *Franz vs. Katy ISD,* 35 S.W.3d 749 (Tex. App.—Houston [1st District], 2000, no writ).

II. BUSINESS PERSONAL PROPERTY TAX TRAPS FOR UNWARY PURCHASERS—OR THEIR LAWYERS.

A. Purchase of Business Personal Property (BPP) subject to a tax lien.

Section 32.01 of the Tax Code provides that a broad tax lien attaches to BPP on January 1 of each tax year. This lien secures the taxes, penalties and interest ultimately imposed for the year. Tex. Tax Code §32.01(a). The lien is on all inventory, furniture, equipment and other personal property owned on January 1 **and** on property subsequently acquired. Tex. Tax Code § 32.01(b). The lien is perfected on attachment. The taxing unit is not required to take any action to perfect the lien. Tex. Tax Code § 32.01(d). Thus, tax liens are not recorded, unlike UCC liens. A purchaser can only determine if a tax lien exists by checking the tax accounts for assessed but unpaid amounts. And, since the tax lien attaches on January 1 of the year for which taxes are assessed, purchasers must investigate taxes for the current year. Current year tax bills are generally mailed in October or November of the year. But tax liens attach on January 1, many months before tax bills are mailed. Purchasers should consider escrowing part of the purchase price if they are not certain whether current year taxes have been paid.

Section 32.05 gives the tax lien priority over claims of any other creditors, even creditors whose liens existed before the tax lien attached. Tex. Tax Code §32.05(b). The only meaningful limitation on the attachment of tax liens to business personal property is in Section 32.03(a), which prohibits lien enforcement against a buyer in the ordinary course of business as defined in Section 1.201(9) (now Section 1.201(b)(9)) of the Texas Business & Commerce Code. Tex. Tax Code §32.03(a). The Texas Business & Commerce Code provides:

> "Buyer in the ordinary course of business" means that a person that buys in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawn-broker, in the business of selling goods of that kind. A person buys in the ordinary course if the

> sale to the person comports with the usual and customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices. A person that sells oil, gas or other minerals at the wellhead or minehead is a person in the business of selling goods of that kind. A buyer in the ordinary course of business may buy for cash, by exchange of other property, or on secured or unsecured credit, and may acquire goods or documents of title under a preexisting contract for sale. Only a buyer that takes possession of the goods or has a right to recover the goods from the seller under Chapter 2 may be a buyer in the ordinary course of business. "Buyer in the ordinary course of business" does not include a person that acquires goods in a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

Tex. Business & Commerce Code § 1.201(b)(9). The last sentence of the definition provides that buyers in the ordinary course of business do not include buyers of goods in bulk or in foreclosure of a security interest. A bank foreclosing its security interest on its borrower's inventory thus takes the inventory subject to the tax lien. *Central Appraisal District of Taylor County v. Dixie-Rose Jewels, Inc.,* 894 S.W.2d 841 (Tex. App.—Eastland, 1995, no writ).

B. Assumption of Personal Liability for the Taxes on BPP.

Not only may an unwary buyer find the acquired goods subject to a tax lien, he may even find that he has assumed personal liability for the taxes owed. Transactional lawyers who represent buyers or sellers of businesses or bulk inventory should be familiar with Section 31.081 of the Texas Tax Code:

> (a) This section applies only to a person who purchases a business, an interest in a business, or the inventory of a business from a person who is liable under this title for the payment of taxes imposed on personal property used in the operation of that business.
>
> (b) The purchaser shall withhold from the purchase price an amount sufficient to pay all of the taxes imposed on the personal property of the business, plus any penalties and interest incurred, until the seller provides the purchaser with:
>
> (1) a receipt issued by each appropriate collector showing that taxes due the applicable taxing unit, plus any penalties and interest, have been paid, or
>
> (2) a tax certificate issued under Section 31.08 stating that no taxes, penalties, or interest is due the applicable taxing unit.
>
> (c) A purchaser who fails to withhold the amount required by this section is liable for that amount to the applicable taxing units to the extent of the value of the purchase price, including the value of a promissory note given in consideration of the sale to the extent of the note's market value on the effective date of the purchase, regardless of whether the purchaser has been required to make any payments on the note.

(d) The purchaser may request each appropriate collector to issue a tax certificate under Section 31.08 or a statement of the amount of taxes, penalties, and interest that are due to each taxing unit for which the collector collects taxes. The collector shall issue the certificate or statement before the 10th day after the date the request is made. If a collector does not timely provide or mail the certificate or statement to the purchaser, the purchaser is released from the duties and liabilities imposed by Subsections (b) and (c) in connection with taxes, penalties, and interest due the applicable taxing unit.

(e) An action to enforce a duty or liability imposed on a purchaser by Subsection (b) or (c) must be brought before the fourth anniversary of the effective date of the purchase. An action to enforce the purchaser's duty or liability is subject to a limitation plea by the purchaser as to any taxes that have been delinquent at least four years as of the date the collector issues the statement under Subsection (d).

(f) This section does not release a person who sells a business or the inventory of a business from any personal liability imposed on the person for the payment of taxes imposed on the personal property of the business or for penalties and interest on those taxes.

(g) For purposes of this section:

(1) a person is considered to have purchased a business if the person purchases the name of the business or the goodwill associated with the business; and

(2) a person is considered to have purchased the inventory of a business if the person purchases inventory of a business, the value of which is at least 50 percent of the value of the total inventory of the business on the date of the purchase.

Tex. Tax Code § 31.081. Thus, if a purchaser buys the name of the business, the goodwill, or 50 percent of the inventory without complying with the statute, the purchaser may assume liability for unpaid BPP taxes. *See Dan's Big & Tall Shop, Inc. v. County of Dallas,* 160 S.W.3d 307 (Tex. App.—Dallas, 2005, pet. denied).

III. POST-JUDGMENT ACTIONS

A. Motions to Void a Tax Sale by the Tax Sale Purchaser

Tax sale purchasers sometimes develop "buyer's remorse," after they complete the due diligence that they should have done before bidding. These buyers may try to void the tax sale and get their money back. Such attempts face overwhelming hurdles.

(1) The Sheriff's or Constable's Deed is Without Warranty.

The Sheriff's or Constable's Deed conveys only the right, title and interest that the judgment debtor had in the property. Texas Civ. Prac. & Rem. Code § 34.045. A sheriff's deed is in the nature of a quitclaim deed because it contains no warranty of title and conveys only whatever interest the judgment debtor had in the property. *Apex Financial Corp. vs. Garza,* 155 S.W.3d 230 (Tex. App.—Dallas, 2004, pet. denied).

(2) The Purchaser Takes Subject to the Interests of Missing Parties

Where lienholders were not joined in the underlying tax suit, the tax sale purchaser takes the property subject to the interests of the missing parties. *Jordan vs. Bustamante,* 158 S.W.3d 29 (Tex. App.—Houston [14th Dist], 2005, pet. denied).

B. Bills of Review

A Bill of Review is an independent action to set aside a judgment that is no longer appealable or subject to a motion for new trial. *Wembley Investment Company vs. Herrera,* 11 S.W.3d 924 (Tex. 1999). The petitioner in a bill of review must ordinarily plead and prove: (1) a meritorious defense to the cause of action in the underlying suit, (2) that he was prevented from making by the fraud, accident or wrongful act of his opponent, (3) unmixed with any fault or negligence of his own. *Caldwell vs. Barnes.* 975 S.W.2d 535 (Tex. 1998). A party who had an available appeal and fails to pursue it is not entitled to relief under a bill of review. *Rizk vs. Mayad,* 603 S.W.2d 773 (Tex. 1980).

So a bill of review petitioner who seeks to set aside a judgment entered in a delinquent tax collection suit faces many hurdles. But if the judgment was by default, and the petitioner can show that he was not properly served, the requirements for a bill of review are met. A defendant who is not served with process is entitled to a bill of review without further showing, because the Constitution discharges the first element, and lack of service establishes the second and third. *Ross vs. National Center for the Employment of the Disabled,* 197 S.W.3d 795 (Tex. 2006).

Where the petitioner alleges that she was not properly served in the underlying suit, the issue may turn on how quickly she filed her bill of review. The four year residual statute of limitations applies to bills of review. *Tex. Civil Prac. & Rem. Code, § 16.051; Caldwell vs. Barnes*, 975 S.W.2d 535 (Tex. 1998). A petitioner seeking to attack a judgment by bill of review, when property was sold at a tax sale, may also be affected by Section 33.54 of the Texas Tax Code:

> (a) Except as provided by Subsection (b), an action relating to the title of property may not be maintained against the purchaser of the property at a tax sale unless the action is commended:
>
> (1) before the first anniversary of the date that the deed executed to the purchaser at the tax sale is filed of record; or

(2) before the second anniversary of the date that the deed executed to the purchaser is filed of record, if on the date that the suit to collect the delinquent tax was filed the property was:

(A) the residence homestead of the owner; or

(B) land appraised or eligible to be appraised under Subchapter C or D, Chapter 23.

(b) If a person other than the purchaser at the tax sale or the person's successor in interest pays taxes on the property during the applicable limitations period and until the commencement of an action challenging the validity of the tax sale and that person was not served citation in the suit to foreclose the tax lien, that limitations period does not apply to that person.

(c) When actions are barred by this section, the purchaser at the tax sale or the purchaser's successor in interest has full title to the property, precluding all other claims.

Thus, Section 33.54 may impose a one or two year statute of limitations where the property has been sold to a tax sale purchaser, unless under subsection (b) the owner was not served with citation in the underlying suit **and** the owner pays taxes on the property during the applicable limitations period.

C. Claims for Excess Proceeds

Section 34.02 of the Tax Code directs the distribution of proceeds from a tax sale. Subsection (d) directs the officer conducting the sale to pay any excess proceeds remaining after payment of all amounts due all participants in the sale to the clerk of the court. The disposition of those proceeds is governed by Sections 34.03 and 34.04 of the Code. Section 34.03 directs the clerk to notify the former owner of the excess proceeds, and to hold the proceeds for two years unless otherwise ordered by the court. After two years, the excess proceeds may revert to the taxing units that were beneficiaries of the sale. As a practical matter, the clerk of the court will generally issue notice to all parties to the judgment, and any person may make a claim for such proceeds under section 34.04.

The court must determine claims for excess proceeds in the following priorities, pursuant to Section 34.04(c):

First, to the tax sale purchaser if the tax sale has been adjudged to be void;

Second, to the taxing units for any taxes, penalties and interest that have become due or delinquent on the property subsequent to the judgment or that were omitted from the judgment by accident or mistake;

Third, to any lienholder for amounts due under a lien;

Fourth, to the taxing units for any unpaid taxes, penalties and interest or other amounts adjudged due under the judgment that were not initially satisfied from the proceeds of the sale; and

Fifth, to the former owners of the property.

Given the popularity of purchasing property at tax sales for investment, many sales generate substantial excess proceeds. Multiple parties often jockey for position in claiming these proceeds.

D. Post Judgment Taxes

Taxes assessed after the judgment, but before a tax sale, also present special issues. First, Section 33.42 of the Texas Tax Code provides that the taxing unit shall include all **delinquent** taxes due to the unit in its suit. Texas Tax Code § 33.42(a). Further, the Court shall include in the judgment any amounts that become delinquent after suit is filed but before entry of judgment. Texas Tax Code §33.42(b). Thus, judgments should include all amounts delinquent as of the date of trial. But current year taxes, not yet delinquent, are not included in the judgment. So at least one year of additional post judgment tax is usually due by the tax sale date. And delays can occur between the judgment and the tax sale for many reasons. In such cases, more than one year of additional post judgment taxes may accrue. Purchasers at a tax sale may acquire property subject to a tax lien for these additional amounts.

The Texas Supreme Court in *State of Texas v. Moak,* 207 S.W.2d 894 (Tex. 1948) considered these questions in a situation where the first sale of the property resulted in the property being struck off to the taxing unit. Where this occurs, the taxing unit can direct the Sheriff or Constable to hold a later resale of the property. But, where the property was first struck off to the taxing unit, the Court held that tax liens which attached before the property was struck off to the taxing unit merged into the title held by the taxing unit. When the taxing unit acquired fee simple title, the prior tax liens merged into the superior title and did not survive the resale. *Moak*, at 896.

After the *Moak* decision, the Tax Code was amended to address the issue. Specifically, the Code now provides:

> Notwithstanding that property is bid off to a taxing unit under this section, a taxing unit that established a tax lien in the suit may continue to enforce collection of any amount for which a former owner of the property is liable to the taxing unit, including any post-judgment taxes, penalties and interest, in any other manner provided by law.

Texas Tax Code § 34.01(l). Another section of the Code provides:

> Except as provided by Section 34.05(k), a taxing unit's claim for taxes that become delinquent after the date of the judgment is not affected by the entry of the judgment or a tax sale conducted under that judgment. Those taxes may be collected by any remedy provided by this title.

Texas Tax Code § 33.52(d). As a result, the Tax Code now authorizes taxing jurisdictions to enforce tax liens for post judgment taxes, even after a strike off of the property to the jurisdiction. *Irannezhad v. Aldine ISD,* 257 S.W.3d 260 (Tex. App.—Houston [1st Dist], 2008, no pet.).

As seen above, Section 33.52(d) contains an exception added in 2011, referring to Section 34.05(k). Section 34.05 allows taxing jurisdictions to sell property struck off to them in a private sale at a sale price at least equal to the market value of the property, if the total of all amounts due under the judgment and the post judgment taxes, penalties and interest exceed the market value and all taxing units entitled to receive proceeds of the sale consent. In such private sales, all liens foreclosed by the judgment and the post judgment liens are extinguished, although the purchaser may remain liable for prorated amounts due for the year of the resale under Texas Tax Code Section 26.10.

Ad Valorem Property Taxation: Appellate Courts Affirm Summary Judgment for Taxpayers on Property Value

By Mary A. Van Kerrebrook[1]

The Texas Supreme Court recently denied review of the first Texas appellate case affirming summary judgment for a taxpayer on the issue of a property's *ad valorem* tax value. *Harris County Appraisal District v. Riverway Holdings* concerned the 2008 market value of a Houston office building. The plaintiffs bought the building in 2005 for $67 million. The assessing entity was the Harris County Appraisal District ("HCAD").

HCAD asserted that the 2005 purchase price reflected the January 1, 2008 market value. Riverway timely protested the noticed value to the Appraisal Review Board ("ARB"). After an adverse ARB decision, Riverway filed suit under Chapter 42 of the Texas Property Tax Code. Riverway responded to HCAD's discovery in the suit, conducted its own discovery, sent HCAD a settlement offer and designation under Section 42.23 of the Texas Property Tax Code, and timely produced an appraisal by MAI appraiser Steve Bach. Bach concluded that the property's market value as of January 1, 2008 was $55 million.

HCAD did not produce an expert report. Riverway moved for summary judgment based on its appraisal and an affidavit from the appraiser. These explained Bach's comparable sales and adjustments, his income analysis, and the other factors involved in his value conclusion.

HCAD filed a response to Riverway's Motion for Summary Judgment. But HCAD neither objected to Bach's appraisal nor proffered controverting expert evidence. Instead, HCAD argued that taxpayers may never obtain summary judgments on a property's valuation, as a matter of law. The trial court entered an order of summary judgment that set the property's 2008 taxable value at $55 million, and awarded attorney's fees to the taxpayers. HCAD appealed.

The Court of Appeals upheld the summary judgment in *Harris County Appraisal District v. Riverway Holdings,* 2011 WL 529466 (Tex. App.—Houston [14 Dist.], February 15, 2011, pet. denied). The Court noted that it did not hold "that HCAD always must proffer a controverting expert opinion to preclude summary judgment when a property owner" seeks "summary judgment on valuation supported by an appraisal expert's affidavit and report." Nor did the Court hold that a taxpayer may obtain summary judgment based on conclusory expert testimony, or when an appraisal district raises timely and valid challenges to the appraiser's methodology. Instead, the court held that:

> When the property owner proffers uncontroverted and non-conclusory expert valuation testimony in support of a traditional motion for summary judgment establishing valuation, the [appraisal district] cannot eschew challenges to the expert's methodology; wait until summary judgment has been granted; and then belatedly attack the expert's methodology. Here, the property owner supported its request for a traditional summary judgment establishing valuation with

uncontroverted and non-conclusory expert testimony. HCAD did not timely challenge the expert's methodology before summary judgment was granted. Summary judgment was appropriate under these circumstances.

Riverway Holdings holds that when a plaintiff timely and carefully develops its *ad valorem* valuation suit, and presents a motion for summary judgment with a thorough expert report, an appraisal district must work, in the trial court, to defeat the motion by producing its own evidence and/or disproving the taxpayer's expert's methodology. In other words, appellate courts will not look at claimed appraisal methodology defects which were not timely raised before the trial judge.

The Texas Supreme Court denied HCAD's Petition for Review on December 22, 2011.

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Pipelines Pipelines Everywhere – Holding Period Issues In Sales of Midstream Assets

By: Brandon Bloom & Todd Lowther[1]

I. Introduction

New pipeline capacity coming online in the Eagle Ford Shale, Marcellus/Utica Shale, and other areas of the country likely will result in more taxpayers acquiring or disposing of newly-built midstream assets during the next 12-24 months. The assets owned in connection with a midstream business typically include tangible personal property, such as pipelines and related equipment, gas transportation contracts, and goodwill or other intangible assets. A sale of an oil and gas midstream business is often structured as a direct sale of tangible pipeline assets, gas transportation contracts, and goodwill or other intangible assets held in connection with the business. Alternatively, the sale could be structured as a sale of the equity in the entity holding such assets. In either case, the seller will be anxious to know what portion of the gain, if any, will qualify as long-term capital gain taxed at the preferential 15% rate available under current law through December 31, 2012.

In preparing for such transactions, advisors likely will negotiate representations and warranties related to taxes and determine an appropriate purchase price allocation. But advisors are remiss to overlook whether the seller has a short-term holding period with respect to part or all of the assets being sold. In transactions involving the sale of assets having a short-term holding period or inherent depreciation recapture, the purchase price allocation is often the primary tax planning tool. A favorable purchase price allocation can minimize depreciation recapture recognized with respect to depreciable pipelines and related equipment, and can also minimizing short-term capital gain recognized with respect to newly-built pipelines and recently-executed gas transportation contracts. Generally, the buyer and seller will have competing interests with respect to the amount of the purchase price allocated to pipelines – the seller generally prefers to minimize this amount (in order to minimize depreciation recapture and/or short-term capital gain) and the buyer generally prefers to maximize this amount (because pipelines are depreciated over a shorter recovery period relative to the 15 year amortization period for goodwill and other intangible assets). If the parties agree on the amount to be allocated to the pipelines, this competing interest should be sufficient for such allocation to be respected by the IRS. However, in determining the amount allocated between short-term gas transportation contracts and other intangible assets with a long-term holding period (such as goodwill), the parties will not have the benefit of competing interests to justify their allocation. While the seller will prefer to allocate less to short-term contracts, the buyer will be indifferent as to the allocation between short-term contracts and other intangible assets. In this case, it would be prudent for the seller to have some independent valuation support for its allocation to short-term contracts and other intangible assets with a long-term holding period. These issues are of particular concern when selling new or recently-acquired midstream assets as discussed in more detail below.

II. General Holding Period Rules

The general rule for any asset is that the holding period begins when the holder acquires the "benefits and burdens" of ownership. The Supreme Court, in considering the issue of when a taxpayer's holding period begins and ends, equates the word "held," as used in the Code, with "ownership," saying:

> "In common understanding, to hold property is to own it. In order to own or hold one must acquire. The date of acquisition is, then, that from which to compute the duration of ownership or the length of holding." *McFeely v. Comm'r*, 296 U.S. 102, 107 (1935).

Thus, the holding period ordinarily starts with the acquisition of the property and ends with its disposition. The Tax Court has summarized the principles governing this determination as follows:

> "In determining the date of acquisition of the ownership of property, no hard-and-fast rules of thumb can be used, and no single factor is controlling.…„Ownership of property is not a single indivisible concept but a collection or bundle of rights with respect to the property,' [and] consequently, we must examine the transaction in its entirety.…The date of the passage of legal title is not the sole criteria; the date on which „the benefits and burdens or the incidents of ownership of the property' were passed must also be considered,…and the legal consequence of particular contract provisions must be examined in the light of the applicable State law." *Hoven v. Comm'r*, 56 T.C. 50, 55 (1971).

Contracts. Under the "benefits and burdens" analysis, the holding period of a contract generally should begin upon execution of the contract. Upon execution, each party thereto becomes entitled to the benefits thereunder, even if they may not actually receive revenue until a later date. Similarly, upon the execution, each party thereto is subject to the obligations under the contract, and thus, bears the burdens of the contract even though they may not be required to perform their obligations until later.

Pipelines. The holding period for pipelines constructed over a period of time is determined by reference to the date(s) on which costs are incurred to construct the pipeline. The Fifth Circuit held in *Williams v. Commissioner* that when a taxpayer incurs costs in the construction of an asset, costs incurred more than six months (the long term holding period at the time of the decision) before the date the asset was sold should be treated as long-term gains, and that costs incurred less than six months before the date of sale were short-term gains. 285 F.2d 582 (5th Cir. 1961). The Tax Court has held, and the IRS has ruled, that if property is constructed over a period longer than the short-term holding period and is sold after completion, the property may have a split holding period, with a portion of the costs incurred having a short-term holding period and the remaining portion having a long-term holding period. The costs incurred in connection with the construction completed within the short-term holding period

ending with the date of sale has a short-term holding period. The costs incurred in connection with the construction completed before the beginning of the short-term holding period ending with the date of sale has a long-term holding period. *See Aagaard v. Comm'r*, 56 T.C. 191 (1971), acq. 1971-2 C.B. 1; *Russo v. Comm'r*, 68 T.C. 135 (1977); *Draper v. Comm'r*, 32 T.C. 545 (1959), acq.; Rev. Rul. 75-524, 1975-2 C.B. 342 .

Thus, pipelines constructed by a taxpayer can potentially have a split holding period, with costs incurred more than one year prior to the sale giving rise to a long-term holding period, and costs incurred less than one year prior to the sale giving rise to a short-term holding period.

Goodwill and other intangible assets. The law is not clear on the commencement of the holding period for goodwill or other intangible assets created by the taxpayer. The little authority existing on the issue of the holding period of goodwill is not very helpful. In one case, the Tax Court held that goodwill is not ordinarily considered to arise at the start of a new business and that ordinarily a business must be operated for substantially longer than the short-term holding period to obtain long-term capital gain treatment for goodwill. *Friedlaender v. Comm'r,* 26 T.C. 1005 (1956) ("goodwill is not an asset which normally is acquired in a relatively short period of time"; "all of the factors which must be considered in determining whether or not goodwill exists involve an element of time"). In another case, however, the Tax Court held that where a business has been operated for a long period of time (15 years in this case), the holding period for goodwill (or any portion thereof) does not restart when new agreements are entered into. *Girt v. Comm'r*, T.C. Memo 1961-286.

However, if the taxpayer can prove that certain other intangible assets were created or in existence at the time that the business began, it seems that an argument can be made that the sale of such intangible asset could qualify for long-term capital gain treatment if the business is sold more than one year after it is begun. For example, if the construction of a pipeline in a certain area gives the taxpayer a market advantage (i.e., a "first-mover" advantage), then arguably an intangible asset is created at the time that the construction of the pipeline begins.

Membership Interests. Generally, the holding period of an LLC membership interest acquired in exchange for a contribution of cash to the LLC commences on the day such membership interest is acquired. If a member makes a subsequent cash contribution to the LLC in exchange for an additional membership interest, such member will have a split holding period in its membership interest, based on the relative fair market values of the previously-acquired and the newly-acquired membership interests. This rule applies even if the LLC does not formally issue new membership interests.

Any gain or loss recognized on the sale of a membership interest generally is capital gain or loss, except to the extent that Section 751(a) applies. Under Section 751(a), the selling member must recognize ordinary income to the extent that such member would be allocated ordinary income (including depreciation recapture) if the LLC sold all of its assets in a taxable transaction. Any remaining capital gain or loss on the sale of such membership interest will be long-term or short-term capital gain or loss depending on the selling member's holding period in its membership interest.

In addition, Section 751(d) generally requires the selling member to recognize ordinary income to the extent that the LLC holds assets with a short-term holding period.

III. Character of Gain Upon Sale - Asset sale v. Interest sale – Examples

For purposes, of this discussion, assume the following facts. On 1/1/11, A and B formed AB LLC, with A contributing $16,000 in exchange for an 80% interest and B contributing $4,000 in exchange for a 20% interest. AB LLC used the $20,000 to immediately begin construction of a pipeline. Also on 1/1/11, AB LLC executed a gas transportation contract ("Contract 1"). AB LLC claimed 100% bonus depreciation on the pipeline in 2011.

One year later on 1/1/12, A and B contributed an additional $16,000 and $4,000, respectively. Immediately before such contributions, their respective AB LLC membership interests had a fair market value of $32,000 and $8,000, respectively. Accordingly, immediately after such contributions, 2/3 of their respective membership interests is attributable to their previously-acquired membership interest and 1/3 is attributable to their newly-acquired membership interest.

AB LLC used the additional $20,000 contributed by A and B on 1/1/12 for additional construction costs of the pipeline. Also on 1/1/12, AB LLC executes a second gas transportation contract ("Contract 2"). AB LLC claimed 100% bonus depreciation on the pipeline in 2012.[2]

On 12/31/12, the fair market value and adjusted tax basis of AB LLC's assets were as follows:

Asset	Tax Basis	FMV
Pipeline	$0	$20,000
Contract 1	$0	$40,000
Contract 2	$0	$20,000
Goodwill/other intangibles	$0	$40,000

For purposes of illustration, the discussion below focuses on the tax consequences to A of an asset sale by AB LLC, or alternatively, a sale by A of its 80% interest in AB LLC on 12/31/12.

Asset Sale by AB LLC. On 12/31/12, AB LLC sells all of its assets to Buyer for $120,000. The purchase price is allocated among the assets in accordance with their FMVs. A will be allocated 80% of the gain attributable to each asset, summarized as follows:

- **Pipeline.** The entire $20,000 gain recognized by AB LLC on the sale of the pipeline is attributable to depreciation recapture, and thus, will be taxed as ordinary income under Section 1245. Accordingly, the holding period of the pipeline is irrelevant because its FMV is less than its original cost (of $40,000). If, however, the pipeline's FMV exceeded its original cost, then such excess generally would give rise to capital gain. Whether such capital gain is long-term depends on the holding period of the pipeline. Here, AB LLC has a split holding period in the pipeline. Its holding period in the pipeline is 50% long-term (*i.e.*, the holding period attributable to the costs

incurred on 1/1/11) and one-half short-term (*i.e.*, the holding period attributable to the costs incurred on 1/1/12). Thus, any gain recognized on the sale of the pipeline would be 50% long-term capital gain and 50% ordinary. However, oftentimes the FMV of hard assets such as pipelines does not exceed the original cost of such assets, and thus, the holding period is irrelevant, as it is under the assumed facts here.

- **Contracts.** The law is not clear on the issue of whether gain on the sale of a contract is taxed as long-term capital gain or ordinary income. However, the better view generally is that gain on the sale of a contract such as a gas transportation/marketing contract is taxed as long-term capital gain if such contract is held for more than one year. Accordingly, the $40,000 gain on the sale of Contract 1 likely will be taxed as long-term capital gain, but the $20,000 gain on the sale of Contract 2 will be taxed as ordinary income.

- **Goodwill.** Whether the sale of the goodwill or other intangible assets gives rise to long-term or short-term capital gain generally will depend on whether such asset(s) existed more than one year prior to the sale. Assuming that AB LLC can prove that such asset(s) existed more than one year prior to the sale, the $40,000 gain attributable to such asset(s) should be taxed as long-term capital gain.

Based on the above, upon the sale by AB LLC, A will be allocated a total of <u>$32,000 of ordinary income</u> ($16,000 of depreciation recapture and $16,000 from the sale of Contract 2) and <u>$64,000 of long-term capital gain</u> ($32,000 from the sale of Contract 1 and $32,000 from the sale of goodwill or other intangible assets).

Membership Interest Sale by A. On 12/31/12, A sells his 80% membership interest in AB LLC for $96,000. A's basis in his membership interest is zero.

Generally, A's $96,000 gain is treated as gain from the sale or exchange from a capital asset. However, under Section 751, A will be required to recognize ordinary income to the extent that he would be allocated ordinary income from the sale of certain ordinary income assets of AB LLC. Thus, A must still recognize his $16,000 share of the depreciation recapture inherent in the pipeline and his $16,000 share of the ordinary income from Contract 2.

A's remaining $64,000 gain from the sale of his membership interest will give rise to capital gain. However, as a result of A's $16,000 cash contribution on 1/1/12, A has a short-term holding period in 1/3 of his membership interest. Thus, $21,334 of A's capital gain will be short-term capital gain.

Based on the above, upon A's sale of his 80% membership interest, A will recognize <u>$53,334 of ordinary income</u> ($16,000 of depreciation recapture, $16,000 from the sale of Contract 2 and $21,334 of short-term capital gain attributable to 1/3 of his membership interest) and <u>$42,666 of long-term capital gain</u> (attributable to 2/3 of his membership interest).

IV. Conclusion

As discussed above, holding period issues are a key concern in midstream transactions involving the direct sale of pipeline assets, gas transportation contracts, goodwill or equity in entities holding such assets. Frequently the seller will have a split holding period with respect to one or more classes of assets, or with respect to the membership interest or other equity being sold. Because the nature of this split holding period may differ in an asset sale versus an equity sale, advisors should be mindful of these issues during the early stages of negotiation, particularly when negotiating the purchase price allocation.

Expect to see holding period issues arise with increased frequency over the next 12-24 months as companies begin to acquire and dispose of newly-built midstream assets in the Eagle Ford, Marcellus/Utica, and other rapidly developing shale plays across the country.

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[2] It is assumed for purposes of this discussion that 100% bonus depreciation applies to property placed in service in 2012, even though generally such property would be entitled to only 50% bonus depreciation.

Structuring Ownership of Privately-Owned Businesses:

Tax and Estate Planning Implications

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Structuring Ownership of Privately-Owned Businesses:

Tax and Estate Planning Implications

by Steven B. Gorin*

With rapid changes in our global economy, flexibility in structuring a business entity is more important than ever. This article focuses on income tax flexibility in buying into a business and also exiting from or dividing a business, also lightly touching the taxation of operations. It then discusses estate planning implications, including drafting and administering trusts to hold business interests, transfer tax issues, and fairness within families.

The author sends a link to the most recent version in his electronic newsletter (roughly quarterly), called "Gorin's Business Succession Solutions." If you would like to receive this newsletter, please email the author at sgorin@thompsoncoburn.com with "Gorin's Business Succession Solutions" in the subject line.

I. Introduction

This article 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.

---

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This article does not attempt to do an in-depth analysis of choice of entity issues, income tax on operations, or entity split-ups. Rather, it focuses 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.

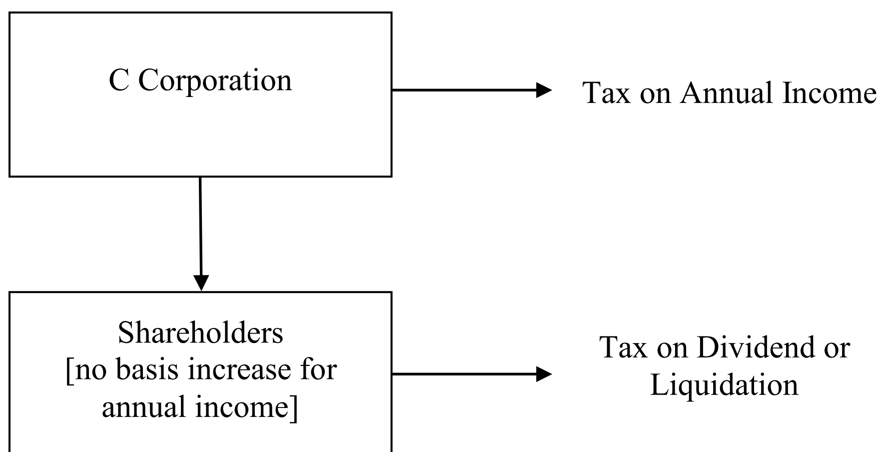
II. Income Tax Flexibility

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.

II.A. Corporation

II.A.1. C Corporation

A C corporation is a corporation[1] that is not taxed as an S corporation.[2] 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.



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.

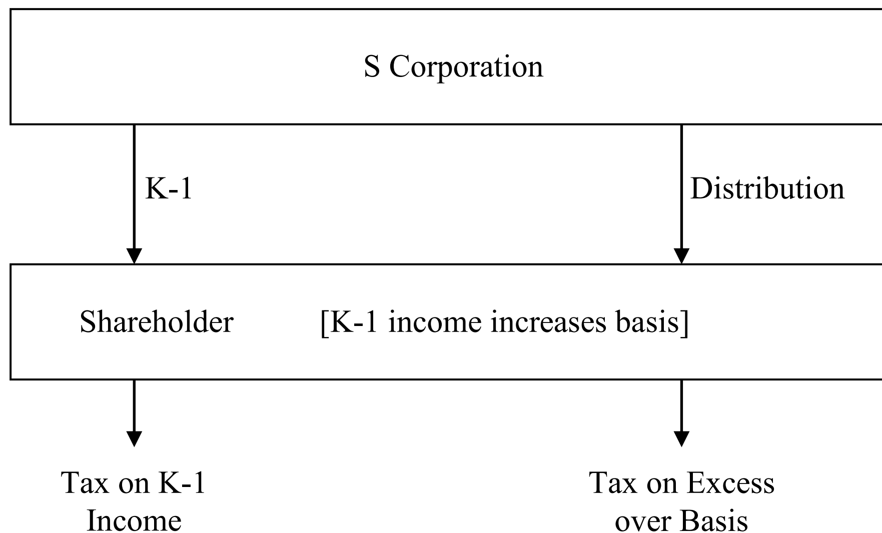
Other corporations are C corporations to minimize taxes. The income tax on the first $50,000 of a corporation‘s taxable income is only 21% (15% federal plus 6.25%

[1] Including a limited liability company, partnership, or other entity that elects taxation as a corporation. Reg. § Reg §301.7701-3.
[2] S corporations are described in part II.A.2 S Corporation.

Missouri).[3] 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. 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 15%. Some special rules provide for even more favorable capital gains tax on the sale of stock in a C corporation.

II.A.2. S Corporation

An S corporation is a corporation whose income generally is taxed to its owners rather than being taxed to the corporation itself;[4] the corporation issues a Schedule K-1 to its owners each year to report the income.



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

- **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 while the corporation was an S corporation.

[3] 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 15% 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. When favorable dividend rates do not apply, this possible bargain turns into a trap for the shortsighted.

[4] 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.

- **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 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.

- **New Corporation - Avoiding Double Taxation and Self-Employment Tax**. As a new business owner, 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. We also use several tools to try to transfer S stock free from estate and gift taxes.

Some tax professionals advise using an S corporation instead of a partnership to avoid FICA tax. 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. Furthermore, aggressively characterizing payments to employee-shareholders as distributions rather than compensation can lead to penalties.[5]

---

[5] IRS Fact Sheet 2008-25, ―Wage Compensation for S Corporation Officers," http://www.irs.gov/newsroom/article/0,,id=200293,00.html; 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*, TC 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 TC 141 (2001) (consulting and surgical services provided to veterinarians); *Joseph M. Grey, P.C. v. Commissioner*, 119 TC 121 (2002) (accounting firm); *Nu-Look Design Inc. v. Commissioner*, 356 F.3d 290 (3rd Cir. 2004) (residential home improvement company); *Robucci v. Commissioner*, TC Memo 2011-19 (psychiatrist's C corporations disregarded for self-

II.A.2.a. Making the S 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. The instructions to IRS Form 2553 discuss when an extension of time to file might be granted.

II.A.2.b. Eligible Shareholders

To be eligible for an S election, a corporation must be a domestic corporation that is not an ineligible corporation and does not have:[6]

- more than 100 shareholders,
- a shareholder who is a person (other than an estate, an eligible trust,[7] or a qualified retirement plan[8] or charity[9]) who is not an individual,
- a nonresident alien as a shareholder, and
- more than 1 class of stock.

In counting the number of shareholders, the following are treated as 1 shareholder:[10]

- 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.[11]

An individual shall be considered to be a common ancestor only if, on the applicable date, the individual is not more than six generations removed from the youngest

employment tax purposes; penalty imposed; excellent example of client not understanding what tax professional was trying to accomplish). For more detailed summaries and additional cases, see Christian & Grant, ―¶4.06. 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 282.

[6] Code § 1361(b)(1).

[7] Code § 1361(c)(2) describes eligible trusts, which are described in more detail in part III.A.5 Trusts Holding Stock in S corporations.

[8] Described in Code § 401(a) and exempt from taxation under Code § 501(a).

[9] Described in Code § 501(c)(3) and exempt from taxation under Code § 501(a).

[10] Code § 1361(c)(1)(A).

[11] 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).

generation of shareholders who otherwise would be members of the family.[12] ―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.[13] 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.[14]

The members of a family are treated as one shareholder solely for purposes of counting shareholders.[15] Each member of the family who owns or is deemed to own stock must be an eligible shareholder.[16] 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.[17]

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 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:[18]

- 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.

---

[12] 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.
[13] Code § 1361(c)(1)(B)(iii).
[14] Reg. § 1.1361-1(e)(3)(i).
[15] Reg. § 1.1361-1(e)(3)(i).
[16] Reg. § 1.1361-1(e)(3)(i).
[17] Reg. § 1.1361-1(e)(3)(i).
[18] Reg. § 1.1361-1(e)(3)(ii).

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

II.A.2.c.i. Generally – Voting and Nonvoting Stock

Although S corporations cannot have more than one class of stock,[19] differences in voting rights do not by themselves create a second class of stock.[20] Generally, if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds, a corporation is treated as having only one class of stock.[21] Thus, the corporation should 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.[22]

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.[23] 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. Retention of voting stock while transferring nonvoting stock does not create estate tax inclusion issues.[24] Such an issuance requires a special informational return to be filed with the IRS.[25]

Future reallocations between voting and nonvoting stock would not create income tax consequences.[26] However, to avoid a taxable gift, a swap of voting for nonvoting stock (or vice versa) should consider the disparity in their values.[27]

---

[19] Code § 1361(b)(1)(D). All references to a ―Code" section are to the Internal Revenue Code, 26 U.S.C.
[20] Code § 1361(c)(4).
[21] Reg. § 1.1361-1(l)(1). All references to a ―Reg." section are to U.S. Treasury Regulations promulgated under the Code.
[22] Code § 2701(a)(2)(C) provides that Code § 2701 does not apply to such a capital structure.
[23] 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.
[24] 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).
[25] Code § 6045(g) generally requires special reporting on IRS Form 8937. S corporations have special alternative rules under Code § 6045(g)(4). The instructions to IRS Form 8937 interpret this law as requiring S corporations to report nontaxable stock dividends. However, the Instructions also provide, ―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."
[26] Code § 1036. Voting trust certificates are also eligible for an income tax-free swap. Letter Ruling 200618004.
[27] *Bosca*, T.C. Memo. 1998-251.

II.A.2.c.ii. Temporary Timing Differences

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. The fact that the corrective action was necessarily non-pro-rata did not itself cause any second-class-of stock problem.

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 corporation 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.

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).[28]

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

[28] Reg. § 1.1361-1(l)(2)(i).

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. 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.[29]

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.c.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.

In *Minton v. Commissioner*,[30] 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.[31]

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.[32]

II.A.2.c.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.[33] The single-class-of-stock rules focus on rights to distribution and liquidation proceeds.[34] 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.

Certainly, an employer can give an employee a bonus based on the company's profitability. How far can an employer go in providing compensation that functions like stock ownership without actually being stock?

[29] Reg. § 1.1361-1(l)(2)(ii).
[30] 562 F.3d 730 (5th Cir. 2009) (per curiam), *aff'g* T.C. Memo 2007-372.
[31] *Minton* is summarized in Steve Leimberg's Business Entities Email Newsletter - Archive Message #124.
[32] Letter Ruling 201016040.
[33] Code § 1361(b)(1)(D).
[34] Reg. § 1.1361-1(l)(1).

- 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.[35] 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.[36]

- 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.[37] 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.[38] 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.[39]

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:[40]

> 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)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded.

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.[41] Could a sale price that is nominal be considered not to be

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[35] 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.

[36] Reg. § 1.1361-1(l)(2)(v), Example (3). Disparate employee fringe benefits are similarly acceptable. *Id.*, Example (4). Letter Ruling 200914019 (split dollar).

[37] Reg. § 1.1361-1(l)(4)(iii)(B)(2).

[38] 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.

[39] Reg. § 1.1361-1(l)(4)(iii)(C).

[40] 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.

[41] 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.

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,[42] 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.

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

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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.

[42] 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.

unless a principal purpose of that portion of the agreement is to circumvent the one class of stock requirement.[43]

II.A.2.c.v. Special Price Protection for Leveraged ESOP Approved

Letter Ruling 201038001 involved the following:

> 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.
>
> 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.

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

II.A.2.c.vi. Warrants Designed to Restore Original Shareholders' Equity Position

As described by a court:[44]

> 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 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:[45]

> 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

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

[45] Pursuant to Reg. § 1.1361-1(*l*)(4)(ii).

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.d. Overcoming Above Rules

The S Corporation can contribute its assets to a limited liability company taxed as a partnership with an ineligible shareholder as a member,[46] with another S corporation as a member (to avoid the limitation on number of shareholders), or with an investor who wants a non-pro rata equity interest in the business.

II.B. Limited Liability Company (LLC)

A limited liability company (LLC) is a business entity that generally has liability protection similar to that of a corporation. However, for federal tax purposes,[47] an LLC is treated as follows:[48]

- **Disregarded Entity**. If it has only a single member (owner), it is disregarded for federal tax purposes unless it elects otherwise;[49] if a charity is the sole owner of an LLC, then contributions to the LLC should be deductible, but no precedential authority has addressed the issue.[50] Ordinarily, a disregarded entity uses its owner's

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[46] Reg. 1.701-2(d), Example 2.

[47] For some examples of federal civil procedure and state real estate transfer tax issues involving single-member LLCs, see Kleinberger and Carter G. 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.E Asset Protection Planning.

[48] 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***.
>
> (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.

[49] Reg. § 301.7701-3(b)(1)(ii), upheld as valid by *Littriello v. United States*, 99 AFTR.2d 2007-2210 (6th Cir. 2007), and *McNamee v. Dept. of Treasury*, 99 AFTR 2d 2007-2871 (2nd Cir. 2007). An entity is also 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.

[50] 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

taxpayer ID.[51] However, if it has employees (other than the owner), the LLC has the same employment filing requirements as a corporation.[52] It is also treated as a separate taxpayer for purposes of certain excise taxes[53] and for certain other purposes as well.[54]

- **Partnership**. If it has more than one member[55] for tax purposes, it is taxed as a partnership for federal tax purposes, unless it elects otherwise.[56] However, if a husband and wife are the sole owners, then the LLC may be treated as a disregarded entity if it held as community property.[57] If an LLC (with more than one member for tax purposes) does not meet one of these exceptions, then it will likely be taxed as a

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(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." However, Letter Ruling 200150027 expressly declined (and Letter Ruling 200134025 implicitly declined) to rule on the deductibility of a contribution to such an LLC, taking the position that it was ―an issue that cannot be readily resolved before a regulation or any other published guidance is issued" (quote excerpted from Rev. Proc. 2000-1, Section 5.14(3)). Thus, commentators suggest making a contribution directly to a charity rather than a wholly-owned LLC subsidiary (or making the LLC a qualified supporting organization), not because the deduction should not be available but rather to avoid arguing with the IRS. My understanding is that some charities obtain a separate ruling for their single member LLCs; also suggested has been an agreement with the charity to the effect that the charity accepts the gift and agrees to use it for whatever purposes were agreed upon, at the charity‘s direction or request, the donor will transfer directly to the charity‘s nominee that is under the charity‘s exclusive control with whatever restrictions the charity and donor agreed upon, and the written acknowledgement (with the statement regarding whether the donor received any goods or services) and IRS Form 8283 will designate the charity as the recipient and be signed by charity On the other hand, 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).

[51] 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.

[52] Reg. § 301.7701-2(c)(2)(iv).

[53] Reg. § 301.7701-2(c)(2)(v).

[54] 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).

[55] Banoff and Liption, ―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, Mar. 2011, explores when an interest in a partnership might be too small to be considered.

[56] Reg. § 301.7701-3(b)(1)(i).

[57] 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). Several 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.

partnership.[58] A business, that is owned and operated by spouses as co-owners and is not in the name of a limited partnership, limited liability company or other state law entity, may be treated as a disregarded entity if it is a ―qualified joint venture."[59] Be sure that the entity qualifies to be disregarded;[60] failure to file 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,[61] unless ten or fewer owners are involved and each owner fully reports that owner‘s share of the income, deductions, and credits of the partnership.[62] 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.[63]

- **Corporation**. An LLC can elect to be taxed as a corporation for federal tax purposes.[64] It may further elect taxation as an S corporation, if every unit of ownership has identical rights to distributions and liquidation proceeds;[65] if the LLC

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[58] Reg. § 1.761-2(a)(2)(i) (joint purchase, retention, sale, or exchange of investment property) and Reg. § 1.761-2(a)(3)(i) (joint production, extraction, or use of property) require the owners to own the property directly. Since the LLC owns the property, members of an LLC do not own the property as co-owners. *See* FSA 200216005. Also, Reg. § 1.761-2(a)(3)(ii) requires the owners to reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used, and Reg. § 1.761-2(a)(3)(iii) does not allow co-owners to 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 one year). For the inapplicability of the Code § 121 exclusion for gain on the sale of a residence when spouses hold their residence in a partnership, see *Farah v. Commissioner*, TC Memo. 2007-369, and Letter Ruling 200119014.

[59] Code § 761(f), effective tax years beginning after December 31, 2006. To qualify for this treatment, the LLC must constitute a trade or business, both spouses must materially participate (within the meaning of Code § 469(h) without regard to Code § 469(h)(5)) in such trade or business, and both spouses must elect disregarded entity status. Chief Counsel Advice 200816030 held that active rental that qualified under this exception was not self-employment income because Code § 761(f) does not interact with Code § 1402(a). 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. 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 http://www.irs.gov/businesses/small/article/0,,id=177376,00.html 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. The IRS‘ view does not appear to be confirmed or refuted by the legislative history.

[60] Reg. § 301.6031(a)-(1)(a)(3)(i) provides that 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.

[61] Code § 6698(b)(1). The penalty is $89 instead of $125 for taxable years beginning before January 1, 2010.

[62] Rev. Proc. 84-35.

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

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

[65] 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) allows LLCs that file Form 2553 to skip the step of filing IRS Form 8832.

had been taxed as a partnership, make sure that distributions upon liquidation are made pro rata instead of according to capital accounts.

Taxpayers must file IRS Form 8832 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.[66]

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.[67]

- **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.[68]

[66] Rev. Proc. 2009-41.

[67] See II.F.9. 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.

[68] In addition to state law liability, for federal income tax purposes a tenancy-in-common might be treated as a partnership. Case law is described at the text accompanying footnotes 1164-1165. Reg. § 301.7701-1(a)(2) provides:

> *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 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 IRS has established some procedures to address this issue. *See* Reg. § 1.761-2; Rev. Proc. 2002-22; see also Letter Ruling 200826005, in which 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. If co-owners have different goals regarding whether to reinvest sale proceeds or engage in a Code § 1031 like-kind exchange, they might want to unwind anything that makes them considered partners;

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 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;[69] however, his analysis does not consider foreign tax issues.[70]

- **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. He/She 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.

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for how to unwind a partnership in anticipation of a possible Code § 1031 exchange, see ―Ike-Kind Exchanges of Partnership Properties," *The Tax Adviser*, page 812, December 2008.

[69] 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 (Code § 311), even if the corporation is an S corporation; if the corporation is a C corporation, or the corporation was a C corporation within the past 10 years (7 years, for a sale in 2009 or 2010 or 5 years for a sale in 2011, all per Code § 1374(d)(7)) and part or all of the excess of value over tax basis occurred while the corporation was a C corporation, then Code § 1374 built-in gain tax applies. 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.F.9 Future Development of Real Estate, discussing tax strategies for converting investment real estate into property that is subdivided and held for sale.

[70] *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.

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.

- **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.

These are just some of the possible reasons to consider forming an LLC. We integrate LLCs with clients‘ business objectives and estate planning goals. We also use several tools to try to transfer interests in LLCs free from estate and gift taxes.

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 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. The IRS appears to be willing to respect these ―Series‖ as separate entities [71] Whether other states would respect this compartmentalization of groups of assets is uncertain in many states. I do not recommend them, although in some cases their use might be appropriate.

[71] 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.

II.C. Partnership

Those holding properties as tenants-in-common should consider whether they are deemed to have formed a partnership.[72]

Clients doing business as a partnership, 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.

Generally, a partnership's conversion from one type of state law entity to another (that is still taxed as a partnership) will trigger income taxation absent a shift in liabilities allocated to various partners.[73]

II.C.1. 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. 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.2. 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.

II.C.3. Limited Liability Partnership Registration

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. In Missouri, a limited partnership with an LLP registration is known as a limited liability limited partnership. However, Missouri LLP (or LLLP) registration often is not quite as easy as LLC registration, and it cannot be retroactively reinstated if not renewed timely.

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[72] See Rev. Proc. 2002-22, *modified* Rev. Proc. 2003-3 (as to procedural issues, not as to substance). 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. 130.

[73] 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).

II.D. Trust as a Business Entity

If the beneficiaries are associates in a joint enterprise for the conduct of business for profit, then as trust might be characterized as a business entity.[74] 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.[75] An ―investment" trust might be treated as a business entity if there is a power under the trust agreement to vary the investment of the certificate holders;[76] a Delaware Statutory Trust, however, may be structured as a multiple grantor trust, the beneficial owners of which can obtain like-kind exchange treatment on the transfer of the trust's underlying assets.[77]

A trust that constitutes a pooling of assets that are actively managed is at risk for being treated as a business entity.[78] 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.[79] 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.[80]

II.E. Asset Protection Planning

II.E.1. Protection from Creditors Generally

Piercing the corporate veil is a doctrine that can apply to any type of limited liability issue.[81]

―Reverse piercing" is the common name for when a creditor 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.

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[74] Reg. § 301.7701-4(a).
[75] Reg. § 301.7701-4(b).
[76] Reg. § 301.7701-4(c).
[77] Rev. Rul. 2004-86. See Lipton, Donovan, and Kassab, ―The Promise (and Perils) of Using Delaware Statutory Trusts in Real Estate Offerings," Journal of Taxation (June 2008).
[78] See generally Zaritsky, Lane & Danforth, ―¶ .07 The Income Tax Meaning of ‗Trust,'" *Federal Income Taxation of Estates and Trusts* (WG&L).
[79] Letter Ruling 9547004.
[80] Letter Ruling 200219017.
[81] 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://law.baylor.edu/faculty/profiles/Miller.htm.

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[82] might be more unattractive than a creditor's remedies of taking possession of stock (particularly voting stock) of a corporation:[83] 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). 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.[84] 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. On the other hand, one court ruled that the bankruptcy trustee took the bankruptcy debtors' interest as a member, holding that bankruptcy law superseded the state's LLC statutory conversion of the debtors' interest into an assignee's interest.[85] 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.

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[82] 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; for a narrative of the creditor's attempts to unwind the debtor's maneuvering, see www.callawyer.com/story.cfm?eid=910388&evid=1.

[83] 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.

[84] 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 January 23, 2012 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). Another helpful resource is at http://www.internationalcounselor.com/chargingorder.htm.

[85] *In re First Protection, Inc.*, 2010 WL 5059589 (9th Cir. BAP (Ariz.) 11/22/2010).

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.[86] Otherwise, one can create something better than a self-settled spendthrift trust. However, Wyoming[87] and Nevada[88] provide such protection.

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.[89] If the entity is already a corporation, consider an F reorganization to convert the corporation into a partnership or LLC taxed as a corporation.[90] These issues were discussed at the Asset Protection Committee Meeting of the American College of Trust &

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[86] *See, e.g., Shaun Olmstead, et. al., 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).

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).

[87] Wyo. Stat. § 17-29-503(g), http://legisweb.state.wy.us/statutes/statutes.aspx?file=titles/Title17/T17CH29.htm, 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.

[88] NRS 86.401.2(a) states that a charging order:

> 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.

[89] 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 contactual 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.

[90] 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 and 73-256 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 and Christian & Grant, ―¶9.07. ‗F' Reorganizations," *Subchapter S Taxation* (WG&L). For whether a new employer identification number (IRS tax ID) is needed, see Rev. Rul. 2008-18.

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.[91]

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.[92]

II.E.2. 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.[93]

II.E.3. Lack of Protection

A partner who has control over payroll tax withholdings generally is personally liable for paying those to the taxing authority. New York might make any partner responsible for unpaid sales tax, even if the partner does not have any control organized the collection and remittance of that tax.[94]

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[91] The primary presenter was by Thomas O. Wells, www.twellslaw.com, tom@twellslaw.com, of Coral Gables, Florida.

[92] 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. My understanding is that Nevada has enacted some sort of charging order protection for corporations with up to 75 shareholders.

[93] *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.

[94] Banoff and Lipton, ―Tax Liability Solely by Reason of Being a Limited Partner or LLC Member," in their ―Shop Talk" column, *Journal of Taxation* (WG&L) (11/2010).

II.F. Income Tax Operating Issues

IRS January 2011 summary of recent Tax Changes for Small Businesses is at http://www.irs.gov/newsroom/article/0,,id=233824,00.html.

II.F.1. 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.[95]

Illinois imposes an income tax, called the ―replacement tax," on partnerships, S corporations and C corporations.[96] LLCs that are treated as disregarded entities do not appear to be subject to this tax.[97]

II.F.2. Excess Unearned Income Medicare Contribution Tax

For taxable years beginning after, December 31, 2012,[98] net investment income in excess of certain thresholds is subject to a 3.8% tax.[99] The legislative history explains:

> In the case of an individual, estate, or trust an unearned income Medicare contribution tax is imposed.
>
> In the case of an individual, the tax is the 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount.
>
> The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.
>
> Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

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[95] Resources include not only various 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.

[96] 35 ILCS 5/201(c).

[97] 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.

[98] P.L. 111-152, section 1402(b)(3).

[99] Code § 1411(a).

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed net investment income or the excess of adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

The tax does not apply to a non-resident alien or to a trust all the unexpired interests in which are devoted to charitable purposes. The tax also does not apply to a trust that is exempt from tax under section 501 or a charitable remainder trust exempt from tax under section 664.

The tax is subject to the individual estimated tax provisions. The tax is not deductible in computing any tax imposed by subtitle A of the Internal Revenue Code (relating to income taxes).

―Net investment income" means the excess (if any) of certain income and gain over deductions allowed for income tax purposes which are properly allocable to such gross income or net gain.[100] ―Net investment income" does not include distributions from IRAs (including Roth IRAs) or most other retirement plans.[101]

Income and gain comprising ―net investment income" consists of:[102]

(i) gross income from interest, dividends, annuities, royalties, and rents, other than income derived in the ordinary course of a trade or business,[103]

(ii) gross income derived from certain types of trades or businesses[104] (and such gross income is subject to tax notwithstanding the exclusion of trade or business income in (i) above or (iii) below), 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.[105]

[100] Code § 1411(c)(1).
[101] Code § 1411(c)(5).
[102] Code § 1411(c)(1)(A).
[103] The legislative history clarifies: ―Gross income does not include items, such as interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence, which are excluded from gross income under the income tax."
[104] Code § 1411(c)(2) defines such a trade or business would be a passive activity (Code § 469) with respect to the taxpayer or a trade or business of trading in financial instruments or commodities (Code § 475(e)(2)). The legislative history states:

> In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.

The exclusion described in the preceding sentence is limited, in that 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. Thus, such items regarding working capital are not protected and therefore would be subject to tax under Code § 1411(c)(1)(A)(i).

If one‘s modified adjusted gross income is not above the threshold, this tax does not apply, and defining ―net investment income” is not necessary. The converse is that, if one‘s modified adjusted gross income is above the threshold, one must consider the tax. Thus, even if income is excluded from ―net investment income” described above, such income might push modified adjusted gross income above the threshold, so even income that is not subject to the tax might cause the tax to apply.

This tax favors (by excluding) trade or business income from partnerships and S corporations in which the taxpayer materially participates. It taxes trade or business income from partnerships and S corporations in which the taxpayer does not materially participate. 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.

II.F.3. Personal Service Corporations

A C corporation that is a ―qualified personal service corporation” is taxed at the highest marginal corporate income tax rate.[106] A ―qualified personal service corporation” is any corporation that satisfies both of these tests:[107]

- 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.[108]

These types of entities are one of the few types of C corporations with more than $5 million of annual gross receipts that can use the cash receipts and disbursements method of accounting.[109]

[105] Gain from a disposition of an interest in a partnership or S corporation is taken into account here only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest, and a similar exception applies to a loss from that disposition. Code § 1411(c)(3). In other words, gain from the inherent sale of the underlying business assets (other than working capital) would not be subject to the tax. For an idea of how the IRS might implement this, see Reg. § 1.469-2T(e)(3)(ii).

[106] Code § 11(b)(2).

[107] Code § 448(d)(2).

[108] Reg. § 1.448-1T(e)(4)(iv), particularly clause (A) and Example (1) of clause (B).

[109] Code § 448(b)(2).

Generally, they also are required to file income tax returns using a calendar year.[110]

II.F.4. Loans between Owner and Entity

Generally, loans between corporations and shareholders are subject to the Code § 7872 rules governing below-market loans.[111]

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.[112]

II.F.5. 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.[113]

II.F.6. Trust Income Tax Disadvantage When Pass-Through Entity Holds Depreciable Property

Code § 179 allows businesses to expense depreciable personal property within certain limits, which limits have become much more generous in recent years.[114] However, a trust cannot deduct this special Code § 179 expense that flows through on its K-1 from a partnership or S corporation.[115] The business entity does not reduce its basis in, and may depreciate, this depreciable property to the extent that this deduction is disallowed.[116] Presumably, this complexity would be avoided by using a grantor trust.[117]

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[110] Code § 444(i)(1). Note, however, that ―personal service corporation” is defined differently for these purposes. Code § 444(i)(2).

[111] Code § 7872(c)(1)(C).

[112] Whitmire, Nelson, McKee, et al, ―¶.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.

[113] TAM 200040004.

[114] See Stevens, ―Section 179‘s Special Pass-Through Entity Rules,” *Business Entities (WG&L)* (July/August 2010).

[115] Code § 179(d)(4).

[116] 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 to the trust or estate.

[117] See fn 412, citing Rev. Rul. 2007–13 as further authority (beyond Rev. Rul. 85–13) that the grantor of a grantor trust is deemed to own directly any asset owned by that trust.

Similarly, 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.[118] Furthermore, the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each; 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 beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each.[119]

II.F.7. Income Tax vs. Estate and Gift Tax

With the estate and gift tax rate at only 35% for 2011 and 2012, 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.[120]

Ordinary income assets include the following depreciable property:[121]

- 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
- 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
- Amortizable goodwill, going concern value, and other intangibles[122]
- 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)[123]

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[118] Rev. Rul. 74-71.

[119] Reg. § 1.167(h)-1(b), incorporated by reference by Reg. § 1.642(e)-1.

[120] 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. ―A2010 Estate that Holds Depreciable Property Might Benefit from Paying Estate Tax,” *Steve Leimberg's Estate Planning Email Newsletter* (Archive Message #1771). Taking his thought one step further, 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.

[121] PPC‘s *1040 Deskbook*, Table T801: Depreciation Recapture. I have not verified all of this.

[122] Code § 197.

- Certain real property bought before 1981

Note that gifts of properties subject to liabilities in excess of basis (sometimes referred to as ―negative basis" assets,[124] which is a technically incorrect description that gets the point across) will trigger gain recognition. Even if one uses an irrevocable grantor trust as the donee, one must consider what happens when grantor trust status terminates.[125] The cleansing effect of a basis step-up at death might be a better planning tool.[126]

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[123] 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.

[124] 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.
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).

[125] If a grantor trust terminates during life, gain is recognized under Rev. Rul. 77-402; Reg. § 1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985). Blattmachr, Gans & Jacobson, ―Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 96 *J. Tax'n* 149 (Sept. 2002) asserts that gain is not recognized at death. One might consider the grantor retaining an interest in the partnership and assuming liabilities in a side agreement under Reg. § 1.752-2(b)(5), 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 as described in n. 126. 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.

[126] Generally, the inherent gain in ―negative basis" assets is cleansed at death. 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). Even if a Code § 754 election is in place, any increase in the basis of the partnership interest generates an increase in the basis of the partnership's assets 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). Thus, if a partnership's liabilities exceed the fair market value of its assets, and the partnership interest has no value, then any basis

II.F.8. Passive Loss Rules

Although owners of partnerships and S corporations generally can deduct losses, subject to various basis limitations, the passive loss rules suspend deductions when the activity is rental or the taxpayer does not materially participate.[127]

This analysis is further complicated when a trust owns the business interest.[128]

Code § 469(j)(12) says that, when an estate or trust terminates, any passive losses suspended under Code § 469 will be permanently disallowed, but, to be fair, added to the basis of the partnership interest.

If an interest in the activity is transferred by reason of the death of the taxpayer, losses are generally 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 shall not be allowed as a deduction for any taxable year.[129]

Suppose an estate is terminating, using fractional pick-and-choose funding. A Code § 469(j)(12) basis increase in the partnership interest does 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, in that the suspended passive losses generating the Code § 469(j)(12) basis increase necessarily occurred post-mortem.

II.F.9. Future Development of Real Estate

Gain on the sale of real estate[130] is taxed as:

- Capital gain, to the extent it is held for investment,

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increase by reason of death will not lead to an increase in the basis of the partnership's assets. If the partnership's assets are later sold, generating a capital gain, then consider liquidating the partnership so that the capital loss on the disposition of the partnership interest will offset the gain on sale of the underlying assets.

[127] Code § 469.

[128] In *Mattie K. Carter Trust v. United States*, 256 F. Supp.2d 536 (N.D. Tex. 2003), the IRS argued that ―material participation" should be based on the trustee's actions alone; 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. The IRS disagrees with this result. TAM 200733023. Letter Ruling 201029014 failed to mention the *Mattie K. Carter Trust* case and agreed that material participation could be determined by the actions of a person who was both a trustee and beneficiary.

[129] Code § 469(g)(2).

[130] For an excellent overview of expenditures 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.

- 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)[131] but then decides to develop it should consider selling it to the taxpayer‘s wholly-owned S corporation to lock in capital gain treatment on the pre-development appreciation;[132] however, any S corporation that holds real estate should have that (together with any ancillary cash) as its only property.[133] 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.[134]

The sale might be using an installment note to defer capital gain until the real estate is sold.[135]

II.F.10. Economic Substance

Income tax benefits with respect to a transaction (including a series of transactions),[136] entered into in connection with a trade or business or an activity engaged in for the production of income,[137] are not allowable if the transaction does not have economic substance or lacks a business purpose.[138]

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[131] Tucker and Langlieb, fn. 130, 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*, TC 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.

[132] 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.

[133] Dividing on a tax-free basis corporations that hold real estate can be

[134] 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).

[135] The gain would be accelerated under Code § 453(e).

[136] Code § 7701(o)(5)(D).

[137] Code § 7701(o)(5)(B).

[138] 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*

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.[139] Income tax effects include not only federal but also state and local income effects.[140] 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.[141]

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.[142]

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remanding 62 Fed. Cl. 716 (2004) (slip opinion at 123-124, 128); *cert. denied*, 127 S. Ct. 1261 (Mem.) (2007). 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 penaltied were not applied)..

[139] Code § 7701(o)(1).

[140] 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.

[141] Code § 7701(o)(4).

[142] Code § 7701(o)(2)(A).

The legislative history carves out some exceptions:[143]

> 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.,

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[143] 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).

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[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).

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[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).

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[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").

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[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).

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.[144] 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).[145] However, the IRS has issued guidance to examiners, including:[146]

The following facts and circumstances tend to show that application of the economic substance doctrine to a transaction is likely not appropriate.…

• Transaction is not promoted/developed/administered by tax department or outside advisors

• Transaction is not highly structured

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[144] Notice 2010-62.
[145] Notice 2010-62.
[146] "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).

• 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.

The examiner is also directed to coordinate with Counsel.[147]

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.[148]

For transactions entered into after March 30, 2010:[149] 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.[150] If the relevant facts affecting the tax treatment are not adequately disclosed in the return or in a statement attached to the return, then the penalty doubles to 40%.[151] Although reasonable

[147] 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.

[148] 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.

[149] P.L. 111-152 at §1409(e).

[150] Code § 6662(b)(6).

[151] 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.

cause generally is a defense to negligence and other penalties, it is not a defense to this 20% or 40% penalty.[152]

II.F.11. Rescinding Conversion of Entity

The IRS often respects rescissions for income tax purposes[153] when a transaction is reversed in the same taxable year. The IRS explains:[154]

> 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.

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[152] 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).

[153] 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.

[154] 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).

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.[155]

The IRS has also allowed a taxpayer to rescind a restructuring involving a subsidiary to reverse unintended adverse Federal income tax consequences.[156]

II.F.12. Sale of Intangible Assets – Capital Gain vs. Ordinary Income

II.F.12.a. Generally

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.[157]

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, 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."[158]

II.F.12.b. 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 any individual whose efforts created such property or 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.[159] However,

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[155] Letter Ruling 200952036.

[156] Letter Ruling 201008033.

[157] CCA 2011440230

[158] Citing *Commissioner v. Gillette Motor Transport Co.*, 364 U.S. 130, 135 (1960) (compensation for temporary seizure of business facilities is ordinary income).

[159] Code § 1235(b).

the latter cannot be the employer of such creator or related[160] to such creator. Thus, this treatment is best suited for someone who creates an invention on his or her own and then transfers it to an entity that then reduces the invention to practice.

Although a partnership cannot be 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.[161] 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.[162]

II.F.13. IRS Audits of Large C Corporations

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[163] 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.[164]

II.G. 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.G.1. Corporations

Generally, initial incorporation is not a taxable event[165] except to the extent that liabilities by the corporation exceed the adjusted basis of assets contributed to the corporation.[166]

[160] As defined in Code § 1235(d).
[161] Reg § 1.1235-2(d)(2).
[162] Letter Ruling 200135015.
[163] 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.
[164] REG-119046-10, issued 9/7/2010, proposing to add paragraphs (4) and (5) to Reg. § 1.6012-2(a).
[165] Code § 351.
[166] 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).

Liabilities that would give rise to a deduction when paid are ignored.[167] However, gain is fully recognized if the transaction's principal purpose is to avoid federal income tax.

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. Various other restrictions on favorable tax treatment may apply depending on the situation.

II.G.2. Partnerships

Generally speaking, when a partner contributes property to a partnership, the partner does not recognize any gain or loss inherent in the property at the time of contribution.[168] Thus, 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.[169] The partner's basis in the partnership is also equal to the partner's basis in the partner's contributed property.[170] If the partnership is mainly to hold marketable securities, using only cash to form it has certain advantages.[171]

However, a contributing partner must recognize gain on certain occasions. First, § 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.[172] The gain recognized by the contributing partner increases the basis of not only the contributor's partnership interest,[173] but also the partnership's basis in the property.[174] 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, 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.[175] Thus, the main way to avoid having a contribution treated as having been made to an investment company is to ensure the transfer does not

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[167] 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).

[168] Code § 721(a).

[169] Code § 723.

[170] Code § 722.

[171] See footnotes 1035-1036 and the accompanying text.

[172] Code § 721(b).

[173] Code § 722.

[174] Code § 723.

[175] 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 (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).

result in diversification of the transferor‘s interests.[176] 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.[177] Another way to avoid investment company status would be to have each transferor contribute a portfolio of stock and securities that is already diversified.[178] Finally, the transferor will not attain diversification (and will not recognize gain) if the contributions of other partners are de minimis.[179]

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.[180] 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.[181] 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.[182]

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[176] 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.

[177] Reg. § 1.351-1(c)(5). Pre-contribution transfers between spouses may be an excellent solution. Letter Ruling 200317011.

[178] 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 twenty-five percent tests requires that not more than twenty-five percent of the value of the portfolio be invested in the stock and securities of any one issuer, and the fifty percent test requires that nor more than fifty percent of the value of the portfolio‘s total assets be invested in the stock and securities of five or fewer issuers.

[179] 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.

[180] Code § 752(a); Code § 722.

[181] Code § 752(b); Code § 731(a).

[182] 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, 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

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. Under Code § 707(a)(2) and Reg. § 1.707-3(b), when a partner receives a direct or indirect transfer of money or other property related to a transfer he made to the partnership, the transfer can be treated as a sale or exchange of property between partner and the partnership.[183] Such transfers 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.[184]

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.[185] If the liability assumed or taken subject to is considered a ―qualified liability" under Reg. § 1.707-5(a)(6),[186] then the liability is not treated as consideration for a sale unless some other reason exists for

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My Brother's Keeper and Other Lessons From the Related-Party Rules of Section 752," *Journal of Taxation* (Jan. 2011).

[183] Reg. § 1.707-3(b)(2) lists facts and circumstances to be considered in determining whether the transfers constitute a 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." See *Canal Corporation v. Commissioner*, 135 T.C. No. 9 (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.

[184] Reg. § 1.707-3(c)(1).

[185] Reg. § 1.707-5.

[186] This section gives four definitions for a qualified liability. The first definition is a liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to the transfer or the date of the transfer and that has encumbered the transferred property throughout that two-year period. The next ―qualified liability" is a liability that was not incurred in anticipation of the transfer to the partnership, but that was incurred by the partner within two years prior to the earlier of the date of agreement to transfer or the date of the transfer and that has encumbered the property since it was incurred. Third, a qualified liability includes a liability that is allocable under Reg. § 1.163-8T to capital expenditures with respect to the property. Finally, a qualified liability can be a liability that was incurred in the ordinary course of business in which the property transferred was used or held but only if all the assets related to that trade or business are transferred, other than assets not material to the continuation of the business. In cases of recourse liabilities, in addition to falling into one of the four categories, the amount of the liability must not exceed the fair market value of the transferred property (less other liabilities) at the time of the transfer.

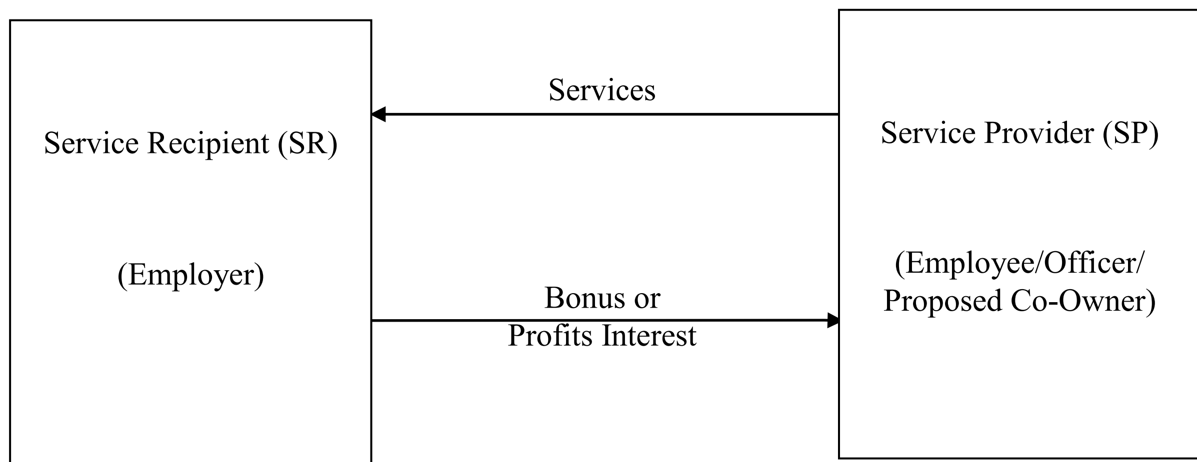
the transfer to be treated as such.[187] If the liability is not a qualified liability, then the partner is treated as having received consideration for his transfer to the extent the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability.[188] If the non-qualified liability is a recourse liability and the contributing partner continues to be the only recourse party, then the liability will never be treated as consideration because the partner's share of the liability does not change.[189] However, if the partner contributes a non-qualified, non-recourse liability, then some of the liability may be treated as consideration, since some of the liability will shift to other partners, but the amount of the non-recourse liability that shifts is not determined under the normal Code § 752 rules for allocating partnership liabilities.[190]

II.G.3. 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.[191] Neither the 80% control test nor any business purpose rule applies.

II.G.4. Providing Equity to Key Employees and an Introduction to Code § 409A Nonqualified Deferred Compensation Rules

II.G.4.a. Overview



[187] Reg. § 1.707-5(a)(5)(i).
[188] Reg. § 1.707-5(a)(1).
[189] Reg. § 1.707-5(a)(2)(i).
[190] Reg. § 1.707-5(a)(5).
[191] However, a shifting of liabilities might constitute a disguised sale.

II.G.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.[192]

[192] See Code § 2701. This was discussed in the 2009 Heckerling Institute in the context of profits interests; when capital accounts and rights to profits are not proportionate to each other, any change in capital structure will cause Code § 2701 problems unless it fits within the exceptions.

II.G.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.[193]

- ―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.

- 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.G.4.b. Introduction to Code § 409A Nonqualified Deferred Compensation Rules

Enacted by the American Jobs Creation Act of 2004,[194] Code § 409A imprints a new layer of rules that supplements previously existing rules on taxing deferred

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[193] 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.

[194] Although the statute became effective January 1, 2005, existing plans did not need to be modified until December 31, 2008. Notice 2007-86.

compensation.[195] 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![196] The service provider must pay a penalty of 20% of the deferred compensation when it is includible in gross income.[197] 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.[198] 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.[199] Special rules apply to split-dollar life insurance arrangements that were entered into before 2005.[200] These materials are 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.

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. Be careful to consider covenants in current loan or bond (for construction companies, etc.) arrangements, as well as the impact on future access to credit and bonds.

II.G.4.b.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.[201] 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.

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[195] Constructive receipt, Code § 83, Code § 457(f), etc.

[196] Notice 2008-62.

[197] Code § 409A(a)(1)(B)(i)(I); Prop. Reg. § 1.409A-4.

[198] Code § 409A(a)(1)(B)(i)(II); Prop. Reg. § 1.409A-4.

[199] 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.

[200] Notice 2007-34. See footnote 395 for a summary of how split-dollar arrangements work.

[201] Reg. §§ 1.409A-1(b)(4)(i), 1.409A-3(b), (d).

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.G.4.b.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 and the payment is deferred at least 5 years.[202]

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 than 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.[203]

II.G.4.b.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.[204] Generally, such a

[202] Code § 409A(a)(4)(C).
[203] See III.B.4.c.v.

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.[205] Similar rules apply to partnerships.[206] Using principles that apply to other forms of performance-based compensation, Code § 2701 should not apply to compensation awarded upon change of control.

II.G.4.c. Issuing Stock to an Employee

II.G.4.c.i. Generally

An employee who receives stock as compensation for services must pay tax on that stock.[207] However, 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.[208] Usually the corporation will ―gross-up" the employee‗s pay by paying the employee‗s taxes on that compensation.

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[204] 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).

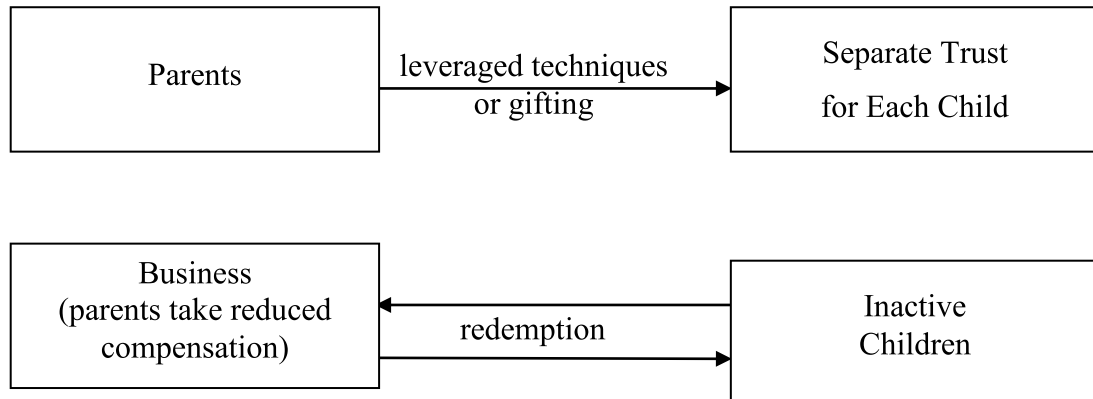
[205] Reg. § 1.409A-3(i)(5)(v)(A). This applies to a change in the ownership of the corporation, a change in effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation. Reg. § 1.409A-3(i)(5)(i).

[206] 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.

[207] Code § 83.

[208] Code § 83(b)(2).

II.G.4.c.ii. Advanced 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 III.B.1.

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 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.

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[209] or S corporations,[210] 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 II.L.4.b.

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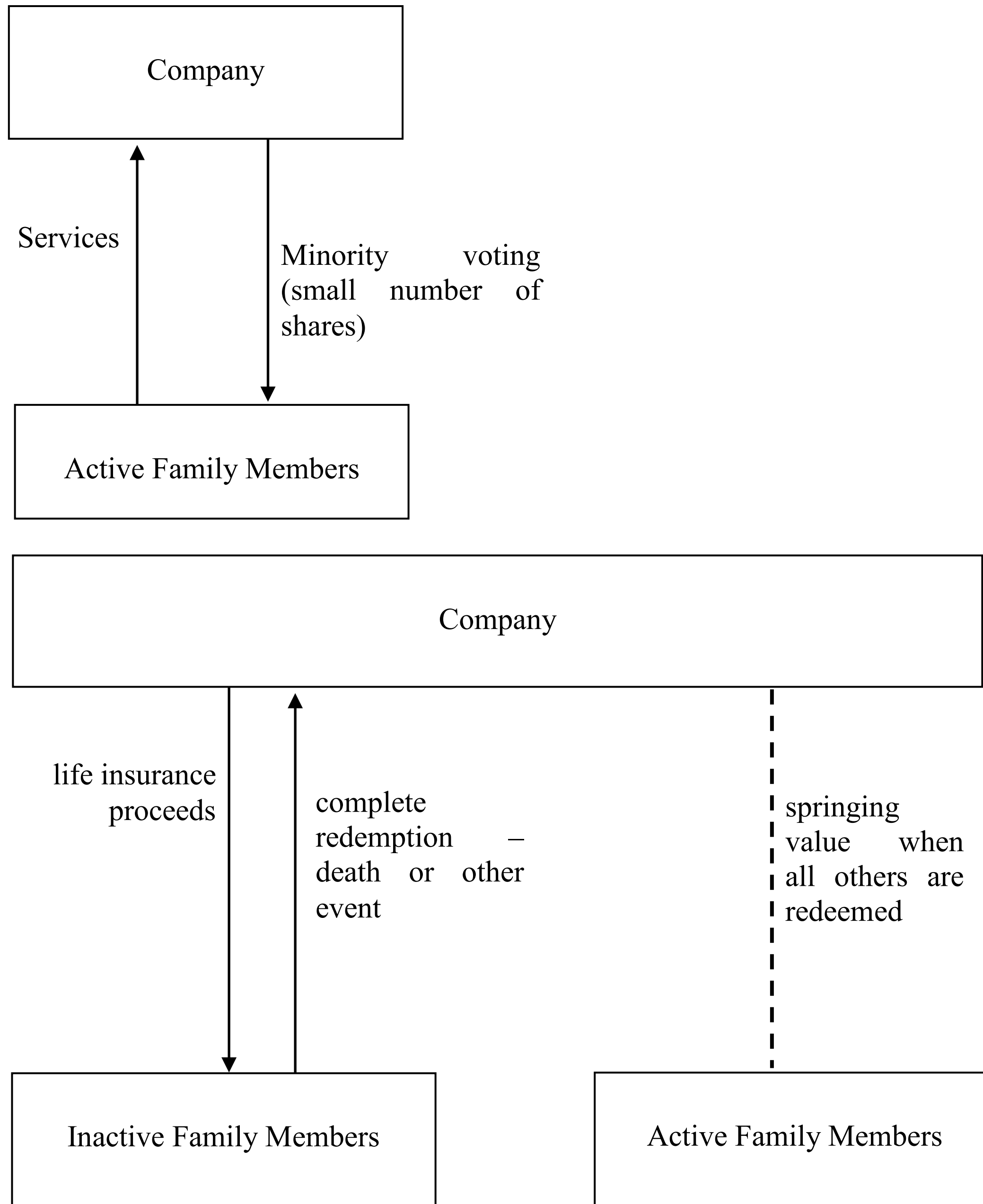
[209] Code § 704(e).
[210] Code § 1366(e).

II.G.4.c.iii. Advanced Succession Planning Using Redemptions Funded by Life Insurance

Consider the following business succession strategy:



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.L.2.b 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,[211] and S corporations that have significant accumulated E&P from when they were C corporations would lose AAA.[212]

- 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.[213]

• 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 II.L.2.c Consequences of a Buy-Sell Agreements Not Dependent on Choice of Entity.

II.G.4.d. Issuing a Profits Interest to an Employee

II.G.4.d.i. Overview

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.[214] The profits interest could turn into golden handcuffs that avoid the strict rules on timing that Code § 409A

[211] See II.L.4.b.i, which discusses the impact on S corporations, but the same principles would seem to apply to partnerships.
[212] II.L.4.b.ii. Although life insurance adds to each shareholder‘s stock basis, it adds to the other adjustments account rather than to AAA.
[213] Code § 101(a)(2).
[214] 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

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.

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.4.c.

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 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.[215]

II.G.4.d.ii. Tax Effect of Issuing a Profits Interest

Under Rev. Proc. 93-27, if a person receives a profits interest[216] for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of 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.

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[215] Rev. Rul. 69-184; Reg. § 1.707-1(c).

[216] 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.

If Rev. Proc. 2001-43 does not apply to the grant of a substantially nonvested partnership profits interest and if case law[217] 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.

The IRS has proposed regulations[218] 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.

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[219] 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:

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[217] *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). The Eighth Circuit in *Campbell* cited an earlier version (that has since been updated) of McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* (WG&L), ¶5.02, ―Distinguishing Taxable From Nontaxable Service-Connected Transfers of Partnership Interests: Is There a Difference Between Capital and Profits Interests?" and of Willis & Postlewaite, *Partnership Taxation* ¶4.06, ―Partnership Profits Interest Received in Exchange for Services."

[218] 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, 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.

[219] See footnote 193.

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.

A recent article explains some of the nuances and practical implications of profits interests.[220]

II.G.4.e. Options to Acquire Equity

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 interest.[221] Thus, they should not be subject to Code § 2701. However, they are subject

[220] 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).

[221] A partner's option to acquire a partnership interest might or might not constitute an equity interest. See III.B.4.c.vi.

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.[222]

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.[223] 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.[224] 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 two ways to determine fair market value:[225]

- Notice 2005-1, Q&A-4(d)(ii) 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.[226]

- Prop. Reg. § 1.409A-1(b)(5)(iv)(B) 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.[227]

- Reg. § 1.409A-1(b)(5)(iv)(B) provides:

  (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

[222] The *Amlie* case is described in the text accompanying footnote 433.
[223] 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.
[224] Reg. § 1.409A-1(b)(5)(i)(A).
[225] Notice 2006-4. Final regulations were effective generally January 1, 2008. Notice 2006-79.
[226] Section XII.C. of the Preamble to the final regulations.
[227] Section XII.C. of the Preamble to the final regulations.

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 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.

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.[228] An SAR is likely have few, if 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).[229] 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,[230] although it could be excluded from Code § 409A for other reasons. However, the IRS takes the position that a gift of a stock option is an incomplete gift until exercise of the option is no longer conditioned on the performance of services by the transferor;[231] presumably, this attitude would also apply to

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[228] Reg. § 1.409A-1(b)(5)(i)(B).

[229] 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 Section 83(b) election should not be made.

[230] Reg. § 1.409A-1(b)(6)(ii).

[231] Rev. Rul. 98-21, reversing the IRS' prior Letter Ruling position. Note that *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 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

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.H. Shareholder Agreements and Operating Agreements

II.H.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,[232] 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.

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, allows 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.

II.H.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.[233] 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.[234]

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

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."

[232] 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.

[233] Code § 761(c).

[234] Reg. § 1.761-1(c).

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.[235]

II.I. Buy-Sell Agreements

II.I.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 rights is called an assignee. LLC and partnership buy-sell provisions specify whether a transferee is an assignee or has voting and management rights.

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://www.abanet.org/dch/committee.cfm?com=RP519000.

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[235] Letter Ruling 9821051.

II.I.2. Spousal Issues in Buy-Sell Agreements and Related Tax Implications

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.[236] Preferably, the spouse would be represented by his or her own counsel. Be sure to update spousal consent when amending the buy-sell agreement.

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.[237]

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

[236] See, e.g. *Suther v. Suther*, 627 P.2d 110 (Wash. App. 1981).

[237] 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.

marital deduction might be totally disallowed.[238] 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 Code §2056(b)(7), which requires that the spouse be the only beneficiary.

When a business passes to a surviving spouse in a trust, a QSST or an ESBT election must be made. All testamentary marital trusts qualify as QSST, and QSSTs generally have more favorable income tax effects than ESBTs.[239] These issues are discussed elsewhere in these materials.

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.[240] 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).[241] However, this disaggregation would not apply to a general power of appointment marital trust (Code §2056(b)(5)).

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*,[242] the decedent 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

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[238] 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.

[239] 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.

[240] See *Estate of Bright v. US,* 658 F.2d 999 (5th Cir. 1981).

[241] See *Estate of Bonner v. US*, 84 F.3d 196 (5th Cir. 1996); *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999); *Nowell v. Comm'r,* T.C. Memo 1999-15.

[242] 88 T.C. 1577 (1987).

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.[243] This same result can occur in the charitable contribution deduction context, when a decedent leaves a minority interest in stock to a charity.[244] Thus, estate planners need to be aware of this whipsaw effect when determining how the estate will be divided. For example, if a controlling interest is to be divided among charities, with each receiving a minority interest, the IRS might argue that the bequest to each receives a minority discount; instead, consider bequeathing the controlling interest to a private foundation for the benefit of those charities.

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 chose 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.J. 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.

II.J.1. Income Taxation of Operations

II.J.1.a. Generally

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. 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.

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[243] 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.

[244] See generally *Estate of Schwan v. Comm'r,* T.C. Memo 2001-174 (taking into account post-mortem transformations occurring in funding a charitable bequest).

S corporations and partnerships generally do not pay income tax.[245] 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.

Owners generally may deduct losses to the extent of the owners' basis in their S stock[246] or partnership interest.[247] 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; instead of guaranteeing a corporation's bank loan, S shareholders should borrow from the bank and then loan the proceeds to the corporation to deduct the loss.[248] [249] In

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[245] 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 a ten year ―recognition period," Code § 1374. See ―Dealing with the S Corporation Built-In Gains Tax, Parts 1 and 2," *Journal of Taxation* April and May 2008. Special rules reduce the recognition period for 2009 and 2010, Code § 1374(d)(7).

[246] 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).

[247] See Code § 704(d). See also Collins, ―Charitable Gifts of Partnership Interests and Partnership Property," ACTEC Business Planning Committee Summer 2008.

[248] The IRS will attack loans that seem too circular. See, e.g. TAM 200619021, which was upheld in *Kerzner v. Comm'r*, 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.), which reasoned:

> In order to acquire basis in indebtedness of an S corporation, the caselaw has required that: (1) The indebtedness run directly from the S corporation to the shareholder and (2) the shareholder make an actual economic outlay that renders him poorer in a material sense. *Underwood v. Commissioner*, 63 T.C. 468 (1975), *affd*. 535 F.2d 309 (5th Cir. 1976); *Perry v. Commissioner*, 54 T.C. 1293, 1296 (1970), *affd*. per order 27 AFTR 2d 71-1464, 71-2 USTC par. 9502 (8th Cir. 1971); *Kaplan v. Commissioner*, T.C. Memo. 2005-218….
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> We have previously held that transactions involving a brief, circular flow of funds (beginning and ending with the original lender) designed solely to generate bases in an S corporation have no economic substance and therefore do not evidence the required economic outlay. *Oren v. Commissioner*, T.C. Memo. 2002-172, *affd*. 357 F.3d 854 (8th Cir. 2004). In *Oren*, the taxpayers engaged in a circular loan transaction in an attempt to claim depreciation deductions otherwise in excess of bases in their S corporations. Starting from the taxpayers' other S corporation, loans of identical or almost identical amounts of money circled around to the taxpayers, to the S corporations with the depreciation deductions, and then back to the first S corporation. In holding that no economic outlay had been made, we found that the economic positions of the parties had not changed and that the disbursements of loan proceeds were the equivalent of offsetting bookkeeping entries. We noted that the cashflow on the loan repayments confirmed the transactions' lack of economic substance because they too followed a circular route. The Court of Appeals for the Eighth Circuit relied on similar reasoning to affirm our decision.
>
> We have reached this same conclusion even where a loan was not used at every step of the circular transaction. *Kaplan v. Commissioner, supra*. In *Kaplan*, the taxpayer lent proceeds of a bank loan to his S corporation. That corporation paid the proceeds over to another S corporation owned by the taxpayer, which then lent the money back to the taxpayer. Since the first S corporation had an account payable due to the second, the taxpayer argued that the transfer between the S corporations was a repayment of debt and the entire transaction was therefore not a circular loan. Because this transfer was not a loan, the debts of the first S corporation and the taxpayer

contrast, partners generally may deduct losses financed by bank loans to the partnership to the extent permitted by the Code § 465 at-risk rules.[250]

II.J.1.b. 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.[251]

II.J.1.b.i. 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�begin{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

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technically continued to exist, unlike those in *Oren v. Commissioner, supra*, since there was no opposing cycle of loan repayments to automatically extinguish those debts.

See *Russell v. Commissioner*, TC 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.

[249] 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* 105 AFTR.2d 2010-2699 (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 close of the S corporation‘s taxable year. Reg. § 1.1367-2(a)(2), (d)(2), (e)(Exs. 7 & 8).

When debt‘s basis has been reduced by losses, and the principal is repaid, payments attributed to the basis reduction constitute income. 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. Rev. Rul. 64-162. However, if the debt is not evidenced by a written instrument (*e.g.,* open account debt), the income upon repayment will be ordinary income. Rev. Rul. 68-537.

[250] 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).

[251] Defining the ownership in a partnership can be challenging. 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).

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.[252] 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.

Special allocation rules govern contributions of property and the income, gain, loss, and deductions associated with contributed property. Under Code § 704(c), contributed property's income, gain, loss, and deductions 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.[253] This allocation ensures that the right person, the contributing partner, will realize any net pre-contribution gain or loss. 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. 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.[254] Note that a partner cannot erase the "Code § 704(c) taint" by transferring his interest to a third party. When a partnership interest is transferred, any tax attributes associated with the interest travel from the old partner to the new partner, and the new partner becomes the "contributing partner."[255] In addition to allocating gain or loss, Code § 704(c) also requires allocations of depreciation and amortization related to contributed property, as outlined in Reg. § 1.704-3.

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:[256]

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[252] 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).

[253] Code § 704(c)(1)(A). 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.4.b Code § 2701 Overview and III.B.4.c Code § 2701 Interaction with Income Tax Planning for a discussion of Code § 2701.

[254] 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).

[255] Reg. § 1.704-4(d)(2).

[256] Reg. § 1.704-1(b)(2)(iv)(f)(5).

- 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.[257]

When the partnership adjusts capital accounts to reflect such an event:[258]

- The adjustments must be based on the fair market value of partnership property on the date of adjustment.

- The adjustments must reflect the manner is 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 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

[257] This last bullet point generally refers to the issuance of a profits interest, as discussed in II.G.3.
[258] Reg. § 1.704-1(b)(2)(iv)(f).

has changed. Allocating the responsibility for these new book-tax differences is called a reverse-704(c) allocation.[259]

If one partner transfers a partnership interest to another person, the transferee receives the transferor‘s capital account.

Because of very complicated estate and gift tax rules governing family businesses,[260] 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.[261] 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.[262]

Tracking Code § 704(c) responsibility often is administratively cumbersome. Special rules simplify this process for certain securities partnerships.[263]

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[259] Reg. § 1.704-3(a)(6).

[260] Code § 2701.

[261] Not only does a pro-rata capital structure help a family partnership avoid Code § 2701 problems, it also enables the partnership to comply with Code § 704(e) rules governing family partnership allocations. Code§ 704(e) requires a partner‘s capital account to be proportionate to the partner‘s profit-loss percentage when capital is a material income-producing factor in the partnership.

[262] Reg § 1.704-3(a)(10), added by T.D. 9485 (6/8/2010).

[263] Reg. § 1.704-3(e)(3) and Rev. Proc. 2007-59, applying special rules to reverse-704(c) allocations (defined in text accompanying footnote 259). *See* Letter Rulings 201028016 and 201028017 (companion letter rulings involving 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. See Letter Ruling 201032003, allowing a partnership 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.

II.J.1.b.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.[264] Special allocations of profits are not permitted, and Code § 704(c) responsibility does not exist.

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.

II.J.1.b.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. 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.

II.J.2. FICA

II.J.2.a. FICA: Partnership or Sole Proprietorship

Generally, all of a partnership's or sole proprietorship's operating income is subject to income tax and FICA (self-employment) tax.[265] Self-employment (SE) tax is 15.3%[266] (13.3% in 2011)[267] on income up to the taxable wage base (TWB) and 2.9%[268] on all

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[264] Code § 1377(a)(1).

[265] 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.

[266] 12.4% under Code § 1401(a) plus 2.9% under Code § 1401(b).

[267] See P.L. 111-312, Sec. 601, for details of this temporary tax cut in the tax imposed under Code § 1401(a).

[268] Code § 1401(b).

(RRA 1993 repealed the cap) income above the TWB. See http://www.ssa.gov/OACT/COLA/cbb.html for the current amount ($110,100 in 2012). Starting in 2013, an additional 0.9% self-employment tax will apply to self-employment income in excess of the following thresholds: $250K for married filing jointly, $125K for married filing separately, or $200K otherwise.[269] Half of the SE tax is deductible for income tax purposes.

However, income from rental activity generally is not subject to SE tax.[270] Income from any other activity that is not a trade or business is not subject to SE tax.[271]

Also, a limited partner‘s income is not subject to SE tax,[272] except for guaranteed payments for services rendered to a partnership that engages in a trade or business.[273] How this exclusion for limited partners is to be applied to LLCs is uncertain.[274] 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," the Tax Court 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.[275] The court pointed out that substantially:

> 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

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[269] 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)

[270] 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).

[271] Reg. § 1.1402(a)-1(b). Trustee and executor fees are exempt from self-employment tax except to the extent that they are attributable to the conduct of a trade or business by the trust or estate. Rev. Rul. 58-5; see also Letter Ruling 8238055.

[272] Code § 1402(a)(13).

[273] Prop. Reg §1.1402(a)-2.

[274] 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. *Gregg v. U.S.*, 186 F.Supp.2d 1123 (D. Ore. 2000); *Garnett v. Commissioner*, 132 T.C. No. 19 (case no. 9898-06 6/30/2009); *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. Commissione*r, 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.

Note, however, that the passive loss rules do not apply to limited partners who satisfy certain tests of material participation, Reg. § 1.469-5T(e)(2), so the scope of this issue is limited.

[275] *Renkemeyer, Campbell and Weaver, LLP v. Commissioner*, 136 T.C. No. 7 (2011), addressing services provided by partners in a law firm.

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.

Subsections (g) through (i) of Prop. Reg. § 1.1402(a)-2 provide:

> **(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.
>
> **(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;[276]
>
> (ii) Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership;[277] 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—

[276] 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?

[277] Does this mean a manager-managed LLC and the ―limited partner" is not a manager, or member-managed with voting and nonvoting interests?

(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

(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).

II.J.2.b. FICA: Corporation

For corporations, compensation, including any distributions re-characterized as salaries, is subject to income tax and FICA tax.[278] Income retained by the corporation and not paid as compensation is not subject to FICA tax.[279] For S corporations, shareholders' health insurance is deductible to the S corporation and considered compensation to owners.[280] 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.[281]

II.J.2.c. FICA: Partnership with S Corporation Blocker

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. The partnership would treat the owner as an employee with respect to reasonable compensation for services rendered. Because S corporation earnings are not subject to FICA, no self-employment tax would be imposed on the distributive share of partnership self-employment income when it passes to the S corporation owner.[282]

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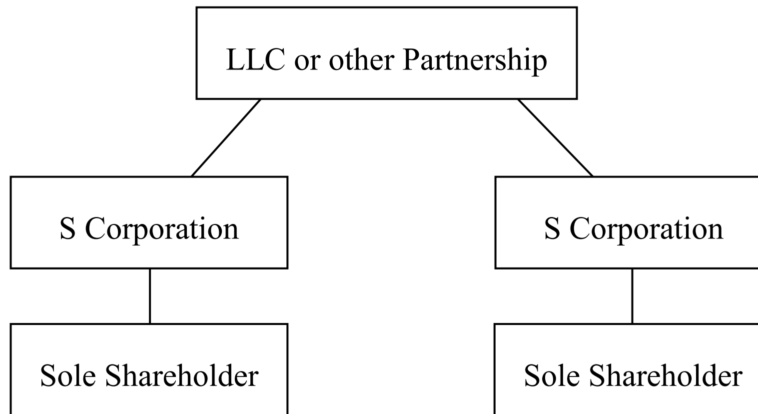
[278] IRS Fact Sheet 2008-25 (http://www.irs.gov/newsroom/article/0,,id=200293,00.html) discusses recharacterizing distributions from S corporations as compensation for this purpose.
[279] *Id.*
[280] Rev. Rul. 91-26.
[281] IRS Announcement 92-16, clarifying Rev. Rul. 91-26. *See also* IRS Notice 2005-8 (health savings accounts).
[282] 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),



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.

II.J.2.d. FICA: Retiring 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,[283] to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death,[284] if:[285]

(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,[286] and

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aff'd 109 AFTR.2d. 2012-XXXX (8th Cir. Docket No. 11-1589). 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.

[283] 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.

[284] Terminating payments before the partner's death disqualifies the payments from this exclusion. Letter Rul. 8052117.

[285] Code § 1402(a)(10); Reg. § 1.1402(a)-17.

[286] 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).

(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.[287] However, although Code § 736 payments are generally excluded from the strict Code § 409A nonqualified deferred compensation rules,[288] payments under this provision are not excluded from Code § 409A.[289]

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[287] Letter Ruling 7905032. For a general discussion of Code § 736, see part II.L.5.a.ii Partnership Redemption – Complete Withdrawal Using Code § 736.

[288] For a general discussion of Code § 409A, see part II.G.4.b Introduction to Code § 409A Nonqualified Deferred Compensation Rules. For general application (or lack thereof) of Code § 409A to partnerships, see text accompanying footnote 214.

[289] 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 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).

II.J.3. 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.[290]

(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.

II.J.4. Conversions for Tax Purposes

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 on S corporation) to

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> 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.

[290] Code § 119. However, this exclusion might apply beyond the C corporation context. See McKee, Nelson & Whitmire, ―¶4.02. 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 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 principals 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 TC 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).

enable the owner to deduct initial losses, and then convert to a C corporation when they become profitable. To the extent that timing is discussed below, it is when changes in entity arise from check-the-box elections.

II.J.4.a. From C 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.[291] 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.[292]

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.[293] 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.[294]

The liquidation of a C corporation is a taxable event.[295] The corporation is taxed on the extent by which any asset‘s fair market value (FMV) exceeds its basis. Each shareholder generally realizes capital gain or loss on the difference between the FMV received and the stock‘s adjusted basis. This double tax can be expensive.[296]

II.J.4.b. From C Corporations to S corporations

II.J.4.b.i. Built-in Gain Tax

This conversion is not, by itself, a taxable event. However, when any asset is disposed of within 10 years of the S election, generally double taxation applies - normal taxation as a flow-through entity, plus a separate corporate level tax imposed on the lesser of the gain

[291] Reg. § 301.7701-3(g)(1)(ii).
[292] Reg. § 301.770l-3(g)(3).
[293] Reg. § 301.7701-3(g)(1)(iii).
[294] Reg. § 301.770l-3(g)(3).
[295] See Code §§ 336 and 337.
[296] *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).

on disposition or the unrealized gain on the effective date of the S election.[297] Assets subject to this tax include inventory and a cash basis taxpayer‘s accounts receivable.

II.J.4.b.ii. Excess Passive Investment Income

Also, if a C corporation with accumulated earnings and profits (E&P)[298] elects S status, it might be subject to a supplemental tax and lose its S status if it has excess passive investment income.[299] The corporation can avoid this treatment by carefully planning its gross receipts or by distributing its E&P.[300]

Some points on planning gross receipts to avoid excess passive investment income treatment include:

- Although the statute defines rent as tainted income,[301] 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.[302]

- Gross receipts (rather than net income) of nonpassive income from partnerships in which the corporation is invested may be counted;[303] some income from controlled

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[297] Code § 1374. See the text accompanying footnotes 499-500 regarding ways to minimize this tax using a charitable remainder trust.

[298] 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 principals. 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).

[299] 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.

[300] 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.

[301] Code § 1362(d)(3)(C)(i).

[302] Reg. § 1.1362-2(c)(5)(ii)(B)(2). Although the IRS had issued various private letter rulings in this area, Rev. Proc. 2011-3 includes a new section 4.01(45) providing that rulings will not ordinarily be issued on whether gross receipts from royalties, rents, dividends, interest, and annuities constitute passive investment income for purposes of Code § 1362(d)(3).

[303] Rev. Rul. 71-455; *see also* Reg. § 1.702-1(a)(8)(ii).

foreign corporations might also count as nonpassive income.[304] Investing in oil and gas partnerships frequently helps generate sufficient nonpassive gross receipts.[305]

- 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.[306] For other capital assets, losses are netted against gains.[307]

The corporation can distribute its E&P. Generally, distributions from an S corporation come first as 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.[308] 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.[309]

Generally, a distribution of E&P must be effected using a distribution of property.[310] ―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).[311] 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: [312]

- The corporation will be considered to elected to bypass AAA for that year.

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[304] CCA 201030024.

[305] *See, e.g.*, 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, 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.

[306] Code § 1362(d)(3)(B)(ii).

[307] Code § 1362(d)(3)(B)(i).

[308] Code § 1368(c).

[309] 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).

[310] Code § 316(a).

[311] Code § 317(a).

[312] 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,[313] 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,[314] as well as consent by each affected shareholder.[315]

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.[316]

II.J.4.b.iii. Problem When S Corporation with Earnings & Profits Invests in Municipal Bonds

Tax-exempt income does not increase AAA.[317]

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.[318]

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[313] 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.
[314] Reg. § 1.1361-1(f)(5)(iii).
[315] Reg. § 1.1361-1(f)(5)(ii).
[316] See footnote 305.
[317] Code § 1368(e)(1)(A).
[318] 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.L.4.b.

II.J.4.c. From Partnerships and Sole Proprietorships to C Corporations or S Corporations

Transfers from a sole proprietorship to a corporation are generally nontaxable.[319]

II.J.4.c.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.[320] 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.[321]

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:[322]

- 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.[323] 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 January 1, 2010, and X is eligible to elect to be an S corporation effective

[319] See text accompanying footnotes 165-166.

[320] 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 608-627 for tax effects of liquidating a partnership.

[321] Reg. § 301.770l-3(g)(3).

[322] Rev. Rul. 2009-15.

[323] Reg. § 301.7701-3(g)(3)(i).

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.[324]

Because S corporations can have only a single class of stock,[325] capital accounts need to be made proportionate to interests in profits and losses before converting to an S corporation.

II.J.4.c.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.[326] 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,[327] followed by a distribution of the stock to the partners in liquidation of the partnership.[328]

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. 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.[329] The corporation's basis in the assets received from the partnership equals their basis to the partnership

[324] See fn. 65.
[325] See II.A.2.c for a description of the single class of stock rules and those rules' surprising flexibility.
[326] Rev. Rul. 84-111.
[327] Code § 351.
[328] Rev. Rul. 70-239.
[329] Code § 351.

immediately before their transfer to the corporation.[330] 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.[331] In addition, the assumption by the corporation of the partnership's liabilities decreases each partner's share of the partnership liabilities, thus, decreasing the basis of each partner's partnership interest.[332] On distribution of the stock to the partners, the partnership terminates.[333] 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.[334] 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).[335] 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.[336] The corporation's holding period in the assets transferred to it includes the partnership's holding period.[337] When the partnership distributes the stock to its partners, the partners' holding periods includes the partnership's holding period of the stock.[338]

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. On the transfer of all of the partnership's assets to its partners, the partnership terminates,[339] and 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.[340] 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.[341] 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.[342] The (former) partners' basis in the corporation's stock is the same as their basis in the assets received

[330] Code § 362(a).
[331] Code § 358.
[332] See Code §§ 752 and 733.
[333] Code § 708(b)(1)(A).
[334] Code § 732(b),
[335] Code § 1223(1).
[336] *See* Rev. Rul. 70-598.
[337] Code § 1223(2).
[338] Code §§ 735(b) and 1223. Furthermore, such distribution will not violate the Code § 368(c) control requirement.
[339] Code § 708(b)(1)(A).
[340] Code § 732(b).
[341] Code § 752.
[342] Code § 351.

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.[343] The corporation's basis in the assets received from the (former) partners equals the (former) partners' basis immediately before the transfer to the corporation.[344] The partners' holding periods for the assets the partnership distributes to them includes the partnership's holding period.[345] 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).[346] However, to the extent that the stock received was in exchange for neither capital nor Code § 1231 assets, the holding period of the stock began 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.[347]

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. 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.[348] When the transfer partners transfer their partnership interests to the corporation, the partnership terminates.[349] 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.[350] The corporation's basis for the assets received in the exchange equals the basis of the partners in their partnership interests.[351] 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,[352] 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.J.4.d. From S corporations to C Corporations

Conversion from S status to C status is not a taxable event. However, it requires an additional tax return if done mid-year and precludes an S election for 5 years.

[343] Code §§ 358(a) and 732(b).
[344] Code §§ 362(a) and 732(c).
[345] Code § 735(b).
[346] Code § section 1223(1).
[347] Code § 1223(2).
[348] Code § 351.
[349] Code § 708(b)(1)(A).
[350] Code §§ 358 and 752(d).
[351] Allocated under Code § 732(c).
[352] Code § 1223(1).

II.J.4.e. 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.[353] 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.[354]

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.[355] Furthermore, payments that would have been deductible by a partnership had it continued in existence are deductible by the successors to the partnership.[356]

Pierre v. Commissioner[357] 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

[353] *See* T.D. 8844 (preamble) (11/29/99) and Rev. Rul. 99-5. See Rev. Rul. 2001–61 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) (March 16, 2009).

[354] See T.D. 8844 (preamble) (11/29/99) and Rev. Rul. 99-5. See Rev. Rul. 2001–61 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. See also ―The Treatment of Liabilities In Rev. Rul. 99-5 and Rev. Rul. 99-6 Situations" TM Memorandum (BNA) (March 16, 2009).

[355] Rev. Rul. 99-6. See Rev. Rul. 2001–61 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) (March 16, 2009).

[356] Rev. Rul. 75-154.

[357] 133 T.C. No. 2 (8/24/2009) (http://www.ustaxcourt.gov/InOpHistoric/Pierre.TC.WPD.pdf).

respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

The Tax Court majority rejected the application of the check-the-box rules[358] 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.[359] Fundamental gift tax precepts require that one look to the bundle of rights transferred. 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.

The court distinguished between classifying the entity and describing the nature of the assets that were transferred. This fine line is likely to breed litigation in the transfer tax area for many years to come.

II.K. Basis Step-Up Issues

II.K.1. Depreciable Real Estate in an S Corporation

Although a partner‘s share of partnership assets can obtain a basis step-up at that partner‘s death,[360] 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.

[358] Reg. §§ 301.7701-1 through 301.7701-3.
[359] Code § 7701 (introductory language).
[360] Code §§ 734, 743, and 754.

Sale to Third Party
(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

If the property is depreciable and the corporation liquidates, then Code § 1239 might apply to convert the K-1 income to ordinary income.[361] In that case, the long-term capital loss on liquidation would not offset the K-1 income. 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. Further below we focus on splitting off the real estate into another corporation if the real estate constitutes a separate line of business;[362] the bottom line is that it's best to do the spin-off at least five years before death.

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 out of the corporation into an entity taxed as a partnership, as described in part II.L.4.e Distributing Assets; Drop-Down Into Partnership.

II.K.2. 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 or not sold to a related party.[363] Thus, all the problems in part II.K.1, Depreciable Real

[361] Code § 1239 is discussed at part II.L.4.d Distributions or Other Dispositions of Depreciable Property.
[362] See part II.L.4.c Corporate Division.
[363] Code § 1245.

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.

II.L. Exiting from or Dividing a Business

II.L.1. General Principles

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.[364] [365]

[364] Although Rev. Rul. 76-483 held that sales of partnership interests are subject to income tax deferral using the installment method, 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. In CCA 200722027 and 200728001, the IRS asserted that installment sale treatment is not available for partnership interests to the extent that the partnership's underlying assets constitute unrealized receivables, based on its interpretation of some cases as holding that compensation for services could not be reported under the installment method; see *Sorensen v. Commissioner*, 22 T.C. 321 (1954) (a reviewed decision). Also, 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. See Notice 2000-26 regarding the application of the installment method to accrual taxpayers. On the other hand, the legislative history to the Tax Reform Act of 1986,

- ***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[366] is more uncertain than in the partnership arena.[367]

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.
  - o For a partnership or S corporation, if owners are taxed on income from operations at a 40% ordinary federal and state income tax rate, the business must earn $167 of profits to fund a $100 principal payment on the debt. [368]
  - o A C corporation structure exacerbates this. If dividends are taxed at a 20% combined federal and state income rate, a $125 dividend generates $100 after tax. To distribute $125 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

PL 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.

[365] Even though stock was generally listed on the stock market, taxpayers who were ―affiliates" as defined in Rule 144 under the 1933 Act. 1 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:

> 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.

[366] Skinner, ―Earn-Outs in Public Company Acquisitions: New CVRs Raise Unsettled Tax Issues, *Journal of Taxation* (Dec 2010).

[367] See part II.L.5.a.ii, Partnership Redemption – Complete Withdrawal Using Code § 736.

[368] 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.

generate over $208 of income. Thus, over $208 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.[369] 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 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.[370]

- The seller pays tax on the sale. For example, if the seller has a combined 20% federal and state income tax rate, the seller nets $80 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 $60 to a seller subject to taxes on income from operations at a 40% ordinary federal and state income tax rate.

From these examples, some principles emerge:

- ***Paying Principal***. Principal payments can require from $167[371]-$208[372] of income to be generated to provide the seller with $80[373]-$100[374] after tax. Thus, the tax cost of principal payments represents 40%-62% of the earnings.

- ***Paying Interest***. Interest payments require $100[375]-$167[376] to provide the seller with $60 after tax. Thus, the tax cost of interest payments represents 40%-60% of the earnings.

- ***Efficiency of Entity***. The tax cost is lowest for:

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[369] See III.A.5.b for a discussion of various types of trusts that can hold stock in an S corporation, including any uncertainty regarding deducting interest on a loan to buy such stock (particularly footnotes 767-770.

[370] 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 at 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.

[371] For a partnership or S corporation.

[372] For a C corporation.

[373] For the gain component of principal payments, net of capital gain tax.

[374] For the portion of principal payments representing a return of basis.

[375] For a partnership or S corporation.

[376] For a C corporation.

- 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.

II.L.1.a. Contrasting Ordinary Income and Capital Scenarios on Value in Excess of Basis

Consider the portion of the business' equity representing internally generated goodwill, and assume the following tax rates, which might or might not be attained:

Capital Gain	20%	(federal and state income tax)
Ordinary Income	40%	(federal and state income tax)

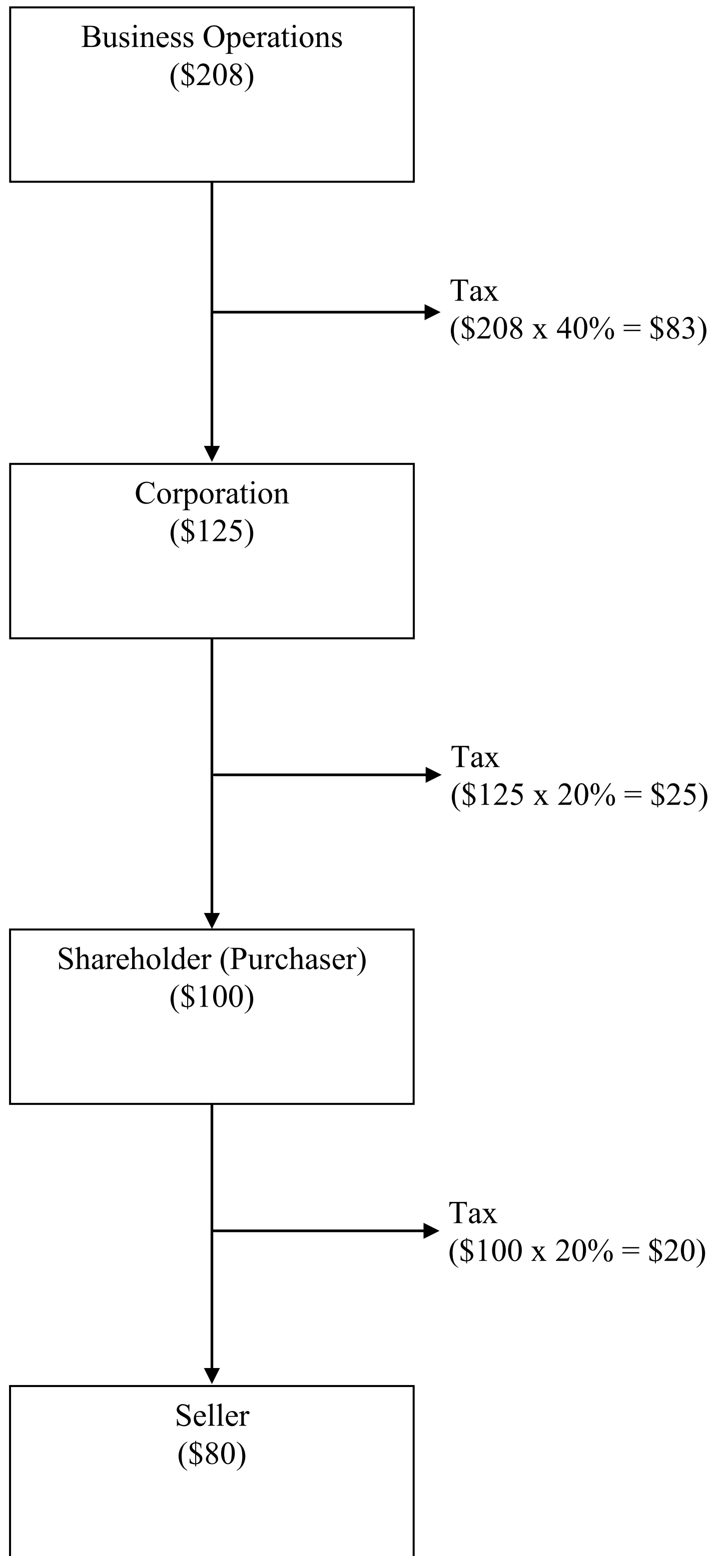
The scenario in the left column below assumes that the buyer uses after-tax dollars to buy the seller's interest in the business. The tax to the buyer in the left column is based on the ordinary income rates, because the buyer is using income generated by operations to fund the payments to the seller. The seller is receiving income at capital gain rates.

	Capital Gain to Seller	Ordinary Income to Seller
Profit	$ 167	$ 133
Tax to Buyer	- 67	- 0
	$ 100	$ 133
Tax to Seller	- 20	- 53
Net to Seller	$ 80	$ 80

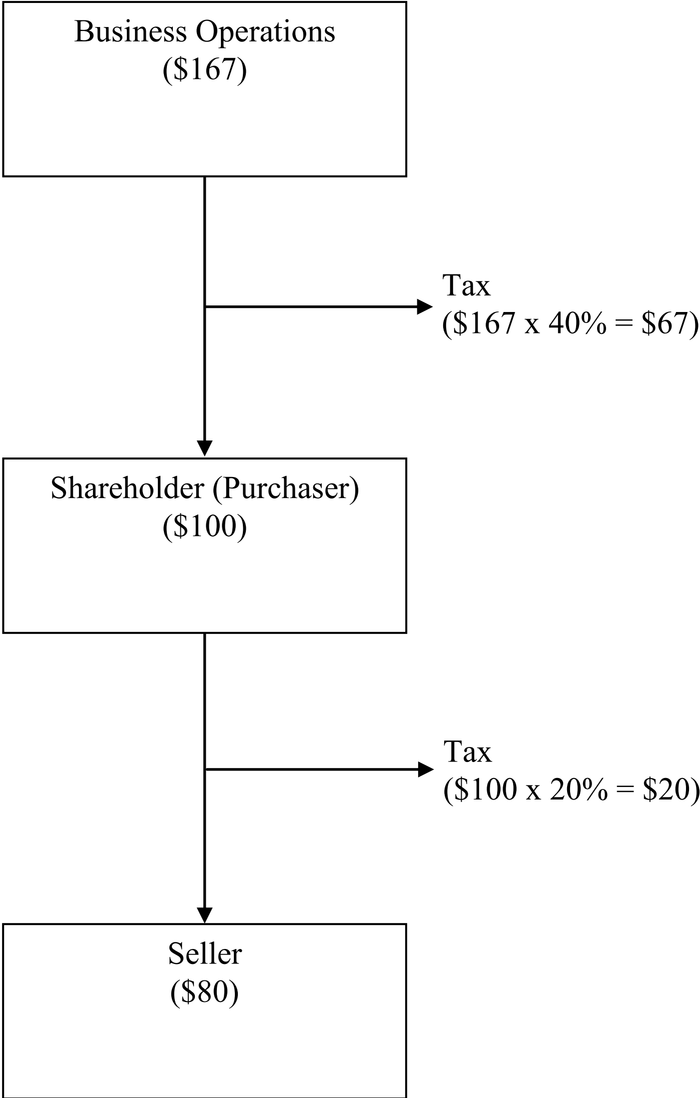
The tax in the right-hand column assumes that the buyer deducts payments to the seller, which is essentially what happens when one pays off a seller by allocating current partnership income to the seller.

The following pages illustrate this concept, showing that it takes a C corporation $208 in earning, an S corporation $167 in earnings, and a partnership only $133 in earnings to get $80 to the seller.

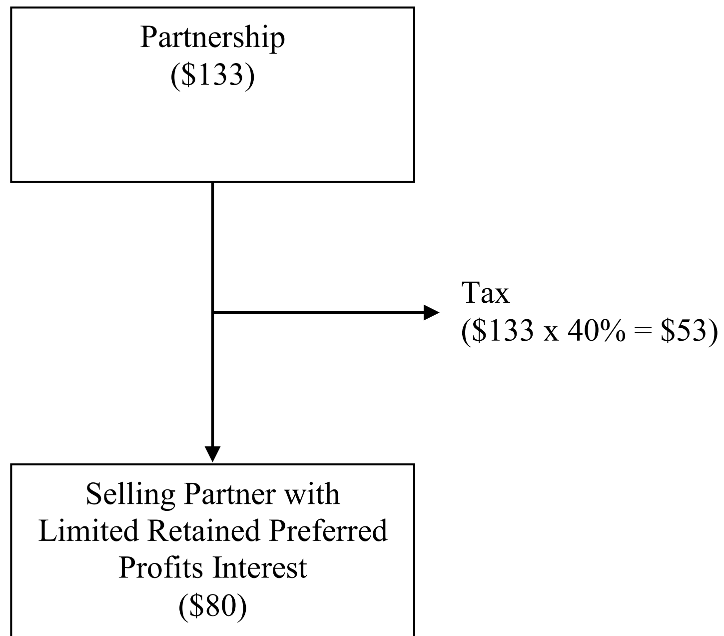
C Corporation Triple Taxation



S Corporation Double Taxation



Partnership Single Taxation of Goodwill



To minimize a sale's tax bite, tax planners seek structures with characteristics similar to interest or other deductible payments on the sale of a partnership or S corporation. Further below is a discussion of special opportunities for partnerships.[377] For now, let's focus on ways to extract value that any entity can try to use.

II.L.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.[378]

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,[379] usually real estate should not be held in a corporation.[380]

II.L.1.c. Personal Goodwill and Covenants Not to Compete.

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 goodwill is sold, generally the seller receives favorable capital gain treatment and the buyer deducts over 15 years the sum of the payments.[381] When a covenant not to compete is involved, generally the seller receives ordinary income

[377] See II.L.5.a.iii regarding how a corporation might shift future appreciation to a partnership.

[378] Lease payments received on a long-term basis are not subject to self-employment tax. Reg. § 1.1402(a)-4(a).

[379] Code § 311 provides that, when a corporation distributes property, the distribution constitutes a sale or exchange by the corporation. 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.

[380] See footnote 69 for some of the issues involved in whether real estate should be in a corporation.

[381] Code § 197(a), (d)(1)(A).

treatment and the buyer deducts the present value of the payments over 15 years.[382] Thus, compensation for current services, which is deductible in full when paid, is much more beneficial to sellers than either of the above alternatives. Even in the case of goodwill being taxed to the seller at capital gain rates, 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 seller 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[383] 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.[384]

II.L.1.d. Deferred Compensation.

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

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[382] Code § 197(a), (d)(1)(E), (f)(3) (buyer‘s deduction); Rev. Rul. 69-643 (seller‘s income); *Kinney v. Commissioner*, 58 TC 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."

[383] 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.

[384] *Muskat v. United States*, 554 F.3d 183 (1st. Cir. 2009); *Kinney*, note 382.

sale proceeds or against the interest or income equity component of any deferred sale proceeds.[385]

Under Code § 409A, however, one is required to have a written plan in place as soon as a legally binding right to deferred compensation exists.[386] Thus, if at the time of sale compensating the owner for past services is reasonable and necessary,[387] 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 used. Absent a prior written plan, however, convincing a court that the owner was undercompensated might be very difficult.[388]

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[385] 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. Com.*, 344 US 6 (1952).

[386] 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. Although the author would make such an argument on audit, the author would prefer to have more certainty when planning in light of Code § 409A's expansive reach.

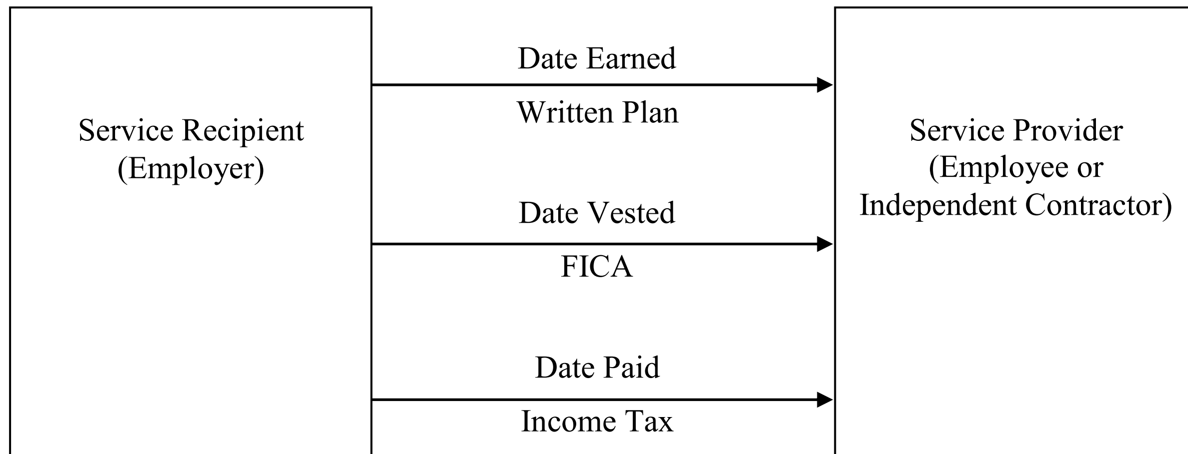
[387] Code § 162 requires any business deduction to be reasonable and necessary. If the future payments relate to compensation earned in the current year, then the taxpayer must prove that (a) the total compensation (current and deferred payments) earned that year is reasonable (to obtain a Code § 162 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)). Cases discussing reasonable compensation include *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*, 103 AFTR.2d 2009-1280 (7th Cir. 2009). 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.

[388] *PK Ventures, Inc. v. Com.*, T.C. Memo. 2006-36, *aff'd sub nom. Rose c. Com.*, 101 AFTR2d 2008–1888 (11th Cir. 2008), disallowed deductions for such deferred compensation beyond what the IRS conceded.

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.[389] Alternatively, consider paying an immediate lump sum if a plan is not already in place.[390] 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).

Here is a timeline for FICA and income taxation of deferred compensation:



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.[391] This vesting is often beneficial when employee‘s compensation, for the year in vesting occurs, exceeds the taxable wage base ($110,100 in 2012) because it is taxed at 2.9% (1.45% x 2) instead of 15.3% (7.65% x 2).[392] The

[389] See text accompanying footnotes 1153-1158.

[390] 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).

[391] Reg. § 31.3121(v)(2)-1(c)(2).

[392] 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. 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. Most of the FICA tax on the present value will be at the lower 2.9% rate. When payments are made in future years, they will not be subject to FICA tax. This could save over $13,200 of FICA tax each year ($110,100 TWB for 2012 multiplied by the 12.4% spread between 15.3% and 2.9%). The savings is slightly less than

employer and employee can negotiate whether the employer should pay the employee 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.

Date Paid. Income tax is due when paid or constructively received, but FICA is not due since that was already paid. Code § 409A places strict limits on events that accelerate payment and events that delay payment.

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.[393]

II.L.2. Consequences of a Buy-Sell Agreements Not Dependent on Choice of Entity

II.L.2.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. Funding with 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 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.[394] Also note that split-dollar life insurance arrangements[395] are subject to Code § 409A rules restricting the events

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indicated, because it does not consider that the employer receives a deduction for the employer's one-half portion of FICA.

[393] Code § 3101(b)(2).

[394] See II.L.2.c Life Insurance LLC.

[395] 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 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). One version involves the premium payor being treated as owning the policy, with the person to whom the term insurance portion is payable being treated as having been transferred the value of one year of term life insurance protection. 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

upon which deferred compensation can be paid, the violation of which trigger significant tax, penalties, and interest.[396] 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.[397] 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, so that they do not constitute an incident of ownership.[398]

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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). The IRS audit guide for split-dollar agreements is at www.irs.gov/businesses/corporations/article/0,,id=136548,00.html. Agreements entered into on or before September 17, 2003 are subject to IRS Notices 2001-10 and 2002-8 and Rev. Rul. 2003-105, so long as they 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 material making under Code § 101(j) (employer-owned life insurance) or 264(f) (limiting deductions for interest expense allocable to unborrowed policy cash value). IRS Notice 2008-42.

[396] Notice 2007-34 sets forth transition rules. See II.G.3 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, ―¶.02. Life Insurance Funding," *Structuring Buy-Sell Agreements: Analysis With Forms*.

[397] If and to the extent that cash surrender value is used, the value does not consider charges imposed on a surrender of the policy. *Matthies v. Commissioner*, 134 T.C. No. 6 (2010). The policy cash value and all other rights under a split-dollar arrangement (including any supplemental agreements), other than current life insurance protection, are treated as property for purposes of determining compensation income under Reg. § 1.83-3(e). Rev. Proc. 2005-25 describes how to value policies. However, 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.

[398] 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 time, the insured declines to participate in the sale of the corporation to a third party, or the

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,[399] and the insurance proceeds received by the corporation will not be subject to income tax.[400] Unless a valid agreement that satisfies Code § 2703[401] provides otherwise, the insurance proceeds will, however, be considered in valuing the decedent's interest in the business.[402] Insurance premiums used to fund the agreement are not deductible by the corporation.[403]

A cross-purchase generally would constitute a taxable sale, treated as a capital gain.[404] In many cases, a cross-purchase or a redemption that is paid over time can qualify for tax deferral as an installment sale.[405] However, tax deferral on installment sales can be limited,[406] 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

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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.

[399] 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. *Id.* 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) the stockholder, for less than adequate and full consideration, disposes of the controlling interest in a corporation that owns a life insurance policy on the stockholder's life. Rev. Rul. 90-21.

[400] Code § 101(a)(1). However, the death benefit might trigger significant alternative minimum tax (AMT), because book-tax differences generate an AMT preference. Code § 56(g).

[401] See part II.L.2.b Establishing Estate Tax Values. The *Blount* case, cited in footnote 428, is particularly troubling and perplexing in this area.

[402] Reg. § 20.2031-2(f); *Newell v. Comm.,* 66 F.2d 102 (7th Cir. 1933).

[403] Code § 264(a)(1). Interest on premiums to buy life insurance is disallowed under §264(a)(4), but it reduces earnings and profits if the payor is a C corporation. Rev. Rul. 2009-25.

[404] However, in a partnership, part of the sale might constitute ordinary income under Code § 751. See part II.L.5.c.i Effect on Transferring Partner.

[405] Code § 453.

[406] Code § 453A.

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.[407] The IRS takes 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.[408] For estate and gift tax purposes, the IRS Form 712 value is usually, but not always, appropriate.[409]

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[407] See Rev Proc. 2005-25, which applies in the context of valuing compensation. 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. No. 6 (2/7/2011) (when surrender charges exceeded cash value, policies valued based on prepaid death benefit when no other evidence of value was introduced) and *Lowe v. Commissioner*, TC Memo 2011-106. *Lowe* summarized the holding of *Schwab*, 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 weight 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)).

[408] See Rev. Ruls. 2009-13 and 2009-14. Commentators disagree with the IRS' position.

[409] 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.

¶ 3.02[2][a][iii] of Zaritsky & Leimberg, *Tax Planning with Life Insurance: Analysis With Forms* (WG&L), provides an interesting discussion.

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.[410] The IRS has taken the position that, when an insured transfers a policy on his life to his business partner, and his business partner 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.[411] 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, 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.[412] A transfer of an interest in a partnership that owns a life insurance policy is not subject to the transfer for value rules if the transfer does not constitute a termination of the partnership.[413]

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[410] Code § 101(a)(2).

[411] 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).

[412] *Id.* 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 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.

[413] 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

Using split-dollar arrangements[414] 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,[415] 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.[416] 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.

Beware that an employer-owned life insurance contract might not qualify for the usual exclusion from regular income tax.[417] An ―employer-owned life insurance contract" is a life insurance contract that 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 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.[418] ―Employee" includes a ―highly compensated employee" under Code § 414(q),[419] and Code § 414(q)(1)(A) pulls in people who own at least 5% of the company;[420] thus, a life insurance-funded buy-sell agreement should be structured to comply with these rules.[421]

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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.

[414] For an explanation of split-dollar agreements, see fn. 395.

[415] Reg. § 1.61-22(c).

[416] To avoid estate tax inclusion under Code § 2042.

[417] Code § 101(j).

[418] Code § 101(j)(3).

[419] Code § 101(j)(5).

[420] 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.

[421] One might consider provisions such as the following in an LLC operating agreement:

> It is anticipated that 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.

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 before the application is signed.[422] IRS Form 8925 would be required each year.

These rules for life insurance contracts issued or materially changed after August 17, 2006.[423] Notice 2009-48 elaborates on the rules described above, as well as providing rules for what constitutes a material modification,[424] including guidance on tax-free exchanges.[425]

As to buy-sell agreements, Notice 2009-48 provides:

The above is an attempt to be a catch-all in case clients do not follow the recommended procedure. Clients should obtain the insured‘s written consent before the life insurance application is signed. The maximum face amount in that consent should 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). Insurance agents usually provide such a consent form, which counsel should consider reviewing, or counsel could provide his/her own consent form to the client.

[422] Leimberg and Zaritsky, ―IRS Provides New and Substantial Guidance on Employer-Owned Life Insurance," 36 Estate Planning, No. 8, 3 (August 2009). Importantly, 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 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.

[423] P.L. 109-280, Sec. 863(a).

[424] 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.

[425] 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.

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.

Notwithstanding the above exceptions, whenever a policy is issued, complying with the notice and consent requirements is recommended regardless of the current plans for the policy, because those plans might change.

However, 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.

II.L.2.b. 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."[426] Regarding buy-sell agreements:[427]

(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.

[426] Reg. § 20.2031-1(b).
[427] Reg. § 20.2031-2(h).

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.[428]

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 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:[429]

> 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.

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.[430]

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[428] *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004); *Estate of Blount*, T.C. Memo. 2004-116, *aff'd* 428 F.3d 1338 (11th Cir. 2005); *Smith III v. U.S.*, 96 AFTR 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.

[429] Reg. § 25.2703-1(a)(3).

[430] *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 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.*, case No. 1:08-cv-00908 (9/1/2010), which is a later development in the same *Fisher* case described at footnote 704.

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. Comm'r*, 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. Comm'r*, 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. Comm'r*, 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 Bank* 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 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

(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.

One way to satisfy this exception is if the entity is not family owned, using Code § 2701 principles:[431]

> 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 [Reg.] § 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 [Reg.] § 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:[432]

(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

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.

431 Reg. § 25.2703-1(b)(3).

432 Reg. § 25.2703-1(b)(4).

> 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.

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*:[433]

> 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, in that they cloud the business‘ future operations.[434]

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.L.2.c. Life Insurance LLC

Wouldn‘t it be nice to avoid using a lot of policies 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.

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433 T.C. Memo. 2006-76.

434 *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.

II.L.2.c.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 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.L.2.c.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.[435] The term "incidents of ownership" includes more than ownership of the 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.L.2.c.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? *Skifter*, 468 F. 2d 699 (2nd Cir. 1972), the court held that the insured as trustee would not have an

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[435] 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)) the grantor when the two designated trustees are unavailable to act as trustee or are removed. 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 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)).

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.*, 511 F. 2d 259 (5th Cir. 1975) 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.

Citing Rev. Rul. 84-179 with approval, Letter Ruling 9602010 reasoned and held:

> Under the facts presented in [Rev. Rul. 84-179], the decedent transferred the policy to the spouse and subsequently, in an unrelated transaction, reacquired incidents of ownership over the policy in a fiduciary capacity. The ruling holds that under these circumstances, the decedent will not be considered to possess incidents of ownership in the policy for purposes of section 2042(2), provided the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for the decedent's personal benefit. The ruling further provides that the result would be the same if the decedent acting as trustee purchased a policy as a trust asset. The ruling states, however, that where the decedent's powers over the policy could have been exercised for the decedent's benefit, they would constitute incidents of ownership in the policy without regard to how those powers were acquired and without consideration of whether or not the decedent was the source of the funds used to pay the premiums. See *Estate of Fruehauf v. Commissioner*, 427 F.2d 80 (6th Cir.1970).
>
> 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.

Estate of Rockwell v. Commissioner, 779 F.2d 931 (3rd Cir. 1985), held that the 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.

II.L.2.c.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.L.2.c.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.[436] 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 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."[437]

[436] *Estate of Knipp v. Comm'r*, 25 TC 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue* 244 F.2d 436 (4th Cir.), *cert. denied*, 355 U.S. 827 (1957).

[437] 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.

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 sections 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.L.2.c.iii. IRS' Response

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 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.[438] Formation of the LLC should not implicate these rules, because formation is a nontaxable transfer.[439] Similarly, a Member receiving an increased ownership percentage of a policy due to an increased contribution is also a nontaxable transfer.[440] 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.[441]

[438] Code § 101(a)(2).
[439] Code §§ 101(a)(2)(A), 721(a).
[440] Code § 721(a).
[441] Code § 101(a)(2)(B).

II.L.2.c.iv. Significance

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.[442] 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 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

[442] See footnote 395 for a summary of how split-dollar arrangements work.

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.[443] 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.

II.L.2.c.v. 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.[444] 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.

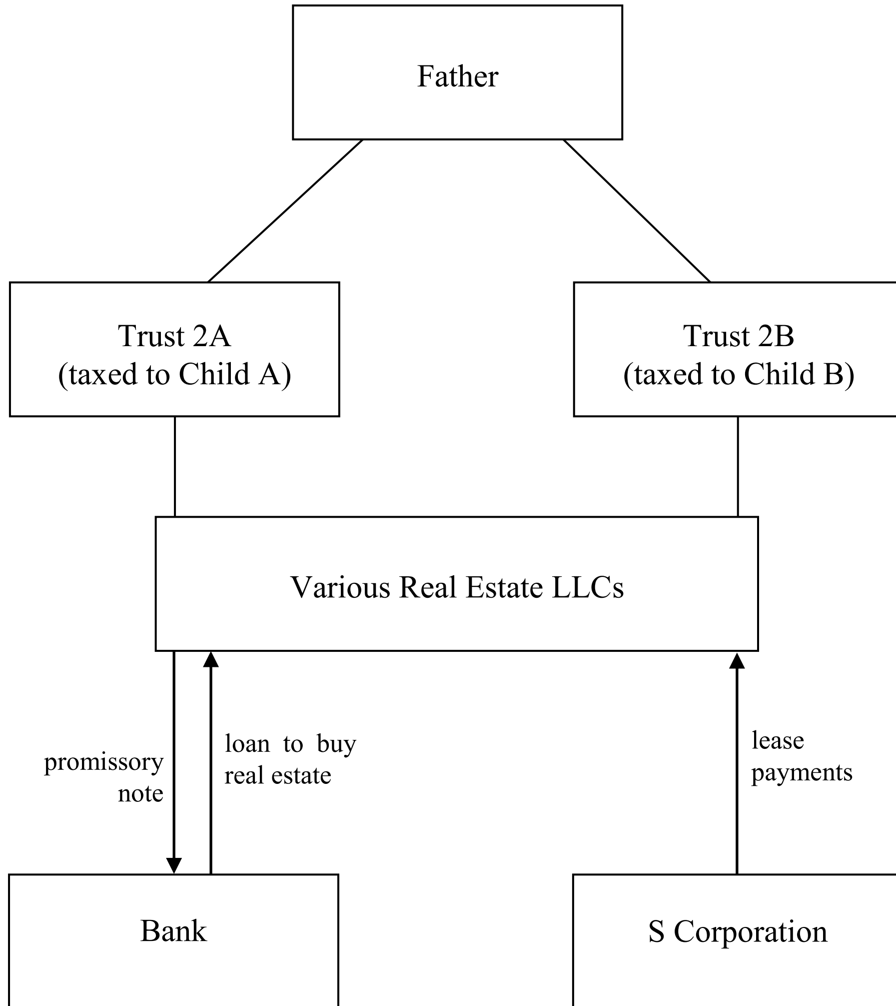
[443] See III.B.2.c, discussing beneficiary grantor trusts.
[444] See also Letter Rulings 200948001 and 200949004, which appear to be companion rulings.

II.L.2.c.vi. 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.

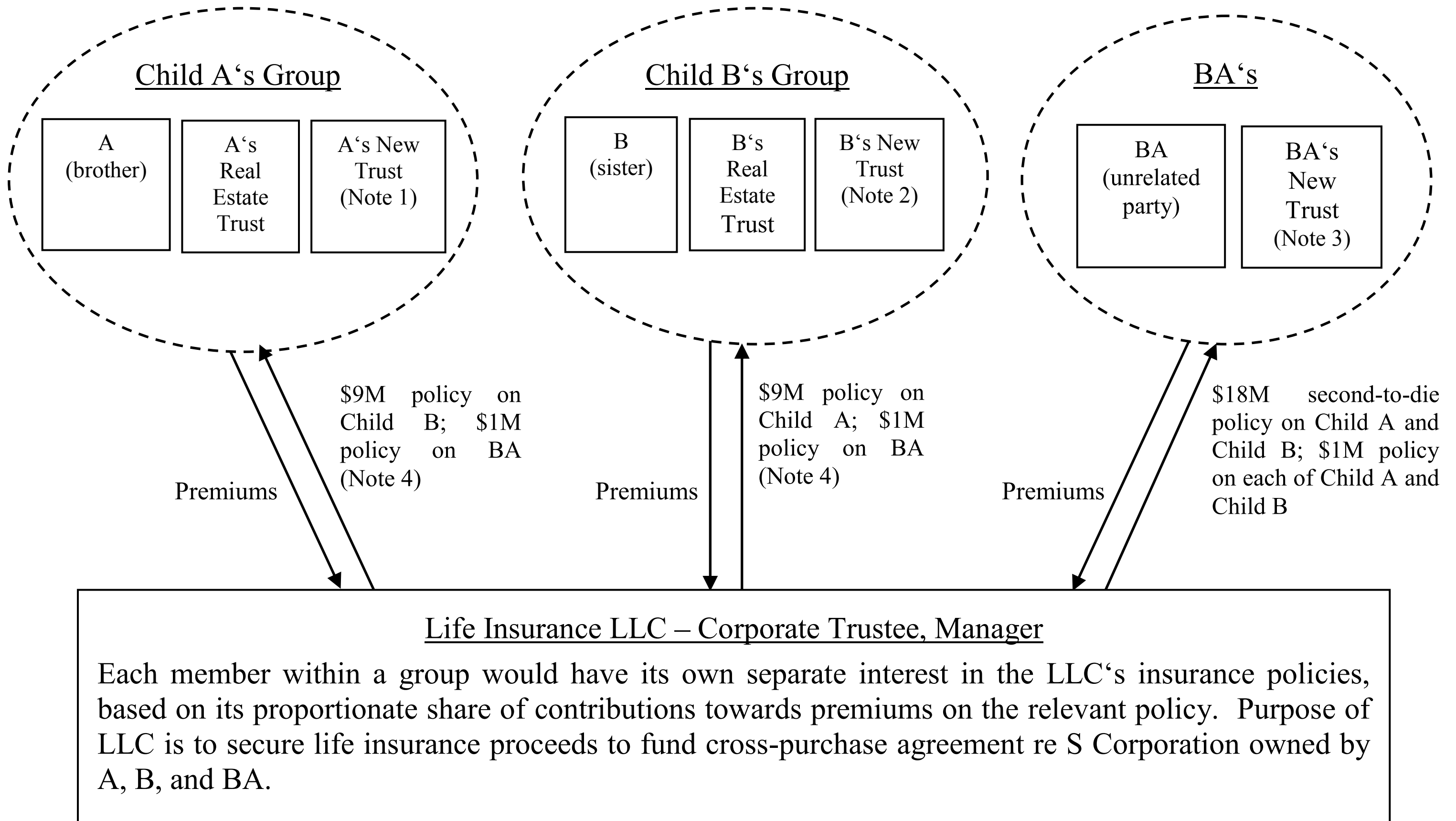
Appendix A

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.

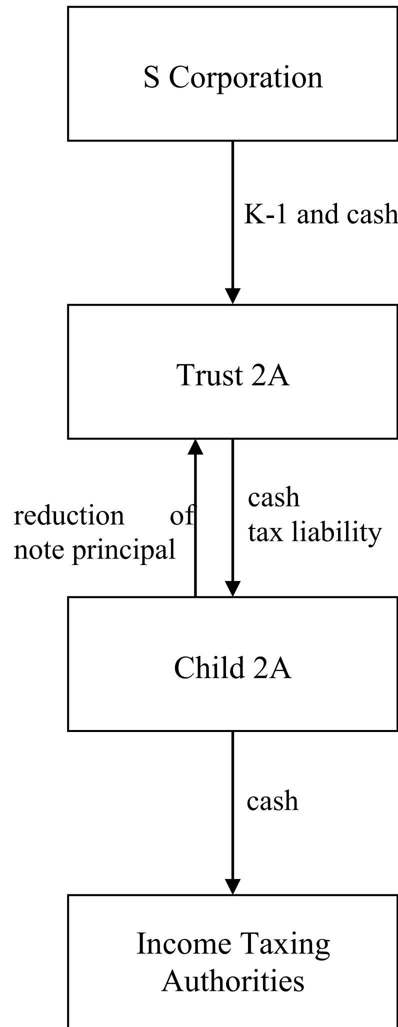
Note 2: Child B would be the grantor and trustee of this irrevocable trust for her descendants' support. (Her children are adults.) Her grandchild would be cut out, but her son could include him.

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.

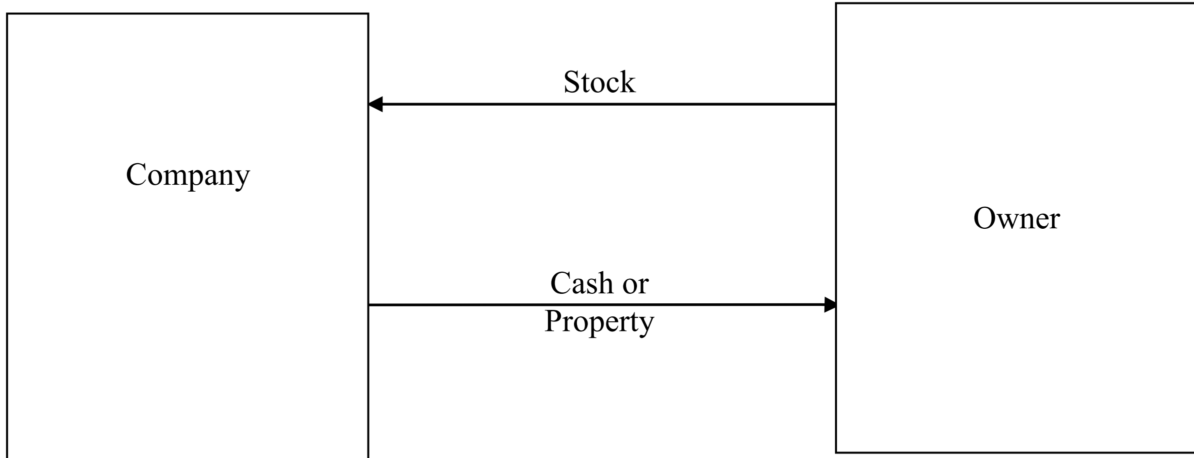
Note 4: If Child A dies first, Child B's group would become the premium payer with respect to Child A's group's policy on BA's life. If Child B dies first, Child A's group would become the premium payer with respect to Child B's group's policy on BA's life.

Appendix C

Later Sale of S Corporation Stock to Irrevocable Grantor Trust



II.L.3. Dividing a Business Using a Redemption - Corporation vs. Partnership



II.L.3.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):
  - Reduction in basis (no gain) to the extent of S corporation accumulated adjustments account (AAA), if applicable.
  - 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.
  - Return of basis.
  - Gain from the sale or exchange of stock.

Corporate redemptions are discussed in more detail at II.L.4.a.

II.L.3.b. Partnerships Generally.

Partnerships do not have a rule equivalent to Code § 302.

Distributions to a partner not taxable to the extent of basis in the partner's partnership interest. Basis includes allocable share of the partnership's debt, a rule that does not apply to corporations.

Partnership distributions are described generally in II.L.5.

II.L.3.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.

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).

Partnership distributions of property are described in II.L.5.a.i.

II.L.4. 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.

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). However, note that a corporation may not deduct unreasonably high 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.

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.L.4.a. Corporate Redemption

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.[445] 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.[446] In other words, what for state law purposes is a redemption is not necessarily treated as a redemption for income tax purposes.[447] Although until 2012 dividends will be 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 if a note is used in the redemption.[448] Furthermore, a redemption for a promissory note that is recast as a dividend is immediately taxed; installment sale deferral does not apply.[449]

II.L.4.a.i. Avoiding Dividend Treatment: Redemptions Under Code §§ 302 and 303

Although recent tax law changes tax dividends at the same rate as capital gains, 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.[450]

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 percent 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).

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[445] Code §§ 302(a), 1001.

[446] 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.

[447] 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.

[448] 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).

[449] Reg. §§ 1.301-1(b), 1.301-1(l); *Cox v. Commissioner*, 78 TC 1021 (1982); *Brams v. Commissioner*, 734 F.2d 290 (6th Cir. 1984), *aff'g* T.C. Memo 1983-25.

[450] See Regs. §§ 1.301-1(d)(1)(ii), 1.301-1(h)(2)(i) and 1.301-1(l) and Code § 312(a)(2).

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.[451]

(b) The redemption is substantially disproportionate. A substantially disproportionate redemption is one that decreases the shareholder's voting stock interest below 80 percent and the shareholder's ownership of outstanding stock below 50 percent immediately following the redemption. Attribution make this exception difficult to satisfy.[452]

(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.[453] A gift of stock to a family member, followed by a redemption of the donor's remaining stock, qualified as a complete termination.[454]

(d) The redemption is a partial liquidation distribution. A distribution is a partial liquidation if:[455]

> (1) it is not essentially equivalent to a dividend (determined at the corporate level rather than the shareholder level);
>
> (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 can 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

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[451] *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).
[452] Code §§ 302(c)(1), 318.
[453] Reg. §§ 1.302-4, 1.302-4T.
[454] Letter Ruling 200939011.
[455] Code § 302(e).

shareholder has the primary, unconditional obligation to enter into a cross-purchase and the corporation redeems the stock instead.[456] 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.[457]

II.L.4.a.ii. 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.[458] 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.[459] However, for the first 3-taxable-year 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.[460]

This tax does not apply to S corporations.[461]

II.L.4.a.iii. Redemptions and Accumulated Earnings Tax

Generally, a C corporation that accumulates funds could also be subject to the accumulated earnings tax.[462] The tax rate through 2008 is 15%.[463] However, the tax does not apply if the corporation can show that the investment is a reasonable business need of the corporation, is being used to fund a redemption to pay estate tax or expenses of estate administration, or is being used to fund certain redemptions of charitable shareholders.[464]

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[456] Rev. Rul. 69-608, Situations 1, 2 and 3.
[457] Rev. Rul. 69-608, Situations 4, 5, 6 and 7, respectively.
[458] Code § 56(g).
[459] Code § 55(e)(1)(A). Only taxable years beginning after December 31, 1993, are taken into account in calculating these averages.
[460] Code § 55(e)(1)(B).
[461] Code § 56(g)(6).
[462] Code § 531.
[463] P.L. 108-27 §§ 302(e)(5), 303.
[464] Code § 537(a)(1), (2).

II.L.4.b. Redemptions or Distributions Involving S Corporations

If the corporation has an S election in place, then taxation as a distribution generally is favorable, in that distributions generally reduce basis,[465] without any part of the distribution being treated as profit on the sale of stock.[466]

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.[467]

II.L.4.b.i. S Corporation Receipt of Life Insurance Proceeds

In 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 the taxable year.[468] 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.

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[465] However, distributions from a QSSS 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 (3).

[466] 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).

[467] Code § 1368(e)(3). See II.J.4.b for special considerations involving S corporations that used to be C corporations.

[468] Code § 1377(a)(2).

II.L.4.b.ii. S Corporation Distributions of or Redemptions Using Life Insurance Proceeds

II.L.4.b.ii.(a). S Corporation Distributions of Life Insurance Proceeds

In Revenue Ruling 2008-42,[469] 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 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.

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

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

[469] See "New Ruling Provides Guidance on AAA of S Corporations," *Business Entities* (WG&L), Jan/Feb 2009.

reduced by the $250,000 to $1,510,000. 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 any more, 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 II.G, as well at II.G.3.a.ii, 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 should 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.[470]

Finally, owners of limited liability companies or other entities taxed as partnerships would not need to even consider this issue.

II.L.4.b.ii.(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.[471]
- E&P is reduced by a ratable share of post-2/28/1913 E&P.[472]
- These reductions in AAA and E&P are independent of each other.[473]

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 II.J.4.b.ii.)

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[470] See II.J.4.b for issues relating to S corporations that have E&P.

[471] Code § 1368(e)(1)(B); Reg. § 1.1368-2(d)(1)(i).

[472] 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.

[473] Reg. § 1.1368-2(d)(1)(iii).

II.L.4.b.iii. S Corporations Owned by a Trust Benefitting Charity

S corporation stock is a challenging asset for a charity to hold.

II.L.4.b.iii.(a). Income Tax Trap - Reduction in Charitable Deduction

Any K-1 income or gain from the sale of the S corporation stock constitutes unrelated business income to a charity.[474] This is yet another disadvantage of S corporations compared to partnerships.

Although trusts can deduct amounts of gross income payable to charity, the trust must actually receive the income. Income included on a trust‘s K-1 from an S corporation does not support a Code § 642(c) deduction unless the S corporation distributes that income to the trust. 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.[475] 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 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.[476]

Although normally trusts may deduct all of their gross income that they pay to charity,[477] this deduction is eliminated to the extent that the trust has unrelated business taxable income (UBTI).[478] However, in computing the UBTI causing this disallowance, a charitable contribution deduction is allowed, using the percentages that apply to contributions by an individual.[479] Thus, a partial charitable contribution is allowed to be made out of unrelated business income.[480] The contribution must be made during the taxable year; the one-year delay permitted by Code § 642(c)(1) does not apply to this deduction.[481]

This partial deduction means that the trustee should not distribute all of the unrelated business income (UBI) to charity, because the trust will need to pay income tax on the

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[474] Code § 512(e).

[475] *Sid W. Richardson Foundation v. U.S.*, 430 F.2d 710 (5th Cir. 1970), *reh. den.* 430 F.2d 710.

[476] CCA 201042023. See also WTAS LLC, ―¶1.09. Source of Payment: Gross Income Only," *Tax Economics of Charitable Giving* (WG&L), citing *Old Colony Trust Co. v. Commissioner*, 301 US 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.

[477] Code § 642(c).

[478] Code §§ 642(c)(4) and 681.

[479] Code § 512(b)(11); Reg. § 1.512(b)-1(g).

[480] Reg. § 1.681(a)-2(b).

[481] Reg. § 1.681(a)-2(a).

UBI that cannot be fully offset by the charitable deduction.[482] 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.[483]

Fortunately, these rules do not apply to estates.[484] If a qualified revocable trust elects to be taxed as an estate, then it should escape this limitation.[485]

II.L.4.b.iii.(b). Private Foundations, Etc.

A private foundation may hold only limited amounts of an S corporation (or similar amounts for other entities, including C corporations and partnerships[486]), and any excess amounts may be held for only five or so years.[487]

II.L.4.b.iii.(c). Assignment of Income

The IRS has attempted to treat, as a sale by the donor, the contribution of stock to a charity, followed by a redemption. After losing,[488] the IRS ruled:[489]

> 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.

An enforceable cause of action under the promissory estoppel theory counts as a legally binding commitment to sell stock.[490]

II.L.4.b.iii.(d). 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.[491] What happens when a trust that owns an interest in an S corporation has a charity as its beneficiary?

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[482] 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.

[483] Section 506(a)(2) of the Uniform Principal and Income Act.

[484] Code § 681 and the regulations thereunder apply to trusts; they does not mention estates.

[485] Code § 645; Reg. § 1.645-1(e)(2)(i) and (e)(3)(i).

[486] Reg. § 53.4943-3(c) applies these rules to partnerships, sole proprietorships, trusts, etc.

[487] Code § 4943.

[488] *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd* on another issue, 523 F.2d 1308 (8th Cir. 1975).

[489] Rev. Rul. 78-197, *followed* Letter Ruling 8623007.

[490] *Blake v. Commissioner*, T.C. Memo 1981-579, *aff'd* 697 F.2d 473 (2nd Cir. 1982).

[491] See Letter Ruling 200402003 regarding an S corporation that merges into a nonprofit corporation.

The charitable income tax deduction should offset dividend income received by the trusts from the corporation.[492] Making an ESBT election should not affect the charitable income tax deduction, because the dividend is not considered part of the S portion.[493] 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.[494]

If distributions exceed AAA and earnings & profits, that excess would be treated as a return of capital,[495] reducing basis.[496] Any amount that exceeds basis would be treated as a gain from the sale of stock,[497] 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.L.4.b.iii.(e). 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 charitable remainder trust (―CRT") for the benefit of the corporation[498] 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.[499] The contributed assets must not constitute substantially all of the corporation's assets,

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[492] Code § 642(c).

[493] Reg. §§ 1.641(c)-1(g)(2), 1.641(c)-1(l), Example (1)(iii).

[494] Code § 512(e)(2). This rule would not apply if the trust acquired its stock by reason of death, since that provisions refers to Code § 1012, not Code § 1014.

[495] Code § 1368(c)(3).

[496] Code § 1368(b)(1).

[497] Code § 1368(b)(2).

[498] 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.

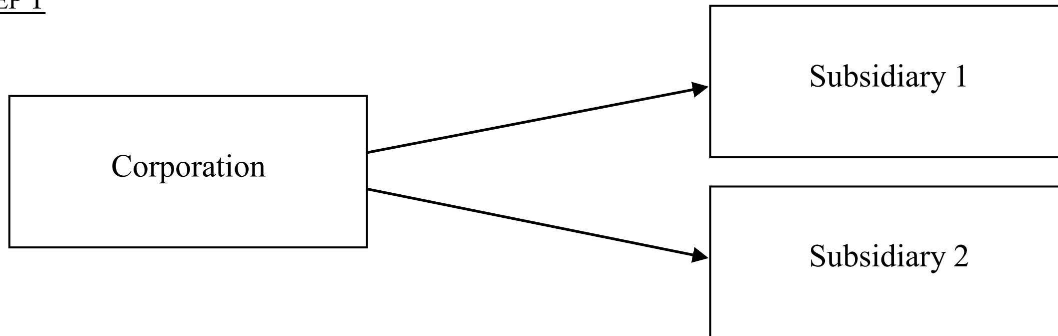
[499] Letter Ruling 200644013 focused on whether a contribution of property that had built-in gain accumulated from prior C corporation years would trigger Code § 1374 built-in gain tax. In that ruling, the corporation contributed real estate to a 20-year CRT. Later, but before the end of the Code § 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 ruled on whether the corporation would have recognized built-in gain under Code § 1374 on unitrust amounts received by it after the Recognition Period.

since a corporation recognizes gain if it conveys substantially all of its assets to a tax-exempt entity.[500]

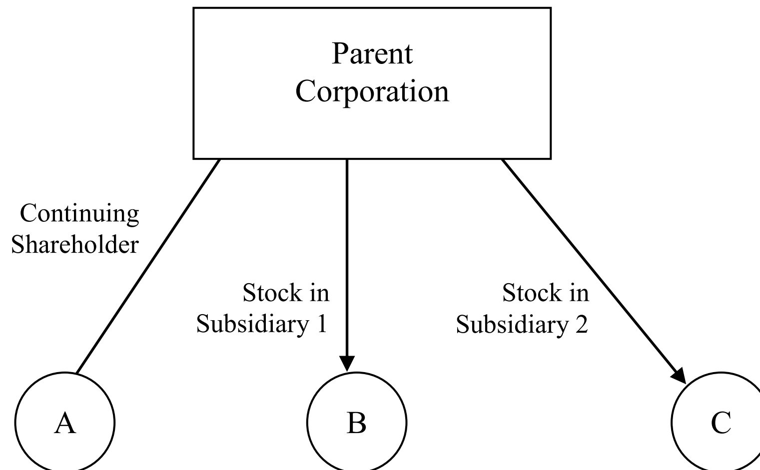
II.L.4.c. Corporate Division

II.L.4.c.i. Overview

STEP 1



STEP 2



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.

[500] Reg. § 1.337(d)-4(a)(1).

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.

Described further below, Letter Ruling 200842003 was a creative estate planning technique:

- 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.

II.L.4.c.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.

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.[501] The distribution can be made in one of three ways. 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.[502] 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

[501] Code § 355(a)(1)(A)(i). A distribution with respect to other securities is beyond the scope of these materials.
[502] Code § 355(a)(2)(A).

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.

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.[503] 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.[504] 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.[505]

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.[506] 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 the Jobs and Growth Tax Relief Reconciliation Act of 2003 temporarily 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.

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.[507] Another factor that may indicate abuse is when stockholders ―cash-out" shortly after the division.[508] The purpose of the Code § 355 tax-free provisions is to allow a corporation to continue its business is the 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,[509] but it is a situation the IRS will examine closely. The IRS will also examine the ―nature,

[503] Code § 355(a)(1)(A).
[504] Reg. § 1.355-2(e)(1).
[505] Reg. § 1.355-2(e)(2).
[506] Code § 355(a)(1)(B).
[507] Reg. § 1.355-2(d)(2)(ii).
[508] Reg. § 1.355-2(d)(2)(iii).
[509] 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).

kind, amount, and use of the assets” of both the distributing and controlled corporations immediately after the transaction.[510] 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.[511] 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.[512]

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.[513]

The fourth requirement of Code § 355 is the "active business" test. 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.[514] –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.[515] Next, such trade or business is required to have been

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[510] Reg. § 1.355-2(d)(2)(iv)(A).

[511] Reg. § 1.355-2(d)(2)(iv)(C).

[512] *Id.*

[513] Reg. § 1.355-2(d)(3).

[514] Code § 355(b)(2)(A).

[515] 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. *Id.* 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.

actively conducted throughout the five-year period ending on the date of the distribution.[516] 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.[517] 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.[518] Additional details are further below.

An important point to note regarding corporate divisions is that 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.

The fifth requirement is that the transaction must have at least one corporate business purpose.[519] 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.[520] The purpose must be a ―real and substantial non Federal tax purpose."[521] 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.[522]

The Regulations also note that a ―shareholder purpose… is not a corporate business purpose."[523] 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.[524] 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.[525] The example involves a corporation, owned by two shareholders, engaged in two businesses – manufacturing and

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[516] Code § 355(b)(2)(B). See Rev. Ruls. 2002-49 and 2007-42 regarding business conducted through an LLC.
[517] Code § 355(b)(2)(C).
[518] Code § 355(b)(2)(D).
[519] Reg. § 1.355-2(b).
[520] *Id*.
[521] *Id*.
[522] Reg. § 1.355-2(b)(3).
[523] Reg. § 1.355-2(b)(2).
[524] *Id*.
[525] Reg. § 1.355-2(b)(5), Example (2).

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.

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.”[526]

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 sixth requirement is "continuity of interest."[527] 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 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.[528] 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.

The final requirement is that the active trade or business that existed five years before the separation must exist after the separation.[529] 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.

[526] Letter Ruling 8943038.
[527] Reg. § 1.355-2(c).
[528] See Reg. § 1.355-2(c)(2), Example (2) and Rev. Proc. 96-30, § 4.07.
[529] Code § 355(b), Reg. § 1.355-2(h) and 1.355-3(b)(3). See also the last sentence of fn 515 regarding proposed regulations under Reg. § 1.355-3.

II.L.4.c.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.

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).

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.

Rev. Rul. 92-17 – Participation by Partners

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 percent 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.

Rev. Rul. 2007-42 – Level of Participation

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.

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.[530] 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.[531] 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

[530] Prop. Reg. § 1.355-3(b)(2)(v)(A).
[531] Prop. Reg. § 1.355-3(b)(2)(v)(B).

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. [532]

Examples illustrate these concepts:[533]

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.[534] 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.[535] The transfer of the Partnership interest is disregarded.[536] After the distribution, C owns 34 percent of Partnership and is therefore engaged in the active conduct of ATB2. [537] 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).[538] 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.[539] 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.[540] Therefore, although Y is attributed Partnership‘s trade or business assets and activities

[532] Prop. Reg. § 1.355-3(b)(2)(v)(C).
[533] Prop. Reg. § 1.355-3(d)(2).
[534] Prop. Reg. § 1.355-3(b)(1)(ii).
[535] Prop. Reg. § 1.355-3(b)(2)(v)(A), (B).
[536] Prop. Reg. § 1.355-3(b)(1)(ii).
[537] Prop. Reg. § 1.355-3(b)(2)(v)(A), (B).
[538] Prop. Reg. § 1.355-3(b)(2)(v)(A).
[539] Prop. Reg. § 1.355-3(b)(2).
[540] Prop. Reg. § 1.355-3(b)(2)(v)(A).

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.[541]

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. 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.

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

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[541] Prop. Reg. § 1.355-3(b)(2)(iii).

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

Whether the Trusts are trusts grantor trusts.

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.L.4.c.iv. Tax Effects When Code § 355 Provisions Are Not Met

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.[542] 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.[543] 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

[542] Code § 355(c)(2).

[543] 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).

corporation after the distribution.[544] 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.[545]

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.[546] 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.”[547] 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. 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.[548] 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 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.”

Controlled Corporation

Regardless of whether Code § 355 is met, the controlled corporation will not recognize gain or loss on a corporate division.[549] 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.[550] When such property distributions are made to the controlled corporation, the distributing corporation must allocate part of its earnings and profits to

[544] 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.
[545] Reg. § 1.355-6(d)(1)(i)(A).
[546] Code § 355(e)(2)(A).
[547] Code § 355(e)(2)(B).
[548] Code § 355(e)(4)(C)(i).
[549] Code § 118(a).
[550] Code § 362(b).

the controlled corporation.[551] 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.[552]

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.[553] 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.

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.[554] 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.[555]

II.L.4.d. Distributions or Other Dispositions of Depreciable Property

Generally, a sale or exchange of property, directly or indirectly, 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.[556]

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[551] 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.
[552] Reg. § 1.312-10(a).
[553] Code § 356(a)(1).
[554] Code § 358(a)(1).
[555] Reg. § 1.358-2(a)(2).
[556] Code § 1239(a).

In this context, “related persons” means:[557]

- 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,[558] 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:[559]

- a corporation more than 50% of the value of the outstanding stock of which is owned (directly or indirectly) by or for such person,
- 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
- any entity which is a related person to such person under certain attribution rules.[560]

Certain constructive ownership rules apply in determining ownership.[561]

Code § 1239 applies not only to depreciable property but also to “an amortizable section 197 intangible.”[562] A “section 197 intangible” includes goodwill,[563] going concern value,[564] workforce in place,[565] any information base,[566] know-how,[567] customer-

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[557] Code § 1239(b).
[558] Within the meaning of Code § 318(a)(3)(B)(i).
[559] Code § 1239(c)(1).
[560] Code § 267(b)(3), (10), (11), or (12).
[561] Code § 1239(c)(2), applying Code § 267(c) (other than Code § 267(c)(3)) for purposes of Code § 1239.
[562] Code § 197(f)(7); Reg. § 1.197-2(g)(8) (which is also consistent with the Joint Committee of Taxation report).
[563] 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.
[564] 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.
[565] This includes the existence of a highly-skilled workforce, any existing employment contracts, or a relationship with employees or consultants.
[566] 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.
[567] 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.

based intangibles,[568] supplier-based intangibles,[569] 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.[570]

Does Code § 1239 apply to 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).[571] 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.[572] Does the sale of a business transform self-created intangibles into amortizable section 197 intangibles at the time of the sale to cause Code § 1239 to apply? 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. When I wrote this, I was unaware of any primary source addressing this analysis. From a planning perspective, one should assume that Code § 1239 applies to the sale of self-created goodwill, because the IRS will almost surely take that position.

However, Code § 1239 does not apply to depletable property.[573]

Furthermore, the IRS would likely assert that Code § 1239 applies to the distribution of assets the corporation holds indirectly through a partnership.[574]

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[568] 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.

[569] 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.

[570] Reg. § 1.197-2(b).

[571] Reg. § 1.197-2(d)(2)(i).

[572] Reg. § 1.197-2(d)(2)(iii)(B).

[573] Letter Ruling 8139052, reasoning:

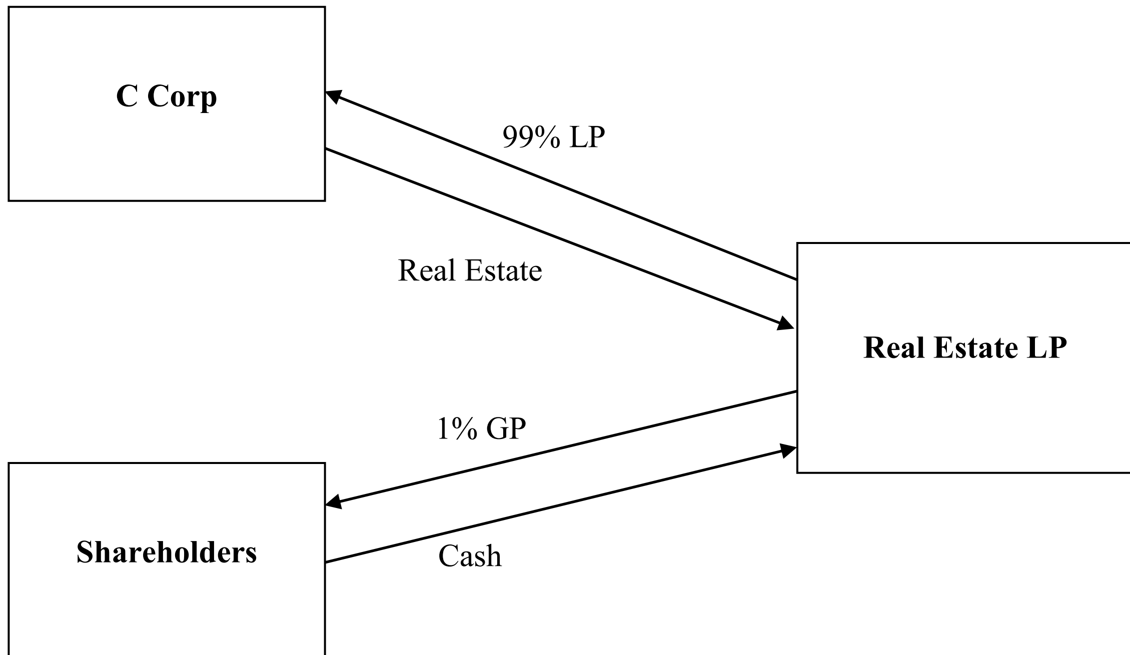
> Depletion is based upon the concept of the exhaustion of a natural resource, whereas depreciation is based upon the concept of exhaustion, wear and tear, and also obsolescence of property, not otherwise a natural resource, used in a trade or business or held for the production of income. Depletion and depreciation are made applicable to different types of assets and the method by which a depletion allowance is spread over 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.).

[574] Rev. Rul. 72-172.

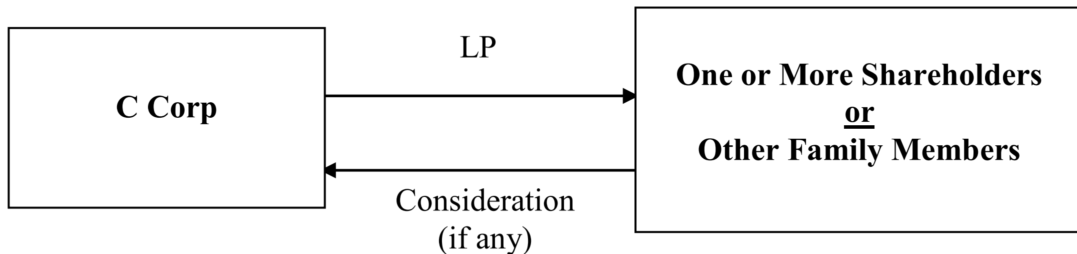
II.L.4.e. Distributing Assets; Drop-Down Into Partnership

II.L.4.e.i. Structure

Step 1



Step 2



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.

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 575.

II.L.4.e.ii. General Discussion

Code § 311(d)(1) taxes a corporation when it distributes appreciated assets to its shareholders. The corporation is deemed to have sold the assets. 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, subject of course to any applicable built-in gain tax under Code § 1374.

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.[575] 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.[576] 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*.[577]

II.L.4.e.iii. Taxpayer Win in Cox Enterprises

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

[575] TAM 200443032; *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), *aff'd* 162 F.3d 1236 (9th Cir. 1999).
[576] 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).
[577] T.C. Memo 2009-134.

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*[578] 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.

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 to 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 in profits compared with the minority partners' capital accounts relative to their respective interests in profits. Judge Halpern did

[578] 408 U.S. 135, 137-138 (1972).

not seem to recognize this issue; if he did, he did not mention it in analyzing the dividend issue.[579] It will be interesting to see whether the companion cases consider this issue to be of consequence.

II.L.4.e.iv. IRS' Conservative Roadmap: Letter Ruling 200934013

This ruling approved a corporation‘s contribution of marketable securities to a partnership in exchange for a preferred partnership interest. 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 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.

[579] 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.

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.[580]

(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.[581]

(g) The assets of LLC immediately prior to the admission of Shareholder A consisted of a diversified portfolio of stocks and securities.[582]

(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.

(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.

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[580] Citing *Pope & Talbot, Inc. v. Commissioner*, 104 T.C. 574 (1995), *aff'd* 162 F.3d 1236 (9th Cir. 1999).

[581] 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).

[582] As defined under Reg. § 1.351-1(c)(6)(i).

The IRS ruled:[583]

- 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.[584] This deemed transaction is treated as a nontaxable contribution of property to LLC by Corp.[585] 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.[586]

II.L.4.e.v. 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 times

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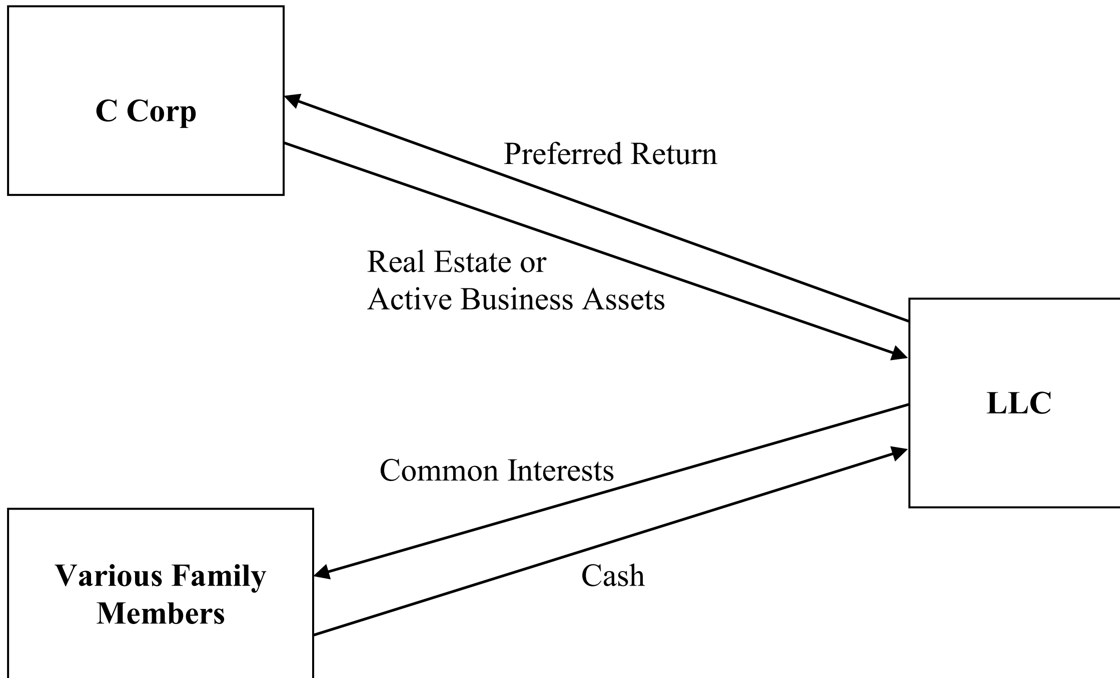
[583] The IRS also ruled regarding Code § 2701 – that a preferred payment right, the rate at which changes over time, was not a qualified payment right except to the extent that a qualified payment right election is made. Reg. § 25.2701-2(b)(6).
[584] Rev. Rul. 99-5.
[585] Code § 721(a).
[586] Code § 311(b).

in separate minority blocks of the partnership, but again they should be prepared for an IRS attack.

II.L.4.e.vi. Value Freeze as Conservative Alternative

Consider the following structure:



The corporation contributes the real estate to a partnership, 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.

The preferred return is to be satisfied out of the LLC'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 under Code § 2701.[587]

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

[587] Reg. § 25.2701-2(b)(6)(i)(B).

more than 150% of the AFR[588] and is limited to the extent of operating cash flow, each of two regulations[589] separately creates a presumption that a sale has not occurred.[590] Although technically not necessary, giving the corporation a small but significant profits interest in the LLC would help show that the corporation really is a partner.

Transferring the common interest in a preferred partnership is less tax-efficient than selling (to an irrevocable grantor trust)[591] 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,[592] which would undermine the whole concept of getting the property out of corporate solution.

II.L.4.f. Special Provisions for Gain on the Sale of Stock in a C Corporation

Code § 1202 excludes from income a portion of the gain from the sale or exchange of qualified small business stock held for more than five years. Code § 1045 allows a taxpayer to rollover the gain into new qualified small business stock.

―Qualified small business stock" means any stock in a C corporation which the taxpayer acquires on original issue by a qualified small business after the date of the enactment of the Revenue Reconciliation Act of 1993 either in exchange for money or other property (not including stock) or as compensation for services provided to such corporation (other

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[588] ―AFR" meaning the applicable federal rate as defined under Code § 1274, which applies for Code § 7872 as well as in other contexts.

[589] Reg. §§ 1.707-4(a)(2) and 1.707-4(b).

[590] It is unlikely that the partnership anti-abuse rules would come into play. To minimize the risk that they would under Reg. § 1.701-2(c)(3), the seller cannot be protected from loss. Reg. § 1.701-2(e)(2)(i) says that, if the transaction is contemplated by a particular regulation, then the situation is not considered an abuse of entity treatment; the proposed strategy contemplates a stream of payments clearly approved by the disguised sale regulations. Looking at the larger picture, the anti-abuse rule applies only if the transaction is inconsistent with the intent of Subchapter K. The intent of Subchapter K has three prongs under Reg. § 1.701-2(a):

- 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 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.
- The form of each transaction must be respected under substance over form principles. 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.
- 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.

[591] As described in III.B.2.

[592] 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).

than services performed as an underwriter of such stock).[593] 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.[594] The corporation's aggregate gross assets cannot have a basis (including cash) exceeding $50 million.[595] The following businesses are not eligible for this treatment:[596]

- any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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,
- 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.[597]

If the above and other requirements are satisfied, then the portion excluded from income is 50% generally (75% for stock acquired in 2009 or 2010 and 60% for gain attributable to an empowerment zone business no later than December 31, 2014). Of course, one must consider any alternative minimum tax consequences.[598]

II.L.4.g. Special Provisions for Loss on the Sale of Stock in a Corporation

The first $50,000 of loss[599] on the sale of "section 1244 stock" is an ordinary loss, rather than a capital loss.[600]

"Section 1244 stock" is stock of a domestic corporation if:[601]

[593] Code § 1202(c)(1).
[594] Code § 1202(c)(2)(A), (e).
[595] Code § 1202(d).
[596] Code § 1202(e)(3).
[597] Code § 1202(e)(4).
[598] See, e.g., Code § 57(a)(7).
[599] $100,000 if married filing jointly. Code § 1244(b).
[600] Code § 1244(a).

- 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.[602]

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.

II.L.4.h. 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).[603]

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.[604] 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.[605]

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[601] Code § 1244(c).
[602] Code § 1244(c)(3).
[603] Code § 1044.
[604] Code § 1044(c)(3).
[605] Federal Tax Cood.2d ¶ I-3794.

II.L.5. 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.

- 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.[606]

- 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.[607]

II.L.5.a. Partnership Redemption

II.L.5.a.i. Distribution of Property by a Partnership

Distributions to a partner may be taxable under Code §§ 731, 704(c)(1)(B), and 737.[608] After the discussion of Code § 731 follows the discussion of the other two sections.

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[606] Reg. § 1.708-1(d).

[607] 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).

[608] 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.

II.L.5.a.i.(a). Code § 731

Partnership distributions of property are usually tax-free to both the partnership and the partner under Code § 731(a)[609] and (b), whether current distributions or liquidating distributions.[610] However, 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.[611] The amount of gain recognized is the excess of the distribution over the partner‘s adjusted basis.[612] When the distribution is a liquidation distribution, the partner‘s adjusted basis in the distributed property is equal to the adjusted basis of the

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[609] 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." The IRS draws a distinction if indebtedness of a partner is purchased by the partnership 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.

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 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.

[610] Reg. § 1.731-1(a)(1)(i).

[611] Code § 731(a)(2) explains potential loss recognition consequences of a partnership distribution.

[612] Code § 731(a)(1). However, to the extent a partner receives in a distribution partnership property that includes unrealized receivables or substantially appreciated inventory items (―hot assets"), in exchange for either all or a part of the partner‘s interest in other partnership property (including money) or partnership property (including money) other than hot assets in exchange for all or a part of his interest in the partnership‘s hot assets, the transaction shall be considered a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution). Code § 751(b). ―Unrealized receivables" include not only accounts receivable but also mining property, stock in a DISC, depreciable property under Code § 1245(a)(3) or 1250(c), stock in certain foreign corporations, farm land, franchises, trademarks, trade names, certain oil, gas, or geothermal property, any market discount bond and any short-term obligation to the extent of the amount which would be treated as ordinary income as if such property had been sold by the partnership. Code § 751(c). However, if the recipient partner had previously contributed the hot assets, then the transaction shall not trigger gain recognition. Code § 751(b)(2)(A). Also, the hot asset rule does not apply to Code § 736(a) redemption payments, presumably because the recipient is taxed on the payments as ordinary income. Code § 751(b)(2)(B).

partner's interest in the partnership, less any money distributed;[613] 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.[614] 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.[615]

Marketable securities may not normally be considered cash, but are treated as "money" for purposes of Code § 731(a)(1) gain calculation.[616] 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. 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.[617] Second, Code § 731(c) does not apply to distributions of marketable securities by investment partnerships to eligible partners.[618] 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 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.[619] 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 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.[620]

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[613] Code § 732(b).

[614] Code § 731(a)(2).

[615] Code § 732(a)(1). 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. Code § 732(a)(2).

[616] 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.

[617] Code § 731(c)(3)(A)(i); Reg. § 1.731-2(d)(1)(i).

[618] 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.

[619] Code § 731(c)(3)(C)(iii).

[620] See text accompanying footnote 1035.

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.[621] 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.[622]

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.[623] 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.[624] 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).

II.L.5.a.i.(b). Code §§ 704(c)(1)(B) and 737

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 within seven years after the contribution. 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 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.[625] 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.

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[621] Reg. § 1.731-2(d)(1)(ii).
[622] Reg. § 1.731-2(d)(1)(iii).
[623] Code § 731(c)(3)(B); Reg. § 1.731-2(b)(2).
[624] *Id.*
[625] Code § 737(a)(1) and (2).

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.[626] 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.[627]

II.L.5.a.ii. Partnership Redemption – Complete Withdrawal Using Code § 736

When a partnership redeems[628] a partner‘s interest in full,[629] Code § 736(a) provides that payments may be deductible to the partnership and ordinary income to the selling partner.[630] Or, one may choose to apply Code § 736(b) so that they are nondeductible to the partnership (although possibly depreciated or amortized) and capital gain to the

[626] Reg. § 1.731-2(g).

[627] *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 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.

[628] Code § 736 applies only to payments made by the partnership and not to transactions between partners. Reg. § 1.736-1(a)(1)(i).

[629] 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 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).

[630] For whether such payments constitute self-employment income, see II.J.2.d.

partner.[631] (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.)[632]

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.

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

[631] Except to the extent Code § 751(b) applies, 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.* Using a promissory note to redeem a partner does not take the transaction out of Code § 736; any interest paid constitutes a Code § 707(c) guaranteed payment, and Reg. §§ 1.267(b)-1(b) and 1.707-1(c) prevent Code § 267 from limiting the timing of the interest deduction. Letter Ruling 8304059.

[632] 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.
>
> *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.

redemption payments receive treatment under Code § 736(a) or (b).[633] However, Code § 736(b) payments cannot exceed the fair market value of the withdrawing partner's share of the partnership property;[634] therefore, Code § 736(a) must apply to such excess.

Furthermore, 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,[635] then Code § 736(b) payments cannot be for (and therefore Code § 736(a) must apply to) the partnership's:

1. Unrealized receivables;[636]

2. 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

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[633] 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 TC 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 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).

[634] Reg. § 1.736-1(b)(5)(iii).

[635] Code § 736(b)(3).

[636] 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). However, for purposes of Code § 736, they do not include includes any market discount bond under Code §1278 or any short-term obligation under Code § 1283.

payments are the only types of payments that can be classified as Code § 736(a) payments instead of Code § 736(b) payments.[637] Code § 736(a) payments are available for payments in the form of mutual insurance not determined by reference to any partnership asset,[638] payments of compensation to a retired partner for past services, and a portion[639] of payments where capital is a material income-producing factor.[640]

See the example in II.L.1.a. The ―Capital Gains to Seller" scenario in II.L.1.a corresponds to Code § 736(b) payments, and the ―Ordinary Income to Seller" scenario in II.L.1.a corresponds to Code § 736(a) payments.

Suppose, however, 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.[641] 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.

Main Points

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 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.

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[637] 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. Comissioner*, T.C. Memo. 1991-538.

[638] Reg. § 1.736-1(a)(2).

[639] 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.

[640] Banoff, ―More on Section 736(a) Payments After RRA ‗93 Changes," 83 *Journal of* Taxation 191 (Sept. 1995).

[641] Reg. § 1.734-1(e)(1), referred to by McKee, Nelson & Whitmire, ―¶5.02. 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..

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.[642] However, the complete redemption may be made over time.[643] If the partnership assumes 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.[644]

5. The above treatment does not apply to the extent that the LLC is repaying the seller's capital account. Generally, 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. 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. 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.

7. 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 easier it will be to prove reasonableness, since the owner-employee will be earning the compensation over time in a manner that is

[642] Reg § 1.736-1(a)(1)(i).
[643] Rev Rul 75-154.
[644] *Whitman & Ransom*, T.C. Memo. 2005-172.

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, since 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.

Code § 736 taxes the retired partner on Code § 736 payments as if the retired partner were still a partner.[645] Code § 736(a) payments are taxed in the year for which they are made, rather than in the year of receipt.[646] 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.[647] Thus, the installment sale rules do not appear to apply to Code § 736 redemptions.

This might preclude interest on deferred tax liabilities under Code § 453A. A prominent treatise states:[648]

> 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.

The treatise later states:[649]

> 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"

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[645] Reg. § 1.736-1(a)(6).
[646] Reg. § 1.736-1(a)(5).
[647] Reg. § 1.736-1(b)(6).
[648] McKee, Nelson & Whitmire, ―¶6.02. Transfers of Partnership Interests by Sale or Exchange: Tax Consequences of Liquidations Compared," *Federal Taxation of Partnerships & Partners.*
[649] McKee, Nelson & Whitmire, ―¶¶ 22.02[4][c] Interest on Deferred Section 736(b) Payments," *Federal Taxation of Partnerships & Partners*.

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 this issue.

II.L.5.a.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.[650] 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.[651] Given that the buyer's deductions relating to

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[650] *Martin Ice Cream Co. v. Commissioner*, 110 TC 189 (1998); *Norwalk v. Commissioner*, T.C. Memo. 1998-279. 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 AFTR.2d 2010-5533 (E.D. Wash. 2010); *Kennedy v. Commissioner*, TC Memo 2010-206 (non-compete agreement precluded sale of personal goodwill) (distinguished from *Martin Ice Cream*) (self-employment tax imposed; reliance on tax advisor avoided negligence penalty).

[651] *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

goodwill are the same as for a noncompetition agreement,[652] 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.[653]

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 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:

1. 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.

2. The deal is more tax-efficient than the traditional sale of goodwill.

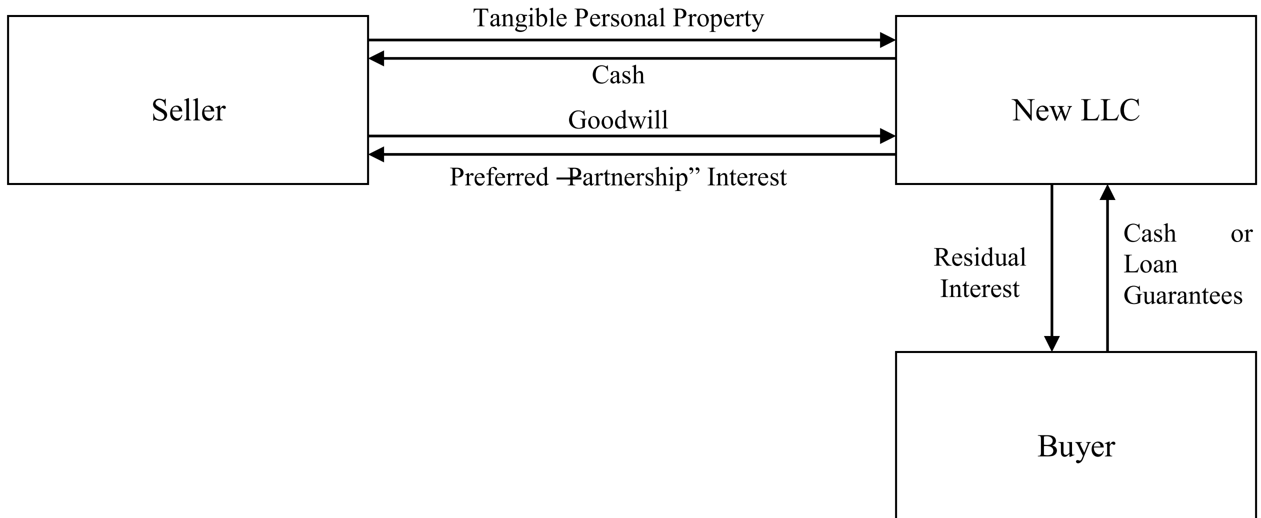
This mechanism recognizes that, although the transfer of goodwill is technically a debt-financed deal, it really carries risks similar to an equity interest. Below is a diagram showing the transaction, in which the seller contributes the goodwill to a new entity (often a limited liability company) in exchange for what for tax purposes is considered a preferred partnership interest.

> 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."

[652] Compare Code § 197(d)(1)(A) (goodwill) with Code § 197(d)(1)(E) (covenant not to compete).

[653] 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.



Let's look at the non-tax financial issues, then discuss the tax issues in addition to the advantages discussed in parts II.L.1.a and II.L.4.e.

Non-Tax Financial Issues

The seller receives preferred payments equal to the lesser of the LLC's net operating cash flow or a target amount before any amounts are distributed to the buyer. If the target is not attained, then:

1. The deficiency is added to the following year's target amount.

2. 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 LLC's operating 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 a member of the LLC.

Tax Issues

Suppose the seller is an S corporation. If all of an S corporation's assets were sold to a new entity, tax would be incurred at the corporate level. The sale of goodwill would be taxable, but the new entity's deduction for that payment would be spread over 180

months (15 years).[654] 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 S corporation transfers its assets to a new LLC, retaining a preferred interest at the AFR (―applicable federal rate" provided under the tax laws as an arms-length interest rate) that distributes only to the extent of operating cash flow, a sale is presumed not to have occurred.[655] 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.

II.L.5.b. Partnership Division

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) shall be considered a continuation of the prior partnership.[656]

Thus, generally a partnership can be divided without immediate income tax recognition.[657] However, some divisions might be taxable. Also, tax elections may be

[654] Code § 197 provides for 15 years, and Reg § 1.197-2(f)(1)(i) applies this starting with a particular month.

[655] Each of Reg. §§ 1.707-4(a)(2) and 1.707-4(b) separately creates such a presumption. It is unlikely that the partnership anti-abuse rules would come into play. To minimize the risk that they would under Reg. § 1.701-2(c)(3), the seller cannot be protected from loss. Reg. § 1.701-2(e)(2)(i) says that, if the transaction is contemplated by a particular regulation, then the situation is not considered an abuse of entity treatment; the proposed strategy contemplates a stream of payments clearly approved by the disguised sale regulations. Looking at the larger picture, the anti-abuse rule applies only if the transaction is inconsistent with the intent of Subchapter K. The intent of Subchapter K has three prongs under Reg. § 1.701-2(a):

- 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 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.
- The form of each transaction must be respected under substance over form principles. 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.
- 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.

[656] Code § 708(b)(2)(B).

[657] Reg. § 1.708-1(d).

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.

II.L.5.c. Transfers of Partnership Interests

II.L.5.c.i. Effect on Transferring Partner

Although the sale of stock in a corporation (whether or not an S election is in place)[658] 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.[659]

―Unrealized receivables” includes previously untaxed rights to payment from the sale of:[660]

1. Inventory or other ordinary income items, or

2. Services rendered, or to be rendered.

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.[661]

―Inventory items” includes not only inventory[662] but certain other ordinary income items,[663] whether those assets would receive that treatment in the hands of the partnership or the selling partner.[664] Under prior law, this provision applies only if those assets are substantially appreciated,[665] meaning that their fair market value exceeds 120% of the adjusted basis to the partnership of such property.[666] 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;[667] thus, the sale of a partnership

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[658] Code § 341, before its repeal, provided exceptions for collapsible corporations.
[659] Code §§ 741, 751.
[660] Code § 751(c).
[661] 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.
[662] Code § 751(d)(1).
[663] Code § 751(d)(2).
[664] Code § 751(d)(3).
[665] Reg. § 1.751-1(a)(1).
[666] Reg. § 1.751-1(d)(1).
[667] 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

interest is treated less favorably than a redemption,[668] since a redemption triggers ordinary income attributable to inventory items only if the inventory items are substantially appreciated.[669]

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 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.[670]

II.L.5.c.ii. Effect on Basis of Partnership's Assets

Upon the death of a partner,[671] or on the sale or exchange of a partnership interest, the partnership‘s property‘s basis is adjusted under Code § 743 if the partnership makes or has in effect a Code § 754 election.[672] If the transferee partner‘s basis in his interest is

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substantially in value." P.L. 105-34 struck ―which have appreciated substantially in value" from Code § 751(a)(2).

[668] Milo, ―The Tax Cost of Hot Assets upon the Disposition of a Partnership Interest," *The Tax Advisor* (August 2010).

[669] Code § 751(b)(3).

[670] Code § 752(d).

[671] 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 § 734(a). Thus, considering the surviving spouse to be a partner for purposes of Code § 734(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 § 734(a).

[672] 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). 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

greater than the former partner‘s share of the basis of partnership assets, then the election will give the new partner a stepped-up basis in the partnership assets; previously non-amortizable self-created goodwill becomes purchased amortizable goodwill.[673] In a sale or exchange situation, the transferee partner‘s basis step-up in partnership assets is based on the amount of gain recognized by the transferring partner;[674] 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 seller.[675] 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;[676] although liabilities are included in the basis of a partnership interest, they do not generate a basis increase in the partnership‘s assets.[677] 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.

Sometimes basis reductions must be made as if a Code § 754 election were in effect.[678] 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.[679] For example, suppose decedent died

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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).

[673] Letter Ruling 9715008 (but only if the remaining partners and the selling partner are not related under Code § 197(f)(9)(C)).

[674] The partner‘s share of income in respect of a decedent under Code § 691 (including unrealized receivables) does not receive a basis step-up. Reg. § 1.755-1(b)(4).

[675] 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).

[676] 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 TC 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 TC 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).

[677] See footnote 126.

[678] See text accompanying footnotes 1030–1034.

[679] In *Malm v. U.S.*, 420 F.Supp. 1040 (DC ND 2005), the court stated:

December 1, 2004, and the partnership sold assets December 31, 2004. The estate tax return is due August 1, 2005 (nine months after 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.[680] 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.

II.L.5.c.iii. Effect on Partnership

If a sale or exchange of 50% or more of the total interest in partnership capital ***and***[681] profits occurs (in the aggregate) within a 12-month period, the partnership is deemed to have terminated.[682] 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.[683]

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

> 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.

[680] 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.*

[681] For example, the sale of a 30-percent interest in partnership capital and a 60-percent interest in partnership profits is not the sale or exchange of 50 percent or more of the total interest in partnership capital and profits. Reg. § 1.708-1(b)(2).

[682] Code § 708(b)(1)(B).

[683] Reg. § 1.708-1(b)(2).

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.[684]

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.[685]

II.M. 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.

[684] Reg. § 1.708-1(b)(4).
[685] Code § 382.

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, 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.

III.A. Drafting and Administering Trusts

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 your surviving spouse 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? In 2011, each person can leave only $1 million to his or her children free from estate taxes (the ―exclusion amount"). Suppose the clients have a $1.5 million estate (with insurance and property, many people have estates this large). If each leaves everything outright to the surviving spouse, the first spouse‘s exclusion amount is wasted. When the surviving spouse dies, the children will pay estate tax on the $500,000 excess over the surviving spouse‘s $1 million applicable exclusion amount.

Clients can avoid these problems 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 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, 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.

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.[686]

[686] See generally, Bogert, *The Law of Trusts and Trustees*, § 679 (Rev. 2d. Ed. 1982).

Under the Uniform Prudent Investor Act (UPIA),[687] 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."[688] 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."[689] While making investment decisions and managing trust assets, the trustee should consider 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.[690] 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.[691] 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.[692] 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.[693] 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)[694] 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.[695] 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.[696] 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.[697] In a corporate context, the

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[687] 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.
[688] UPIA §2(a).
[689] UPIA §2(b).
[690] UPIA §2(c) .
[691] UPIA §2(c)(8).
[692] UPIA §3.
[693] UPIA § 6.
[694] 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.
[695] UTC §105.
[696] UTC §802, §803.
[697] UTC §802(g).

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.[698] 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.[699] 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.

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.[700] 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 objectives of the account.[701]

Although trust agreements can seek to absolve trustees from liability, state law frequently imposes duties of at least some level of good faith.

See the later discussion of why a business interest might be a trust's primary (even sole) asset and how to handle income tax issues and beneficiaries' expectations.[702]

III.A.3. Income and FICA Tax Issues

After a modest run up in brackets, trusts quickly become subject to tax at the highest marginal tax rate. However, to the extent that a trust distributes its income, its beneficiary is taxed on that income instead of the trust being taxed on that income.

Absent an abusive situation, trusts are not subject to FICA tax.

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[698] UTC §806.
[699] UTC §816(6), (7).
[700] 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).
[701] Office of the Comptroller of the Currency, Comptroller's Handbook for Fiduciary Activities, July 1998, pg. 42.
[702] Text accompanying footnotes 785-794.

III.A.4. Estate and Gift Tax Issues

Generally, irrevocable trusts are not included in the grantor‘s estate for estate tax purposes. However, certain advanced planning techniques and/or certain mistakes can cause inclusion in the donor‘s estate for estate tax purposes.

Also, trusts can be structured to avoid inclusion in the beneficiary‘s estate for estate tax purposes. Again, certain advanced planning techniques or certain mistakes can cause inclusion in the beneficiary‘s estate for estate tax purposes.

Gift planning typically involves special features that allow gifts to trusts to qualify for the $13,000 annual exclusion for each current beneficiary.[703] This amount can be doubled if the donor‘s spouse elects to split gifts with the donor. It is not unusual for larger gifts to be made, and sometimes gifts of the $1 million applicable exclusion amount are appropriate.

An interest in a closely-held business qualifies for annual exclusion only if it can be sold or annual distributions of the entity‘s income are planned and made.[704] Regarding the latter:[705]

> In order to show that the gifts of the partnership interests afforded the donees the right to immediately use, possess, or enjoy the income therefrom, petitioners must show that: (1) the partnership would generate income at or near the time of the gifts; (2) some portion of that income would flow steadily to the donees; and (3) the portion of income flowing to the donees can be readily ascertained.

I generally include a right of first refusal that simply allows the entity to match the outsider‘s offer.[706] 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.[707]

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[703] If a trust does not have *Crummey* powers, consider adding them to the gift instrument. See, *e.g.*, TAM 8445004.

[704] *Hackl v. Commissioner*, 118 TC 279 (2002) (income not expected to be generated annually; donee could not transfer to third party without violating operating agreement), *aff'd* 335 F.3d 665 (7th Cir. 2003); *Price v. Commissioner*, T.C. Memo. 2010-2 (annual exclusion denied even though large distributions in four out of six years; mere possibility of donor buying donee‘s interest as only way to sell asset was insufficient); *Fisher v. U.S.*, 105 AFTR.2d 2010-1347 (S.D. Ind.) (right of first refusal to be satisfied by non-negotiable 15-year promissory note did not constitute a right to sell and obtain present enjoyment).

[705] *Price v. Commissioner*, T.C. Memo. 2010-2, citing *Hackl*.

[706] 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.

III.A.5. Trusts Holding Stock in S corporations

III.A.5.a. Generally

The following trusts may be shareholders:

1. 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.[708] The owner could be a grantor or beneficiary and is treated as the owner for purposes of the 100-shareholder limitation.[709] As we will discuss in more detail later, a beneficiary may be treated as the owner either by the way the trust is designed or if the beneficiary makes a ―QSST" election[710] to have the grantor trust rules apply.

2. 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.[711] This includes a former QSST.[712] 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.[713]

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[707] *Crummey v. Commissioner*, 397 F.2d 82, (9th Circ. 1968); see *Estate of Cristofani v. Commissioner*, 97 TC 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).

[708] Code § 1361(c)(2)(A)(i). The requirement that only one individual be a deemed owner has made me reluctant to have a *Crummey* trust that its grantor is deemed to own be the shareholder, given theoretical uncertainty of the scope of Code the shareholder, given theoretical uncertainty of the scope of Code § 678(b). However, Letter Ruling 200942020 approved an irrevocable grantor trust as an S corporation shareholder when it had multiple *Crummey* power holders, holding that Code § 678(b) caused the grantor's deemed owner status to trump the beneficiaries' deemed owner status.

[709] Code § 1361(c)(2)(B)(i).

[710] 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), Ex. (2).

[711] Code § 1361(c)(2)(A)(ii).

[712] 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).

[713] Regs. §§ 1.1361-1(k)(1), Example 3, paragraph (i). Query how stock transferred to a revocable trust by reason of a nonprobate beneficiary designation would be handled; it would be best to avoid this and have the trust own the stock directly during the grantor's life.

However, if the trust is subject to an election under Code § 645, 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 estate.[714] In either such case, the grantor's estate is treated as the owner for purposes of the 100-shareholder limitation.[715]

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, by filing IRS Form 8855. 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). 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.[716]

3. 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.[717] In such a case, the testator's estate is treated as an owner for purposes of the 100-shareholder limitation.[718] Because a revocable trust that has made 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.[719]

4. A trust created primarily to exercise the voting power of stock transferred to it.[720] In such a case, each beneficiary of the voting trust is treated as the owner for purposes of the 100-shareholder limitation.[721] Qualifying a voting trust is not as simple as one might think. The beneficial owners must be treated as the owners of their respective portions of the trust under the grantor trust rules,[722] and the trust agreement must require that 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

[714] Regs. §§ 1.1361-1(k)(1), Example 3, paragraph (ii) and 1.645-1(e)(2)(i); Letter Ruling 200529006. For who may consent to a new S election on behalf of a decedent, see Rev. Rul. 92-82.
[715] Code § 1361(c)(2)(B)(ii).
[716] 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."
[717] Code § 1361(c)(2)(A)(iii).
[718] Code § 1361(c)(2)(B)(iii).
[719] Reg. § 1.1361-1(h)(1)(iv)(B).
[720] Code § 1361(c)(2)(A)(iv).
[721] Code § 1361(c)(2)(B)(iv).
[722] Reg. § 1.1361-1(h)(1)(v). This regulation was adopted by TD 8600 (7/20/1995). For the IRS' interpretation before then, see Letter Ruling 9344020.

of that stock.[723] This is automatic for the settlors of the trust,[724] 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.[725] It has also been suggested that the voting trust might qualify as an investment trust,[726] in which case a transferee would be treated as a grantor[727] and therefore the trust would automatically qualify.[728] However, under an investment trust, there must be ―no power under the trust agreement to vary the investment of the certificate holders." [729] One must then determine what constitutes a ―power … to vary the investment" and then avoid (preferably prohibit) such a power. A power to sell trust assets does <u>not</u> constitute a power to vary the investment.[730]

5. <u>An electing small business trust</u>.[731] In such a case, each potential current beneficiary of the trust is treated as the owner for purposes of the 100-shareholder limitation.[732] If any of the surviving spouse and the grantor‘s descendants are shareholders themselves, double counting does not occur.[733] In the next section of this article, we will discuss trust drafting techniques and a comparison between this type of trust and a QSST.

Again, 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.

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

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[723] Reg. § 1.1361-1(h)(1)(v)(B).
[724] Code § 677(a) combined with Reg. § 1.1361-1(h)(1)(v)(B).
[725] 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.
[726] Reg. § 301.7701-4(c).
[727] 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.
[728] Code § 677(a) combined with Reg. § 1.1361-1(h)(1)(v)(B).
[729] Reg. § 301.7701-4(c).
[730] Rev. Rul. 78-149. For additional guidance, see Rev. Ruls. 2004-86, 89-124, 86-92, and 75-192. A voting trust may participate in a Code § 1036 exchange of stock. Letter Ruling 200618004.
[731] Code § 1361(c)(2)(A)(v).
[732] Code § 1361(c)(2)(B)(v).
[733] For the 100 shareholder limit, see Reg. section 1.1361-1(m)(4)(vii)(third complete sentence). For the family attribution rule, see 2004 Blue Book (General Explanation of Tax Legislation Enacted in the 108th Congress), p. 189, footnote 321.

are not trusts that qualify under these rules.[734] Second, qualified retirement plans are taxed on unrelated business taxable income,[735] including income from S corporations.[736] However, employee stock ownership plans (ESOPs) are not subject to this tax.[737]

III.A.5.b. Trusts as Shareholders: QSST vs. ESBT, Including How to Fix a Late Election and Regulations Dealing with ESBTs

This section focuses on irrevocable trusts, including trusts created by bequests under a revocable trust. Revocable trusts are taxed as grantor trusts,[738] so they automatically qualify as S shareholders[739] whose grantors are treated as the shareholders for all tax purposes,[740] including the 100-shareholder limitation.[741] The 100-shareholder limitation is made less severe by a family attribution rule.[742]

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[734] Treasury Regulation 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 Section 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.

[735] Code § 511(a)(1), 501(a).

[736] Code § 512(e)(1).

[737] Code § 512(e)(3).

[738] Code § 676.

[739] Code § 1361(c)(2)(A)(i).

[740] 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).

[741] Code § 1361(c)(2)(B)(i).

[742] That provision is interpreted by Reg. § 1.1361-1(e)(3)(i), which provides:

> *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 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

To qualify as S corporation shareholders for any length of time,[743] generally[744] an irrevocable trust must either be a grantor trust or an electing small business trust (ESBT). An irrevocable trust may qualify as a grantor trust under the normal rules of Code §§ 671-678 or may be treated as a grantor trust through a QSST election made by the beneficiary.[745] If a beneficiary has a withdrawal right with respect to all gifts to the trust (a *Crummey* trust), the trust might be taxable to the beneficiary under Code § 678.[746] For example, an unusual but acceptable alternative would be to make a bequest 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; such a trust would lack protection from the beneficiary's creditors if and to the extent the withdrawal right is exercisable and might or might not lack protection after the withdrawal right lapses.[747]

The rest of this section focuses on the features of QSSTs and ESBTs.

A QSST may have only one beneficiary (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[748] must be distributed currently to that beneficiary[749] while the trust holds S stock.[750] However, 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

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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.

[743] 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) (see text accompanying footnotes 717-719).

[744] A voting trust does not have time limits on how long it is an eligible shareholder under Code § 1361(c)(2)(A)(iv).

[745] See text accompanying footnotes 708-710.

[746] See discussion of IRS Letter Rulings in 730-2nd T.M., *S corporations: 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).

[747] For further discussion, see III.B.2.c Code § 678 (Beneficiary Grantor) Trusts.

[748] 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.

[749] Code § 1361(d)(3). All of the trust's income, not just the income from the S stock, must be distributable currently. Letter Ruling 9603007.

[750] 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.

separate share.[751] For example, a grantor sets up an irrevocable trust for the benefit of his four children. 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. This could also work well for a vested trust for a grandchild, which qualifies for the GST annual exclusion.[752]

An ESBT may have more than one beneficiary.[753] However, each potential current beneficiary is treated as a shareholder for the purposes of the 100-shareholder limitation.[754] 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.[755] 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,[756] and the regulations now reflect this change.[757] 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 of the ESBT portion.[758]

An ESBT cannot have a beneficiary whose interest was acquired by purchase.[759] This prohibition does not have anything to do with whether the trust has purchased or might later purchase S stock.[760]

ESBT income taxation is complicated. 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.[761] Very few deductions are allowed against this income, and the income

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[751] Code § 1361(d)(3). Although the statute cites to the separate share rules under Code § 663(c), 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 that remote possibilities *are* considered.

[752] 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.

[753] For all of the ESBT requirements, see Code § 1361(e)(1).

[754] Code § 1361(c)(2)(B)(v).

[755] Code § 1361(e)(2).

[756] Code § 1361(e)(2).

[757] Reg. § 1.1361-1(m)(4)(vi)(A).

[758] Letter Ruling 200913002 held that such a modification did not affect GST grandfathering.

[759] Code § 1361(e)(1)(A)(ii).

[760] Reg. § 1.1361-1(m)(1)(iii).

[761] Code § 641(c)(1).

distribution deduction is not available.[762] 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, to name some of the most common problematic areas.

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.[763]

A QSST is best used when:

1. 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 rules,[764] 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.[765]

2. 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,[766] 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.

A QSST complicates purchases made out of earnings. In QSSTs, all income must be distributed to the beneficiary rather than being used to repay the principal on a promissory note; an exception should apply when the note is secured by the stock and by all distributions with respect to the stock,[767] but that risks income tax uncertainty about interest deductions.[768] In ESBTs, interest on the promissory note is deductible only for

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[762] Code § 641(c)(2).
[763] Letter Ruling 201122003.
[764] Code §§ 2056(b)(1) and 2523(b).
[765] Code § 651.
[766] Code § 1(e)(2).
[767] Letter Rulings 9140055 and 200140046. Compare Sections 502(b) and 504(b)(4) of the Uniform Principal And Income Act (last amended or revised in 2000; see http://www.law.upenn.edu/bll/ulc/upaia/2000final.htm); in Missouri, see RSMo §§ 469.453.2 and 469.457.2(3). Thus, a QSST should be able to repay principal of a promissory note if properly secured; however, if the QSST has other assets or later sells the stock, it might be required to distribute the other assets or sale proceeds to make up for the income that was used to pay principal on the promissory note.
[768] 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....” Notwithstanding that argument, the principle behind the ESBT regulation quoted in fn 769 tends to support the beneficiary‘s deduction of interest under Code § 1361(d)(1)(B).

tax years beginning after December 31, 2006.[769] A better solution is a trust taxable to its beneficiary under Code § 678.[770] On the other hand, 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.[771]

The beneficiary must make a QSST election no later than fifteen days and two months after the trust received the stock.[772] The trustee of an ESBT must file the ESBT election within the same time framework. A late ESBT or QSST election may be made within 24 months of the original due date of the election, without the $14,000 fee generally required for letter rulings under Code § 9100.[773] The late election requires the consent of all the shareholders.

III.A.5.c. What If Grantor Trust Is Not a Wholly Owned Grantor Trust?

Should a QSST or an ESBT election be filed for an irrevocable grantor trust taxable to the grantor, just in case the trust is not a wholly-owned grantor trust taxable to only one individual?

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.[774]

A grantor trust may make an ESBT election.[775] However, grantor trust treatment trumps ESBT taxation.[776] That doesn‘t mean that the ESBT election is not technically in effect - it just means that it has no income tax consequences.

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[769] 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).

[770] See fn 746.

[771] See III.B.2.c.xi QSST as an Alternative Form of Beneficiary Grantor Trust.

[772] 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).

[773] Rev. Proc. 2003-43, as supplemented by Rev Proc 2007-62. The annual Revenue Procedure for issuing letter rulings, Rev. Proc. 2011-1, continues to refer to these procedures as good law. Section 5.02 of that Rev. Proc. provides:

> In lieu of requesting a letter ruling under this revenue procedure, a taxpayer may obtain relief for certain late S corporation and related elections by following the procedures in Rev. Proc. 2004-49, 2004-2 C.B. 210; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998, or Rev. Proc. 97-48, 1997-2 C.B. 521. These procedures are in lieu of the letter ruling process and do not require payment of any user fee. See section 4.04 of Rev. Proc. 2004-49, section 3.01 of Rev. Proc. 2004-48, section 3.01 of Rev. Proc. 2003-43, section 3 of Rev. Proc. 97-48, and section 15.03(3) of this revenue procedure.

The reader should always check the first Revenue Procedure of the year to make sure that these procedures remain current.

[774] Reg. § 1.1361-1(j)(6)(iv).

[775] Reg. § 1.1361-1(m)(2)(v).

[776] Reg. § 1.641(c)-1(c).

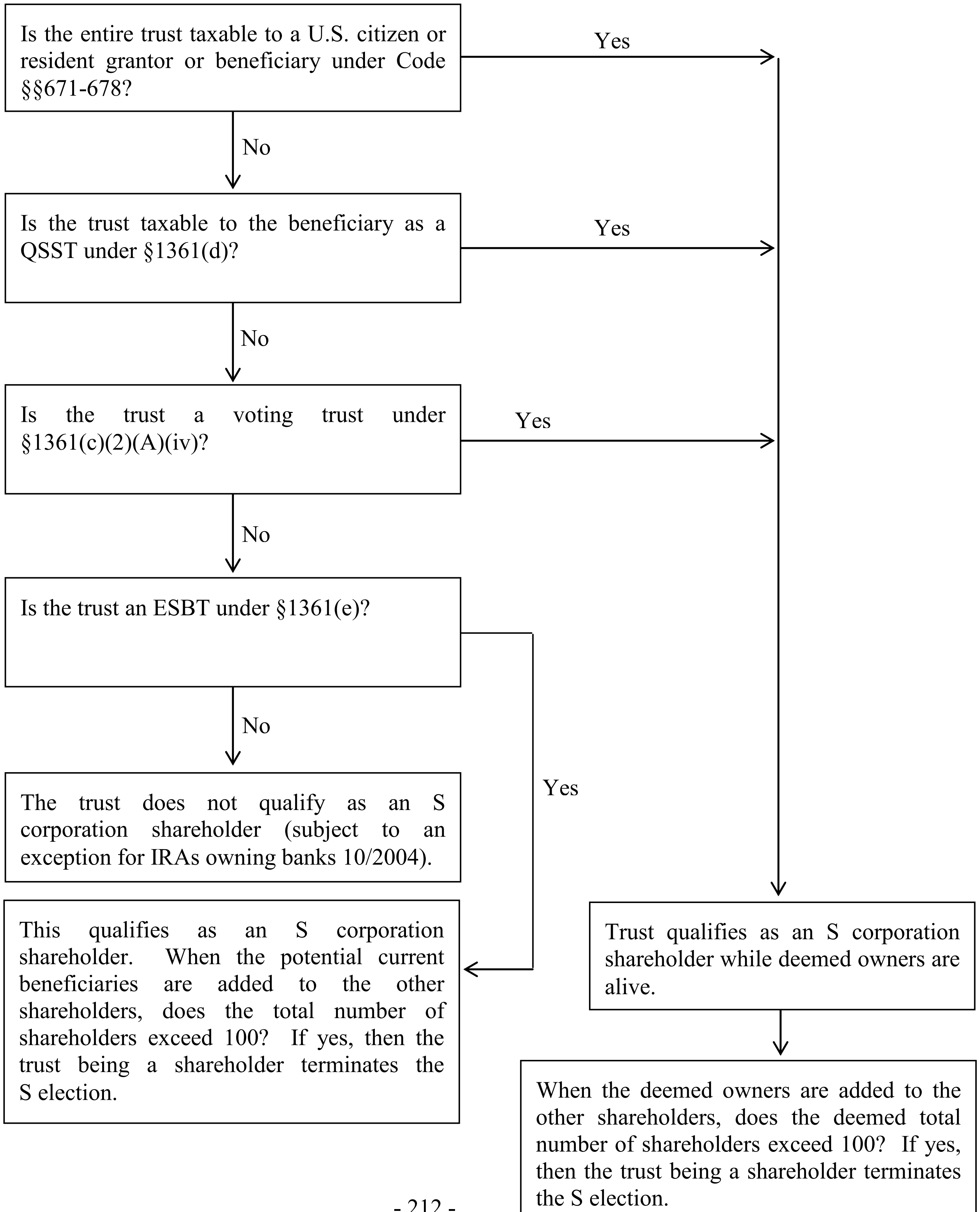
Some grantor trusts might qualify as a QSST or an ESBT upon termination of grantor trust status. The regulations limit how often one can switch back and forth between QSST and ESBT status. For these trusts, one might not want to make an ESBT election. For other trusts, one might consider an ESBT election in case it turns out that the trust was not a 100% grantor trust or to avoid deadlines upon termination of grantor trust status. However, note that 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.[777] 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.

III.A.5.d. Flowcharts

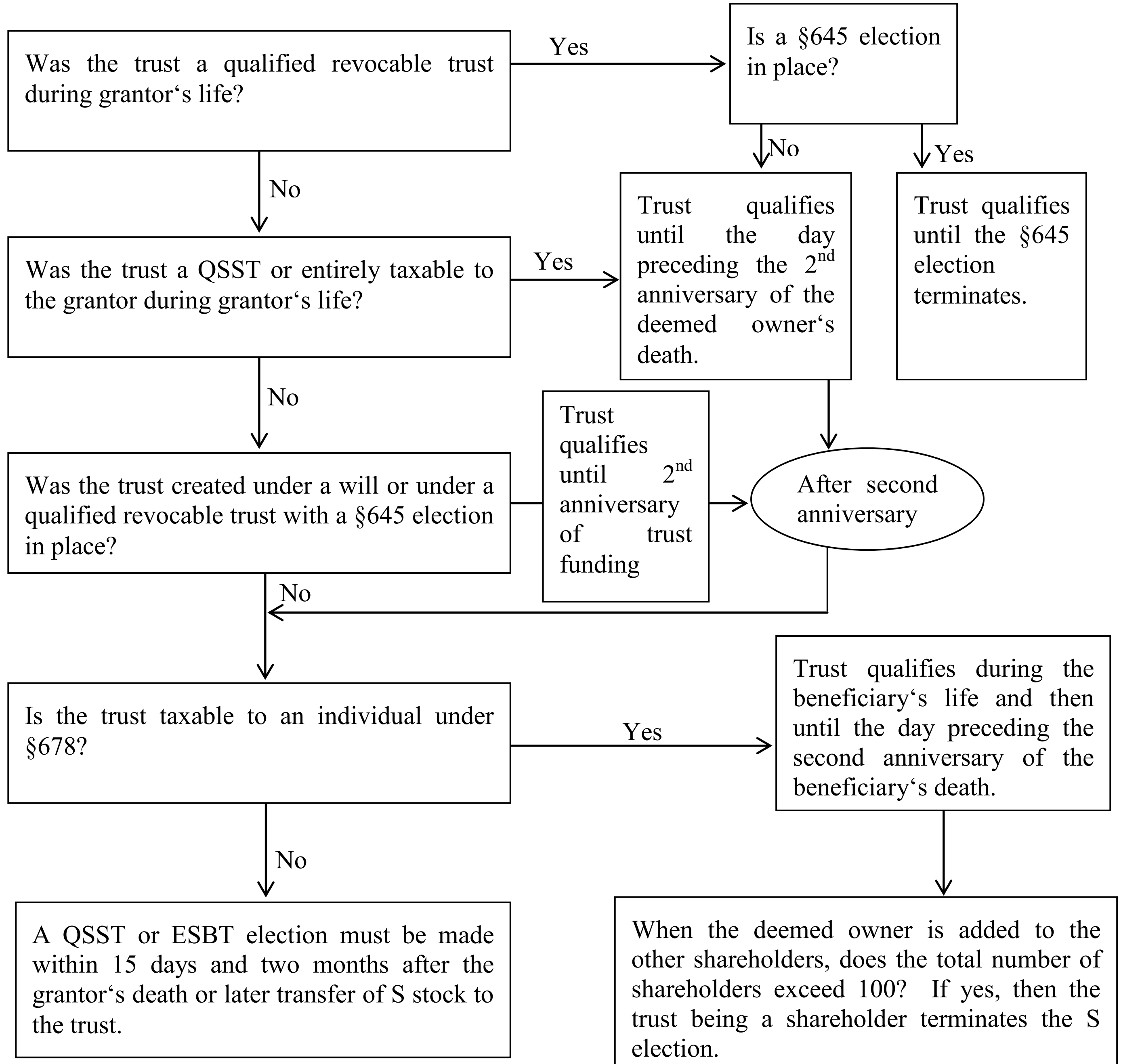
Below are some flowcharts illustrating trust qualification as a shareholder of an S corporation. The flowcharts do not consider trusts that are tax-exempt.

[777] Code § 1361(c)(2)(A)(ii). See Code § 641(c) for ESBTs' unfavorable income tax treatment.

III.A.5.d.i. Flowchart of Inter Vivos Trusts (Trusts Created while Grantor is Alive)



III.A.5.d.ii. Flowchart of Testamentary Trusts (Trusts Created on Grantor's Death or Continued after QSST Beneficiary's Death)



III.A.6. 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, there will likely be differences between taxable income and accounting income. An example of such a difference would be capital gains. Capital gains are usually principal for fiduciary accounting purposes, but are taxable income for income tax purposes.

III.A.6.a. 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.[778] 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[779] 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.[780] 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.

The hypothetical at the end of these materials includes another example with a flowchart.

III.A.6.b. 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

[778] Uniform Principal and Income Act § 401(b). See footnote 779.

[779] 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.

[780] See also RSMo §469.459.3(1).

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.

III.A.6.b.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:

- C Corporation. 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).

- S Corporation. 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, Code Sections 651 and 661; 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.). Code Sections 652 and 662.

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. Sections 1.643(b)-1, 1.651(a)-2, and 1.661(a)-2(b) of the United States Treasury Regulations (the ―Regulations"). 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. UPAIA Section 401(b). 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, 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.6.b.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.[781]

- 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.[782] Therefore, the trustee would distribute to the beneficiary all of the tax distribution.

[781] Code § 1361(e); Reg. § 1.641(c)-1(i).
[782] Code § 1361(d)(1)(B).

- 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 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).[783]

III.A.6.b.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.

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.[784] 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.[785] If the client uses a fixed-price buy-sell agreement, the client might protect the marital deduction with respect to other assets by

[783] Code Section 1361(c)(2). See Gorin *et al.*, *The Tax Advisor*, March 2006, pages 152-157, ―Checklists for Determining Whether a Trust Is a Valid S Shareholder;" Gorin, *Journal of The Missouri Bar*, Vol. 61, No. 2, March-April 2005, page 92, ―Transferring Ownership of Stock in an S Corporation."

[784] 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).

[785] *See, e.g., Estate of Rinaldi*, 38 Fed. Cl. 341 (1997), *aff'd per curium*, 82 A.F.T.R.2d 98-7217 (Fed. Cir. 1998); *Estate of McCabe v. United States*, 475 F.2d 1142 (Ct. Cl. 1973); Technical Advice Memorandum 9147065.

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.

- *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.

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."[786]

- The trustee must further consider not only total return from income and appreciation of capital but also needs for liquidity and regularity of income.[787]

- "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."[788]

- "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

[786] Section 2(a) of the Investor Act.
[787] Section 2(c)(5) and (7) of the Investor Act.
[788] Section 3 of the Investor Act.

requirements, and other circumstances of the trust, and with the requirements of this [Act]."[789]

- ―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."[790]

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. 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.[791] 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.[792] 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.[793]

- 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.

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[789] Section 4 of the Investor Act.

[790] Section 6 of the Investor Act.

[791] *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).

[792] 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).

[793] Reg. § 20.2056(b)-5(f)(4) suggests such a provision if the trust's assets ―consist substantially of unproductive property."

- 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.[794]

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:

1. 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

2. 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.

III.A.6.b.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

[794] Section 5 of the Investor Act.

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.

III.A.6.b.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 percent 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 percent 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[795]

[795] 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).

Trust Taxable Income		$ 769,231
35 percent 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 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.7. Fiduciary Duties Regarding Business Interests Held in Trust

Issues regarding the duty to diversify are discussed in part III.A.6.b.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.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.

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 has special knowledge of a leasing business. He helps 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 may 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 is the moving force behind the transactions, his family and

close friends own most of the business from inception and therefore receive 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*.[796] In *Dickman*, the Supreme Court established that the gratuitous gift of the use of property constituted a taxable gift.[797] In holding such, the court stated that, ―Congress intended the gift tax statute to reach all gratuitous transfers of any valuable interest in property.”[798] The court goes further by adding, ―the gift tax was designed to encompass all transfers of property and property rights having significant value.”[799] 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.”[800] The gift tax is ―broad enough to include property, however conceptual or contingent,”[801] and may ―reach every kind and type of transfer by gift.”[802] 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*[803] 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.[804] Furthermore, the child‘s use of the money was not an interest with an exchangeable value.[805]

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

[796] 465 U.S. 330 (1984).
[797] *Id*. at 333.
[798] *Id*. at 334.
[799] *Id*.
[800] *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945).
[801] *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943).
[802] *Robinette v. Helvering*, 318 U.S. 184, 187 (1943).
[803] 585 F.2d 234 (7th Cir. 1978).
[804] *Id.* at 239.
[805] *Id*.

represents a transfer of property by gift.[806] 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 (then) unified credit.[807] However, *Crown* should apply in particular circumstances. For instance, a parent who allows his or her adult child to use the family vacation home rent-free should not engender any gift tax liability if the child does not have a legally enforceable right, against the parent, to stay in the home.[808] *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.

Thus, although a short-term use of property might be free from gift tax, indefinite use of property is more problematic.[809]

III.B.1.a.i. Interest-Free and Below-Market Loans

Interest-free or below-market loans are governed by Code § 7872, which generally requires imputation of interest of such loans.[810] 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.

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.F.4 Loans between Owner and Entity, 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;[811] characterization of a

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[806] *Dickman*, 465 U.S. at 333.
[807] *Id.* at 341-42.
[808] The *Dickman* Court expressly reserved for future cases adult children's use of cars or vacation cottages. *Id.* at 336.
[809] See Letter Ruling 8104207.
[810] *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.
[811] Gift tax applies to not only direct but also indirect gifts. Code § 2511(a). 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

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.[812]

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.[813] The same rule holds true for compensation-related and corporate shareholder loans.[814] Also, Code § 7872 provides for an income tax (but not gift tax) exclusion of accrued interest where aggregate loans do not exceed $100,000.[815]

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 year's 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.[816] The present value is calculated using a discount rate equal to the AFR for the term of the loan.[817] 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.[818]

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

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> 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.

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).

[812] Code § 2701(e)(5). See III.B.4.b Code § 2701 Overview and III.B.4.c Code § 2701 Interaction with Income Tax Planning.

[813] Code § 7872(c)(2)(A).

[814] Code § 7872(c)(3)(A).

[815] Code § 7872(d)(1).

[816] Code §§ 7872(b)(1), 7872(d)(2).

[817] Code § 7872(f)(1).

[818] 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.

loan.[819] 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.[820]

III.B.1.a.i.(c). Refinancing Loans

Regulations provide some flexibility in loan work-outs[821] or other loan modifications.[822]

III.B.1.a.ii. Loan Guarantees

III.B.1.a.ii.(a). Gift Tax Issues

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:[823]

> 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 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.

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[819] 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).

[820] 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).

[821] Prop. Reg. § 1.7872-11(a)(2), providing no income taxation in some situations when accrued interest is forgiven.

[822] Reg. § 1.1001-3(c), discussing exceptions to the general rule that a significant modification of debt instrument is a taxable exchange.

[823] *Bradford v. Commissioner*, 34 TC 1059, 1064-65 (1960).

> 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*, 183 F. 2d 32 (C.A. 9, 1950), affirming 12 T.C. 468. 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.[824] 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,[825] 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 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.[826] Thus, a parent should be able to make his or her credit standing available to his or her children without creating an income

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[824] *See* Randall J. Gingiss, *The Gift of Opportunity*, 41 DEPAUL L. REV. 395, 409 (1991-1992).
[825] Rev. Rul. 2010-24.
[826] Letter Ruling 9409018.

or gift tax event.[827] 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,[828] 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 guaranties as ―unmatured, potential claims.‖[829]

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.‖[830]

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. 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 remedies against the debtor to recover the right to be reimbursed for that payment.[831] If a later forgiveness is gratuitous, then the forgiveness of principal should be treated as a gift rather than cancellation of indebtedness income.[832] The forgiveness of interest will not

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[827] 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).

[828] 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.

[829] *Estate of Theis v. Commissioner*, 81 TC 741, 748 (reviewed decision 1983) (rejecting estate tax deduction for claim due to guaranties 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.

[830] Treas. Reg. § 1.1273-1(c)(1)(ii).

[831] 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.

[832] 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.

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.[833]

If one is concerned that a loan guarantee is a gift, one should structure the loan as a back-to-back loan.[834] If that is impractical, consider paying the parent a reasonable guarantee fee.

III.B.1.a.ii.(b). Income Tax Consequences

Code § 102 (no income on a gift) trumps Code § 61(a)(2) (discharge of indebtedness is income income). *Helvering v. American Dental*, 318 U.S. 322 (1943) (interpreting predecessors to these statutes); *Bosse v. Commissioner*, TC Memo 1970-355 (not citing *Helvering v. American Dental* but rather determining the gratuitous nature of the forgiveness).

Normally, a guarantor‘s payment on a debt will be deductible, either as a business bad debt or non-business bad debt. It does not matter whether such a deduction was a business bad debt or nonbusiness bad debt, because 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.[835]

If a corporation is thinly capitalized, the shareholder‘s payment of the corporation‘s bank loan pursuant to a guaranty 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.[836]

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": ―[I]t] 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."[837]

Code § 108(e)(6) confirms no cancellation of indebtedness income when a shareholder cancels a debt owed by the corporation to the shareholder.

[833] Prop. Reg. § 1.7872-11(a)(2).

[834] 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.

[835] Reg. § 1.166-9(e); *Lair v. Commissioner*, 95 T.C. 35 (1990) (imposing penalties for deducting loss on guaranty of family member‘s obligation in light of that regulation).

[836] *Titmas v. Commissioner*, TC Memo 1995-267; *Peterson v. Commissioner*, TC Memo 1997-377.

[837] *Dickman*, 465 U.S. at 336, quoting *Passailaigue v. U.S.*, 224 F.Supp.682, 686 (MD Ga. 1963).

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.[838] "The taxpayer is not under any duty to cultivate the fruits of his capital (or labor) and will not be taxed as if he had when he hasn't."[839] Also, *Dickman* states that the gift tax is an excise tax on transfers of property.[840] *Dickman* did not address gifts of services.

Revenue Ruling 66-167[841] held that a timely waiver of fees for serving as executor was neither income to, not a gift by, the executor. The IRS reasoned:

> 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.

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[838] *Hogle v. Commissioner*, 7 TC 986 (1946 reviewed decision), *aff'd* 165 F.2d 352 (10th Cir. 1947).
[839] *Crown*, 585 F.2d at 236
[840] *Dickman*, 465 U.S. at 340.
[841] *Followed Breidert v. Commissioner*, 50 TC 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.

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.

III.B.1.a.iv. Family Partnerships

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. These are similar facts, in certain respects, to those of *Carriage Square, Inc. v. Commissioner*.[842]

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 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.[843] Code § 704(e)(1), a non-exclusive safe harbor, states 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, a façade 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

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[842] 69 TC 119 (1977).

[843] 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.

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.[844] 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).[845]

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.[846] 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) will preclude the partnership from passing the *Culbertson* hurdle.[847]

Commentators have long questioned the *Carriage Square* holding.[848] The case, as the Tax Court admitted, was an egregious example of tax avoidance.[849] Today, it is readily distinguishable and, with proper planning, should cause little concern for the gift of opportunity described above. One reason for this is the IRS' change of attitude regarding loan guarantees.

III.B.1.a.v. Sending Business

In *Crowley v. Commissioner*,[850] 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.[851] 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

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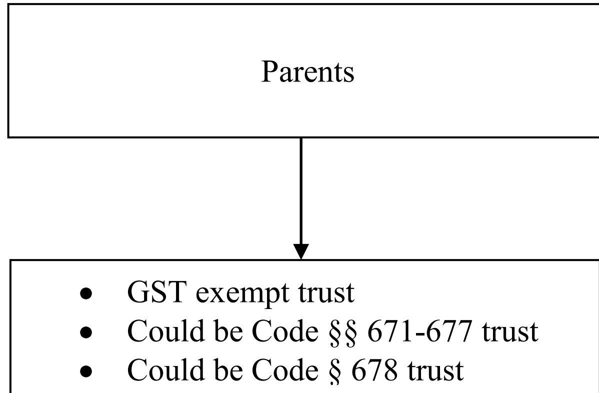
[844] *Carriage Square*, 69 TC at 128.
[845] *Id*. at 140-41.
[846] *Commissioner v. Culbertson*, 337 U.S. 733 (1949).
[847] Howard Zaritsky, ¶ *10.09 The Family Partnership Rules*, Tax Planning for Family Wealth Transfers: Analysis With Forms.
[848] W. McKee, W. Nelson, R. Whitmire, Federal Taxation of Partnerships and Partners, ¶ 14.02 (3d 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).
[849] *Carriage Square*, 69 TC at 131.
[850] 34 TC 333 (1960).
[851] *Id*. at 345-47.

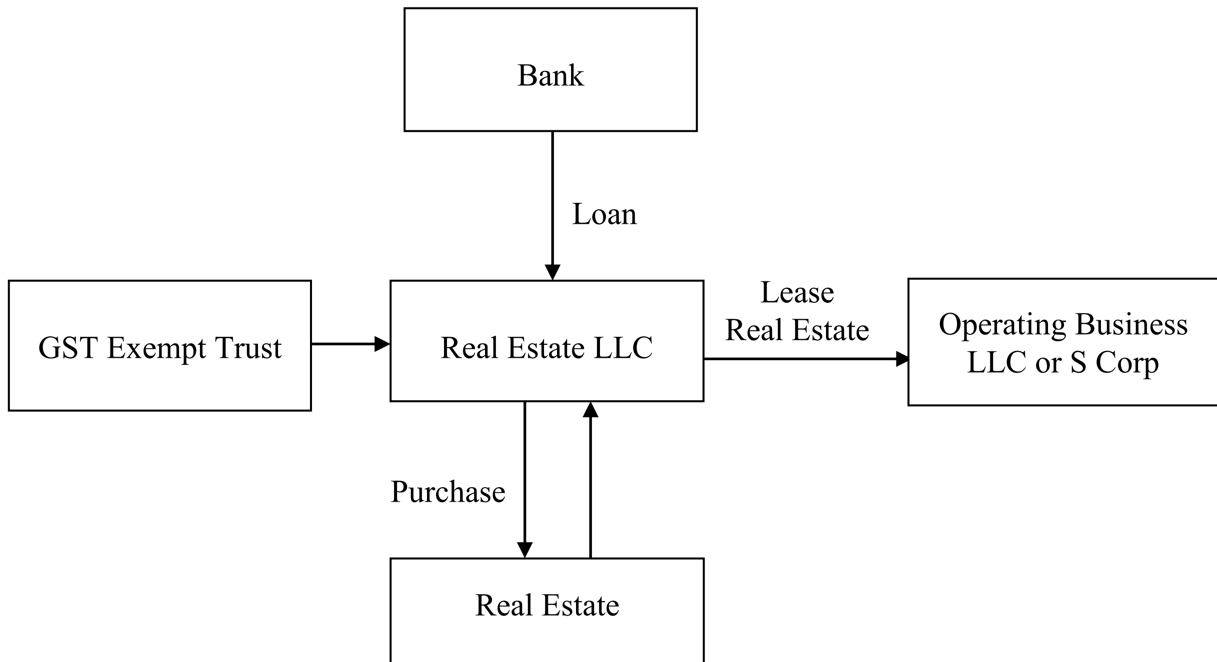
on the basis of individual ability. One author suggested that such nepotism, however, would be extraordinarily difficult to tax, and the IRS does not regularly pursue it.[852]

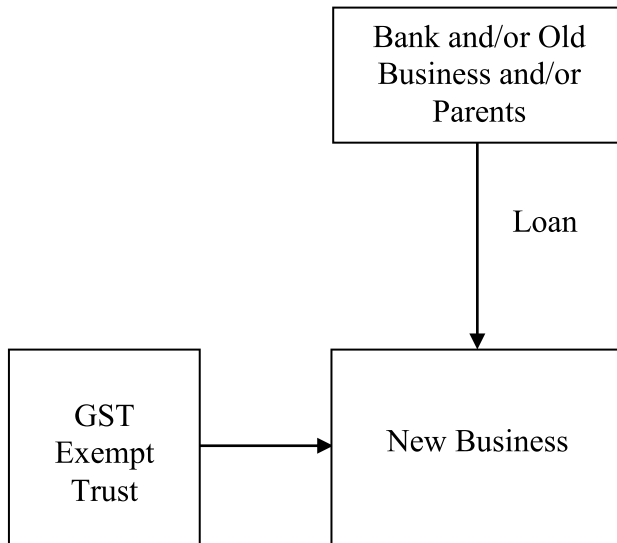
[852] Gingiss, *The Gift of Opportunity*, 41 DEPAUL L. REV. 395, 410 (1991-1992).

III.B.1.a.vi. Business Expansion into New Location

Consider the following:







Estate Planning

The new business or real estate often has either minimal value or net asset value. This structure moves future growth outside of the estate tax system.

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.

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.

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.J.2.a for a detailed discussion.

III.B.1.b. Gifts Without Consideration, Including Restructuring 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.[853]

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.[854]

For corporations, the author frequently recommends that clients create nonvoting stock, doing a 19-for-1 nonvoting-for-voting stock dividend.[855] 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.[856] 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).[857] 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,[858] 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.5, this article discusses the merits of QSSTs compared to other alternatives.

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[853] Rev. Rul. 93-12.

[854] 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 reg 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 regs did not apply to determine the gift tax effect of the transfer of an interest in a single-member LLC. See text accompanying fn 357. 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.

[855] See fn 25 for reporting requirements relating to this stock dividend.

[856] A transfer of nonvoting stock poses much less estate tax risk than a transfer of minority voting stock. See fn 24.

[857] Code § 1361(d)(3).

[858] Code § 1361(d)(1)(B).

III.B.1.c. Valuation Issues

Because S corporations are not publicly traded, they are inherently difficult to value.

S 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 III.C for a further discussion of valuation.

III.B.1.d. Self-Canceling Installment Note

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. Typically, an older family member sells to a younger family member and the cancellation event is the seller's death.[859] 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.[860]

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: no stepped-up basis at death, a finite term of payments, restrictions on alienability,[861] 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.[862] To avoid inclusion of the value of the property in the gross estate under Code § 2036, the seller cannot retain an interest in the property.[863] Also, the loan's terms must cancel the note at death; a bequest of a note is not a SCIN.[864] Most importantly, the

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[859] The cancellation event could also be the buyer's death, the first to die of the buyer and seller, or the death of a 3rd party.

[860] However, any delinquent payments will be included in the gross estate.

[861] Code §453(e) (accelerates income if the buyer sells the property within two years after an installment sale; if the property is marketable securities, income may be accelerated on sales during or after the two-year period).

[862] *Estate of Costanza v. Comm'r*, 320 F.3d 595, 597 (6th Cir. 2003).

[863] *See Cain v. Comm'r*, 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.

[864] *Estate of Buckwalter v. Comm'r*, 46 T.C. 805, 816-817 (1966).

buyer has to pay a premium to the seller as compensation for the chance that the seller may die before full payment is received.[865] If this risk premium is too low, the IRS might re-characterize the transaction as a bargain sale or part gift.[866] Lastly, 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.[867]

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.[868] Also, Chapter 14 should not apply to a properly structured SCIN.[869]

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.[870] A more complicated issue is whether buyers recognize gain based on cancellation of indebtedness[871] 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).[872] The more complicated income tax issue for the seller is whether any gain is realized upon death. That issue was

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[865] *See Estate of Moss v. Comm'r*, 74 T.C. 1239, 1246-47 (1980) (full consideration for SCIN includes consideration for the cancellation provision), *acq.* 1981-2 C.B. 2. 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.

[866] *See Estate of Berkman v. Comm'r*, 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.").

[867] GCM 39503 (1986).

[868] *See Wilson v. Comm'r*, 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 881.

[869] *See* Priv. Ltr. Rul. 9436006 (1994) (neither §2701 nor §2702 applied to a note because debt is not a retained interest in a trust).

[870] GCM 39503 (1986). S*ee Frane v. Comm'r*, *supra* note 873, 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.

[871] Code § 61(a)(12).

[872] 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).

resolved in *Estate of Frane v. Comm'r*,[873] where the Eighth Circuit affirmed that cancellation upon death is treated as a transfer by the estate. Thus, the estate must pay income tax on the amount of the installment obligation cancelled.[874] The dissent in the Tax Court claimed that income should not be realized because no payments are due after death that can be cancelled.[875] The dissent further suggested a way around the holding by phrasing the exchange as a contingent sale,[876] but that technique has not been tested in court.[877]

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, and the seller‘s income tax bracket is relatively low and estate tax bracket is relatively high.

III.B.1.e. Private Annuity

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.

Private annuities[878] offer many of the same advantages as SCINs. The property and its future appreciation are excluded from the gross estate, 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 may be drafted to cap payments so that they do not extend for more than a short time after life expectancy.

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[873] 998 F.2d 567 (8th Cir. 1993). *Accord* Rev. Rul. 86-72.

[874] Code § §691(a)(2).

[875] *Estate of Frane v. Comm'r.*, 98 T.C. 341 (1992) (reviewed decision), *aff'd in part and rev'd in part*, 998 F.2d 567 (8th Cir. 1993).

[876] 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.

[877] 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.

[878] There are three types of private annuities. The normal private annuity, or private annuity for life, requires payment for the transferor‘s life (or transferors‘ joint lives). A private annuity for a stated term ends at the earlier of the transferor‘s death or the stated term (which cannot exceed the transferor‘s life expectancy). A private annuity with a maximum payout ends at the earlier of the transferor‘s death or at the maximum payout amount. *See* GCM 39503 (1986).

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.[879] The annuity's actuarial value is based on the §7520 rate of interest and the transferor's life expectancy.[880] To determine life expectancy, the actuarial tables should be used unless the transferor is terminally ill or has a 50% chance of death within one year.[881] 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 §2036(a), the transferor cannot retain an interest in the property.[882] Hence, as long as the private annuity is properly structured, gift tax will be avoided on the exchange, and the property will be excluded from the transferor's gross estate.

For income tax purposes, ***on or before October 18, 2006***, if the annuity is unsecured,[883] 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.[884] 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).[885] 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.[886] 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.[887]

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[879] *Estate of Cullison v. Comm'r*, T.C. Memo. 1998-216 (1998), *aff'd*, 221 F.3d 1347 (9th Cir. 2000) (unpublished decision). *See also 212 Corp. v. Comm'r*, 70 TC 788, 798 (1978) (reviewed decision).

[880] *Id.* (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. Valuation is complicated if the annuity is to be paid from a trust or other limited fund and it might be exhausted before the annuitant attains age 110. Reg. §§ 25.7520-3(b)(2)(i), 1.7520-3(b)(2)(i) and 20.7520-3(b)(2)(i).

[881] Regs. §§1.7520-3(b)(3), 20.7520-3(b)(3), 25.7520-3(b)(3). If the transferor survives for 18 months, the transferor is rebuttably presumed not to have been terminally ill.

[882] *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. Comm'r*, 47 BTA 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.

[883] If the annuity is fully secured, gain is recognized immediately (although the interest portion is deferred). GCM 39503 (1986); *Bell v. Comm'r*, 60 TC 472 (1973) (reviewed decision, *aff'd per curiam* 668 F.2d 448 (8th Cir. 1982)), *followed by 212 Corp. v. Comm'r*, 70 TC 788, 802 (1978) (reviewed decision).

[884] An installment sale has limitations on deferral, which limitations do not apply to annuities. See fn. 872.

[885] Code § 72(b); Rev. Rul. 69-74.

[886] Rev. Rul. 69-74.

[887] 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

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.[888] The transferee's basis varies for different circumstances.[889] 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[890] 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;

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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).

[888] Rev. Rul. 55-119.

[889] *Id.*

[890] 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).

(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;

(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.

When a private annuity involves a trust, the transaction might be characterized as a gift to a trust instead of a sale. In a reviewed decision, the Tax Court held that it will look at several factors to make this determination, 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.[891] Courts have upheld properly structured annuity sales to trusts.[892] 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 the examiner made and asked the examiner to try to find other attacks.[893]

A properly structured private annuity should not implicate chapter 14, with the exception of private annuities transferred to a trust, which may involve Code § 2702 issues. Code § 2702 applies to gifts in trust where the transferor or an applicable family member retains a qualified interest.[894] Thus, Code § 2702 can be avoided where no gift exists (the fair market value of the property equals the actuarial value of the annuity) or where

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[891] *Weigl v. Comm'r*, 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).

[892] *Estate of Fabric*, 83 T.C. 932 (1984); *Stern*, 747 F.2d 555 (9th Circ. 1984), rev'g 77 T.C. 614 (1981). However, the Tax Court has openly expressed hostility towards private annuity sales to trusts when not required by the appellate court to uphold them. *Melnik*, T.C. Memo. 2006-25, responding to a taxpayer's attempt to rely on *Fabric* and *Stern*.

[893] Chief Counsel Advice 200923024.

[894] Code § 2702(a), (b).

neither the transferor retains an interest in the trust after the transfer nor the transferee had an interest before the transfer.[895]

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 transferee has means to make payments, and the transferor wants a source of retirement income. 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.

III.B.2. GRAT vs. Sale to Irrevocable Grantor Trust

III.B.2.a. General Description

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).[896] The grantor gives property (nonvoting stock) 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 percentage of the initial value of the trust's assets.[897] This initial value is the value determined for federal tax purposes,[898] and adjustments to payments are required if the initial value is incorrectly determined.[899] 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.[900] 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.[901]

- 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.[902] The grantor makes a gift[903] equal to at least

[895] See Priv. Ltr. Rul. 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).
[896] 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.
[897] Code § 2702(b)(2).
[898] Reg. § 25.2702-3(b)(1)(ii)(B).
[899] Reg. § 25.2702-3(b)(2).
[900] Code § 2702(a)(2)(B).
[901] 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.
[902] 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

one-ninth of the value of the property the grantor is going to sell.[904] The grantor sells property (nonvoting stock) to the trust and receives a promissory note.[905] While the trust is a grantor trust, income tax does not apply to the sale.[906]

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.[907] A sale to an irrevocable grantor trust triggers income tax if the grantor trust powers are turned off; to the extent that the note's principal exceeds the basis of the trust's assets, a bargain sale is likely to have occurred.[908] [909] It also does not require an

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fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value. Section 8.09 of Rev. Proc. 2007-45 approved such a power as triggering grantor trust status. Rev. Rul. 2008-22 provides guidelines for such a power not to trigger Code § 2036. To avoid arguments that Code § 2042 causes estate tax inclusion, the author excludes life insurance from this power and instead relies on Code 677(a)(3). The author also tends to fund irrevocable grantor trusts with *nonvoting* stock when closely-held businesses are involved; see fn 24.

[903] The trust should not grant withdrawal rights (*Crummey* rights) to the beneficiaries. To do so may call into question whether the grantor owns all of the trust for all purposes. Code § 678(b) provides that a grantor's rights to income supersede a beneficiary's right to income for grantor trust purposes, and many tax advisors are concerned whether a grantor's rights to principal supersede a beneficiary's right to principal for grantor trust purposes. However, one might be able to obtain a letter ruling permitting this. See Letter Rulings 200603040 and 200606006 and numerous rulings before and after those rulings.

[904] *Estate of Anne Y. 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.

[905] 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).

[906] Rev. Rul. 85-13.

[907] Formula sales are described in III.B.2.d.

[908] See *Madorin v. Commissioner*, 84 TC 667 (1978) and Reg. § 1.1001–2(c), Example 5. Arguably, this tax treatment does not apply when grantor trust treatment is terminated by death. Blattmachr, Gans & Jacobson, ―Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 *Journal of Taxation* 149 (2002). Chief Counsel Advice 200923024 appears to have accepted their arguments. 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.

[909] 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, but a transfer at death does not. *Harry F. Shannon v. Commissioner*, 29 T.C. 702 (1958) (construing the predecessor to Code § 453B that had provisions substantially the same as Code § 453B(a)); Code § 453B(c). 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.

up-front gift, which can be a problem when the grantor tries to move more than $18M in stock.[910] Finally, GRATs have a 105-day grace period in the event of a late payment.[911]

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.[912] Also, if the grantor dies during the term, the assets in the trust should not be brought back into the grantor‘s estate.[913] 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.[914]

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.

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[910] If the stock to be transferred is worth $18M, then the gift would be $2M, which will be the gift tax applicable exclusion amount for the foreseeable future for a married couple that splits gifts. Any larger initial gift would trigger gift tax. However, when an irrevocable grantor trust starts building equity, the grantor can make additional sales to the trust, so long as the trust always has at least 10% equity.

[911] Reg. § 25.2702-3(b)(4).

[912] 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.

[913] If the promissory note is considered an interest in the trust and is worth less than the stock sold, the IRS could 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). 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. However, the IRS reversed this position in proposed regulations, REG-119097-05, dated June 7, 2007, in which it took the position that Code § 2036 applied, applying the Code § 7520 rates to the retained interest to determine the portion includible, with Code § 2039 not applying except to annuities that are in the trust. See Prop. Regs. §§ 20.2036-1(c), 20.2039-1(e).

[914] Code § 2642(f).

III.B.2.b. Grantor Trust Powers – Power of Substitution

Code § 675(4), a provision commonly relied upon in drafting irrevocable grantor trusts, treats a grantor of a trust as the owner if:

> *General powers of administration*.
>
> 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.

Rev. Rul. 2008-22 held:

> 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, provided the trustee has 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.

Government officials have informally indicated that they will not clarify this ruling's application for voting stock in closely-held corporations under Code § 2036(b) or for life insurance under Code § 2042.

Most practitioners do not believe that prior documents need to be fixed. Going forward, documents frequently refer to this ruling.

Guidance on the use of this power can also be found in the charitable area. Rev. Proc. 2008-45 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:

(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, 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.

Its companion pronouncement, Rev. Proc. 2008-46, issued forms for testamentary CLUTs.

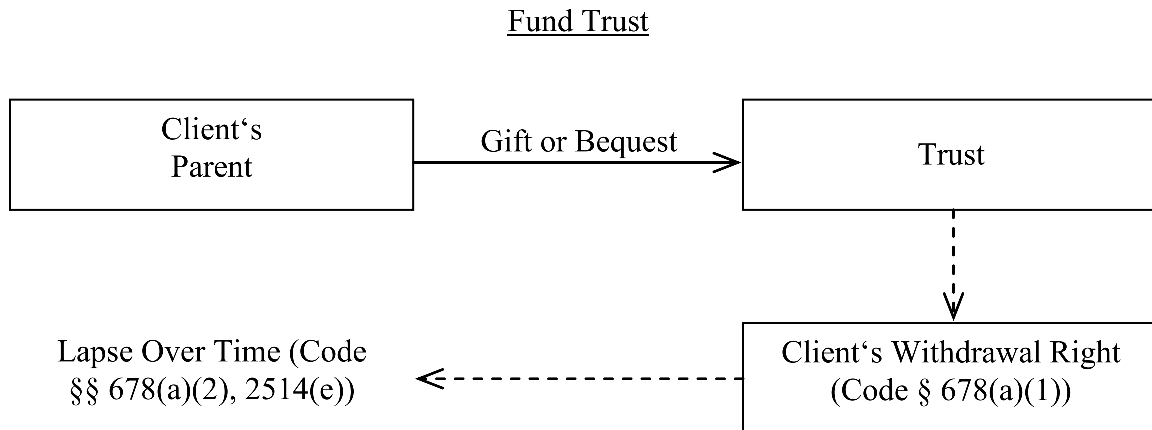
Letter Ruling 200944002 ruled that transfers to a self-settled spendthrift trust was a completed gift and that the trust's assets would not be included in the grantor's estate. It provides a good roadmap for obtaining a private letter when creating such a trust in light of Rev. Rul. 2008-22, which requires certain procedural safeguards when a grantor exercises a swap power (the right to substitute assets of equivalent value).[915]

[915] The trust provided the settlor ―with the power, exercisable in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to acquire property held in the trust by substituting other property of an equivalent value. Grantor will exercise the power by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value and Trustee shall have a fiduciary obligation to ensure Grantor's compliance with the terms of the power to substitute property. Before the substitution of property is completed, the trustee must be satisfied that the properties acquired and substituted are in fact of equivalent value. In addition, the power can not be exercised in a manner that can shift benefits among the trust beneficiaries."

III.B.2.c. Code § 678 (Beneficiary Grantor) Trusts

Beneficiary grantor trusts can be helpful tools; one proponent calls his version a Beneficiary Defective Inheritor's Trust (BDIT).[916] This article describes what a beneficiary grantor trust is, when it is useful, sales to the trust, and the structures used in recent rulings.

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.

Power to restructure who serves as independent trustee should a vacancy in that position occur; may not name a person who is a related or subordinate party with respect to the independent trustee.[917]

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[916] "The Beneficiary Defective Inheritor's Trust ("BDIT"): Finessing the Pipe Dream," www.oshins.com/images/BDIT_article.pdf.

[917] 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

Broad inter vivos limited power of appointment.
Broad testamentary limited power of appointment.

Independent Trustee:

May distribute for welfare.
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 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.[918]

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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), and 201207001 (power to remove distribution trustee and replace with a party that is not a related or subordinate party). I have been told (but have not verified) that Letter Rulings 9735023, 9746007, 200031008, and 200533010 had a similar result.

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*, TC 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.

[918] 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)) 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 suggest that its spirit carries into other areas, as discussed in notes 435 (Code § 2042 life insurance) and 917 (Code § 2041 general power of appointment).

III.B.2.c.i. General Concept of Beneficiary Grantor Trusts

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[919] 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.[920] 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[921] of the portion that beneficiary can withdraw.[922] The trust is drafted so that the grantor is not taxed as the owner for income tax purposes[923] and so that, if the beneficiary had been the settlor, the beneficiary would have

[919] 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).

[920] 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.

[921] 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.

[922] 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 applies even to a beneficiary who lacks legal capacity to exercise the power. Rev. Rul. 81-6.

[923] If Grantor is taxed as the owner under other provisions of the grantor trust rules, then Beneficiary is not taxed as the owner to the extent provided in Code § 678(b). Although Code § 678(b) appears limited in scope, most commentators believe, and numerous recent Letter Rulings hold, that any conflict in whether

been taxed as the owner for income tax purposes.[924] 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.[925] Note, however, that, 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.

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.[926] Partial withdrawal rights generate partial deemed ownership,[927] so that any future sale to

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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) would not work, in that both Grantor and Beneficiary would be deemed owners, and Code § 678(b) would make Grantor the trust's deemed owner. 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.

[924] 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… 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."

[925] 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).

[926] Reg. § 1.671-3(a)(3).

[927] 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

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.[928]

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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 929-930, 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 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.

[928] See Zaritsky, ―¶ 4.08[3][l][i] Beneficiary ownership of the trust," *Tax Planning for Family Wealth Transfers: Analysis With Forms* (WG&L).

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.[929] I disagree with this suggestion[930] but recommend that those who plan sales to beneficiary grantor trusts 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.

Many letter rulings requested that 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.[931]

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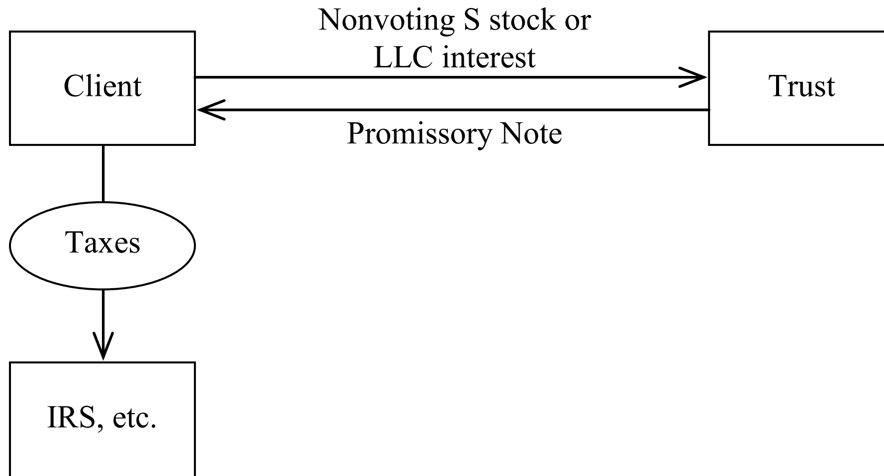
[929] *Lazarus v. Commissioner*, 58 T.C. 854 (1972), *acq.* 1973-2 C.B. 1, *aff'd*, 513 F.2d 824 (9th Cir. 1975); *LaFargue v. Commissioner*, 73 T.C. 40 (1979), *aff'd in part, rev'd and rem'd in part*, 689 F.2d 845 (9th Cir. 1982), on remand, T.C. Memo. 1985-90, aff'd, 800 F.2d 936 (9th Cir. 1986); and *Stern v. Commissioner*, 77 T.C. 614 (1981), *rev'd and rem'd*, 747 F.2d 555 (9th Cir. 1984).

[930] In *Lazarus* and *LaFargue*, note 929, 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; I believe that 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 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.

[931] 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).

III.B.2.c.ii. 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.[932] 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[933] and the IRS asserts that the sale price was inadequate, any resulting gift is an incomplete gift[934] and therefore is not subject to gift tax.[935] This might be less susceptible to IRS attack than a defined value clause.

Why might the senior family member not want to do a traditional sale to an irrevocable grantor trust?

[932] See Rev. Rul. 85-13.

[933] That is not a general power of appointment under Code § 2041(b)(1), since the goal is avoiding inclusion in Beneficiary's estate.

[934] Reg. § 25.2511-2(b).

[935] 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.

- The client is concerned about preserving income for retirement or emergencies. The client might not feel comfortable reducing his or her estate to $1M or $3M or whatever the estate tax applicable exclusion amount is.
- 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.c.iii. Funding the Trust 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").[936] 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.[937] The guarantee fee will constitute income to the recipient but might not be deductible by the trust.[938]

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[936] 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.

[937] The guarantee fee is not a tax law requirement; see part III.B.1.a.ii Loan Guarantees. However, 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.

[938] *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*,

A more conservative strategy involves a trust that was set up to take advantage of business opportunities,[939] 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;[940] 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.

- 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,[941] split up,[942] or passes to beneficiaries.[943]

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.[944] One might recommend that a client use some of

134 T.C. No. 5 (2010) (addressing withholding rules in internation 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.

[939] See generally part III.B.1.a Business Opportunities.

[940] See text after footnote 443, including the chart shown as Appendix C to that portion of these materials.

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

[942] See part II.L.4.c Corporate Division.

[943] See part II.K Basis Step-Up Issues.

[944] See n. 923 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.

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 gift tax applicable exclusion amount that became available in 2011. 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.c.iv. 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.

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.[945]

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.

[945] 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.

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.[946]

So, after seven years, the withdrawal right has lapsed at least $50K per year, for a total lapse in excess of $350K.[947] 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.[948]

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,[949] 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.[950] 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.

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[946] 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.
[947] 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.
[948] Assuming no change in the stock‘s value.
[949] $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.
[950] $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.

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.

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.[951]

- 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 primary beneficiary.

- These gifts were of S corporation stock. In ruling that the beneficiaries were deemed to own all trust Q's assets,[952] the IRS did not mention the fact that each grantor trust holding S corporation stock must have a sole owner.[953] I would not risk transferring S corporation stock to such a trust.

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

[951] Citing Code § 678 and Reg. § 1.671-3 (without any analysis of the latter).
[952] Citing Rev. Rul. 85-13.
[953] Code § 1361(c)(2)(A)(i).

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.c.v. Concerns about Using a Large Gift

Reg. § 1.671-3(a)(3) provides:[954]

> 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, 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 above. 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 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.

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[954] 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.

The IRS has issued numerous letter rulings without expressing this view.[955] Thus, I would feel confident in submitting a ruling request. Nevertheless, if one 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. 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.

[955] 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.

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.

III.B.2.c.vi. Problem with Currently Exercisable Withdrawal Rights

When a beneficiary holds a withdrawal right, in many states the beneficiary's creditors can force that beneficiary to exercise the withdrawal right.[956]

From an estate tax viewpoint, this is not troublesome, because 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 beneficiary's creditors.[957]

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. An allocation of the grantor's GST exemption might turn out to be wasted to a certain extent.

III.B.2.c.vii. Problem with Lapsed Withdrawal Rights

As discussed above, if and to the extent that the beneficiary's creditors can reach the trust's assets, the beneficiary's interest in that portion of the trust's assets are included in the beneficiary's estate[958] and therefore the beneficiary grantor trust strategy does 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 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…."[959]

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[956] *See, e.g.*, Uniform Trust Code § 505(b)(1). 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), North Carolina General Statutes § 36c-5-505(b)(1).

[957] Code § 2041(b)(1).

[958] Code § 2041(b)(1).

[959] 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.

Thus, any state that has adopted Uniform Trust Code § 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, Illinois, Indiana, Kansas, Louisiana, Michigan, Missouri, Nebraska, Nevada, New Hampshire, North Carolina, Ohio, Oregon, Tennessee, Texas, Utah, Vermont, Virginia, and Wisconsin.[960] This is just a partial listing received from a list-serve inquiry; I have not reviewed Uniform Trust Code states not listed above and have not researched the law of any other state.

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[960] *See, e.g.*, Section 19-3B-505(c)(2) of the Code of ***Alabama***; ARS section 14-10505(B)(2) (***Arizona*** - protection applies to lapsed annual exclusion gift, even if above 5&5); [ULA cites ***Arkansas*** and ***D.C.*** as having no variation in this language]; ***Florida*** Statutes section 736.0505(2) (protection applies to lapsed annual exclusion gift, even if above 5&5); 12 Del. C. § 3536(c)(1) (***Delaware*** - protection applies to lapsed annual exclusion gift, even if above 5&5); 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); ***Louisiana*** Revised Statutes Title 9, Section 2004(2) (protecting any lapsed withdrawal right, without limit); MCL § 700.7506 (***Michigan*** – protection provided even in excess of 5&5); RSMo § 456.5-505.5 (***Missouri*** - protection applies to lapsed annual exclusion gift, even if above 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]; ***North Carolina General Statutes*** section 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)]; ***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 § 55-545.05(B) (protection applies to lapsed annual exclusion gift, even if above 5&5); ***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. 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.

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.c.viii. Letter Ruling 200949012

The ruling describes the subject trust, where the beneficiary was deemed the owner under the grantor trust rules, as follows:[961]

> …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.
>
> 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).

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[961] 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.

> 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:

- 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.[962]

- 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.

- 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.[963]

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 affected by the exercise of

[962] The person who obtained this ruling has suggested that the right to withdraw should not completely lapse, because Code § 678(a)(2) requires that 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 Ruling 201038004 implicitly confirms that the IRS does not agree with his reading of Code § 678(a)(2).
[963] Code § 679.

> 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. 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.

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? [964]

III.B.2.c.ix. 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?[965]

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[964] 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 960.

[965] 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

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.[966] 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

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dominion and control of the trust assets ceases, such as by the trustee's 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" subject trust's assets to the grantor's creditors. 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).

[966] 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. 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.

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.[967] If 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;[968] 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.c.x. 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.

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[967] 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 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).

[968] 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.

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.

- 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, 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.

- 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:

- 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.[969] One might consider special drafting to authorize the trustee to impose these limits without violating a duty to the beneficiary.

- 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.c.xi. 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), 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.[970]

A prominent ACTEC Fellow suggested that, 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).

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, 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[971] 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 would not be a concern when the trust is buying stock. Perhaps an income beneficiary who sells S corporation stock to an existing QSST that already owns stock in the same S corporation would not recognize gain? That would certainly be more handy than going through all of the above analysis. Consider, however, issues regarding cash flow and interest deductions on an installment purchase of stock.[972]

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[969] See *Townsend v. Commissioner*, 5 T.C. 1380 (1945).
[970] Reg. § 1.1361-1(j)(8).
[971] T.D. 8600.
[972] See III.A.5.b Trusts as Shareholders: QSST vs. ESBT, Including How to Fix a Late Election and Regulations Dealing with ESBTs, text accompanying footnotes 767-771.

III.B.2.c.xii. 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.

Special care should be taken to protect against excessive estate burn off due to impose 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.

III.B.2.d. Defined Value Clauses in Gift Agreements or Disclaimers

III.B.2.d.i. Overview

Usually the 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* approved a gift of LLC interests defined by a fixed dollar amount, without any excess going to a charity or other entity, so we now have a clear path for making gifts.

The discussion below relates to the use of entities for an excess gift. It might now be considered superfluous in light of *Wandry*.

It has been suggested that a charity provides an independent third party that has the attorney general and the IRS (through intermediate sanctions) looking over its shoulder. In *Petter* and *McCord* (described below), representatives from the charity described their due diligence. That was absent in *Christiansen*, 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 is great for families who don‘t mind getting more money to charities. *McCord* is better for those who want to agree up front.

An alternative is to have a defined value consideration clause.[973] Grantor sells to trust an interest in an operating business in exchange for an interest in an LLC that holds marketable securities. The LLC is designed to minimize 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.

III.B.2.d.ii. 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.

- Leaving some money in escrow if any contingent liabilities, capital calls, or unrelated business income tax are involved.

[973] Carlyn McCaffrey suggested this idea at the 2011 Heckerling Institute.

- 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.2.d.iii. *Wandry*

Wandry v. Commissioner[974] 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 |

[974] T.C. Memo. 2012-88.

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.

III.B.2.d.iv. *Hendrix*

Hendrix v. Commissioner,[975] was similar to *McCord*[976] with respect to having a formula division between charitable and noncharitable donees, and the Tax Court followed the Fifth Circuit's holding.

III.B.2.d.v. *Christiansen* (2009)

Estate of Helen Christiansen v. Commissioner,[977] 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,[978] 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

[975] T.C. Memo 2011-133.
[976] See part III.B.2.d.vii.
[977] 586 F.3d 1061 (8th Cir. 2009).
[978] 130 T.C. 1 (2008).

Court also held that Christiansen's estate was entitled to a charitable deduction for this amount.

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:[979]

> 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

[979] 130 T.C. at 5.

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 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 twenty-five percent 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.

III.B.2.d.vi. *Petter* (2009)

In *Estate of Petter v. Commissioner*,[980] 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[981] 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.

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

[980] T.C. Memo 2009-280 (Judge Holmes).

[981] 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."

> 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.2.d.vii. *McCord* (2003, 2006)

In *McCord v. Commissioner* taxpayers prevailed in the Fifth Circuit[982] after losing in the Tax Court in a reviewed opinion.[983] *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,[984] 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 — 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

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[982] 461 F.3d 614 (2006).
[983] 120 T.C. 358 (2003).
[984] The court‘s abbreviation for the Community Foundation of Texas, Inc.

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.[985]

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.

III.B.2.d.viii. Earlier 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 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

[985] Citing Reg. § 25.2512-1.

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:

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 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,*[986] 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:

> [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.

In *Harwood v. Commissioner*,[987] the Tax Court reviewed the following provision:

> 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.]

[986] 87 TC 78 (1986).
[987] 82 TC 239 (1984).

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 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.

The case cited above, *King v. United States*,[988] had 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.

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

[988] 545 F.2d 700 (10th Cir. 1976).

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 Dickinson, Jr. v. Commissioner[989] 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

[989] 63 TC 771 (1975).

> 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:
>
> 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), affd. 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), affd. 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.2.d.ix. Sample Formula Assignment

One might consider the following to assign an interest in a limited liability company:

1. Assignment. Assignor assigns, transfers, and conveys to Assignee the GST-Exempt Portion of Assignor‘s entire Company Interest.

   a. The GST-Exempt Portion shall be a fraction, the numerator of which shall be the GST-Exempt Amount and the denominator of which shall be the value of Assignor‘s entire Company Interest, as finally determined for generation-skipping transfer tax (―GSTT”) purposes.

   b. GSTT means the tax imposed on generation-skipping transfers under Chapter 13 of the Internal Revenue Code of 1986, as amended (the ―Code”).

   c. The ―GST-Exempt Amount” means the lesser of (i) the fair market value of Assignor‘s entire Company Interest, as finally determined for GSTT purposes, or (ii) the largest amount of Assignor‘s entire Company Interest that can be distributed to Assignee without the imposition of any GSTT, as finally determined for GSTT purposes.

2. Determination of Applicability of GSTT. The parties understand that, under current law, the GSTT is not in effect and thus would not be imposed on the interest assigned, transferred, and conveyed herein. However, the parties understand that it is possible that current law relating to the GSTT will be retroactively amended or repealed. References to final determinations for GSTT purposes take into account any such retroactive amendment or repeal; if such retroactive legislation is finally determined to be unconstitutional or otherwise invalid, the retroactive amendment or repeal shall be deemed never to have taken effect. Until the extent to which the imposition of GSTT is finally determined, the Company may make distributions to such of Assignor and Assignee as the Company‘s manager determines. Neither the Company nor its manager shall be liable for any distributions made in good faith to the party that appeared entitled to the distribution, even if it turns out that the party that received such distributions was the incorrect party. Any party that receives a distribution made as a result of this Assignment that was finally determined to be more than what that party was entitled to receive shall return such excess, with interest, to the correct party, within a reasonable amount of time after that final determination was made. Interest shall be in an amount sufficient for the deemed loan not to be a ―below-market loan,” as that term is used in Code section 7872.

III.B.2.d.x. Beneficiary Grantor Trust as an Alternative to Formula Sale

The beneficiary grantor trusts discussed in part III.B.2.c 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.

III.B.2.d.xi. Adequate Disclosure on Gift Tax Returns

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.[990] 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.

III.B.2.e. Tax Allocations Upon Change of Interest

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.[991] 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, 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.[992]

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.[993] 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

[990] Reg. 301.6501(c)-1(f)(5).
[991] For the lack of income tax on payments using appreciated property, see Rev. Rul. 85-13.
[992] Rev. Rul. 2004-64, Situation 2.
[993] 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.

(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.[994]

The following discussion details the tax allocations upon a change of interest in S corporations and partnerships.

III.B.2.e.i. S Corporations

III.B.2.e.i.(a). Generally

Although basis adjustments apply to partnership assets when a partnership interest is transferred in a taxable event or at a partner‘s death,[995] 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,[996] 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.[997] 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;[998] thus, where possible, liquidate the S corporation before funding a QSST after a basis-changing event.

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[994] Reg. § 1.671-3(a)(1). Although various rulings discuss how this effects 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.
>
> (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.

[995] See text accompanying footnotes 672-680 and 1022-1034.

[996] Code § 336.

[997] 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.L.4.d Distributions or Other Dispositions of Depreciable Property.

[998] Reg. § 1.1361-(j)(8) provides:

Below is a discussion of pro-rating income from the transfer of stock.[999]

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 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.[1000] If the stock is held in trust before and after the transfer, the Uniform Principal and Income Act might remedy this mismatch.[1001]

III.B.2.e.i.(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:[1002]

(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.[1003]

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.

[999] See footnote 21 for a distribution method to take into account varying interests.

[1000] See text accompanying footnotes 1004-1007.

[1001] Section 506 of the Uniform Principal and Income Act. The Comments mention that QSSTs were considered when drafting Section 506(a)(3).

[1002] Code § 1377(a)(1).

[1003] Reg. § 1.1377-1(a)(2)(ii).

III.B.2.e.i.(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.[1004] 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.[1005]

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:[1006]

(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.[1007]

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

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[1004] Code § 1377(a)(2).

[1005] 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 <u>shareholder's</u> 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."

[1006] Code § 1377(a)(2)(B).

[1007] Reg. § 1.1377-1(b)(1).

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.

III.B.2.e.i.(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.[1008] 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.[1009]

***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.[1010] As before, all affected shareholders must consent to the election.

III.B.2.e.i.(e). 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. 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.[1011]

[1008] Reg. § 1.1366-1(a)(1).
[1009] Senate Report, 1982 Subchapter S Revision Act, PL 97-354.
[1010] Reg. § 1.1377-1(b)(5)(ii).
[1011] *Miller v. Commissioner*, TC Memo 2011-189.

III.B.2.e.ii. Partnerships

(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).[1012] However, the sale or exchange of at least 50% of a partnership terminates the partnership, closing the books.[1013]

Because the partnership did not terminate, but a change occurred in the varying partners' interests during the taxable year, all partners' distributive shares are determined by taking into account their varying interests in the partnership during the year. [1014] These distributive share rules apply not only to the partner whose interest is transferred, but also to any other partner whose interest is increased as a consequence.[1015]

Likewise, the special rule for determining a partner's share of the partnership's allocable cash-basis items also applies.[1016] *See* Modified Accrual Method below.

(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.)"[1017]

If the transfer terminates the partner's entire interest in the partnership, the books for both the transferor partner and the transferee partner must be treated as two separate taxable years. The first taxable year ends on the date of transfer, while the second year begins the following day.[1018] The terminating partner, upon the day of partnership termination, shall no longer be treated as a partner. As such, partnerships, unlike S corporations, default to the ideal position, an interim closing of the books without the necessity of complete termination. The partners, if they so choose, however, may avoid this interim closing of the books by agreeing to the special pro rata rule outlined below.

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.[1019]

[1012] Code § 706(c)(2)(B).
[1013] Reg. § 1.708-1(b)(3).
[1014] Code § 706(d)(1); Reg. § 1.706-1(c)(4).
[1015] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships & Partners* ¶11.01.
[1016] Code § 706(d)(2).
[1017] Code § 706(c)(2)(A).
[1018] Reg. § 1.706-1(c)(2)(ii).
[1019] Reg. § 1.708-1(b)(3).

To avoid the interim closing of the books, the partners may agree to estimate their distributive shares of § 702(a) items according to each individual partner's pro rata portion of those partnership items, based on a formula.[1020] This formula may be based on: (1) the number of days the individual (or entity) is a partner and the partner's percentage interest in the partnership; or (2) any other reasonable method.[1021] The partners must agree, either by contemporaneous agreement or by provision detailed in the partnership or operating agreement, to allocate their individual portions based on the chosen formula.

Despite, however, an agreement by the partners to allocate partnership items on a pro rata basis, the interim closing of the books method might be required to comply with other sections of the Internal Revenue Code. For instance:

(1) Because determination of the adjusted basis and fair market value is necessary to comply with Code § 755 allocations, a Code § 754 election by the partnership to adjust the basis of partnership assets for the benefit of a transferee partner[1022] or in the case of a liquidation[1023] will require an interim closing of the books; and

(2) To apply Code § 732(d), special partnership basis, to a transferee; and

(3) If under Code § 708(b), the partnership is terminated due to the sale of 50% or more of the partnership's capital and profits within a 12-month period.

Furthermore, if a change occurs in any partner's interest in the partnership, each partner's distributive share of any allocable cash basis items shall be determined:[1024]

(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.

This is, in effect, a daily interim closing of the books. The modified accrual method must be applied with respect to the following allocable cash basis items, as paid or received by the partnership:[1025]

(1) interest; or

(2) taxes; or

[1020] Reg. § 1.706-1(c)(2)(ii).
[1021] *Id*.
[1022] Code § 743(b).
[1023] Code § 734(b).
[1024] Code § 706(d).
[1025] Code § 706(d)(2)(B)(i-iv).

(3) payments for services or for the use of property, for example, rent; or

(4) any other item specified by regulation.

(c) Death of a Partner — Treated Like a Sale of a Partner's Entire Interest

The death of a partner is treated as if the partner had sold his or her entire interest in the partnership. As such, the applicable tax allocation rules upon the death of the partner are similar to those of a transfer of the entire interest, as enunciated above. This was not always the case.

Previously, the deceased partner's estate received all of the deceased partner's income for the partnership taxable year in which the death occurred. Under Code § 706(c)(2)(A), this is no longer true, and the taxable year closes with respect to a partner whose entire interest in the partnership has terminated.[1026] Thus, the death of a partner is treated as a transfer of the deceased partner's entire partnership interest to his or her estate.[1027]

As above, subject to Reg. § 1.706-1(c)(2)(ii), the partners may opt away from the interim closing of the books method and adopt a pro rata allocation method based upon a formula. As before, the partners must agree to adopt this method, subject to provisions in the partnership or operating agreement. Although this seems a reasonable interpretation of Code § 706 and the applicable Treasury Regulations, the Treasury Regulations have not yet been amended to reflect the changes made to Code § 706(c)(2)(A). Thus, it is possible that an election to use the pro rata method, as outlined above, upon the death of a partner may be disallowed.

(d) Code § 754 Elections; Mandatory Basis Adjustments When Partnership Holds Assets With Built-In Losses Greater Than $250,000

Generally, Code § 754 election adjusts the basis of a partnership's assets when an event occurs that changes the basis of any interest in that partnership.[1028] 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.[1029]

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.

[1026] Code § 706(c)(2)(A).
[1027] The Treasury Regulations do not currently reflect this recent change in the Internal Revenue Code. However, see Proposed Regulations (REG-144689-04, 4/14/09) and Carman, ―The Section 706 Prop. Regs.: A Mechanical Rule With Surprises (and Questions)," *Journal of Taxation* (July 2009).
[1028] Code §§ 734, 743.
[1029] Notice 2002-50; see also Reg. § 1.701-2(e)(1).

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.[1030] The first rule applies to limit the transfer of built-in losses on property contributed to a partnership after October 22, 2004.[1031] 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.[1032] 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.[1033]

Limited exceptions apply to certain electing investment partnerships and securitization partnerships.[1034] 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 partnership interest; and the partnership has a term of no more than 15 years;[1035] this structure has other advantages as well.[1036]

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....

[1030] 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.

[1031] Code § 704(c)(1)(C).

[1032] Code § 734(b).

[1033] Code § 743(a) and (b), as amended.

[1034] Code §§ 734(e) and 743(e), (f).

[1035] Code § 743(e).

[1036] Distributions of marketable securities might be considered nontaxable distributions of property rather than potentially taxable distributions of cash. See text accompanying footnotes 618-619.

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.[1037]

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, 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. One might envision even more profound changes – supposed valuation adjustments produced a $3M reduction in basis in the partnership interest. That would cause a $3M basis step-down in the basis of the partnership's assets, even though the built-in loss was only $300K.

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.

For more details on Code § 754 elections, see the text accompanying footnotes 670–679.

III.B.2.e.iii. Income Tax Reimbursement Clause

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 grantor trust, an income tax reimbursement clause may be a valuable tool to remedy this problem.

[1037] 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).

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.[1038] Any retention of a right to apply the trust property towards the discharge of a legal obligation causes inclusion under Code § 2036[1039] 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.[1040] When trust language provides the trustee discretionary power to reimburse the grantor for excess income taxes, the reimbursement clause will not cause estate inclusion.[1041]

However, if the grantor has an enforceable right to reimbursement, the reimbursement right will cause estate inclusion.[1042] 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. 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.[1043] To the extent creditors can reach a self-settled trust, they are generally includible under Code § 2038 as an incomplete gift due to the grantor's retained power to terminate the

[1038] Code § 2036(a)(1-2). 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."

[1039] 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.

[1040] *See also* William S. Forsberg & James C. Worthington, *Income Tax Reimbursement Clauses in Irrevocable Grantor Trusts – When to Use Them and When Not to Use Them*, PROB. & PROP., Vol. 19 No. 3, May/June 2005.

[1041] Rev. Rul. 2004-64, Situation 3.

[1042] Rev. Rul. 2004-64, Situation 2.

[1043] Rev. Rul. 76-103; Forsberg & Worthington, *supra* note 27 at 7 (citing 2A Austin W. Scott, Trusts § 156).

trust by consigning his or her creditors to the trust assets.[1044] However, some states permit self-settled trusts to be protected from the grantor's creditors.[1045]

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.[1046] 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.[1047] 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 estate planning tools.[1048] 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.[1049] 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 new bankruptcy bill, 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.

III.B.3. Estate Tax Issues

Estate tax issues include general valuation problems, deferral under Code § 6166, and marital deduction considerations and related planning.

III.B.3.a. General Valuation Problems

[reserved for discussion of projected operating cash flow and its reliability given the subject stockholder's ability to cause distributions to occur.]

[1044] Rev. Rul. 76-103; Code § 2038(a)(1).

[1045] Alaska, Delaware, Missouri, and Rhode Island have endorsed self-settled trust creation by statute, while other states, such as Indiana, Maryland, and New York have case law supporting self-settled trusts. Forsberg & Worthington, *supra* note 27 at 7.

[1046] 11 U.S.C. § 548(e)(1)(A-C).

[1047] *Id*. at § 548(e)(1)(D).

[1048] David G. Shaftel & David H. 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.

[1049] 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.

III.B.3.b. Estate Tax Deferral or Financing

III.B.3.b.i. Overview of Discretionary Extensions Under Section 6161

Use IRS Form 4768 to request the extensions of time to pay described below.[1050]

(a) Tax Shown on 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

[1050] 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 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).

> 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.
>
> 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."

(b) <u>Deficiencies Resulting from IRS Audit</u>

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….

(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.

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.3.b.ii. Code § 6166 Deferral

Code § 6166 allows the payment of estate tax to be deferred for certain closely-held businesses.[1051] 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.[1052]

[1051] 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.

[1052] 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.

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. It does not apply to GST tax imposed on a taxable termination.[1053] The election must be made on a timely filed return.[1054]

For a discussion of liens associated with Code § 6166 elections, see ―Liens: Selected Internal Revenue Manual Materials" below.

III.B.3.b.iii. *Graegin* Loans: Overview

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).[1055]

- 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*, TC Memo 1988-477, 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

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[1053] Letter Ruling 200939003.

[1054] 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.

[1055] 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)."

deduct the interest for income tax purposes (because it was already deducted for estate tax purposes).[1056]

In Litigation Guideline Memorandum TL-65 (1989), the IRS stated that it will challenge deductions for balloon payments:

- 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.[1057]

Letter Rulings 199903038 and 199952039 allowed deductions for interest for a loan from a commercial bank (the latter guaranteed by the family business), but each qualified the deduction:

> 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 *Keller v. United States*, [1058] 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 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

[1056] 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. Commissioner*, T.C. Memo 2010-192.
[1057] 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.
[1058] 104 AFTR 2d 2009-6015 (S.D. Texas 2009).

estate under Code § 2036 and disallowed the interest. The court reject both arguments and allowed the estate to deduct the interest.

In *Estate of Murphy v. United States*,[1059] 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 reject both arguments and allowed the estate to deduct the interest.

In *Estate of Black v. Commissioner,*[1060] 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 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.

[1059] 104 AFTR 2d 2009-7703 (D. Ark. 2009).

[1060] 133 T.C. No. 15 (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.

Estate of Duncan v. Commissioner[1061] clarified *Black*. This new case permitted 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.

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.

A few other cases have addressed deductions for borrowing from related parties to pay estate tax.[1062]

[1061] TC Memo 2011-255. Carol Harrington represented the taxpayer.

[1062] *Beat v. U.S.*, 107 AFTR 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.").

III.B.3.b.iv. Liens: Article on General Rules[1063]

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.[1064]

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.

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.[1065]

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.[1066] 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.[1067] The general tax lien arises on assessment and is effective until the assessed taxes are paid or the lien becomes unenforceable because of a lapse of time.[1068] The IRS is required to give notice and an opportunity for a hearing.[1069] 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.

[1063] This portion is from ―Estate Tax Liens: The Surprising Truth That Estate Planning and Real Estate Lawyers Often Ignore," Gorin and Reynolds, *Probate & Property* January/February 2007. Jonathan Blattmachr made some useful suggestions, including referring to the Code § 6324 lien as the ―secret estate tax lien."

[1064] 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.

[1065] A similar lien applies for gift tax purposes, Code § 6324(b).

[1066] Internal Revenue Manual § 5.5.8, Estate Tax Liens.

[1067] Treas. Reg. § 301.6321-1.

[1068] Code § 6322.

[1069] Code § 6320.

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.

Exceptions to the Estate Tax Lien

A lien will not apply the following types of purchasers or transactions:[1070]

- 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.

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)). 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,[1071] the Code § 6324A lien releases the secret estate tax lien and is subordinate to all liens that attached before the Code § 6324A lien attached. 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.

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.

[1070] Code § 6324(c), incorporating by reference certain important exceptions found in Code § 6323(b).
[1071] See footnote 1100 and accompanying text.

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*,[1072] 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.[1073]

But, in *United States v. Saleh*,[1074] 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*,[1075] 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.

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.

Probate Assets

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.[1076] Internal Revenue Manual ¶ 5.5.7.5.2 provides an example of how far-reaching the estate tax lien's priority is:

[1072] 325 F. Supp. 871 (N.D. Ind. 1971), *aff'd* 517 F.2d 230 (7th Cir. 1975).
[1073] See *New England Acceptance Corp. v. United States*, 35 F. Supp. 2d 53, 55–56 (D.N.H. 1997).
[1074] 514 F. Supp. 8 (D.N.J. 1980).
[1075] No. 83-CIV3717 (LBS), 1985 WL 2575 (S.D.N.Y. Sept. 18, 1985).
[1076] Treas. Reg. § 301.63311(a).

> Example: An estate owes unpaid tax in the amount of $100,000. Five 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 three 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 before 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.

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, including estate taxes, unless the payment is permitted under another federal law. The executor, however, would not be liable for a bona fide sale, because the sale proceeds are subject to the same rules.

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.[1077] The release of the executor does not release the estate tax lien, 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.[1078]

<u>Nonprobate Assets</u>

Trustees of revocable trusts and other recipients of nonprobate included property have personal liability under not only 31 U.S.C. § 3713(b) but also Code § 6324(a)(2). 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. 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).[1079]

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 with the IRS if:[1080]

- the remaining property in the estate has a value that is double the amount owed to the IRS,

[1077] Treas. Reg. § 20.2204-1.
[1078] Code § 6324(a)(3).
[1079] Code § 6324(a)(2).
[1080] Code § 6325(b).

- 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.[1081]
- 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.[1082]
- 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.[1083]

[1081] Code § 6324(a)(1).
[1082] Code § 6324(a)(2).
[1083] Code § 6324(a)(3).

- Property that has been discharged under Code § 6325(a) is no longer subject to the lien.

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. At this point, the estate tax lien is removed, 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.

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). 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.3.b.v. Liens: Transferee Liability Extends Past Original Estate Tax Lien

In *United States v. Kulhanek*,[1084] 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.[1085] 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.[1086] The U.S. District Court held that the collection action was timely, because it was a transferee liability case,[1087] not an estate tax collection case, and was brought less than ten years[1088] after the event that accelerated payment of the estate tax.[1089]

[1084] 106 A.F.T.R.2d 2010- 7263 (W.D. Pa.).
[1085] Code § 6166(g)(1)(A).
[1086] Relying on Code § 6324(a)(1).
[1087] Relying on Code § 6324(a)(2).
[1088] Relying on Code § 6502(a)(1).
[1089] 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 AFTR 2d 2008-7268 (E.D. Cal. 2008).

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*,[1090] the IRS gave an estate six annual Code § 6161[1091] 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 collectibility 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 section 6901[1092] and that the Tax Court has found those cases to be persuasive and well reasoned.[1093] 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

[1090] T.C. Memo. 2011-24.
[1091] All references to the ―Code" are to the Internal Revenue Code of 1986, as amended.
[1092] 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).
[1093] Citing *Ripley v. Commissioner*, 102 T.C. 654, 659 (1994).

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.

III.B.3.b.vi. 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 §] 6324(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.

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.[1094]

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

[1094] *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).

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.[1095] Procedurally, this occurs when the property is listed on a recorded IRS Form 668-J.[1096] Recording the § 6324A lien also discharges the executor or other fiduciary.[1097] 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.[1098]

TIGTA‘s most recent report on 6166 liens makes the following general comment:[1099]

> 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.

[1095] Code § 6324A(d)(4); IRM 5.5.8.5(4)(d).
[1096] IRM 5.5.8.1(4)(b).
[1097] Reg. § 20.2204-3; IRM 5.5.8.5(4)(e).
[1098] Reg. § 20.6324A-1(c)(2). Once filed, the notice of lien remains effective without being refiled. *Id.*
[1099] http://www.treas.gov/tigta/auditreports/2007reports/200730174fr.pdf.

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
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[1100] provides:

> (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 it's recording.

The taxpayer can choose the security to be offered. 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.

[1100] See F.A.A. 20070801F regarding how the IRS expects this security interest to be established with respect to a partnership or LLC interest.

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 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.[1101]

III.B.3.c. Marital Deduction Considerations and Related Planning

III.B.3.c.i. 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.

III.B.3.c.ii. Related Planning

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

[1101] *Alessio Azzari, Inc. v. Commissioner*, 136 T.C. No. 9 (2/24/2011) (Code §§ 6159, 6320, 6323, and 6325).

aggregated with the surviving spouse's other assets.[1102] 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 are 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.

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.[1103] The $400,000 excess of value over purchase price is a distribution from

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[1102] See part II.I.2 Spousal Issues in Buy-Sell Agreements and Related Tax Implications, footnote 241.

[1103] The irrevocable inter vivos QTIP trust is a grantor trust taxable to the husband under Code § 677, since all of the income and principal are distributed or accumulated for the grantor's spouse. Code § 1041 provides that sales between spouses are not taxable. Note, however, that interest income on any promissory note related to the sale would be taxable. 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, followed by *Craven v. U.S.*, 70 F.Supp.2d 1323 (D.C. Ga.); *Seymour v. Commissioner*, 109 T.C. 279 (1997) (allowing an interest deduction); *Yankwich v. Commissioner*, T.C. Memo. 2002-37; TAM 200624065. The

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.[1104]

III.B.4. 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 the ―General Income Tax" discussion above. 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.

III.B.4.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.[1105] Furthermore, those regulations generally apply to protect transactions made between unrelated parties from gift tax scrutiny, whereas transactions between related parties are subjected to the usual scrutiny even if the business is an operating business.[1106]

Gibbs court pointed out that, although under certain circumstances 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.

[1104] An adverse tax consequence could occur if wife did not receive adequate and full consideration for the stock she transferred to the trust.

[1105] See the last sentence of Reg. § 25.2512-8.

[1106] 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), Rev. Rul. 77-131 (ignore subjective intent), 80-196 (no gift tax when shareholders transferred stock to unrelated key employees; note that Reg. § 1.83-6 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), 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*, 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

III.B.4.b. Code § 2701 Overview

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 to a ―member of the transferor‘s family” (a younger generation). Let‘s examine the meaning of these quoted terms and consider exceptions to these rules.

―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.[1107]

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.”[1108] ―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.”[1109]

―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:[1110]
    - 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.[1111] However, it does not include:[1112]

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*, 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*, 428 F.3d 1338 (11th Cir. 2005) (when an ESOP and decedent were the only shareholders in the company, the estate had to pay estate taxes for having made a bargain sale to the ESOP), *aff'g in part and rev'g in part* T.C. Memo. 2004–116; ***but see*** *Estate of Pearl I. Amlie*, 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).

[1107] See Code § 2701(e)(5) and Reg. § 25.2701-1(b)(2)(i).

[1108] Code § 2701(e)(2); see Reg. § 25.2701-1(d)(2).

[1109] Code § 2701(e)(1); see Reg. § 25.2701-1(d)(1).

[1110] Code § 2701(b)(1)(A); Reg. § 25.2701-2(b)(1)(ii).

[1111] Code § 2701(c)(1)(A).

[1112] Code § 2701(c)(1)(B); Reg. § 25.2701-2(b)(3).

- 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.

o ―Control" means:

- In the case of a corporation, at least 50%, by vote or value, of the corporation's stock.[1113] To be considered, voting rights must extend beyond the right to vote in liquidation, merger, or a similar event.[1114] A person is considered to own a voting right if that person can exercise that right alone or in conjunction with another person.[1115] 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.[1116] Voting rights subject to a contingency that has not occurred do not count unless the holder of the right can control the contingency.[1117]

- In the case of a partnership:[1118]

  - At least 50% of the capital or profits interests, or

  - In the case of a limited partnership, any interest as a general partner.[1119]

The above excludes any Code § 707(c) guaranteed payment of a fixed amount.[1120]

Solely for purposes of this ―control" test, ―applicable family member" includes any descendant of any parent of the transferor or the transferor's spouse.[1121]

- An extraordinary payment right.[1122] 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

[1113] Code § 2701(b)(2)(A).
[1114] Reg. § 25.2701-2(b)(5)(ii)(B).
[1115] *Id.*
[1116] *Id.*
[1117] *Id.*
[1118] Code § 2701(b)(2)(B).
[1119] Reg. § 25.2701-2(b)(5)(iii).
[1120] Reg. § 25.2701-2(b)(5)(iii). See text accompanying footnote 1128.
[1121] Code § 2701(b)(2)(C).
[1122] Reg. § 25.2701-2(b)(1)(i), (b)(2); see Code § 2701(b)(1)(B).

interest's value.[1123] A ―call right" includes any warrant, option, or other right to acquire one or more equity interests.[1124]

Notwithstanding the above, certain rights are not applicable retained interests:[1125]

- A mandatory payment right.[1126] 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.[1127] 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).[1128] 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.

- A non-lapsing conversion right.[1129] 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.

[1123] Reg. § 25.2701-2(b)(1)(i), (b)(2).
[1124] Reg. § 25.2701-2(b)(2).
[1125] Reg. § 25.2701-2(b)(4).
[1126] Reg. § 25.2701-2(b)(4)(i).
[1127] Reg. § 25.2701-2(b)(4)(ii).
[1128] Reg. § 25.2701-2(b)(4)(iii).
[1129] Reg. § 25.2701-2(b)(4)(iv).

III.B.4.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 complicated subtraction method[1130] is beyond the scope of these materials.

Our discussion begins with partnership interests, which are favorable treated for income tax purposes and are not subject to the restrictions that Code § 409A places on deferred compensation.[1131] 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.4.c.i. 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 parent's capital account generally 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.[1132] 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
    - 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

[1130] 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.
[1131] See II.G.4.d Issuing a Profits Interest to an Employee.
[1132] Presumably this would be the discounted present value of the payment of the capital account upon liquidation, ignoring the family's right to compel liquidation. See text accompanying footnote 1127.

➢ Liquidation (at which time the capital account would be paid to the parent) cannot be 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[1133] or was cumulative,[1134] 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.[1135] In a 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.[1136] Although a profits interest typically would be junior with respect to capital, generally it would not be junior with respect to income.[1137] 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.

[1133] 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.

[1134] 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).

[1135] 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.

[1136] Code § 2701(a)(4)(B); Reg. § 25.2701-3(c)(2).

[1137] 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.

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.[1138] 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[1139] does not have Code § 409A implications.[1140] 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.[1141] However, Code § 2701 applies to a change in capital structure only if:[1142]

  (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.

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,[1143] has the parent "received" an applicable retained interest in the transaction?

[1138] The author thanks Mil Hatcher for his creativity in suggesting the GRAT alternatives described here.

[1139] 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.

[1140] See II.G.4.d.

[1141] Code § 2701(e)(5).

[1142] Reg. § 25.2701-1(b)(2)(i)(B).

[1143] This approach cannot be taken if done in conjunction with a contribution to capital. Reg. § 25.2701-1(b)(2)(i)(A).

III.B.4.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.[1144] 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.[1145] 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.[1146] 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.[1147] In that case, the parent 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

[1144] Code § 2701(b)(2)(B)(i); Reg. § 25.2701-2(b)(5)(iii).
[1145] Code § 2701(b)(2)(B)(ii); Reg. § 25.2701-2(b)(5)(iii).
[1146] See Reg. § 25.2701-1(c)(3),(4).
[1147] 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 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.

partnership, the child should have a proportionate obligation to leave income in the partnership; the parent's leaving profits in the partnership might[1148] constitute a contribution to capital, triggering Code § 2701,[1149] in which case one needs to find an exception to Code § 2701, such as transactions involving proportionate vertical slices.

III.B.4.c.iii. Possible Application of Same Class Exception to Profits Interest

Not much guidance explains how to implement the regulations under Code § 2701. The "same class" exception provides:[1150]

> 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.

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

[1148] 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.

[1149] Reg. § 25.2701-1(b)(2)(i)(A).

[1150] Reg. § 25.2701-1(c)(3).

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.

It has been suggested that profits interest are analogous to common stock in this letter ruling and therefore are not subject to Code § 2701.[1151] 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.

- 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:[1152]

> 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.

[1151] Robinson, ―Business Succession Planning, Profits Interests and § 2701," *ACTEC Journal* (Spring 2009).
[1152] TAM 199933002.

> 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 account. The service provider could then have compensation incentives to enable him or her to repay the loan.

III.B.4.c.iv. 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 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.

III.B.4.c.v. Deferred Compensation.[1153]

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,[1154] but only if the parent continues to work for the entity until the parent attains age 65.[1155] 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.[1156] Similarly, as a payment that is fixed in amount at a specific time, it is not subject to Code § 2701,[1157] 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 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.[1158]

[1153] Although this is not equity, it reduces the entity's value for many purposes and makes it easier to sell. It is realistically available only if the entity earns sufficient income.

[1154] 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).

[1155] 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 II.L.1.d.

[1156] 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.

[1157] Reg. § 25.2701-2(b)(4)(i)(in the case of a corporation) or (iii) (in the case of a partnership).

[1158] 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.

- 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.[1159]

III.B.4.c.vi. 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.[1160] Similar rules apply to partnerships. For purposes of Code § 2701, the IRS tends to view options as compensation, not equity:[1161]

> 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.[1162] 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.[1163]

III.B.4.c.vii. 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

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[1159] 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).

[1160] See II.G.4.e Options to Acquire Equity.

[1161] 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).

[1162] *Dorman v. US*, 296 F.2d 27 (9th Cir. 1961) (option was a capital asset but not a partnership interest); *Vestal v. US*, 498 F.2d 487 (8th Cir. 1974) (option was neither a capital asset [because its value was too speculative] nor a partnership interest); *Mayhew*, T.C. Memo. 1992-68 (option and right to bonus did not constitute a profits interest).

[1163] See text accompanying footnotes 428-433.

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.

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.[1164] The most commonly cited factors, none of which is conclusive, are:[1165]

- [t]he agreement of the parties and their conduct in executing its terms;
- 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;
- whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, 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.

Some very entrepreneurial taxpayers have been treated as employees and not as owners when they:

- Received salary plus 50% of the profits.[1166]

[1164] *Commissioner v. Culbertson*, 337 US 733 (1949), clarifying *Commissioner v. Tower*, 327 US 280 (1946).
[1165] *Luna v. Commissioner*, 42 TC 1077-78 (1964). Although this case dealt with an insurance agent, it has been cited in many other situations, including *Holdner v. Commissioner*, T.C. Memo. 2010-175 (presumption of partners holding equal interests). See footnote 68 (and text nearby) regarding when real estate co-ownership might be partnership.
[1166] *Friednash v. Commissioner*, 209 F.2d 601 (9th Cir 1954); *Duley v. Commissioner*, T.C. Memo. 1981-246.

- 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.[1167]

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.[1168] 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. Although Code § 707(a) provides that a partner may be considered as dealing with a partnership other than in his/her capacity as a partner,[1169] under Code § 707(c) fixed payments to a partner for services constitute guaranteed payments. Such 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.[1170] Whether a particular compensation arrangement is a guaranteed payment or a distributive share of profits is a fluid concept.[1171] Generally, a payment based on gross income constitutes a guaranteed

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[1167] *Luna*, 42 TC 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.

[1168] 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.

[1169] See ―The Lost Regulations—Section 707 and the Definition of Partner Capacity," *Business Entities* (WG&L), Jan/Feb 2009.

[1170] Reg § 1.1402(a)-1(b) ; *Grubb v. Commissioner*, T.C. Memo. 1990-425.

[1171] Reg. § 1.707-1(c) provides:

> Payments made by a partnership to a partner for services or for the use of capital 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. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of §1.706-1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). 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. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). 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

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).[1172] The author suggests the following guidelines for partnerships:

- If the service provider has a clearly-defined equity interest in the partnership, any additional compensation constituting a guaranteed payment will be reported on the

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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. The provisions of this paragraph may be illustrated by the following 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 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.

[1172] 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 Revenue Ruling 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)….

service provider's Schedule K-1.[1173] 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 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.[1174]

III.B.4.d. Code § 2703 Overview

See discussion in part II.L.2.b Establishing Estate Tax Values.

III.B.4.e. Code § 2704 Overview

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.[1175] Code § 2704(b) disregards restrictions on liquidation that are not commercially reasonable and are more restrictive than state law defaults.

In the context of an affirmative transfer of an equity interest, regulations do not apply these rules regarding liquidation restrictions to the ability to liquidate one's equity interest.[1176] Thus, Code § 2704 generally will not be significant in most cases involving incentive compensation or the transfer of an equity interest.

If the entity is not family-controlled (using a combination of Code § 2701 and 2704 principles), then Code § 2704 does not apply.

[1173] See footnote 1171.

[1174] Many states have statutory close corporation provisions allowing a corporation to abolish such formalities. 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.

[1175] The lapse of voting rights at death was includible in the decedent's gross estate in the *Estate of Rankin Smith v. U.S.*, Court of Claims No. 07-676T (2/13/2012). 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.

[1176] *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 fight to compel the entity to redeem the interest).

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.[1177] 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 have to take into consideration those differences. The stakeholders in the business have to be treated equitably 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 the biggest expense of the succession process – the transfer tax cost of the succession.

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."[1178] 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."[1179] 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 valued, and the value of stock of other corporations engaged in similar lines of business which are listed on a stock exchange.[1180] Revenue Ruling 59-60 mirrors the Regulations and lists eight fundamental factors that should be considered in valuation cases: the nature of the

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[1177] 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.
[1178] Reg. §20.2031-1(b) and §25.2512-1.
[1179] Code §2031(b).
[1180] Reg. §20.2031-2(f)(2) and §25.2512-2(f)(2).

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.[1181]

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.

[1181] 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.

Fair value is usually 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 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 the ―human element" of a family business. The success of these businesses 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 members of the family are active participants 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. The business owner has to recognize this reality and deal with it preemptively or the business may fail. The plan will usually be to have family members interested in the business take over and leave other non-business assets to those uninterested family members. This is the logical answer to the problem, but it is more complex than that. This is why valuation is so important. In order to divide assets fairly among family members, one has to know the value of those assets. And once the business has been valued, it is critical to appropriately value the worth of each family member's contribution to that business. But family members are not the only parties who need to be considered in a business succession plan. Non-related owners and employees are also critical to a company's success, and they need to be taken care of as well so that they will continue to be productive.

In addition to the valuation process discussed previously, a number of issues should be addressed in a fair and successful business succession plan. These include 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.[1182]

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 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.

[1182] 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.

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.[1183] 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.[1184] All four children (Angie, Bob, Cindy, and Dan) are in their late thirties,

[1183] 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.

[1184] 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) The Trust. 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) The Trustees. 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) The Problems.

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 guaranty of the Trust, including, perhaps, a pledge of a portion of the Trust's marketable securities.

4) FiDuc has demanded that any collateral or guaranty 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, since under §401 of the Uniform Principal and Income Act, a trustee must allocate money received from an entity to income.[1185] 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,[1186] 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.

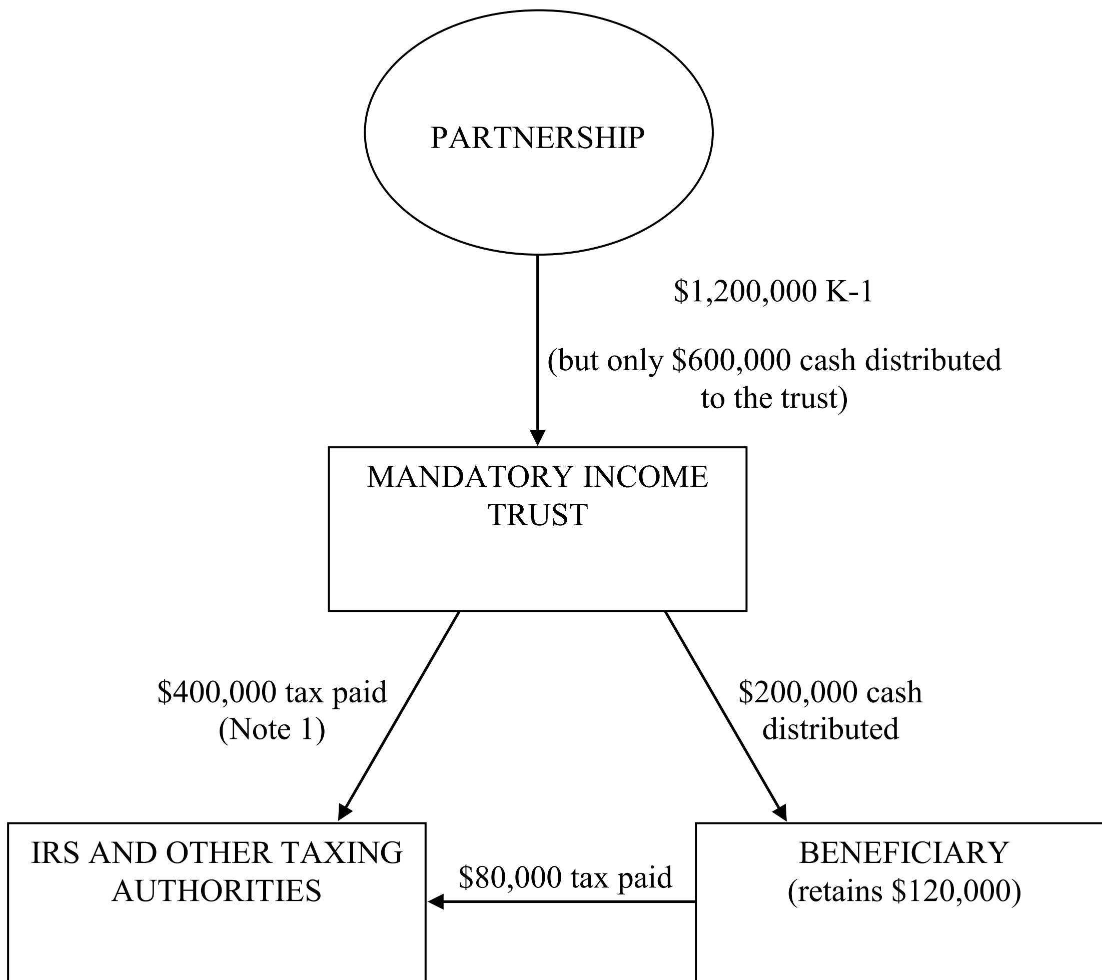
In this hypothetical, all $600,000 of cash received was properly allocated to income, so 100% of the tax due on the trust taxable income must come out of income. Thus, the trustee has to do a circular calculation to determine how much of the $600,000 must be withheld in order to cover the tax on that 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

[1185] See also RSMo §469.423.2.
[1186] RSMo § 469.459.3.

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).



Note 1: $1,200,000 K-1 income minus $200,000 income distribution deduction equals $1,000,000 taxable income. Assumes a combined federal and state tax rate of 40%.

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February 27, 2012

Mr. Robert R. Di Trolio
Clerk of the Court
U.S. Tax Court
400 2nd Street, N.W., Room 111
Washington, D.C. 20217

RE: Proposed Amendments to the Rules of the United States Tax Court

Dear Mr. Di Trolio:

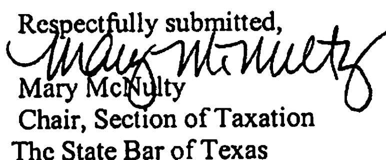
On December 28, 2011, the United States Tax Court (the "Court") announced proposed changes to its rules of practice and procedure. The Court requested comments on the proposed changes by February 27, 2012. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments on the proposed changes.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Court for the time and thought that has been put into preparing the proposal, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,



Mary McNulty
Chair, Section of Taxation
The State Bar of Texas

1414 Colorado Street, Austin, TX 78701
(512) 427-1463 or (800) 204-2222

COMMENTS ON PROPOSED AMENDMENTS TO THE RULES OF THE UNITES STATES TAX COURT, AS SET FORTH IN RELEASE NOTICE 2011-62 ISSUED ON JULY 19, 2011

Principal responsibility for drafting these comments was exercised by Robert D. Probasco. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Elizabeth Copeland reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Chair of COGS, also reviewed the comments on behalf of COGS.

Although members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: February 27, 2012

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We commend the Court for the time and thought that has been put into preparing the proposed amendments to its rules of practice and procedure. We also appreciate the opportunity to comment on the proposal and hope that our comments prove to be helpful. We agree with the proposed rules for the most part and believe that they represent an improvement for taxpayers, practitioners, and the Court. We respectfully suggest, however, the Court consider certain changes that we believe could further improve the procedures.

Privacy Protection For Whistleblower Actions

Proposed Rule 345

The protection of privacy in whistleblower actions is a difficult issue. As discussed in *Whistleblower 14106-10W v. Commissioner*, 137 T.C. No. 15 (2011), our system has a tradition of protecting individuals' privacy during administrative proceedings but reducing that protection in judicial proceedings. A party seeking judicial review, whether a whistleblower challenging the denial of an award or a taxpayer challenging a notice of deficiency, must balance the advantages of judicial review against the disadvantages of public disclosure. The public's right to information concerning judicial proceedings, however, is not complete in either situation. We therefore concur that it is appropriate to formalize the procedures for whistleblowers to seek anonymity and that anonymity will often be appropriate.[1]

We are concerned, however, about the level of protection for the privacy of the taxpayer in a whistleblower case. Proposed Rule 345(b) provides for the redaction of information that might identify the taxpayer to whom the claim relates. We believe such a change would significantly improve the Court's rules. As pointed out by National Taxpayer Advocate Nina Olson, the taxpayer in a whistleblower case is not a party and cannot choose judicial review over the risk of disclosure. It is, therefore, appropriate to protect his/her or its privacy. However, proposed Rule 345(b) may be less effective than desirable because protection of the taxpayer's identity is left up to the discretion of the Court. The taxpayer is almost always a better judge of what information might disclose his/her or its identity. Proposed Rule 345(b) provides the taxpayer in a whistleblower action with no opportunity for input concerning what information should be protected. The proposal states that "it is contemplated that the trial judge would have discretion to direct that prior notice be provided to the nonparty taxpayer." In effect, however, this establishes "no notice" as the default rule unless the Court determines otherwise.

Although it may not always be feasible to provide the taxpayer an opportunity to review filings and request redaction of additional information, we believe such an opportunity should be afforded the taxpayer, whenever possible. We encourage the Court to consider amending the rules accordingly. For example, the rules could provide for the notification of the taxpayer of commencement of the case and the automatic sealing of filings for the case for a limited time to allow the taxpayer an opportunity to review them and request additional redactions as necessary to preserve privacy. Although such a rule would impose an administrative burden, it would affect a relatively small number of cases, and we believe the importance of taxpayer privacy justifies the burden.

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[1] We also encourage the Court to consider further changes to formalize the procedures for taxpayers in deficiency actions to proceed anonymously, where such anonymity is warranted.

We further suggest that the taxpayer should have another opportunity to be heard before the Court concludes "that the public's interest in knowing the nonparty taxpayer's identity was sufficiently great that the nonparty taxpayer's name should no longer be protected." In general, we believe that the balance of policy considerations will rarely, if ever, justify such disclosure of the taxpayer's identity. Taxpayers often agree to assessment of substantial tax liabilities, and even if the assessments resulted from a whistleblower's actions, the taxpayer's identity is generally protected under Section 6103 of the Internal Revenue Code. That could change under the proposed rule simply because the Internal Revenue Service and the whistleblower did not agree as to an award and the whistleblower sought judicial review. Such a dispute, however, adds little or no additional justification for disclosing the taxpayer's identity. We therefore suggest that the proposed rule or associated commentary incorporate a statement that, in deciding whether to disclose identifying information about the taxpayer, the Court give appropriate weight to the taxpayer's privacy rights inherent in Section 6103.

Mandatory Electronic Filing

Proposed Rule 26

In the interests of efficient administration, we support the Court's requirement that most represented parties file papers with the Court electronically. We further support the exceptions for self-represented petitioners and counsel who file a motion to allow paper filing for good cause. These provisions will, in our opinion, cover most circumstances where this requirement should be relaxed. We suggest, however, that the Court consider a further change concerning practitioners with low-income taxpayer clinics or Bar-sponsored pro bono programs. In most instances, these practitioners only assist the petitioners without making an actual appearance. In such cases, proposed Rule 26(b)(2) would apply and mandatory electronic filing would not apply. If these practitioners do make an appearance, however, they would be subject to the mandatory electronic filing requirement. The Court's proposal suggests that, if good cause exists, these practitioners could file a motion for exception under proposed Rule 26(b)(3).

We believe that this approach may be unduly cumbersome in some instances. Some volunteers for these programs may not have registered yet for eAccess with the Court. They might be discouraged from entering an appearance for a petitioner by the need to either register or file a motion for exception, with no guarantee that the motion would be granted. An automatic exception from the requirement, tied to the entry of appearance, could avoid this problem. Accordingly, we suggest that the Court consider revising the rule by adding an exception under proposed Rule 26(b) for "counsel who enter an appearance in a case and state in their entry of appearance that they are doing so as part of a low-income taxpayer clinic or Bar-sponsored pro bono program." We anticipate that most practitioners who are already registered for eAccess will wish to use it, despite the automatic exception. Others might register but would have the flexibility to proceed without doing so if they wished. We believe that such a practice would serve the best interests of taxpayers, practitioners, and the Court by encouraging practitioners not only to participate in such clinics and pro bono programs but also to enter appearances for petitioners when appropriate.