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# *22nd Annual* **Oregon Tax Institute**

*Cosponsored by the Taxation Section*

Thursday, June 2, 2022  
9 a.m.–4:15 p.m.

Friday, June 3, 2022  
9 a.m.–3:45 p.m.

9.75 General CLE credits and  
1 Abuse Reporting credit (ID 89886)



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## 22ND ANNUAL OREGON TAX INSTITUTE

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OREGON STATE BAR  
16037 SW Upper Boones Ferry Road  
P.O. Box 231935  
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— ATTORNEYS —

## SCHEDULE

Thursday, June 2, 2022

**8:00 Registration and Continental Breakfast**

**9:00 Testamentary Planning with IRAs**

George Karibjanian, *Franklin Karibjanian & Law PLLC, Boca Raton, Florida*

**10:00 The Road Between Subchapter C and Subchapter S—It May Be a Well-Traveled Two-Way Thoroughfare, But It Isn't Free of Potholes**

Larry Brant, *Foster Garvey, Portland*

**10:45 Break**

**11:00 Partnership Book/Tax Disparities: How to Recognize, Create, and Exploit Them**

Professor Howard Abrams, *Harvard Law School, Cambridge, Massachusetts*

**12:15 Lunch**

**1:30 Hot Topics in Real Estate**

Richard Lipton, *Baker & McKenzie LLP, Chicago, Illinois*

**2:30 Break**

**2:45 Finding Gems in the Ashes of the Dumpster Fire**

Paul Lee, *Northern Trust, New York, New York*

**4:15 Adjourn to hosted reception**

Friday, June 3, 2022

**8:30 Late Registration and Continental Breakfast**

**9:00 Mandatory Abuse Reporting for Oregon Attorneys**

Nik Chourey, *Oregon State Bar, Tigard*

**10:00 Break**

**10:15 Metro Tax Update**

Jennifer Young, *Moss Adams, Portland*

**11:30 Lunch**

**12:30 Federal Tax Developments**

Professor Bruce McGovern, *South Texas College of Law, Houston, Texas*

**2:00 Break**

**2:15 Federal Tax Developments (continued)**

**3:45 Adjourn**



## FACULTY

**Professor Howard Abrams**, *Harvard Law School, Cambridge, Massachusetts*. Classes taught by Professor Abrams include Partnership Taxation, Taxation of Pass-Thru Entities, Fundamentals of Income Taxation, Corporate Taxation, Derivatives, Taxes and Business Strategy, Federal Regulation of Tax-Exempt Organizations, Professional Responsibility for the Tax Lawyer, Contracts, and Evidence. Professor Abrams is the author of numerous publications, including *Partnership Noncompensatory Options*, 721 BBNA Tax Management Portfolio Series (2018), *Disregarded Entities*, 704-2 BBNA Tax Management Portfolio Series (2d ed. 2012, coauthored with F. Witt), *Federal Income Taxation of Corporations and Partnerships*, Aspen Law & Business (6th ed. 2019, coauthored with D. Leatherman), and *Federal Corporate Taxation*, Foundation Press (8th ed. 2020, coauthored with D. Leatherman). Among other honors, he is the recipient of the 2006 Emory Williams Award for Excellence in Teaching. Professor Abrams is a member of the State Bar of California (inactive), the District of Columbia Bar, and the American Law Institute.

**Larry Brant**, *Foster Garvey, Portland*. Mr. Brant focuses on assisting public and private companies, partnerships, and high net-worth individuals with tax planning and advice, tax controversy, and business transactions. He regularly advises clients in entity selection and formation, structuring mergers and acquisitions, joint ventures and other business transactions. Mr. Brant is a member of the Portland Tax Forum Board of Directors, past chair of the Oregon State Bar Taxation Section, a Fellow of the American College of Tax Counsel, and an Expert Contributor to Thomson Reuters Checkpoint Catalyst. Mr. Brant publishes articles on numerous income tax issues and regularly speaks at national, regional, and local tax institutes. Mr. Brant is the editor and an author of Larry's Tax Law (<https://www.foster.com/larry-s-tax-law>), a nationally recognized tax blog dedicated to providing technical support to tax and accounting professionals. Mr. Brant is the 2015 recipient of the Oregon State Bar Taxation Section Award of Merit.

**Nik Chourey**, *Oregon State Bar, Tigard*. Mr. Chourey is Deputy General Counsel of the Oregon State Bar and represents the OSB in all nondisciplinary litigation. He also provides legal advice to the OSB in matters of bar governance, regulation of lawyers, employment, policy development, and public records and meetings law. He provides ethics advice to all OSB members in writing and by phone and writes and speaks on ethics and mandatory abuse reporting issues for continuing legal education programs and OSB publications. Mr. Chourey is the OSB's ADA Coordinator and serves as the OSB's liaison for the Unlawful Practice of Law Committee and State Lawyers Assistance Committee.

**George Karibjanian**, *Franklin Karibjanian & Law PLLC, Boca Raton, Florida*. Mr. Karibjanian practices exclusively in the areas of estate planning and probate and trust administration and also represents numerous clients with respect to nuptial agreements. He is an active member of the American Bar Association and Florida Bar Real Property Probate & Trust Law Section Executive Committee; he is also member of the Greater Boca Raton Estate Planning Council and the South Palm Beach County Bar Association. He has given over 200 presentations to national, statewide, and local groups and has more than 80 publication credits in national and regional periodicals and journals. Mr. Karibjanian is board certified by the Florida Bar in Wills, Trusts & Estates and is a Fellow in the American College of Trust and Estate Counsel. He is a member of the Florida, D.C., Maryland, and Virginia bars. Mr. Karibjanian holds an LL.M. in Taxation from the University of Florida.

## FACULTY (Continued)

**Paul Lee**, *Northern Trust, New York*. Mr. Lee is the Chief Tax Strategist for Northern Trust Wealth Management. In this role, he leads research and strategy development as it relates to tax issues and wealth planning. He specializes in advising and consulting with ultra-high net worth families and their businesses, with a focus on complex income, transfer, and international tax issues. Mr. Lee is a Fellow of the American College of Trust and Estate Counsel. He has been inducted into the NAEPC Estate Planning Hall of Fame and designated an Accredited Estate Planner (Distinguished). He is a member of the Heckerling Institute on Estate Planning Advisory Committee, the Bloomberg BNA Estates, Gifts and Trusts Advisory Board, and the University of Florida Tax Institute Advisory Board. He served as the American Bar Association Advisor to the Uniform Law Commission Uniform Fiduciary Income and Principal Act. He speaks regularly at national conferences on taxation and estate planning topics, and his articles are widely published in professional journals and periodicals. Mr. Lee received his LL.M. in Taxation from Emory University School of Law.

**Richard Lipton**, *Baker & McKenzie LLP, Chicago, Illinois*. Mr. Lipton advises on tax planning for corporations, partnerships, and limited liability companies and has handled numerous engagements in structuring partnership and real estate transactions. Mr. Lipton is a member of the American Bar Association House of Delegates and Taxation Council, a Fellow and past chair of the American College of Tax Counsel, and past chair of the Chicago Bar Association Federal Tax Committee. He served on the Internal Revenue Service Advisory Council and is an adjunct professor at the University of Chicago Law School, where he teaches partnership taxation. He is admitted to practice in Texas, the District of Columbia, and Illinois.

**Professor Bruce McGovern**, *South Texas College of Law, Houston*. Professor McGovern is the Vice President and Associate Dean of Academic Administration at the South Texas College of Law. He teaches and writes in the areas of federal taxation and business organizations. He has been a Visiting Professor at both the Loyola University Chicago School of Law and the University of Florida Levin College of Law. Professor McGovern is a regular presenter and author on federal taxation and is coauthor of *Agency, Partnerships and Limited Liability Companies* (2d ed. Carolina Academic Press 2013) (with Gary S. Rosin and Michael L. Closen).

**Jennifer Young**, *Moss Adams, Portland*. Ms. Young, a certified public accountant and director at Moss Adams, provides tax assistance to large multistate companies. She has state income, franchise, sales, Oregon CAT, Portland CES, Washington B&O, and property tax experience in multiple industries, with a specialization in transportation and logistics. She also handles incentives identification and negotiation, audit defense and settlement, due diligence, corporate reorganizations, tax accounting, and entity simplification. Ms. Young has performed and reviewed multi-state nexus and apportionment studies, as well as tax provisions including documentation of uncertain tax positions. She is a member of the American Institute of Certified Public Accountants, the Council on State Taxation, and the Oregon Society of Certified Public Accountants. Ms. Young is a frequent article author and speaker.

# Chapter 1

## Helping Ira Plan His IRA from the IRA—Testamentary Planning with Individual Retirement Accounts<sup>1</sup>

**GEORGE KARIBJANIAN**

Franklin Karibjanian & Law PLLC  
Boca Raton, Florida

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In addition to the Internal Revenue Code, Treasury Regulations and certain rulings, the following sources were utilized in preparing these materials:

- Natalie Choate, *Life and Death Planning for Retirement Benefits*, 7th Ed. 2011
- Natalie Choate, *The Estate Planner's Guide to the Treasury's Proposed Regulations Regarding SECURE's Changes to the Minimum Distribution Rules (and a Few Other Things)*, March 2022
- Lexis® Federal Code Reporter
- Kathryn J. Kennedy, *BNA Income Tax Portfolio 367-2nd*, IRAs
- *IRAs and Qualified Retirement Plans*, by Christopher M. Hoyt, as reprinted by the Planned Giving and Design Center (<https://www.pgdc.com/pgdc/iras-and-qualified-retirement-plans>)
- Lester B. Law and George D. Karibjanian, *Finding Security Under the Secure Act: A Comparative Analysis of the Rules Pre and Post Secure Act: Parts 1 and 2*, 32 Probate Practice Reporter Nos. 2 and 3 (February and March 2020)



**“Helping Ira Plan His IRA from the IRA”  
Testamentary Planning With Individual Retirement Accounts**

A. The Importance of Estate Planning for IRA's

(1) Example 1

- (a) Bojack is a 55 year old retired football player living in Eugene, Oregon. Bojack's assets are as follows:
  - (i) Residence - \$2,000,000
  - (ii) Stocks, Bonds and other Tradeable Securities - \$1,000,000
  - (iii) IRA - \$15,000,000
  - (iv) Life Insurance (owned by Bojack) - \$2,000,000
- (b) Bojack is single and has three children:
  - (i) Diane, age 24, married and divorced twice, currently single and unemployed.
  - (ii) Caroline, age 22, single, recent graduate from UCLA and working with a public accounting firm, and living with Peanutbutter, a self-described “on the cusp” musician who is unemployed.
  - (iii) Todd, age 20, single, unemployed, just returned from rehab for addiction to prescription pain relievers, with current credit card debt in excess of \$60,000.
- (c) Bojack suffers from depression and his health is deteriorating from a blood disorder. Bojack then visits attorney Woodchuck Goodchuck-Berkowitz for his estate planning matters. Woodchuck realizes that should something imminently happen to Bojack, the three children are irresponsible and will have free reign with their respective inheritances. Thus, Woodchuck creates a plan involving discretionary dynasty trusts for each child, naming Rutabaga Rabbitowitz as the independent trustee.
- (d) One problem with the planning document – Woodchuck doesn't ask Bojack for a complete list of his assets, and, at the meeting, Bojack fails to tell Woodchuck about the IRA. Thus, the plan is conceived thinking that Bojack has an estate of only \$5,000,000.
- (e) Three weeks after signing his estate planning documents, Bojack dies. The estate is valued at \$20,000,000, and, assuming a flat \$12,000,000 exemption, leaves a taxable estate of \$8,000,000 with a federal estate tax liability at 40% of \$3,200,000.
- (f) As for the original plan, the thought was that those assets would pass in trust for the children and therefore be protected; however, by ignoring the IRA, not only is there an estate tax liability, but the IRA passes in shares to the three children with each having an immediate ability to withdraw his or her entire share. Thus, assuming that 75% of the estate taxes are payable from the IRA (or \$2,400,000), this means that \$12,600,000 is divided among the children (\$15,000,000 - \$2,400,000), resulting in each child receiving an Inherited IRA of \$4,200,000 each.

- (g) Soon after receiving his or her share, each child withdraws the entire balance of his or her Inherited IRA, and immediately spends the entire withdrawn amount without making any provision for the ultimate paying of income taxes on the withdrawn amount in the following year.
  - (h) By ignoring the IRA, the plan actually fails to accomplish its goals.
- (2) Premise of Outline
- (a) This outline is not intended to encompass all of the rules regarding IRA's and payouts; for example, it does not discuss the 10% penalty for "early" withdrawals (defined as withdrawals prior to attaining age 59 ½) under §72(t),<sup>1</sup> and the exceptions thereto, the 50% excise tax for underwithdrawal of required distributions under §4974(a), or some of the more complex rules regarding IRA's.
  - (b) Rather, the purpose is to provide an overview of IRA's, the required minimum distribution ("RMD") rules, and the beneficiaries of accounts, and how the Treasury's recently issued Proposed Regulations regarding required minimum distributions (the "Proposed Regs")<sup>2</sup> affect the planning for IRA's at death.
  - (c) From that premise, the outline will then cover situations on the estate planning aspects of IRA's including the use of trusts and payments to charities.
  - (d) For simplicity purposes, this outline will refer to the IRA account owner as the "participant," whereas the Code and Treasury Regulations may use the term "employee."
  - (e) Earlier versions of this outline may be incorrect based on the changes as of January 1, 2020 as a result of the Setting Every Community Up for Retirement Enhancement Act of 2019 (referred to herein as the "SECURE Act" or "SECURE") and the introduction of the "Proposed Regs."

### B. Individual Retirement Accounts – The Basics

#### (1) Generally

- (a) §408(a) defines an "Individual Retirement Account" as a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries.
- (b) Governing instrument must meet 6 requirements:
  - (i) Except in the case of certain rollover contributions, no contribution will be accepted unless it is in cash, and contributions will not be accepted for the taxable year on behalf of any individual in excess of the amount in effect for such taxable year under §219(b)(1)(A).
  - (ii) The trustee is a bank (as defined in §408(n)) or such other person who demonstrates to the satisfaction of the Secretary that the manner in which such other person will administer the trust will be consistent with the requirements of §408.

---

<sup>1</sup> Unless otherwise specifically stated, all section references shall be to sections under the Internal Revenue Code of 1986, as amended.

<sup>2</sup> See Department of the Treasury, Internal Revenue Service, 26 CFR Parts 1 and 54, REG-105954-20, Fed. Reg., Vol. 87, No. 37 (February 24, 2022).

- (iii) No part of the trust funds will be invested in life insurance contracts.
- (iv) The interest of an individual in the balance in his account is non-forfeitable.
- (v) The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.
- (vi) Under regulations prescribed by the Secretary, rules similar to the rules of §401(a)(9) and the incidental death benefit requirements of §401(a) shall apply to the distribution of the entire interest of an individual for whose benefit the trust is maintained.

(c) The Power of Compounding

- (i) IRA's, like other retirement plans, defer any and all income tax consequences until funds are distributed; thus, the longer the deferral continues, the larger the growth on account of the lack of the withdrawal of funds for income tax purposes.

(ii) Example 2

(A) Liz, a 35 year old, has \$100,000 to invest. Assume a modest 5% average rate of return, with annual taxes on the rate of return at 25%.

(I) By the time Liz attains age 71, the Tax Deferred Account is 67% larger than the Taxable Account.

Growth Rate	6%
Tax Rate	25%

Age	Taxable Account			Tax Deferred Account		
	Int. & Growth	Taxes	Balance	Int. & Growth	Taxes	Balance
35			\$100,000.00			\$100,000.00
36	\$6,000.00	(\$1,500.00)	\$104,500.00	\$6,000.00	\$0.00	\$106,000.00
37	\$6,270.00	(\$1,567.50)	\$109,202.50	\$6,360.00	\$0.00	\$112,360.00
38	\$6,552.15	(\$1,638.04)	\$114,116.61	\$6,741.60	\$0.00	\$119,101.60
39	\$6,847.00	(\$1,711.75)	\$119,251.86	\$7,146.10	\$0.00	\$126,247.70
40	\$7,155.11	(\$1,788.78)	\$124,618.19	\$7,574.86	\$0.00	\$133,822.56
**	**	**	**	**	**	**
71	\$28,004.09	(\$7,001.02)	\$487,737.85	\$46,116.52	\$0.00	\$814,725.20

(II) If unrealized income taxes are taken into consideration, such taxes are \$203,681.30 for net after-tax balance of \$611,043.90, which is \$123,306.05 greater than the taxable account.

(B) Assume Growth Rate of 8% and an increased Tax Rate of 30%.

(I) By the time that Liz attains age 71, the additional growth, without the reduction for the increased taxes, produces a Tax Deferred Account that is 124.57% larger than the Taxable Account.

Growth Rate	8%
Tax Rate	30%

Age	Taxable Account			Tax Deferred Account		
	Int. & Growth	Taxes	Balance	Int. & Growth	Taxes	Balance
35			\$100,000.00			\$100,000.00
36	\$8,000.00	(\$2,400.00)	\$105,600.00	\$8,000.00	\$0.00	\$108,000.00
37	\$8,448.00	(\$2,534.40)	\$111,513.60	\$8,640.00	\$0.00	\$116,640.00
38	\$8,921.09	(\$2,676.33)	\$117,758.36	\$9,331.20	\$0.00	\$125,971.20
39	\$9,420.67	(\$2,826.20)	\$124,352.83	\$10,077.70	\$0.00	\$136,048.90
40	\$9,948.23	(\$2,984.47)	\$131,316.59	\$10,883.91	\$0.00	\$146,932.81
**	**	**	**	**	**	**
71	\$53,867.54	(\$16,160.26)	\$711,051.50	\$118,282.75	\$0.00	\$1,596,817.18

(II) If unrealized income taxes are taken into consideration, such taxes are \$479,045.15 for net after-tax balance of \$1,117,772.03, which is \$406,720.53 greater than the taxable account.

(d) Asset Protection

- (i) Generally, with respect to the participant, many states exempt IRA proceeds from creditors.
- (ii) Under Ore. Rev. Stat. §18.358(2), a retirement plan, which includes an IRA,
 

“... shall be conclusively presumed to be a valid spendthrift trust under these statutes and the common law of this state, whether or not the retirement plan is self-settled, and a beneficiary’s interest in a retirement plan shall be exempt, effective without necessity of claim thereof, from execution and all other process, mesne or final.”
- (iii) Pursuant to Ore. Rev. Stat. §18.358(3), the full exemption does not apply in whole as to certain support orders under Ore. Rev. Stat. §25.501, in which case only 75 percent of a beneficiary’s interest in a retirement plan, or 50 percent of a lump sum retirement plan disbursement or withdrawal, shall be exempt from execution or other process arising out of a support obligation or an order or notice.
- (iv) Note that in these statutes, “beneficiary” is the “participant.”
- (v) Inherited IRA’s
  - (A) While IRA’s are mostly exempt in Oregon, what about “Inherited IRA’s” (discussed below) as to the beneficiary of the IRA upon the participant’s death? It is believed that such accounts are exempt, but the statute is silent on this issue.<sup>3</sup>
  - (B) Without a specific reference, Inherited IRA’s may be subject to creditor’s claims pursuant to the United States Supreme Court’s opinion in Clark v. Rameker, 134 S. Ct. 2242 (2014).
  - (C) Florida is an example of a state that specifically excludes Inherited IRA’s.

<sup>3</sup> See the ACTEC Inherited IRA Exemption chart at [https://www.actec.org/assets/1/6/50\\_STATE\\_INHERITED\\_IRA\\_CHART.pdf?hssc=1](https://www.actec.org/assets/1/6/50_STATE_INHERITED_IRA_CHART.pdf?hssc=1).

- (I) Florida exempts IRA's as well as Inherited IRA's under Fla. Stat. §222.21(2)(c),
  - (II) The statute provides: "any money or other assets or any interest in an IRA or other certain qualified retirement account that is exempt from claims of creditors of the owner, beneficiary, or participant does not cease to be exempt after the owner's death by reason of a direct transfer or eligible rollover that is excluded from gross income, including, but not limited to, a direct transfer or eligible rollover to an inherited individual retirement account as defined in §408(d)(3) of the Internal Revenue Code of 1986, as amended."
- (vi) Wait...don't all states protect IRA's? Well...look to the south for the answer to that. Suppose that you practice in Southern Oregon near the California border, are licensed to practice in both Oregon and California, and have California clients. All of what is said above about Oregon (and Florida) applies to California, right?
- (A) Um...well...let's consider California Code of Civil Procedure §703.140(b)(10)(E), which provides, as a general rule, that IRA's are exempt, but only to the extent *reasonably necessary for the support of the debtor and any dependent of the debtor*.
    - (I) Courts will determine by formula what is "reasonably necessary," and any amounts in excess of the "reasonably necessary" amount are available for creditors.
    - (II) Courts have wide discretion in determining what is "reasonably necessary" but generally rely on what is referred to as the "Moffat" factors from In re Moffat, 119 B.R. 201 (9th Cir. BAP 1990):
      - (01) The debtor's present and anticipated living expenses and income;
      - (02) The age and health of the debtor;
      - (03) The debtor's ability to work and make a living, including his/her training, skills and education;
      - (04) The debtor's ability to save for retirement; and
      - (05) Any special needs of the debtor and his/her dependents.
  - (B) Inherited IRA's – Not protected as California does not have a statute like Fla. Stat. §222.21(2)(c).
- (vii) OK, so no, I lied. I don't practice in Oregon or California. Instead, I practice in that pro-trust and asset protection jurisdiction of South Dakota. Surely they provide as much protection as Florida, right?
- (A) Um...partially? And don't call me Shirley.
  - (B) For IRA's, South Dakota protects the value in the account, so long as contributions were less than or equal to the applicable limits on

deductible contributions, but only up to \$1,000,000. See S.D. Cod. Laws §43-45-16.

- (C) Inherited IRA's? Likely NO. From the ACTEC "50 State Inherited IRA Chart": [South Dakota exempts] IRA's, Roth IRA's, and other retirement accounts "from the employee's benefit plan" up to \$1 million (subject to the state or its subdivisions as creditors). The exemption does not expressly extend to inherited accounts and the language restricting the exemption to an "employee's" account suggests there would be no exemption for an inherited IRA. There is no interpretative case law on point, however."<sup>4</sup>
- (D) "Well, at least we're not as bad as California as, after all, our exemptions amount is fixed." You sure about that??? See S.D. Cod. Laws § 43-45-18:

Court determination of appropriate exemption. In the event that any court of South Dakota finds the exemption provided in § 43-45-16 is excessive, the court is hereby directed to determine the amount of the exemption permissible under the S.D. Const., Art. XXI, § 4.

(2) Contributions

(a) General Limits (§219(b)(1)(A))

- (i) The amount allowable as a deduction for the contribution to an IRA to any individual for any taxable year shall not exceed the lesser of:
- (A) The deductible amount, or
- (B) An amount equal to the compensation includible in the individual's gross income for such taxable year.
- (ii) What is the "Deductible Amount"? (§219(b)(5))
- (A) The base deductible amount is \$5,000.
- (B) Catch-up contributions for individuals 50 or older - in the case of an individual who has attained the age of 50 before the close of the taxable year, the deductible amount for such taxable year shall be increased by the applicable amount, which is \$1,000.
- (C) Cost-of-living adjustment. In the case of any taxable year beginning in a calendar year after 2008, the \$5,000 amount is increased (rounded to the nearest \$500) by the Code's cost-of-living adjustment in which the taxable year begins, applying 2007 as the base year.
- (D) For 2022, the deductible amount is \$6,000, and for persons who have at least attained age 50, \$6,500.

(b) Non-Deductible Contributions (§219(g))

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<sup>4</sup> *Id.*

- (i) Reduction in Deductible Contribution Amounts due to Contributions to Employer Sponsored Plans
  - (A) IRA's are supplemental retirement plans; therefore, they are secondary to other employer sponsored plans.
  - (B) If the participant's contribution to the employer's plan is not equal to the maximum deductible contribution amount under §219(b)(5), the balance may be used as a deductible contribution to an IRA.
  - (C) If the employee is an "active participant" in an employer retirement plan, the amount of the deduction for an IRA contribution is reduced, ultimately to \$0.
  - (D) The formula is the ratio of, (I) the excess of the taxpayer's adjusted gross income for the year over the "applicable dollar amount" (\$109,000 if filing jointly or \$68,000 otherwise), to (II) \$10,000 (\$20,000 if jointly filing).
- (ii) Non-Deductible Contributions
  - (A) Even if the contributions to employer sponsored plans have exceeded the deductible amount, this does not prevent contributions to an IRA.
  - (B) The contribution thresholds are applicable regardless of whether the contribution is deductible; therefore, even if the deduction is completely denied, a participant may still make a non-deductible contribution to an IRA.
  - (C) Maximum amount of any non-deductible contributions is limited to the otherwise-deductible amount (i.e., \$5,000 adjusted for inflation).
- (c) When are Contributions Prohibited
  - (i) Before the SECURE Act, contributions ceased once the owner went into "pay status."
  - (ii) Under the SECURE Act, there is no age limitation for contributions, so an owner can continue to make contributions even if the owner is in "pay status."
- (d) Rollovers (§408(d)(3))
  - (i) Distributions are not taxable if they are rolled over in one of two ways:
    - (A) The entire amount received (including money and any other property) is paid into an individual retirement account or individual retirement annuity (other than an endowment contract) for the benefit of such individual not later than the 60th day after the day on which he receives the payment or distribution; or
    - (B) The entire amount received (including money and any other property) is paid into an eligible retirement plan for the benefit of such individual not later than the 60th day after the date on which the payment or distribution is received, except that the maximum amount which may be paid into such plan may not exceed the portion of the amount received

which is includible in gross income (determined without regard to this paragraph).

- (ii) “Eligible retirement plan” means an eligible retirement plan described in:
  - (A) A “Qualified Trust,” which is defined as an employees’ trust described in §401(a) which is exempt from tax under §501(a). (§402(c)(8)(B)(iii))
  - (B) An annuity plan described in §403(a). (§402(c)(8)(B)(iv))
  - (C) An eligible “deferred compensation” plan described in §457(b) which is maintained by an eligible employer described in §457(e)(1)(A). (§402(c)(8)(B)(v))
  - (D) An annuity contract described in §403(b). (§402(c)(8)(B)(vi))
- (iii) Rollover Exception: the rollover rules will not apply if at any time during the 1-year period ending on the day of such receipt, such individual received any other amount from an individual retirement account or an individual retirement annuity which was not includible in his gross income because of the application of this paragraph.

(3) Distributions

- (a) Under §408(e)(1), the IRA plan itself is generally exempt from taxation; distributions from a plan, however, are included in the recipient’s gross income under §408(d)(1).
- (b) IRA distributions are not subject to the §1411 “net investment income” 3.8% tax. (§1411(c)(5))
- (c) The exception to the general rule of §408(d)(1) is if the account contains non-deducted contributions, then the annuity rules of §72(e) apply so that each distribution contains a proportionate amount of basis and the balance of the account.
- (d) Section 402(a) provides that any amount actually distributed to any distributee shall be taxable to the distributee in the taxable year of the distributee in which distributed.
- (e) Post-Death Distributions – The Potential for Double Tax
  - (i) As to any taxable portion of the IRA, receipt by the beneficiary of any amounts that would have been taxable to the participant has the participant received the amounts remains taxable to the beneficiary under §691 as “income in respect of a decedent,” or “IRD.”
  - (ii) Wait...I thought that appreciated assets received a full step-up in basis upon death under §1014(a)? Ordinarily, yes, but not if the amounts would all have been taxable income in the hands of the decedent.
  - (iii) IRD usually applies to income, dividends, salary, etc., and does not apply to appreciated assets, except for assets that are tax-deferred such as those in qualified retirement plans.
  - (iv) Thus, if the decedent’s estate paid federal estate taxes, the IRA is “double-taxed,” meaning taxed for transfer tax purposes and then taxed for income tax purposes.

- (v) Example 3 - How bad is it? Consider the following example:
  - (A) Lucille dies with three aspects to her estate: she has fully utilized her applicable exclusion amount, the only other asset is an IRA (which was funded with all deductible contributions) of \$2,000,000, and her estate has no available estate tax deductions.
  - (B) As a result, Lucille's IRA is subject to 40% federal estate taxes of \$800,000, leaving \$1,200,000 available for the beneficiary or beneficiaries (\$2,000,000 - \$800,000).
  - (C) The Designated Beneficiary of the IRA is Lucille's son, Buster, where all distributions to Buster are fully taxable and Buster is in the top federal income tax bracket of 37%.
  - (D) This means that, from the \$1,200,000 that Buster would receive, after the payment of Lucille's estate taxes, 37% would be paid in federal income taxes (or \$444,000) so that the net portion of the original IRA that would be received by Buster is \$756,000, or only 37.8% of the IRA balance at Lucille's date of death.
  - (E) Even though it is clear that income taxes were due on distributions from the IRA, there is no §2053/Schedule K debt deduction for anticipated income taxes on IRA's on the federal estate tax return. The reason for this is because the tax liability is an unknown – as the liability is not recognized until the future, there could be other offsets so that the ultimate tax liability could be reduced to \$0.
- (vi) Some relief for the double-tax: the §691(c) Deduction
  - (A) In a complicated formula, the recipient of a distribution from an IRA that was subject to federal estate tax receives an income tax deduction of the estate taxes paid as to the distribution. The deduction is calculated as the marginal proportion of the tax that relates to the ratio of the distribution to the gross estate.
  - (B) The estate tax subject to the deduction is calculated by determining the estate tax with and without the IRA, and then multiplying that amount by the ratio of the distribution to the value of the account.
- (f) Distributions to Charity
  - (i) Receipt of RMD and then Contribution to Charity
    - (A) What happens if the participant takes the RMD and then donates it to charity? Suppose that the RMD is \$100,000.
    - (B) Participant recognizes \$100,000 in income, and the donation to charity is limited to the 50% applicable "adjusted gross income" ("AGI") limitation.
    - (C) Itemized Deduction Phase Out
      - (l) Prior to 2018, itemized deductions were phased out at \$300,000 for married taxpayers filing jointly, \$250,000 for single taxpayers and \$275,000 for head of household taxpayers. The phase out

reduces, up to 80%, certain allowable itemized deductions (including the charitable deduction) by 3% of the excess of AGI over the phase out amounts.

(II) Under the Tax Cuts and Jobs Act of 2017 (the “TCJA”), the phase out is suspended through 2025.

(D) The effect of the deduction limitation is that, even though the full RMD was donated to charity, the beneficiary is still paying income taxes on the RMD.

(ii) Qualified Charitable Distribution (§408(d)(8))

(A) A “qualified charitable distribution” goes directly from the IRA to charity without distribution to the participant.

(B) The advantage of a qualified charitable distribution is that the RMD is excluded from the participant’s gross income, akin to a full deduction as opposed to a deduction subject to an AGI limitation.

(C) The amount of a qualified charitable distribution is limited to \$100,000 per year (§408(d)(8)(A)), which, in a change enacted as part of the SECURE Act, is reduced for any post-age 72 contributions made to the IRA.

(D) In addition, the distribution prevents an increase in the participant’s adjusted gross income.

C. Required Minimum Distribution Rules

(1) Introduction

(a) The starting point for when an RMD is first payable is when the participant attains age 72 (changed under the SECURE Act, which increased the age from 70 ½). (Prop. Reg. §1.401(a)(9)-2(b)(1))

(b) This can be referred to as the participant being in “pay status,” and the date of the participant’s attaining age 72 may be referred to as the “Required Beginning Date,” or “RBD.”

(2) Tables

(a) Generally

(i) Pursuant to Treas. Reg. §1.401(a)(9)-9, three tables are used to determine the life expectancies used for the RMD Calculation.

(ii) Participant during the Participant’s life: Uniform Life Table, Treas. Reg. §1.401(a)(9)-9, A-2. (See Exhibit A)

(iii) Certain Beneficiaries after Participant’s death: Single Life Table, Treas. Reg. §1.401(a)(9)-9, A-1. (See Exhibit B)

- (iv) Special Circumstance for Participant where Beneficiary is the Participant's spouse and is 10 or more years younger than the Participant: Joint and Survivor Table, Treas. Reg. §1.401(a)(9)-9, A-3. (see Exhibit C)
- (b) New Tables!
  - (i) In November 2020, the IRS finalized regulations to §1.401(a)(9)-9 updating the life expectancy and distribution period tables used to calculate RMDs.
  - (ii) The tables under the new regulations apply for distribution calendar years beginning on or after January 1, 2022.
  - (iii) Transition Rules
    - (A) Use of Single Life Table
      - (I) The first transition rule applies if the participant were to die before January 1, 2022, and, under the rules of §1.401(a)(9)-5, the distribution period that applies for a calendar year following the calendar year of the participant's death is equal to a single life expectancy calculated as of the calendar year of the participant's death (or, if applicable, the following calendar year), reduced by one for each subsequent year.
      - (II) In this situation, the distribution period that applies for a distribution calendar year beginning on or after January 1, 2022, will be determined by using the single life table in paragraph (b) of §1.401(a)(9)-9 to determine the initial life expectancy for the age of the relevant individual in the relevant calendar year and then reducing the resulting distribution period by one for each subsequent year.
    - (B) Spouse Dies Before 1/1/22
      - (I) The second transition rule applies if an employee's sole participant is the employee's surviving spouse, and the spouse dies before January 1, 2022.
      - (II) In such a case, the spouse's life expectancy for the calendar year of the spouse's death is reset in the same manner as the participant's as described in the preceding paragraph.
- (3) Required Minimum Distribution
  - (a) Introduction
    - (i) Once the beneficiary attains age 72, the IRA must be withdrawn at a minimum annual rate, which is determined under the IRS Uniform Life Table; this minimum amount is the RMD.
    - (ii) I'm confused...is it "Required Minimum Distribution," meaning "RMD," or is it "Minimum Required Distribution," or "MRD"? Answer: who cares! Both are acceptable, although the Treasury Regulations use "RMD." See Treas. Reg. §1.401(a)(9)-5, A-1.

- (b) The year in which the participant attains age 72 is called the “First Distribution Year” (Treas. Reg. §1.401(a)(9)-5, A-1(b)); however, for this First Distribution Year, the participant is not required to withdraw the first RMD until April 1 of the following year (Treas. Reg. §1.401(a)(9)-5, A-1(c)), which is the RBD. (§401(a)(9)(C))
- (c) For each year after the First Distribution Year, the RMD must be made no later than 12/31.
  - (i) For maximum deferral purposes, it is recommended that the participant wait as long as possible to take the RMD.
  - (ii) While hornbooks and guides will suggest that the RMD be withdrawn on 12/31, in the real world, this is extremely difficult, so the custodian/broker/bank should be notified on or about December 1 to confirm how late a withdrawal request can be made for distribution prior to 12/31; often this will be on or around 12/15.
- (d) The calculation is based on the value of the IRA as of 12/31 of the year before the participant attains age 72.
- (e) If the participant delays the initial RMD until April 1 of the year after she/he attains age 72 (the “Second Year”), the participant will actually have 2 RMD withdrawals in the Second Year.
- (f) Each RMD will be fully taxable to the participant (unless the participant made non-deductible contributions, in which case the withdrawal will be non-taxable basis until it is all withdrawn); therefore, the participant should plan for this with respect to estimated income taxes.
- (g) Multiple IRA's
  - (i) The general rule for qualified retirement plans is that if a participant has benefits in multiple plans, the RMD must be calculated for each separate account and each plan must distribute the RMD calculated for the particular plan. (Treas. Reg. §1.409(a)(8), A-1)
  - (ii) Unlike other retirement accounts, if the participant has benefits in more than one IRA, the RMD calculation is by the same method, but the total RMD can be withdrawn from any account or accounts as the participant requests. (Treas. Reg. §1.408-8, A-9)

### D. Death of the Owner

#### (1) Generally

- (a) Pay Status and RMD Not Paid in Year of Death – Who Gets It?
  - (i) If the participant has not received her/his entire RMD for the year of death, then the balance of the RMD must be distributed to the named beneficiary by the end of the year of the participant's death.
  - (ii) Why isn't the participant's estate the recipient of the RMD? Because the participant had the right to withdraw the RMD and didn't, should that mean that the estate receives any unpaid RMD? No – upon death, the IRA immediately vests with the beneficiary, so the RMD should be payable to the beneficiary (PLR 199930052).

- (iii) Does this rule out post-mortem planning through disclaimers, meaning, if the IRA immediately vests in the beneficiary, isn't that "acceptance" which prevents a qualified disclaimer? NO! "Ownership" is not necessarily "acceptance of the interest or accepting the benefits" – under Rev. Rul. 2005-36, the RMD is severable from the IRA so that a beneficiary can accept the RMD but still disclaim the balance of the IRA.<sup>5</sup>
- (b) RMD if Owner is Not in Pay Status - If the participant dies before the Required Beginning Date, the account passes to the named beneficiary or beneficiaries as set forth in the beneficiary designation.
- (c) Passage of Account to "Designated Beneficiaries"
  - (i) Plan Custodians will always require that a "beneficiary designation" be completed for each IRA account.
  - (ii) The named beneficiary is referred to as a "Designated Beneficiary." (§401(a)(9)(E))
  - (iii) The Designated Beneficiary need not be specified by name in the plan or by the participant, so long as the individual is identifiable. (Treas. Reg. §1.401(a)(9)-4, A-1); for example, if the beneficiary designation provides that the account passes to the beneficiary's children, this would be sufficient to identify the Designated Beneficiaries.
  - (iv) Only individuals may be Designated Beneficiaries
    - (A) As described below, the Designated Beneficiary is covered under the RMD rules; if a non-individual is a Designated Beneficiary, the tax deferral at the Designated Beneficiary level is not available.
    - (B) Estates may NOT be Designated Beneficiaries.
    - (C) Although a trust is not an individual, it is possible to "look through" the trust and treat the individual trust beneficiaries as if the beneficiary had named the individual trust beneficiaries as the Designated Beneficiaries (see below).
    - (D) Partnerships, corporations and LLCs are not individuals, even if they would be treated as an individual for federal income tax purposes.
    - (E) Charitable organizations are not individuals; however, if amounts are paid to a charitable organization, the adverse tax consequences are irrelevant because the charitable organization would not pay income taxes.
- (d) Accounts Paid to Beneficiaries
  - (i) Unless the IRA is withdrawn completely upon the death of the participant, the IRA can take one of two forms:

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<sup>5</sup> See George D. Karibjanian, *Disclaimers and IRA's – In Certain Circumstances, Beneficiaries Can Have Their Cake and Eat It Too*, LISI EMPLOYEE BENEFITS & RETIREMENT PLANNING NEWSLETTER #583 (October 4, 2011) at <http://www.leimbergservices.com>.

- (A) An account for a beneficiary other than the surviving spouse, which is called an “Inherited IRA.”
- (B) An account for the surviving spouse, which is called a “Rollover IRA” and is treated as if the spouse were the initial contributor to the account.

### (2) Beneficiaries of IRA’s and Payout Rules

- (a) After the participant dies, the distribution rules now apply to the Designated Beneficiaries.
- (b) The SECURE Act changed the way that distributions were made – previously, a beneficiary was subject to the RMD rules and could receive payments over her/his lifetime; under SECURE, beneficiaries have a fixed period of time (generally 10 years) in which to withdraw the entire account.

### (3) Game Changer – 2022 Proposed Regulations

- (a) Since SECURE’s passage in 2019, practitioners were left to analyze and determine how the distribution rules would be changed as a result of SECURE, especially since the current Treasury Regulations as to “stretching” payments over a beneficiary’s lifetime were theoretically determined to be obsolete.
- (b) In 87 Fed. Reg. No. 37 (Feb. 24, 2022), the “world turned upside down” with the release of the Proposed Regs interpreting the changes to IRA’s as a result of the SECURE Act.
- (c) For example, under SECURE, it was believed that the same rules applied whether the participant died on or after her/his RBD; the Proposed Regs create two separate set of rules, leaving practitioners to re-evaluate everything that they believed that they knew about the way that SECURE affected IRA’s.
- (d) When this outline discusses the Proposed Regs, the discussion will presume that the rules set forth in the Proposed Regs will likely be the procedures set forth in final regulations.

### (4) Beneficiaries of decedents who died prior to 1/1/20

- (a) Upon the passage of SECURE, it was thought that they would be subject to the old, pre-SECURE rules.
- (b) Under the Proposed Regs, as shown below, this isn’t necessarily the case in all instances.

## E. Payouts Pre-SECURE Act

### (1) Generally

- (a) If there are multiple Designated Beneficiaries, special rules apply for possibly dividing the IRA into separate accounts (discussed below), but if multiple Designated Beneficiaries are receiving payments from the same account (or separate account), the RMD is based on the oldest beneficiary.
- (b) If a beneficiary is not a Designated Beneficiary (a “Non-DB”), then the payout must be paid pursuant to the “5-Year Rule” (see below).

- (2) Surviving Spouses and Spousal Rollovers
  - (a) If certain requirements are met, §402(c)(1) allows a participant in a qualified retirement plan to roll over certain plan distributions to another qualified retirement plan.
  - (b) Under Treas. Reg. §1.408-8, A-5 provides that the surviving spouse of an individual may elect to treat the spouse's entire interest as a beneficiary of an individual's IRA (or the remaining part of such interest if distribution thereof has commenced to the spouse) as the spouse's own IRA.
  - (c) The effect of the election is that subsequent RMD's are determined under §401(a)(9) with the surviving spouse as the participant, i.e., the measuring life.
  - (d) The rollover election may be made at any time after the participant's date of death, including after the surviving spouse's own RBD.
  - (e) The spouse must be the sole beneficiary of the IRA and have an unlimited right to withdraw amounts from the IRA.
  - (f) Making the Election
    - (i) There is no statute or regulation that gives instructions as to how to properly effect a rollover.
    - (ii) Affirmative Election – the surviving spouse redesignates the account as an account in the name of the surviving spouse rather than in the name of another beneficiary.
    - (iii) Contribution – if the spouse makes a contribution to the IRA, then, as contributions are not allowed to Inherited IRA's, this an indication that the IRA has become the spouse's IRA.
  - (g) Failure to Take RMD – if the spouse is not in pay status and fails to take an RMD after the participant's death, then, under Treas. Reg. §1.408-8, A-5, this indicates that the spouse has deemed this to be her/his own IRA.
- (3) No Designated Beneficiary and Death Prior to "Pay Status" – the "5-Year Rule" (Treas. Reg. §1.401(a)(9)-3, A-2)
  - (a) If a beneficiary is NOT a Designated Beneficiary, all benefits from the IRA must be distributed no later than December 31 of the year that contains the 5<sup>th</sup> anniversary of the participant's date of death.
  - (b) Under the 5-Year Rule, annual distributions are not required – the only requirement is that the account must be distributed by December 31 of the year that contains the 5<sup>th</sup> anniversary of the participant's date of death (the "5 Year Deadline").
  - (c) "5 Years" is a misnomer – it could be, for all intents and purposes, 6 years. Consider if death occurs on 1/1/19. Since death occurs in 2019, the 5<sup>th</sup> year after the year of death is 2025, and the distribution is not required until the 5 Year Deadline. Thus, under this scenario, with a death on January 1, 2019, the IRA is not required to be distributed until December 31, 2025, or 6 years later.

- (4) Designated Beneficiary and Death Prior to “Pay Status” (Treas. Reg. §1.401(a)(9)-3, A-1; also, §401(a)(9)(B)(iii) and (iv))
- (a) Generally, a Designated Beneficiary receives the IRA and, beginning in the year following the year of the participant’s death, will start taking RMD’s based on her/his life expectancy (or over a period not extending beyond the life expectancy of such beneficiary) (the “Life Expectancy Rule”).
  - (b) The plan itself may, however, provide for an election for the Designated Beneficiary to choose the Life Expectancy Rule or the 5-Year Rule.
    - (i) The deadline for making the election is the earlier of:
      - (A) The end of the calendar year in which distributions would be required to commence in order to satisfy the requirements for the Life Expectancy Rule, or
      - (B) The end of the calendar year which contains the 5 Year Anniversary.
    - (ii) For everyone other than the surviving spouse, the “earlier of” would be (I) because the Life Expectancy Rule requires payments to commence by December 31 of the year following the year of the participant’s death, and this will necessarily precede the 5 Year Deadline.
    - (iii) Through the “rollover” feature, a surviving spouse whose RBD is more than 6 years from the participant’s date of death, the “earlier of” date would be (II).
    - (iv) Example 4
      - (A) Eleanor dies on January 1, 2017 when she is 45 years old and is a participant in an IRA that has, as of her date of death, a balance of \$1,000,000. The IRA agreement provides beneficiaries with the option of electing either the 5-Year Rule or the Life Expectancy Rule.
      - (B) Scenario #1: Eleanor is survived by her son, Jason, who is then 22 years old. Jason’s deadline for electing the 5-Year Rule is December 31 of the year that contains the 5<sup>th</sup> anniversary of Eleanor’s date of death; for this purpose, the deadline is December 31, 2022, which is one day shy of the 6<sup>th</sup> anniversary of Eleanor’s date of death. Jason’s deadline for electing the Life Expectancy Rule is December 31 of the year following the year of Eleanor’s death, or December 31, 2018. Therefore, the “earlier of” date for making the election is December 31, 2018.
      - (C) Scenario #2: Eleanor is also survived by her husband, Michael, who, at the time of Eleanor’s death, is 48 years old. As a surviving spouse, Michael has the option of rolling over the IRA, which, if he did, would cause the RBD to be when he turns 70 ½ sometime in 2039. The “earlier of” date for making the election between the Life Expectancy Method and the 5-Year Rule becomes the 5-Year Rule deadline of December 31, 2022.
    - (v) If the plan does not provide for a default rule, the default rule is the Life Expectancy Rule.

- (5) Death during “Pay Status” (Treas. Reg. §1.401(a)(9)-5, A-5)
- (a) No Designated Beneficiary
- (i) Once the participant attains pay status, the 5-Year Rule is inapplicable - the payout remains on the participant’s single life expectancy (which, by definition, cannot be lower than 15 years based on the applicable mortality tables).
- (ii) The life expectancy is calculated using the Single Life Table, and then finding the distribution period based on the age that participant would have attained on his/her birthday during the year of his/her death, and then reducing that distribution period by 1. For example, if a 73 year old born in November dies in July 2017, the beneficiary would have turned 74 in 2017. For a 74 year old, the life expectancy is 14.1, which is reduced by 1, making it 13.1. Thus, RMD for the Estate in 2018 becomes 1/13.1 of the account balance, and then in 2019 becomes 1/12.1, and so on.
- (iii) Important Safety Tip: when going to the tables, always remember – during the participant’s life, the table is the UNIFORM LIFE TABLES; after the participant’s death, the table for the beneficiary is the SINGLE LIFE TABLES.
- (b) Single Designated Beneficiary
- (i) With a Designated Beneficiary, the payout becomes the longer of the participant’s life expectancy or the beneficiary’s life expectancy.
- (ii) General Rule
- (A) The general rule is that, beginning in the year following the year of the participant’s death, the beneficiary’s RMD is calculated by dividing the prior year-end account balance by the life expectancy under the Single Life Table. In each subsequent year, the divisor is reduced by 1.
- (B) In other words, for the beneficiary, the Single Life Table is only used once to determine the initial life expectancy, whereas, for the participant, the Uniform Life Table is used each year.
- (C) Note that the regulation describing the calculation, which is Treas. Reg. §1.401(a)(9)-5, in A-5, provides that the “life expectancy” is determined as the longer of the owner’s remaining life expectancy or the beneficiary’s life expectancy. This “longer of” rule is intended to prevent a beneficiary who is older from having to receive the IRA in a shorter period of time than the owner.
- (iii) Example 5
- (A) Same facts as Example 4, Scenario #1. Upon Eleanor’s death in 2017, Jason is 22 years old. In 2018, the year after the year of Eleanor’s death, Jason will be 23. The value of the IRA as of 12/31/17 is \$1,000,000.
- (B) Under the Single Life Table, the factor (divisor) for a 23 year old person is 60.1. Applying this to the IRA Value as of 12/31/17, Jason’s RMD for 2018 is \$16,638.94, which must be withdrawn any time prior to 12/31/18.

- (C) Further suppose that, on 12/31/18, the value of the IRA is \$1,100,000. For Jason's 2019 RMD calculation, the divisor becomes 1 subtracted from the original divisor of 60.1, for 59.1. Jason's 2019 RMD is \$18,612.52.
- (6) Multiple Designated Beneficiaries
- (a) Two rules exist with respect to when more than one Designated Beneficiary is named.
- (i) If any of the beneficiaries are not individuals, the default is that there are no Designated Beneficiaries and the 5 Year Rule applies.
- (ii) If all of the beneficiaries are individuals, the RMD is based on the oldest beneficiary.
- (b) Separate Accounts Rule (Treas. Reg. §1.401(a)(9)-8, A-2)
- (i) If the participant's benefit is divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts, then, for years subsequent to the calendar year containing the date as of which the separate accounts were established, or date of death if later, such separate account under the plan is not aggregated with the other separate accounts under the plan in order to determine the RMD (the "Separate Account Rule").
- (ii) The deadline for establishing the separate accounts is the date no later than the last day of the year following the calendar year of the employee's death.
- (A) If the participant dies on 6/30/17, naming 3 individuals as the Designated Beneficiaries, the Separate Account Rule must be implemented by 12/31/18.
- (B) This makes perfect sense because December 31 of the following year is the last day in which the Designated Beneficiary's initial RMD must be calculated and paid.
- (iii) The Separate Account Rule does NOT apply to multiple beneficiaries who take their interests through a trust that is the named beneficiary of the IRA.
- (iv) Each Separate Account must share in all of the pre-division gains, losses, etc.
- (v) Divisions are allowed after the deadline where each Separate Account can account for its own income tax attributes; the only difference being that it is still subject to the same measuring life for RMD purposes as the pre-separation account.
- (vi) No set rule exists for how to establish Separate Accounts; the consensus is that some physical post-death action must occur in order to create the Separate Accounts.
- (vii) Is it clear that each Designated Beneficiary under the Separate Account Rule can use her/his life expectancy for RMD purposes? Not really – this, though, is clarified in the Proposed Regs.

- (c) Removing Beneficiaries (Treas. Reg. §1.401(a)(9)-4, A-4)
  - (i) The beneficiaries for RMD purposes are those who are entitled to receive the benefit from the account as of the participant's date of death minus any beneficiary who ceases to have an interest by September 30 of the calendar year following the calendar year of the participant's death.
    - (A) What is special about September 30? The roots are based in the estate tax.
    - (B) It is conceivably possible that the IRA would be used to pay debts or taxes...in particular, if the IRA is the only asset in an individual's gross estate, and if that estate is taxable, then the IRA would be required to pay the estate taxes.
    - (C) By setting the beneficiary "fixing date" as September 30 of the year following the year of the participant's death, it is likely that all estate taxes would be paid by this date. Consider that even if the participant died on December 31, estate taxes are due on the date that is 9 months from the date of death, so such taxes would be paid by September 30.
  - (ii) This rule allows beneficiaries to "clean" up the Designated Beneficiaries so that no negative effects apply to the RMD.
  - (iii) Example 6
    - (A) Michael, who was in pay status, provides in his IRA Beneficiary Designation that the first \$400,000 of his IRA is to be given to TBD, a charitable organization, with the balance left to his son, George Michael. Michael dies on July 1, 2017.
    - (B) On its face, since TBD is not an individual, the IRA would fail and would be paid based on Michael's remaining life expectancy. However, if TBD is paid its \$400,000 by September 30, 2018, the balance of the IRA may be paid to George Michael based on George Michael's life expectancy because TBD was not then a current beneficiary of the IRA.
  - (iv) Estate Taxes and September 30 - what about additional taxes that might be due after September 30? Would that disqualify the account if there is a subsequent audit and additional taxes are paid after the September 30 deadline?
    - (A) One would think that it should, seeing as how all taxes are technically due by the due date, so some retroactivity should be applied so as to not disqualify the IRA from using the Life Expectancy Rule.
    - (B) However, consider In PLR 201008049, where the IRS ruled that, under the life expectancy rule of §401(a)(9)(B)(iii), IRA funds should have been distributed to a beneficiary of a deceased IRA owner's estate over a period not exceeding the decedent's life expectancy where the designated IRA beneficiary murdered the decedent and a state slayer statute applied.
      - (l) According to state law, a person who feloniously and intentionally kills a decedent is not entitled to benefit under an IRA, and the IRA

is treated as becoming payable as though the killer predeceased the decedent.

- (II) The IRS concluded that the murder conviction did not have the effect of retroactively removing the murderer as the designated IRA beneficiary as of the date of the decedent's death, or as of September 30 of the calendar year immediately following the year of the decedent's death, because the murderer was alive, had not disclaimed his interest in the IRA under §2518, was not subject to a final state court judgment as to his guilt in the murder of the decedent, and had not received any part of the interest in the IRA.
- (III) Thus, the IRS decided that, pursuant to Reg. §1.401(a)(9)-4, A-4, the murderer remained the designated IRA beneficiary for purposes of determining the applicable required minimum distribution period.
- (IV) Query whether the IRS might have reached a different result if a final state court judgment as to the murderer's guilt had been issued by September 30 of the year following the decedent's death.

- (C) However, consider PLRs 200432027 and 200432029, where the IRS conceded that the trust's contingent liability to pay additional estate taxes after the September 30 date did not disqualify the trust from having a Designated Beneficiary; however, no specific reasoning was given.

(d) Special Rule for Older Beneficiaries

- (i) Under the "lesser of" rule, Designated Beneficiaries with Inherited IRA's could take the lesser RMD based upon either the Designated Beneficiary's life expectancy (determined the year following the participant's year of death), or the participant's life expectancy as if the participant had lived.
- (ii) The purposes of this "lesser of" rule was because a Designated Beneficiary who was older than the participant should not be forced to withdraw the IRA faster than if the Designated Beneficiary was treated as a Non-DB (i.e., recall that withdrawals for Non-DB's who inherited IRA's from a participant who dies after the RBD, was based on the participant's remaining life expectancy).

F. Payouts Under the SECURE Act

(1) Introduction

- (a) Many of the special rules, such as multiple beneficiaries, remain the same after the passage of the SECURE Act, but the ability to use a beneficiary's life expectancy after the owner's death is, except in few circumstances, eliminated.
- (b) SECURE creates three categories of beneficiaries:
  - (i) Designated Beneficiaries (§401(a)(9)(E)(i))
    - (A) Individuals, or trusts that qualify as "see-through" trusts (described below), are "Designated Beneficiaries."

- (B) Designated Beneficiaries are a larger subset that includes “Eligible Designated Beneficiaries” (“EDB’s,” described below) and non-EDB’s; for purposes of discussing Designated Beneficiaries that are not EDB’s, such Designated Beneficiaries will be referred to as “Regular DB’s.”
- (C) A Regular DB must withdraw her/his inherited IRA’s under the “10-Year Rule” (described below).
- (ii) Eligible Designated Beneficiaries (§401(a)(9)(E)(ii))
  - (A) EDB’s are a subset of Designated Beneficiaries that receives special treatment with respect to distributions.
  - (B) EDB’s include:
    - (I) The surviving spouse of the participant;
    - (II) A person who is not more than 10 years younger than the participant;
    - (III) A minor child of the participant;
    - (IV) A disabled individual; or
    - (V) A chronically ill individual.
  - (C) Certain EDB’s may receive distributions based on the “old” rules, i.e., based on their life expectancies.
- (iii) Non-Designated Beneficiaries
  - (A) As was the case pre-SECURE, a beneficiary that is an estate, charity, or a non-“see-through” trust (described below), is considered to be a Non-DB.
  - (B) Non-DB’s are still subject to the 5-Year Rule if the participant died before his or her required beginning date, or over the deceased participant’s remaining life expectancy (if the participant died after his or her required beginning date).
- (2) Death Before Pay Status
  - (a) If the participant dies before entering pay status, the payout depends on the identity of the beneficiary.
  - (b) Spouse as Beneficiary
    - (i) The pre-SECURE rules apply to spouses – the spouse has the option to roll over the IRA into her/his own IRA and begin distributions based on her/his required beginning age.
    - (ii) Rollovers are the same as pre-SECURE, except that the spouse’s required beginning date is 72; this occurs even the participant died prior to 2020.

- (c) Regular Designated Beneficiaries – “10-Year Rule”
  - (i) If all of the beneficiaries are Designated Beneficiaries, and if none of the Designated Beneficiaries are Non-DB’s, the portion allocated to a particular Regular DB is subject to the “10-Year Rule,” which works just like the 5-Year Rule except that it lasts for 10 years.
  - (ii) Under §401(a)(9)(B)(ii), with an adjustment by §401(a)(9)(H)(i)(I), the Inherited IRA must be fully distributed on or before December 31 of the 10<sup>th</sup> year after the year of death (said December 31 date to be referred to as the “10-Year Deadline”). (Prop. Reg. §1.401(a)(9)-3(c)(3); also, Prop. Reg. §54.4974-1(c)(2))
  - (iii) While the Inherited IRA must be fully distributed by the 10-Year Deadline, the Regular DB is not required to withdraw any amounts from the Inherited IRA prior to the 10-Year Deadline.
  - (iv) This is a huge change from pre-SECURE, as required distributions from Inherited IRA’s could have been stretched for the beneficiary’s lifetime.
  - (v) In theory, the 10-Year Rule isn’t as bad as it seems.
    - (A) Greater Deferral - at least as to the 10 years, the deferral is more advantageous than paying out over a life expectancy because no distributions have to be made, so if the beneficiary doesn’t need the distributions, the beneficiary doesn’t have to take one during the term.
    - (B) As is the case under the 5-Year Rule, 10 years is a misnomer – it could be, for all intents and purposes, 11 years. Consider if death occurs on 1/1/22. Since death occurs in 2022, the 10<sup>th</sup> year after the year of death is 2033, and the distribution is not required until December 31 of the 10<sup>th</sup> year. Thus, under this scenario, with a death on January 1, 2022, the IRA is not required to be distributed until December 31, 2033, or 11 years later.
    - (C) Further, if the beneficiary is a trust, even in a jurisdiction such as California which does not afford full protection to IRA’s, the Inherited IRA would be protected until the mandatory distribution date.
  - (vi) Eligible Designated Beneficiaries - Generally
    - (A) Generally, an Eligible Designated Beneficiary will receive distributions from the Inherited IRA calculated by using the beneficiary’s life expectancy.
    - (B) EDB’s can also elect to use the 10-Year Rule, but only IF the plan authorizes the election. (Prop. Reg. §1.401(a)(9)-3(c)(5)(iii))
  - (vii) EDB – 10-Years Younger
    - (A) A person who is not more than 10 years younger than the participant is also an EDB who may stretch distributions, as well as any beneficiary who is older than the decedent (the “10-Years Younger EDB”).
    - (B) “10-Years Younger” is defined based on the actual dates of birth, not the year of birth. (Prop. Reg. §1.401(a)(9)-(4)(e)(6))

- (C) Example 7
  - (I) Ted dies in 2022 at age 82, naming his friend, Beard, as the beneficiary of his IRA. At the time of Ted's death, Beard is age 74.
  - (II) Because Beard is less than 10 years younger than Ted, Beard is an EDB and the Inherited IRA is payable over his life expectancy.
  - (III) In 2023, Beard would have to take his first RMD (when he is then 75). At age 75, using Table 1, Beard's life expectancy is 14.8 years, so the fraction used to determine the initial RMD for 2023 would be 1/14.8.
- (D) Anomaly created under SECURE
  - (I) Recall above that under the "lesser of" rule, a beneficiary's payout period is the lesser of the owner's or beneficiary's life expectancy at the time that the Inherited IRA begins.
  - (II) If the EDB's life expectancy is less than 10 years, it would be better to be treated as a Regular DB than to be treated as 10-Year Younger EDB because the payout would be longer.
- (d) EDB - Minor Children
  - (i) Minor children are EDB's (a "Minor Child EDB"), and can use the life expectancy method; however, when a Minor Child EDB attains majority, she/he must switch to the 10-Year Rule.
  - (ii) Under SECURE, a major open question was "what is majority?"
    - (A) Before the Proposed Regs, no one really knew.
      - (I) State law usually defines when a minor child reaches majority – for example, in Florida, this is age 18.
      - (II) However, under other areas of the regulations, "minor child" means age 26 if the child has not yet completed a specified course of education.
      - (III) Fortunately, this is no longer an issue.
    - (B) The Proposed Regs solve this problem by stating that "majority" equal age 21 (Prop. Reg. §1.401(a)(9)-5(e)(1), (3) and (4)).
- (e) EDB - Disabled and Chronically III
  - (i) EDB's include individuals who are defined as "Disabled" or "Chronically III."
  - (ii) Disabled Individuals – under Prop. Reg. § 1.401(a)(9)-4(e)(4)(iv), a "Disabled" individual is an individual who, as of the date of the participant's death:
    - (A) Is age 18 or older and is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental

impairment that can be expected to result in death or to be of long-continued and indefinite duration. Prop. Reg. § 1.401(a)(9)-4(e)(4)(ii)

- (B) Is under age 18 and has a medically determinable physical or mental impairment that results in marked and severe functional limitations and that can be expected to result in death or to be of long-continued and indefinite duration. Prop. Reg. § 1.401(a)(9)-4(e)(4)(iii)
  - (C) Has been determined by the Commissioner of Social Security has determined that, as of the date of the participant's death, an individual who is "disabled" within the meaning of 42 U.S.C. 1382c(a)(3).<sup>6</sup>
- (iii) "Chronically III" Individuals – under Prop. Reg. § 1.401(a)(9)-4(e)(5), a "Chronically III" person is an individual is "chronically ill" within the definition of §7702B(c)(2) and satisfies the documentation requirements of Prop. Reg. §1.401(a)(9)-4(e)(7).

(A) Definition in §7702B(c)(2):

(2) Chronically ill individual.

(A) In general. The term "chronically ill individual" means any individual who has been certified by a licensed health care practitioner as—

(i) being unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of at least 90 days due to a loss of functional capacity,

(ii) having a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described in clause (i), or

(iii) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

Such term shall not include any individual otherwise meeting the requirements of the preceding sentence unless within the preceding 12-month period a licensed health care practitioner has certified that such individual meets such requirements.

(B) Activities for daily living. For purposes of subparagraph (A), each of the following is an activity of daily living:

- (i) Eating.
- (ii) Toileting.
- (iii) Transferring.

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<sup>6</sup> The definition under 42 U.S.C. §1382c is extremely lengthy and is not very pertinent to this outline; the link to view such definition may be found at <https://www.law.cornell.edu/uscode/text/42/1382c>.

- (iv) Bathing.
- (v) Dressing.
- (vi) Continence.

A contract shall not be treated as a qualified long-term care insurance contract unless the determination of whether an individual is a chronically ill individual described in subparagraph (A)(i) takes into account at least 5 of such activities.

- (B) Prop. Reg. §1.401(a)(9)-4(e)(7) contains certain documentation requirements that are applicable to both Disabled and Chronically Ill individuals.
- (iv) Documentation Requirements – a individual is “Disabled” or “Chronically Ill” if they satisfy the documentary requirements under Prop. Reg. §1.401(a)(9)-4(e)(7).
  - (A) Certain documentation of the disability or chronic illness must be provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the participant's death.
  - (B) With respect to Chronically Ill persons, the documentation must include a certification from a licensed health care practitioner (as that term is defined in §7702B(c)(4)) that the individual is unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for an indefinite period which is reasonably expected to be lengthy in nature (and not merely for 90 days).
  - (v) Note that a beneficiary's status as disabled or chronically ill is determined as of the participant's death, meaning a later disability or development of a chronic illness would not allow the beneficiary to switch to the life expectancy method.
- (3) Death After Pay Status
  - (a) Introduction
    - (i) Initially, when SECURE was passed, it was believed by most practitioners that the payout rules were identical regardless of whether the participant died before or after the RBD.
    - (ii) Under the Proposed Regs, however, this is not the case! Rules are wildly different depending on the participant's status at the time of her/his death.
  - (b) Spouse as Beneficiary
    - (i) The surviving spouse of a participant who died before 2020 (i.e., before SECURE's effective date) can wait until the deceased participant would have reached age 72 before commencing required distributions as her/his beneficiary, IF the deceased spouse was born after June 30, 1949.
    - (ii) The surviving spouse must take RMD's under the “longer of” rule – this means that the RMD's are calculated based on the longer of the spouse's life

expectancy or the decedent’s life expectancy (or, as Natalie Choate refers to this, the “ghost life expectancy”). (Prop. Reg. §1.401(a)(9)-5(d)(1)(ii))

- (iii) Surviving spouse’s life expectancy is recalculated annually, but the ghost life expectancy is not. (Prop. Reg. §1.401(a)(9)-5(d)(1)(ii), (iv))

(c) Regular Designated Beneficiaries – “10-Year Limit”

- (i) When the participant dies in pay status, the 10-Year Rule still applies, but with a twist - a Regular DB must take RMD’s based on the longer of the beneficiary’s life expectancy or the ghost life expectancy for the first 10 years, with the balance distributable no later than the 10-Year Deadline. (Prop. Reg. §1.401(a)(9)-5(d)(1)(i))
- (ii) Wait...how can the “longer of” rule apply? Consider that if the “longer of” rule is the participant’s life expectancy, this would mean that the Regular DB would be older than the participant, and if that were the case, wouldn’t the Regular DB be a 10-Year Younger EDB?
- (iii) According to Natalie Choate, this presents some legislative tongue-twisting as it would appear that the 10-Year Rule is somehow working both with and in lieu of the “longer of” rule. This is how Treasury determined that two sets of rules can exist for a Regular DB depending on when the participant dies.
- (iv) Example 8
  - (A) Siegfried dies on 12/31/22 at age 78. Siegfried names his son, Tristan, age 48, as the sole beneficiary of his IRA which has a value at Siegfried’s death of \$1,000,000. Assume that Siegfried had already received his RMD for 2022.
  - (B) At the time of his death, Siegfried’s life expectancy was 12.6 years, and Tristan’s was 38.1. In determining Tristan’s payout as the sole beneficiary, the “longer of” rule would apply his life expectancy of 38.1 years.
  - (C) Tristan begins his RMD’s in 2023 based on his life expectancy, but must withdraw the entire balance by 12/31/32, which is the 10<sup>th</sup> year after the year of Siegfried’s death.

Age	Beginning Year	8% Annual	Pre-RMD	Life			Year End	
	Year	IRA Balance	Growth	Balance	Expectancy	Divisor	RMD	IRA Balance
48	2022				38.1			\$1,000,000.00
49	2023	\$1,000,000.00	\$80,000.00	\$1,080,000.00	37.1	0.0269542	\$26,954.18	\$1,053,045.82
50	2024	\$1,053,045.82	\$84,243.67	\$1,137,289.49	36.1	0.0277008	\$29,170.24	\$1,108,119.24
51	2025	\$1,108,119.24	\$88,649.54	\$1,196,768.78	35.1	0.0284900	\$31,570.35	\$1,165,198.43
52	2026	\$1,165,198.43	\$93,215.87	\$1,258,414.31	34.1	0.0293255	\$34,170.04	\$1,224,244.27
53	2027	\$1,224,244.27	\$97,939.54	\$1,322,183.81	33.1	0.0302115	\$36,986.23	\$1,285,197.58
54	2028	\$1,285,197.58	\$102,815.81	\$1,388,013.38	32.1	0.0311526	\$40,037.31	\$1,347,976.07
55	2029	\$1,347,976.07	\$107,838.09	\$1,455,814.16	31.1	0.0321543	\$43,343.28	\$1,412,470.88
56	2030	\$1,412,470.88	\$112,997.67	\$1,525,468.55	30.1	0.0332226	\$46,925.94	\$1,478,542.61
57	2031	\$1,478,542.61	\$118,283.41	\$1,596,826.01	29.1	0.0343643	\$50,809.02	\$1,546,016.99
58	2032	\$1,546,016.99	\$123,681.36	\$1,669,698.35		1.0000000	\$1,669,698.35	\$0.00

- (d) EDB – 10-Years Younger
  - (i) The treatment of the 10-Years Younger EDB is identical to that of a surviving spouse – the annual distributions are determined based on the “longer of” rule, meaning the longer of the 10-Years Younger EDB’s life expectancy or the ghost life expectancy rule.
  - (ii) Unlike a spouse who could be older than the participant, in which case the “longer of” rule could determine that the ghost life expectancy is used, it would seem that a beneficiary who is younger than the participant would always use the beneficiary’s life expectancy; however, the use of the term “10-Years Younger” is misleading.
    - (A) SECURE defined a “10-Years Younger EDB” as “an individual not described [in another category of EDB’s] who is not more than 10 years younger than the employee.” (§401(a)(9)(E)(II)(v).
    - (B) Note that under this definition, it is any individual *who is not more than 10 years younger than the employee* – in other words, there is no requirement that the individual must be younger than the participant.
    - (C) Therefore, if the beneficiary is *older* than the participant, the beneficiary would qualify as a 10-Year Younger EDB.
  - (iii) Example 9
    - (A) Assume the same facts as Example 8, but assume that Tristan is age 85 at the time of Siegfried’s death.
    - (B) Under the “longer of” rule, the denominator applicable under Table 1 at Siegfried’s death for Tristan’s life expectancy of age 85 is 8.1, and because the denominator for Siegfried’s “ghost” life expectancy is 12.6, Tristan’s RMD’s are based on Siegfried’s “ghost life expectancy.”
    - (C) Further, because Tristan’s life expectancy is being used, the 10-Year Limit will presumably not be reached because the entire account will be withdrawn by 2030/Year 8 and in which Tristan attains age 93, when the life expectancy factor will be reduced to 0.1 (and, if any portion of the account remains, it will definitely be withdrawn in 2031/Year 9.
- (e) EDB - Minor Children
  - (i) The provisions for payments to a Minor Child EDB are the same regardless of whether the participant was in pay status.
  - (ii) Therefore, just as when the participant dies prior to the RBD, the Minor Child EDB must take RMD’s, but can use the life expectancy method until the Minor Child EDB attains majority (now set as age 21), after which the payment switches to the 10-Year Rule.
  - (iii) Logic dictates that once the minor child attains 21, the 10-Year Rule payouts will be based on the child’s life expectancy in that it is somewhat inconceivable that the “longer of” rule would apply to use the participant’s life expectancy.

- (f) EDB - Disabled and Chronically Ill - same as with a minor child – the payout provisions are not dependent on the participant being in pay status as of her/his death.
- (4) IRA Distributable as Whole and Not Separated into Shares
- (a) Under the existing regulations, it appeared as if the beneficiaries could separate the IRA into separate shares by December 31 of the year after the year of the participant's death, but this just seemed related to how shares would be divided and did not emphasize whether each beneficiary could have her/his own calculated RMD.
  - (b) The Proposed Regs clarify that such treatment is possible – each beneficiary would have control over her/his own share as well as have the RMD paid pursuant to her/his classification.

### G. Death of the Designated Beneficiary

#### (1) Introduction

- (a) The person or entity entitled to the benefits after the death of the Designated Beneficiary is called the “Successor Beneficiary.”
- (b) Pre-SECURE, except as to a spousal rollover IRA, regardless of who is named as the Successor Beneficiary, there was no effect for income tax purposes because the payouts did not change.
- (c) SECURE and the Proposed Regs introduce significant changes to the payout provisions of an Inherited IRA.

#### (2) Successor Beneficiary's Payout Determined Pre-SECURE Act

- (a) If the beneficiary's payout began pre-SECURE Act, meaning that the payout was determined by using the beneficiary's life expectancy, the RMD does not change – once the RMD is determined as to the beneficiary, the RMD calculations remain regardless of how many deaths occur and Successor Beneficiaries are named.
- (b) Example 10
  - (i) Assume the same facts as Example 6, with the amount of the Inherited IRA passing to George Michael is \$1,000,000. In 2018, when George Michael takes his first RMD, he is 50 years old.
  - (ii) Under the Single Life Table, the divisor for RMD purposes is 34.2.
  - (iii) George Michael dies in 2027 when he is 60 years old, and leaves the Inherited IRA to his only child, Maeby, who is 15 years old.
  - (iv) Because the IRA is an Inherited IRA, the RMD is not recalculated based on Maeby's life expectancy, but rather is continued to be calculated based on George Michael's life expectancy. Therefore, the divisor for 2028 is not 66.9, which is the divisor for a 16 year old, but is 24.4, which is the divisor for a 61 year old (which would have been George Michael's age in 2028).

- (v) The same process repeats regardless of how many more Successor Beneficiary deaths occur – the calculation is always based on George Michael's life expectancy.
- (3) Successor Beneficiary's Payout Determined Under SECURE
- (a) Participant Died Before Pay Status
    - (i) Surviving Spouse - if the participant's IRA had been rolled over, then, upon the spouse's death, the rules are applied as if the spouse were the participant.
    - (ii) Regular Designated Beneficiary
      - (A) Recall that if the participant died prior to her/his RBD, the Regular DB was subject to the 10-Year Rule.
      - (B) Similar to the approach taken pre-SECURE as to maintaining the beneficiary's life expectancy for RMD's payable to the Successor Beneficiary, as to the balance of an Inherited IRA after the death of the Regular DB, the Successor Beneficiary not required to receive any amounts from the Inherited IRA; however, the Inherited IRA must be fully distributed by the Regular DB's 10-Year Deadline.
      - (C) Example 11
        - (I) Assume the same facts as Example 10, except Michael died on January 1, 2023.
        - (II) George Michael's Inherited IRA is subject to SECURE payouts, meaning that he must withdraw the entire balance by December 31, 2033, which is the last day of the year that contains the 10<sup>th</sup> anniversary of Michael's death (which is 2023).
        - (III) Upon George Michael's death, Maeby does not receive a new 10-Year Term; she must withdraw the balance pursuant to George Michael's 10-Year Term, or December 31, 2033.
    - (iii) EDB – 10-Years Younger or Disabled/Chronically Ill
      - (A) The treatment for the Successor Beneficiary to an Inherited IRA where the EDB was a 10-Years Younger EDB or a Disabled/Chronically Ill EDB are both subject to a modified 10-Year Rule, applied as to the EDB.
      - (B) Payments extend through December 31 of the 10<sup>th</sup> year after the EDB's death, at which point the entire Inherited IRA must be distributed to the Successor Beneficiary; the payments, however, continue to be based on the now-deceased EDB's life expectancy.
    - (iv) EDB – Minor Child
      - (A) If a Minor Child EDB dies prior to attaining majority, the Inherited IRA must be distributed by the end of the year that contains the 10<sup>th</sup> anniversary of the earlier of the Minor Child EDB's death or the Minor Child EDB's 21<sup>st</sup> birthday. (Prop. Reg. §1.401(a)(9)-5(e)(1), (3), (4))

- (B) The rule creates a modified 10-Year Rule, under which the Inherited IRA is fully distributed either by the date that it would have been fully distributed had the Minor Child EDB lived to the 10-Year Deadline, or within 10 years of the Minor Child EDB's death.
- (C) Example 12
  - (I) Abbi dies in 2023 and leaves names her daughter, Ilana, as the sole beneficiary of her IRA. At the time of Abbi's death, Ilana is 16 years old.
  - (II) Because Ilana is a minor, she is a Minor Child EDB and is required to withdraw an annual RMD based on her life expectancy; once she attains age 21, the 10-Year Rule applies.
  - (III) Upon Ilana's death, the Inherited IRA passes to her cousin, Bevers.
    - (01) Assume Ilana dies in 2026 when she was 19 years old. The RMD's payable to Bevers are based on Ilana's life expectancy and continue until 2036, which is the first to occur of the 10<sup>th</sup> year of Ilana's death or 10 years after Ilana attained age 21.
    - (02) If Ilana dies in 2029 when she was 22 years old, the RMD payable to Bevers only continues until 2038, which is the 10<sup>th</sup> year after Ilana had attained age 21.
- (b) Participant Died After Attaining Pay Status
  - (i) Surviving Spouse
    - (A) As with a spousal death before attaining pay status, if the spouse dies after RMD's have begun, the Successor Beneficiary rules are applied based on the spouse's death (meaning that the 10-Year Rule in each of the Regular DB and EDB circumstances applies as of the spouse's date of death).
    - (B) Generally, the deadline for full distribution of the Inherited IRA is the earliest to occur of the year that contains the 10<sup>th</sup> anniversary of the spouse's death or the final year of the spouse's ghost life expectancy.
  - (ii) Regular Designated Beneficiary - similar to approach by the pre-SECURE rules, if the Regular DB dies prior to the participant's 10-Year Deadline, the Inherited IRA must be withdrawn by the earlier of:
    - (A) The participant's 10-Year Deadline, or
    - (B) The end of the participant's ghost life expectancy.
  - (iii) EDB – 10-Years Younger or Disabled/Chronically Ill –the Inherited IRA must be withdrawn by the earliest to occur of:
    - (A) The end of the year that contains the 10<sup>th</sup> anniversary of the EDB's death;

- (B) The end of the EDB's life expectancy; or
- (C) The end of the participant's ghost life expectancy.
- (iv) EDB – Minor Child – the rules are the same regardless of whether the participant was in pay status - the Inherited IRA must be distributed by the earlier of:
  - (A) The end of the year that contains the 10<sup>th</sup> anniversary of the Minor Child EDB's death; or
  - (B) The end of the year that contains the 10<sup>th</sup> anniversary of the Minor Child EDB's 21<sup>st</sup> birthday.
  - (C) Example 8
    - (I) Assume the same facts as Example 7, except Michael died on January 1, 2021.
    - (II) George Michael's Inherited IRA is subject to the SECURE Act payouts, meaning that he must withdraw the entire balance by December 31, 2032, which is the last day of the 10<sup>th</sup> year after the year of Michael's death (which is 2021).
    - (III) Upon George Michael's death, Maebly does not receive a new 10-Year Term; she must withdraw the balance pursuant to George Michael's 10-Year Term, or December 31, 2032.
- (c) The identity of the Successor Beneficiary depends on the terms of the IRA Agreement.
  - (i) Most of the time, the Successor Beneficiary names his/her own beneficiaries.
  - (ii) Common fallacy: the successor beneficiary on the original beneficiary designation is the Successor Beneficiary. This is *incorrect* – unless specifically stated, the successor beneficiary on the original beneficiary designation only receives the account if the Designated Beneficiary predeceases the participant – in other words, the successor beneficiary speaks as of the death of the participant.
- (4) Charitable Beneficiaries
  - (a) Outright distributions to charity avoid income taxation on the distribution amount because the charity does not pay income tax, so its receipt of income in respect of a decedent is irrelevant.
  - (b) Distribution has to be either as a Separate Account or must be distributed to the charity no later than September 30 of the year following the year of death in order to prevent the IRA from suffering from a failure of the Designated Beneficiary rule.
  - (c) For individuals who are charitably inclined and want to benefit family members and descendants, the use of the IRA to pass to charity reduces the amount of IRD items that would pass to the family, thus allowing for a greater overall amount to pass to family members as the non-IRD items will not be subject to income tax on the distribution to family members.

### H. Changes Under the CARES Act

#### (1) Introduction

- (a) News Flash – the World is currently facing a global pandemic in the form of COVID-19.
- (b) News Flash #2 – despite reports to the contrary, the pandemic is not over.
- (c) In 2020, as part of the government-provided financial relief from the pandemic, the Coronavirus Aid, Relief, and Economic Security Act, or the “CARES Act,” was signed into law on March 27, 2020.
- (d) With respect to IRA’s, the CARES Act provided relief from the excise taxes regarding distributions and loans for taxpayers who had not yet attained the required beginning age.

#### (2) Key Provisions

##### (a) Coronavirus-Related Distributions

- (i) For certain distributions called “coronavirus-related distributions” (“CRD’s”), no penalties are assessed.
- (ii) CRD’s can occur at any time during 2020.
- (iii) Taxpayers are limited to \$100,000 in total CRD’s.

##### (b) RMD’s are waived for 2020.

##### (c) Loan limitations on qualified plans (beyond the scope of this outline) are modified to increase the threshold to the lesser of \$100,000 (up from \$50,000) or 100% of the present value of the retirement account.

### I. Roth IRA’s (§408A)

#### (1) Generally

- (a) Introduced in 1998, the Roth IRA allows for the elimination of income taxes on an IRA.
- (b) The trade-off is that, at the time of conversion from a traditional IRA, all income taxes must be paid up-front.
- (c) However, after the payment of income taxes, all distributions from the account – even as to the income and growth after the conversion – not tax deferred but tax free.

#### (2) Three ways to create a Roth:

- (a) Non-deductible contributions.
- (b) Conversion of a traditional IRA.
- (c) Rollover from another Roth account.

#### (3) Contributions to a Roth (§408A(c))

- (a) There are two types of contributions that can be made to a Roth IRA:
  - (i) Regular contributions, and
  - (ii) Qualified rollover contributions.
- (b) Regular Contributions
  - (i) The maximum aggregate amount that an individual may contribute to the individual's Roth IRA's as a regular contribution for a taxable year is the maximum contribution amount or, if less, that individual's compensation (as defined below) for the year.
  - (ii) This contribution limit is the same as applies to regular IRA's, meaning that for 2017, the maximum contribution amount \$5,500, if under age 50, and \$6,500, if over age 50.
  - (iii) As with regular IRA's, individuals who have reached age 50 may make additional catch-up contributions, with the maximum contribution amount for an individual who has attained age 50 before the end of the taxable year is increased by \$1,000.
  - (iv) Also as with regular IRA's, a married individual filing a joint return may make an IRA contribution by treating his/her spouse's higher compensation as his/her own, but only to the extent that the spouse's compensation is not being used for purposes of the spouse's making a contribution to a Roth IRA or a deductible or non-deductible contribution to a regular IRA.
  - (v) Phase Outs
    - (A) The maximum contribution limit (determined without regard to any reduction for regular IRA contributions) is phased out between certain levels of modified "adjusted gross income" ("AGI").
    - (B) 2022 Phase Outs
      - (I) For an individual who is not married, the phase out is between modified AGI of \$129,000 and \$144,000
      - (II) For a married individual filing a joint return, the phase out is between modified AGI of \$204,000 and \$214,000.
      - (III) For a married individual filing separately, the phase out is between modified AGI of \$0 and \$10,000.
  - (vi) A significant difference between Roth IRA's and regular IRA's is that contributions may continue to be made to a Roth IRA after the individual for whom the account is maintained has reached age 72.
- (4) Conversions to a Roth
  - (a) Regular IRA's may be converted; an Inherited IRA may not be converted.
  - (b) When Roth's were first enacted, there were modified AGI and filing status thresholds for conversion; these were eliminated as of 2010.

- (c) Tax Consequences
  - (i) A plan or IRA balance that is converted into a Roth IRA is includible in taxable income as if it had been distributed by the plan or traditional IRA that formerly held it.
  - (ii) If the transaction spans taxable years (e.g., a traditional IRA makes a distribution in December that is rolled into a Roth IRA in the following January), the income is taxed in the earlier year.
- (5) Roth's and RMD Rules
  - (a) During the lifetime of the account owner, there is no RBD and thus no RMD requirements. A participant is never required to make a distribution from a Roth account.
  - (b) Death of Roth Owner
    - (i) Once death occurs, however, the RMD rules apply as to the Designated Beneficiary.
    - (ii) RMD rules are applied under the approach that the Roth owner died prior to his/her RBD. (Treas. Reg. §1.408A-6, A-14)
  - (c) Distributions from a Roth are not applied to fulfill a distribution requirement from a traditional IRA; likewise, a Roth conversion is not applied to fulfill a distribution requirement because the conversion is considered to be a rollover.
- (6) Qualified Distributions (§408A(d)(1))
  - (a) Only distributions that are “qualified distributions” are not subject to income taxes.
  - (b) “Qualified Distributions” are defined as:
    - (i) Made after the “5-Year Period” (as opposed to the 5-Year Rule); and
    - (ii) Is made:
      - (A) On or after the date of the participant’s attaining age 59 ½;
      - (B) After the participant’s death; or
      - (C) Is attributable to the participant’s being totally disabled.
    - (iii) Any distribution that is not a Qualified Distribution is a “Non-Qualified Distribution.”
  - (c) 5-Year Period (§408A(d)(2)(B); Treas. Reg. §1.408A-6, A-2)
    - (i) The 5-Year Period begins on January 1 of the first year for which a contribution was made to any Roth IRA maintained for that participant.
    - (ii) The 5-Year Period only occurs once, so that subsequent contributions do not generate a new 5-Year Period.

- (7) Non-Qualified Distributions
  - (a) A “Non-Qualified Distribution” still receives favorable tax treatment as compared with distributions from a traditional IRA.
  - (b) Roth IRA’s consist of two sources of funds – the participant’s contributions, which are already taxed as they are post-tax contributions, and the growth in excess of the contributions.
  - (c) The contributions are considered to be the “basis” in the Roth IRA.
  - (d) The general rule is that Non-Qualified Distributions are deemed to consist first from contributions, i.e., basis, which means that, even during the 5 Year Period, tax-free distributions can be made from a Roth.
  - (e) Contrast this treatment with traditional IRA’s that contain basis, whereby distributions are deemed to come proportionately between basis and the rest of the account.
- (8) Distribution Ordering Rules (§408A(d)(4)(B), Treas. Reg. §1.408A-6, A-9)
  - (a) First, distributions come from participant’s contributions.
  - (b) Second, if the participant has made both regular contributions and rollover contributions, the distributions come first from regular contributions.
  - (c) Third, if a distribution is deemed to come from rollover contributions, the rollover contributions are exhausted on a first in, first out methodology.
  - (d) Fourth, within a particular rollover contribution, the dollars that were includible in gross income by virtue of the rollover are exhausted first.
  - (e) Fifth, distributions come from earnings.

### J. What Almost Happened – 2021’s Build Back Better Act

- (1) Introduction
  - (a) On or about September 13, 2021, On September 13, 2021, House Ways & Means Committee Chairman Richard E. Neal (D-MA) released the initial legislative text and a summary of the proposed “Build Back Better Act” (the “BBB Proposal”).
  - (b) On September 15, 2021, the Committee approved its sections of the BBB Proposal that mostly addressed social issues and plans to pay for them with tax increases. The BBB Proposal contains provisions that, presumably, seek to increase taxes on the higher income and high net worth taxpayers.
- (2) Key IRA Provisions within the BBB Proposals
  - (a) Introduction
    - (i) Most of the following changes, if enacted, would be effective January 1, 2022.
    - (ii) Many of the limitations apply to “High Income Taxpayers,” which would be defined as individuals with income over \$400,000, married couples filing jointly with income over \$450,000 and heads of households with income over \$425,000.

- (b) Prohibition of Contributions to Excess Value IRA's - IRA contributions would be prohibited if the value at the end of the prior year of all of the taxpayer's IRA's exceeds the "applicable dollar amount" (which is \$10 million, adjusted for inflation starting in 2023, rounded to nearest \$250,000).
- (c) Excess Value RMD
  - (i) For High Income Taxpayers, if the individual's combined IRA value exceeds \$10 million (adjusted for inflation) at the end of the prior year, then, regardless of the individual's age, a RMD in the following year is made of an amount equal to the excess, if any, of:
    - (A) The sum of:
      - (I) 100% of the "applicable Roth excess amount" (defined below),  
Plus
      - (II) 50% of the "excess aggregate vested retirement plan balance" reduced, but not below zero, by the applicable Roth excess amount,  
  
Less
    - (B) The sum of RMD's (determined without this formula) for all such plans.
  - (ii) For all intents and purposes, this rule is basically 50% of the value by with the sum of all IRA's exceed \$10 million (adjusted for inflation).
  - (iii) The applicable Roth excess amount applies to a taxpayer for a taxable year if the aggregate vested balances to the credit of the taxpayer (whether as a participant, owner or beneficiary) in all applicable retirement plans (determined as of the close of the calendar year preceding the calendar year to which the taxable year begins) exceeds 200 percent of the applicable dollar amount for the calendar year in which the taxable year begins (or \$20,000,000, adjusted for inflation). The applicable Roth excess amount for any taxable year to which this provision applies is an amount equal to the lesser of (1) the excess as determined in the prior sentence, or (2) the aggregate balances to the credit of the taxpayer (whether as a participant, owner or beneficiary) in all Roth IRA's and Roth designated accounts.
  - (iv) Such distributions are excepted from the 10% excise tax on early distributions.
  - (v) Distributions are treated as a non-periodic distribution and subject to 35% withholding.
- (d) No Roth Conversions for High Income Taxpayers - High Income Taxpayers would be prohibited from converting a traditional IRA to a Roth IRA.
- (e) Limitation on IRA Investments – for certain IRA's, non-traditional investments or investments in which the owner has an interest of 10% or more would be prohibited.

K. Trusts as Beneficiaries

- (1) Introduction

- (a) In Example 1, the danger of poor planning for the IRA meant that Bojack’s children received full access to the funds upon attaining age 21. Given the family dynamics, the better plan would have been to have the IRA distributions from a child’s share paid to a trust for the benefit of the child.
  - (b) Additional rules apply when an IRA is left to a trust, and the practitioner must be aware of these rules, as well as the payment options for distributions.
  - (c) Furthermore, problems existed because the IRA regulations did not expand on many particulars of whether trusts could hold an IRA and, more particularly, how to designate a trust as a beneficiary without imposing quicker payouts.
- (2) Accounting Principles
- (a) Goes without saying – taxable income is NOT fiduciary accounting income.
  - (b) Often, no attempt is made to distinguish between principal and income in an IRA because, tax-wise, all income taxes are deferred and, distribution-wise, distributions are driven by the RMD and not income vs. principal.
  - (c) Pre-2019: Uniform Principal and Income Act - §409(c)
    - (i) If an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction.
    - (ii) To the extent that a payment is required to be made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset.
  - (d) Ore. Rev. Stat. §129.355
    - (i) Oregon adopted the UPAIA in 2008 as Chapter 129 of the Oregon Revised Statutes.
    - (ii) Ore. Rev. Stat. §129.355 was modeled after the uniform statute with the “10% Rule.”
  - (e) Florida Begg to Differ
    - (i) Upon adoption of the UPAIA, Florida adhered to the standard provisions of UPAIA §409 as codified in Fla. Stat. §738.602.
    - (ii) In 2009, however, the Florida legislature adopted revisions to Fla. Stat. §738.602 to remove the 10% Rule in favor of one of two methods for determining income already present under the principal and income act – traditional methods of income and principal allocation, or the unitrust methodology adopted by Fla. Stat. §738.1041.
    - (iii) Florida estate planning attorneys from the Real Property Probate & Trust Law Section were concerned that, under the Uniform Act approach, the potential

existed that a QTIP trust might lose its qualified status if it were funded with a retirement account because the 10% Rule could be deemed to be arbitrary; this was, in fact, the position advocated by the Internal Revenue Service in Revenue Ruling 2006-26.

- (A) In the Revenue Ruling, the IRS indicated that the 10% was not based on total return of the IRA so the allocation does not reflect a reasonable apportionment.
  - (B) Further, the 10% is not income with regard to the UPAIA §104 “power to adjust.”
  - (C) In the Ruling, it was indicated that a provision giving the spouse the power to compel the withdrawal by the Trustee of the greater of the RMD or the IRA income.
- (iv) Furthermore, in more modern accounting methods, electronic accounting is more sophisticated in terms of accounting for principal and income, thereby allowing the Trustee to more accurately determine what is income and what is principal.
- (f) 2018 – A New Principal and Income Act
- (i) In 2016, the National Conference of Commissioners for Uniform State Laws convened a new committee to revise the Uniform Principal and Income Act; the final version, adopted on July 26, 2018, changed the name of the Act to “Uniform Fiduciary Income and Principal Act” (the “2018 Act”).
  - (ii) The 2018 Act further revises and simplifies Section 409. Former general subsections (b) and (c) are omitted, leaving marital trusts as the focus. The 2018 Act treats marital trusts and other trusts the same, except as provided in subsection (e).
  - (iii) Under the 2018 Act, an entirely new Section 409(b) is adopted – NO MORE 10%% RULE!!! Now relies on the actual income and principal of the account.
  - (iv) Section 409(b):
    - “(b) For each accounting period, the following rules apply to a separate fund:
      - (1) The fiduciary shall determine the internal income of the separate fund as if the separate fund were a trust subject to this [act].
      - (2) If the fiduciary cannot determine the internal income of the separate fund under paragraph (1), the internal income of the separate fund is deemed to equal [insert a number at least three and not more than five] percent of the value of the separate fund, according to the most recent statement of value preceding the beginning of the accounting period.
      - (3) If the fiduciary cannot determine the value of the separate fund under paragraph (2), the value of the separate fund is deemed to equal the present value of the expected future payments, as determined under Section 7520 of the Internal Revenue Code of 1986[, as amended,] 26 U.S.C.

Section 7520[, as amended], for the month preceding the beginning of the accounting period for which the computation is made.”

- (v) New Section 409(d) focuses solely on marital trusts, and reaches the same result as former (f) in order to satisfy the concerns of Revenue Ruling 2006-26, but clarifies the ordering and interrelationships of the respective provisions. Subsection (d) prescribes what the fiduciary is required to do if the settlor's surviving spouse requests an income allocation and does not limit the fiduciary's discretion to make withdrawals from the separate fund in excess of what the spouse requests or in excess of the internal income of the fund.
  - (vi) New Section 409(e) provides that a trust that is not a marital trust but is required to distribute current income, the fiduciary must transfer principal to income to make up for the amount of the internal income of an IRA or similar fund that is not withdrawn. But the section is silent on whether the fiduciary should withdraw greater amounts from the fund, leaving that to the fiduciary's discretion guided by general fiduciary standards such as the standards set forth in Section 201(a) of the 2018 Act.
- (3) Type of Trust Matters – “See-Through” vs. “Non-See-Through”
- (a) The rules regarding the elements of a trust named as the beneficiary of an IRA will govern the payout period.
  - (b) If retirement benefits are left to a “see-through” trust (a “See-Through Trust”), the benefits can be distributed in accordance with the Designated Beneficiary rules described above, just as if the IRA had been distributed to an individual and not a trust.
  - (c) If the beneficiary trust is not a See-Through Trust, then the IRA is treated as if there is no Designated Beneficiary, meaning:
    - (i) If the participant was not in pay status: the 5-Year Rule applies, even under the SECURE Act.
    - (ii) If the participant was in pay status: payments continue based on the participant's life expectancy.
  - (d) The See-Through Trust Defined
    - (i) The reason for the name See-Through Trust is that, if the trust satisfies certain requirements, the IRS will look through the trust and treat the trust beneficiaries as the participant's Designated Beneficiaries just as if they had been named directly as the Designated Beneficiaries.
    - (ii) For a trust to be considered to be a See-Through Trust, 5 rules must be satisfied:
      - (A) The trust must be valid under state law.
      - (B) The trust must be irrevocable or become irrevocable upon the death of the participant (thus allowing a revocable trust to be named as the beneficiary of an IRA).
      - (C) The beneficiaries must be identifiable from the trust instrument.

- (D) Certain documentation must be provided to the plan administrator.
- (E) All trust beneficiaries must be individuals.
- (iii) Valid under State Law
  - (A) This seems like an easy rule to satisfy, considering that there is no written guidance giving an example of a trust that would flunk the test.
  - (B) Under Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Ex. 1 and 2, a testamentary trust passes the test even though, upon the naming of the beneficiary, it does not exist. This makes sense because there is no requirement that the trust be “in existence” at the time that the designation is created.
- (iv) Must be Irrevocable
  - (A) A statement that the trust is irrevocable is helpful, but not required.
  - (B) Under PLR 200537044, a post-death power granted to a trust protector to amend certain administrative provisions was not held to affect the trust’s status as “irrevocable.”
- (v) Beneficiaries Must be Identifiable
  - (A) Treas. Reg. §1.401(a)(9)-4, A-1 generally provides that the members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. Ordinarily this means the oldest trust beneficiary, but, at the time of determination, but keep in mind that, in determining this, it is done by year, so it would be possible to appoint to someone born in the same year but who technically would be older. See PLR 200235038.
  - (B) If the trust beneficiaries are “all my issue living from time to time,” then the members of the class of potential beneficiaries is identifiable even though that the class is not closed because by definition, there is already in existence the oldest member of the class.
  - (C) What about adoption or the takers under a power of appointment? Good point – the regulation does not address this. The solution is a drafting solution (described below).
  - (D) Even if the test is flunked at the date of death, disclaimers can resolve the issue. PLR 200438044.
- (vi) Documentation Required
  - (A) The Trustee must supply the plan administrator with certain documentation by September 30 of the calendar year following the calendar year of the participant’s death.
  - (B) Specifically, this information includes:

- (I) The list of beneficiaries of the trust, including contingent and remainder beneficiaries with a description of the conditions on their entitlement.
  - (II) Copy of the trust instrument or an agreement to provide a copy upon request.
- (vii) All Beneficiaries Must be Individuals
- (A) An estate is not an individual.
  - (B) What if taxes are apportioned against the IRA; does this categorize the estate as a beneficiary? In many PLRs, the trustee was able to withdraw and segregate prior to September 30 of the year following the year of death all amounts needed to pay debts and taxes; the only requirement is that there be individuals as beneficiaries as of said September 30.
- (e) See-Through Trusts – Conduit vs. Accumulation
- (i) Introduction
    - (A) When a trust is named as the beneficiary of an IRA, the trust usually takes one of two forms – a “conduit” trust or an “accumulation” trust.
    - (B) A “conduit” trust (“Conduit Trust”) is defined as a trust where all distributions will, upon receipt by the trustee, be paid directly to, or for the benefit of, specified beneficiaries. (Prop. Reg. §1.401(a)(9)-4(f)(ii)(A))
    - (C) An “accumulation” trust (“Accumulation Trust”) pays the RMD to the trustee, who thereafter must pay out the trust fiduciary accounting income to a beneficiary or beneficiaries or can exercise discretion with respect to distributions, thereby accumulating the undistributed balance; in other words, an Accumulation Trust is defined as any see-through trust that is not a Conduit Trust. (Prop. Reg. §1.401(a)(9)-4(f)(1)(ii)(B))
    - (D) The use of Accumulation Trusts was troublesome because these are not defined in the Code or the regulations, so their use was based on logic and interpretation; fortunately, with the Proposed Regs, the term “Accumulation Trust” has become a legal term and the use is authorized.
  - (ii) Conduit Trust
    - (A) A Conduit Trust beneficiary is in the same position as if he/she had been named directly as the Designated Beneficiary.
    - (B) The primary difference is that the individual beneficiary receives the RMD; he/she cannot force a distribution of funds in excess of the RMD.
    - (C) The Conduit Trust approach is popular for this reason – given that the trust’s distribution provisions are based on the RMD rules, if the beneficiary lives out the applicable payout period, he/she will have received the complete IRA. Therefore, certain rules, such as beneficiary ages, are disregarded and the only “beneficiary” for RMD purposes is the current beneficiary.

- (D) The Conduit Trust lessens the trustee's control over the main asset in the trust because the RMD can only be paid in intervals over the beneficiary's lifetime.
- (iii) Accumulation Trust
  - (A) With the Accumulation Trust, the trustee receives the RMD, but is not required to pay it to the beneficiary.
  - (B) Regular trust accounting rules apply – as the IRA is an asset of the trust, the payment of the RMD is not a distribution for fiduciary accounting purposes; further, income generated from the IRA is attributed to the trust.
- (4) Proposed Regs Provide Clarity for Trusts and RMD's
  - (a) Beneficiary Age Now Irrelevant
    - (i) Pre-SECURE, the objective was always to attempt to use the longest life expectancy for payments to a trust; attention had to be given to remainder beneficiaries as well as permissible takers under a power of appointment.
      - (A) For this reason, many practitioners preferred a Conduit Trust because only the income beneficiary was considered for RMD purposes; all others were disregarded.
      - (B) For those who preferred Accumulation Trusts, much care and caution had to be given.
        - (I) Often it was suggested that if a taker under a power of appointment was a charity or an entity, this would cause the trust to have a Non-DB and therefore subject it to the 5-Year Rule.
        - (II) Likewise, an older remainder beneficiary would cause the RMD to be based on such older remainder beneficiary's life expectancy.
        - (III) Further, it was believed that a non-individual named as a remote beneficiary could be enough to cause the trust to have a Non-DB.
    - (ii) Pursuant to the Proposed Regs, the RMD trust rules no longer include a provision that RMD's are based on the beneficiary with the shortest life expectancy. (Prop. Reg. §1.401(a)(9)-4(f)(ii)(A)) This makes sense since lifetime payouts are eliminated in favor of the 10-Year Rule.
  - (b) Certain Persons Not Considered in Beneficiary Determination
    - (i) Under the pre-SECURE rules, Treas. Reg. §1.401(a)(9)-5, A-7(c)(1) had provided that a beneficiary was a "mere potential successor" to another beneficiary would be ignored, but no clarification was given, and, as such, practitioners were always concerned that such a beneficiary, such as a contingent remainder beneficiary or a taker under a power of appointment, could skew the RMD determination.
    - (ii) The Proposed Regs now provide what Natalie Choate refers to as a "three tier system" for beneficiary determination:

- (A) First Tier – beneficiaries who are entitled to receive distributions upon the participant’s death (think “first line qualified beneficiaries” in Uniform Trust Code jurisdictions).
  - (B) Second Tier – those who could receive amounts if not distributed to the First-Tier beneficiaries; in other words, the presumptive remainder beneficiaries or the “third line qualified beneficiaries” in UTC jurisdictions.
    - (I) Never counted in Conduit Trusts.
    - (II) Always counted in Accumulation Trusts with one exception (described below).
  - (C) Third Tier – those who could receive amounts if not distributed to Second Tier beneficiaries; in other words, the remote contingent beneficiaries of a trust.
    - (I) Third Tier beneficiaries are always disregarded unless they are also Second Tier beneficiaries.
    - (II) Example 13
      - (01) Jay provides that his IRA passes to a testamentary trust for the benefit of his daughter, Claire. The trust provides that discretionary income and principal is payable to Claire for her lifetime. Upon Claire’s death, the remainder passes to her descendants, per stirpes, or, in default thereof, to her brother, Mitchell, per stirpes.
      - (02) Upon Jay’s death, Jay is survived by his daughter, Claire, her three children, Hailey, Alex and Luke, his son, Mitchell, and Mitchell’s daughter, Lily. Claire is the First Tier beneficiary and Hailey, Alex and Luke are the Second Tier beneficiaries.
      - (03) If, upon Jay’s death, Claire is not survived by any children, Claire is the First Tier beneficiary and Mitchell is a Second Tier beneficiary.
- (iii) In addition to generally disregarding Third Tier beneficiaries, this also means that takers under the exercise of a power of appointment are disregarded.
  - (iv) A special rule was created for any trust where there is an outright distribution of the entire trust to the beneficiary by age 31 – if this occurs, then all other beneficiaries of the trust can be disregarded, including Second Tier beneficiaries.
- (c) Multiple Trust Beneficiaries
    - (i) As described above, a difficult issue was when, for RMD purposes, the trust has multiple beneficiaries in determining the life expectancy as well as how this would coincide with complying with the other rules regarding leaving an IRA to a trust, such as whether this was allowed for a Conduit Trust.

- (ii) As for the Conduit Trust, the Proposed Regs specially authorize trusts for several beneficiaries.
  - (iii) If all of the trust's beneficiaries are EDB's, much like the old rules with all DB's, the oldest EDB's life expectancy will be used in determining the payouts. (Prop. Reg. §1.401(a)(9)-4(f)(6)(ii))
  - (iv) What if one of the beneficiaries is an EDB?
    - (A) Generally, if there are multiple DB's and at least one is an EDB, the special rules for EDB's is disregarded. (Prop. Reg. §1.401(a)(9)-4(e)(2))
    - (B) Primary Exception: if the EDB is a Minor Child EDB, then the trust's RMD is based on the oldest Minor Child EDB and NOT the oldest trust beneficiary; therefore, the deadline under the trust would be 10 years after the oldest Minor Child EDB attains 21 or dies.
    - (C) This rule supersedes the normal rule as to the other DB's.
- (5) Beneficiary Designations
- (a) Introduction
    - (i) Before SECURE, in order to name a trust as a beneficiary, usually a separate rider would be needed for the beneficiary designation.
      - (A) If the designation named "the revocable trust," then ALL beneficiaries of the revocable trust would be taken into consideration, regardless of whether the trust separated out into separate shares.
      - (B) Thus, in order to guarantee that the IRA would be divided into separate shares and allow each beneficiary to use her/his life expectancy for the RMD calculation, the designation would have to do the splitting into separate shares and then designate the particular trust under the revocable trust as the recipient.
      - (C) It is nearly impossible to do the division and payment instructions on the investment/brokerage firm's Beneficiary Designation form, so this usually necessitates the drafting of a "rider" that contains the requisite instructions (the "Rider").
      - (D) Considering the lengthy Riders that this would necessitate, many investment and brokerage firms tend to reject the language in the Rider, which leads to countless hours of negotiating in order to have the language approved.
      - (E) Some, like Fidelity, will not permit Riders whatsoever.
    - (ii) SECURE – Could we now just name the Revocable Trust?
      - (A) Under SECURE, the advantage of using a young person's life expectancy is no longer applicable thanks to the 10-Year Rule; therefore, would naming the Revocable Trust work instead of the Rider approach?

- (B) When SECURE was passed, this was a distinct possibility since the rules were the same regardless of whether the participant was in pay status at her/his death; the only catch was determining whether there were any Non-DB's under the revocable trust.
  - (C) With the release of the Proposed Regs, it is relatively clear that, in most instances, the “general” designation of the revocable trust does not work and is not advantageous.
    - (I) Does this really matter? If all of the beneficiaries are DB's and none are EDB's, then maybe not.
    - (II) However, if there is an EDB who is to receive a separate share, the EDB may not be able to have her/his share payable under the special provisions for EDB's.
  - (D) Could this change before the Proposed Regs become final? Hopefully they will – if the Service is seeking simplification, avoiding the Rider route is perhaps the easiest way for accounts to pass.
- (iii) Drafting the Beneficiary Designation Rider
- (A) The Rider should consist of three parts – the division, the distribution and the “hold harmless” provisions.
  - (B) Division
    - (I) The Rider should clearly divide the IRA into shares for the beneficiaries.
    - (II) Example:

“II. Contingent Beneficiaries if My Spouse Predeceases Me

If my spouse predeceases me, my interest in the Plan shall be divided into as many equal shares as may be necessary to provide one for each of my children, [CHILD 1] (d/o/b [Child 1's DOB]; SSN: [Child 1's SSN]), [CHILD 2] (d/o/b [Child 2's DOB]; SSN: [Child 2's SSN]) and [CHILD 3] (d/o/b [Child 3's DOB]; SSN: [Child 3's SSN]), who survives me, and one for each of them who predeceases me but who leaves one or more descendants who survive me (each share for a child of mine who predeceases me is to be divided into further shares, per stirpes, among his/her descendants), and each share shall be disposed of as provided in Section III of this Designation.
  - (C) Distribution
    - (I) The Rider should then direct the shares be added to the trust created for the beneficiary under the revocable trust or will.
    - (II) The Rider should also direct that payments are to be made in accordance with §401(a)(9).

(III) Finally, if no separate trust is created because no other assets pass under the revocable trust, the Rider should nevertheless direct that a trust be created.

(IV) Example:

“III. Disposition of Shares

Any share set aside for a particular descendant of mine shall be added to the separate "Descendants Trust" of which said descendant is the "Primary Beneficiary" under Section [REDACTED] of the [CLIENT] REVOCABLE TRUST dated [Trust Date], between me, as Settlor, and me, as Trustee, as amended or restated from time to time (the "Revocable Trust").

The Custodian shall pay the proceeds of such share, (a) as directed by the Trustee in accordance with the provisions of §401(a)(9) of the Code, or, (b) if the beneficiary under such trust is an "Eligible Designated Beneficiary" (as defined in §401(a)(9) of the Code), in installments equal to the minimum amount that is required to be distributed pursuant to the provisions for Eligible Designated Beneficiaries under §401(a)(9) of the Code. In addition, the Trustee of said trust shall have the right at any time to withdraw any part or all of such share.

Notwithstanding the foregoing paragraph of this Section III, if, notwithstanding the Descendants Trust Provisions of Section [REDACTED] of the Revocable Trust, a separate Descendants Trust is not created for a particular descendant of mine, then the share set aside for said descendant shall instead be held in trust pursuant to the Descendants Trust Provisions of the Revocable Trust, which are hereby incorporated by reference, and under which the Trustee designated to act as the Trustee of said Descendants Trust shall act as the Trustee of said trust.”

(D) Hold Harmless

(I) The Rider should contain language that absolves the custodian from any independent actions and direct the custodian to only take directions from the Trustee.

(II) Example:

“IV. Other Provisions

The Plan custodian shall have no responsibility other than to act upon the written request of the Trustee, provided that the request is not inconsistent with the provisions of the Plan agreement or of applicable law. The Trustee shall be solely responsible for the further disposition of any payment made in accordance with the terms of this Designation. The Plan custodian shall have no duty to perform actions other than those specified in the Plan agreement. In the event of a conflict between this Beneficiary Designation and the Plan agreement, the Plan agreement shall prevail.

For all purposes of this Beneficiary Designation, “Code” shall refer to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.”

(6) Trust Provisions and Potential Modifications

(a) Trust Provisions

- (i) As stated above, the RMD must be distributed through the trust and to the beneficiary.
- (ii) Draft language within the trust regarding the possibility that an IRA could become part of the trust, such as the following:

“(a) Generally. If, (1) any Retirement Plan assets are payable to any trust under this Agreement and (2) required distributions under section 401(a)(9) of the Code are, or could be, based on the life expectancy of an “Eligible Designated Beneficiary” (as defined in section 401(a)(9)(E)(ii)) of such trust who is then eligible to receive income but such method of distribution, as applicable, will be permitted under the minimum distribution rules only if the Trustee is required to distribute promptly to beneficiaries all amounts withdrawn from such Retirement Plan, the Trustee shall distribute promptly to such beneficiary of such trust any and all amounts withdrawn from such Retirement Plan during the lifetime of such beneficiary whose life expectancy is used to determine the required distributions. Such amounts shall be distributed to such beneficiary in such proportions as the Trustee determines, subject to the limitations in Section 4.2 and taking into consideration my directions regarding discretionary distributions as provided below. If the amount withdrawn from a Retirement Plan exceeds the amount distributable under the limitations of Section 4.2, then the Independent Trustee shall distribute such excess amount to the beneficiary of such trust.”

(b) The trust has some bad provisions – can they be modified in order to maximize the usage of an IRA in trust?

- (i) The Proposed Regs seemingly adopt language that would permit modifications to a trust so long as occur on or before the date that beneficiaries must be finalized, i.e., September 30 of the year after the year of the participant's death. (Prop. Reg. §1.401(a)(9)-4(f)(5)(iii)(A))
- (ii) Assuming that modifications are possible, what if the governing instrument already provides for an Accumulation Trust for the beneficiary and it may be better to have the IRA share paid to a Conduit Trust, or vice-versa? Add a clause to allow the Trust Protector to modify the language accordingly:

“(b) Payable to Trust. In addition, if Retirement Plan assets are payable to any trust under this Agreement, then the Trust Advisor may, in its discretion, amend this Agreement to structure or restructure the provisions of such trust to enable qualifications so that such trust would be considered a so-called “conduit trust” or an “accumulation trust.” In exercising its discretion, the Trust Advisor, may, but is not required to, consider the following non-exclusive list of factors, which include: the income tax implications, estate, gift and GST tax implications, asset protection implications, and retention of assets for the benefit of the beneficiaries consistent with the desires under this Agreement.”

- (c) Savings Provision – what if the trust has a Non-DB as a beneficiary? Add provisions to the trust that negate Non-DB's.
  - (i) Prevent estate taxes from being paid from the IRA.
    - (A) Model Language: “Notwithstanding any provision herein to the contrary, after September 30 of the year after my death, no benefits from any Retirement Plan may be used or applied for the payment of any debts, taxes or other claims against my estate as provided for hereunder.”
    - (B) The purpose of this sentence is to proactively negate the use of the IRA for any purpose other than distribution to beneficiaries and to prevent any portion from having a “non-individual” as the beneficiary.
    - (C) Key language is “after September 30” – this allows for debts, expenses and taxes to be used up to the critical September 30 date.
  - (ii) Prevent other Non-DB's:
    - (A) Model Language: “Notwithstanding any provision herein to the contrary, if any beneficiary (vested or remote) of such trust is a non-individual, such non-individual shall cease to be a beneficiary of any portion of such trust as is the beneficiary of any benefits from said IRA.”
    - (B) This provision negates any effect that the remote beneficiary provision could have; for example, if one of the remote beneficiaries is a non-individual, so long as the IRA is part of such trust, the non-individual would no longer be a remote beneficiary. Note that the way in which this provision is drafted would allow the non-individual to remain as a beneficiary if trust is severed so that one portion only contains the IRA.
- (d) Decanting
  - (i) What if the trust is later decanted? You want to be certain that the new trust will not contain any prohibitive provisions that would disqualify the trust as a DB.
  - (ii) Under the Proposed Regs, decanting should be authorized as a modification.
  - (iii) Model Language: In addition, if the Trustee distributes the principal of a particular trust (the “First Trust”) to another trust (the “Second Trust”) for the benefit of one or more of the beneficiaries of the First Trust, the provisions of the Second Trust must contain the same restrictions as provided in this Section XX.
- (7) Designations, Modifications, Reformations – Is It Really Worth It?
  - (a) From what is described above, extra care and caution must be given with respect to planning for an IRA to pass to a see-through trust, especially with an accumulation trust. The real question is whether it is really worth it?
  - (b) Example 14
    - (i) Same facts as Example 8, but assume that the RMD is paid to an Accumulation Trust for Tristan's benefit.

- (A) Upon Tristan’s death, the balance of his Accumulation Trust would be paid one-half to his descendants and one-half to a qualified charity.
  - (B) The Accumulation Trust does not prevent Siegfried’s debts from being paid from it after September 30 of the year after the year of Siegfried’s death, so the Accumulation Trust is reformed to provide a September 30 limitation.
  - (C) Tristan does not need to expend any amounts from the IRA, so the Trustee of Tristan’s Accumulation Trust deposits the RMD’s into a taxable brokerage account that, like the IRA, grows at an annual 8%.
  - (D) The marginal income tax rate for all taxing authorities (i.e., Federal and State) is 30%.
- (ii) By the 10-Year Deadline, the trust’s brokerage account holds \$1,511,247.50.
- (A) IRA Summary:

Age	Year	Beginning Year IRA Balance	8% Annual Growth	Pre-RMD Balance	Life Expectancy	Divisor	RMD	Year End IRA Balance
48	2022				38.1			\$1,000,000.00
49	2023	\$1,000,000.00	\$80,000.00	\$1,080,000.00	37.1	0.0269542	\$26,954.18	\$1,053,045.82
50	2024	\$1,053,045.82	\$84,243.67	\$1,137,289.49	36.1	0.0277008	\$29,170.24	\$1,108,119.24
51	2025	\$1,108,119.24	\$88,649.54	\$1,196,768.78	35.1	0.0284900	\$31,570.35	\$1,165,198.43
52	2026	\$1,165,198.43	\$93,215.87	\$1,258,414.31	34.1	0.0293255	\$34,170.04	\$1,224,244.27
53	2027	\$1,224,244.27	\$97,939.54	\$1,322,183.81	33.1	0.0302115	\$36,986.23	\$1,285,197.58
54	2028	\$1,285,197.58	\$102,815.81	\$1,388,013.38	32.1	0.0311526	\$40,037.31	\$1,347,976.07
55	2029	\$1,347,976.07	\$107,838.09	\$1,455,814.16	31.1	0.0321543	\$43,343.28	\$1,412,470.88
56	2030	\$1,412,470.88	\$112,997.67	\$1,525,468.55	30.1	0.0332226	\$46,925.94	\$1,478,542.61
57	2031	\$1,478,542.61	\$118,283.41	\$1,596,826.01	29.1	0.0343643	\$50,809.02	\$1,546,016.99
58	2032	\$1,546,016.99	\$123,681.36	\$1,669,698.35		1.0000000	\$1,669,698.35	\$0.00
59	2033							
60	2034							

Chapter 1—Testamentary Planning with Individual Retirement Accounts

(B) Taxable Account Summary:

Age	Year	Taxable Account			RMD Added to Account	Income		Taxable Acct. Balance
		Balance at Beg. of Year	8% Annual Growth	Balance Before RMD		Taxes on RMD	After-Tax RMD	
48	2022							\$0.00
49	2023	\$0.00	\$0.00	\$0.00	\$26,954.18	\$8,086.25	\$18,867.92	\$18,867.92
50	2024	\$18,867.92	\$1,509.43	\$20,377.36	\$29,170.24	\$8,751.07	\$20,419.17	\$40,796.53
51	2025	\$40,796.53	\$3,263.72	\$44,060.25	\$31,570.35	\$9,471.10	\$22,099.24	\$66,159.50
52	2026	\$66,159.50	\$5,292.76	\$71,452.26	\$34,170.04	\$10,251.01	\$23,919.03	\$95,371.29
53	2027	\$95,371.29	\$7,629.70	\$103,000.99	\$36,986.23	\$11,095.87	\$25,890.36	\$128,891.35
54	2028	\$128,891.35	\$10,311.31	\$139,202.66	\$40,037.31	\$12,011.19	\$28,026.12	\$167,228.77
55	2029	\$167,228.77	\$13,378.30	\$180,607.08	\$43,343.28	\$13,002.98	\$30,340.30	\$210,947.37
56	2030	\$210,947.37	\$16,875.79	\$227,823.16	\$46,925.94	\$14,077.78	\$32,848.16	\$260,671.32
57	2031	\$260,671.32	\$20,853.71	\$281,525.03	\$50,809.02	\$15,242.71	\$35,566.32	\$317,091.35
58	2032	\$317,091.35	\$25,367.31	\$342,458.65	\$1,669,698.35	\$500,909.50	\$1,168,788.84	\$1,511,247.50
59	2033	\$1,511,247.50	\$120,899.80	\$1,632,147.30				\$1,632,147.30
60	2034	\$1,632,147.30	\$130,571.78	\$1,762,719.08				\$1,762,719.08

(iii) What happens if the Accumulation Trust is not reformed? The potential for the payment of debts after September 30 means that the Accumulation Trust has Non-DB's as recipients of trust property, which, since Siegfried was in pay status at his death, means that the IRA is payable over Siegfried's ghost life expectancy.

(iv) Under these facts, certainly the 10-Year Rule is more advantageous, right? Well...

(A) IRA Summary:

Age	Year	Beginning Year IRA Balance	8% Annual Growth	Pre-RMD Balance	Life			Year End IRA Balance
					Expectancy	Divisor	RMD	
48	2022				12.6			\$1,000,000.00
49	2023	\$1,000,000.00	\$80,000.00	\$1,080,000.00	11.6	0.0862069	\$86,206.90	\$993,793.10
50	2024	\$993,793.10	\$79,503.45	\$1,073,296.55	10.6	0.0943396	\$93,754.07	\$979,542.49
51	2025	\$979,542.49	\$78,363.40	\$1,057,905.88	9.6	0.1041667	\$102,035.68	\$955,870.21
52	2026	\$955,870.21	\$76,469.62	\$1,032,339.83	8.6	0.1162791	\$111,147.70	\$921,192.13
53	2027	\$921,192.13	\$73,695.37	\$994,887.50	7.6	0.1315789	\$121,209.49	\$873,678.01
54	2028	\$873,678.01	\$69,894.24	\$943,572.25	6.6	0.1515152	\$132,375.46	\$811,196.79
55	2029	\$811,196.79	\$64,895.74	\$876,092.53	5.6	0.1785714	\$144,856.57	\$731,235.96
56	2030	\$731,235.96	\$58,498.88	\$789,734.84	4.6	0.2173913	\$158,964.34	\$630,770.50
57	2031	\$630,770.50	\$50,461.64	\$681,232.14	3.6	0.2777778	\$175,214.03	\$506,018.11
58	2032	\$506,018.11	\$40,481.45	\$546,499.56	2.6	0.3846154	\$194,622.35	\$351,877.21
59	2033	\$351,877.21	\$28,150.18	\$380,027.39	1.6	0.6250000	\$219,923.26	\$160,104.13
60	2034	\$160,104.13	\$12,808.33	\$172,912.46			\$172,912.46	\$0.00

(B) Taxable Account Summary:

Age	Year	Taxable Account			Income			Taxable Acct. Balance
		Balance at Beg. of Year	8% Annual Growth	Balance Before RMD	RMD Added to Account	Taxes on RMD	After-Tax RMD	
48	2022							
49	2023	\$0.00	\$0.00	\$0.00	\$86,206.90	\$25,862.07	\$60,344.83	\$60,344.83
50	2024	\$60,344.83	\$4,827.59	\$65,172.41	\$93,754.07	\$28,126.22	\$65,627.85	\$130,800.26
51	2025	\$130,800.26	\$10,464.02	\$141,264.28	\$102,035.68	\$30,610.70	\$71,424.97	\$212,689.25
52	2026	\$212,689.25	\$17,015.14	\$229,704.39	\$111,147.70	\$33,344.31	\$77,803.39	\$307,507.78
53	2027	\$307,507.78	\$24,600.62	\$332,108.41	\$121,209.49	\$36,362.85	\$84,846.64	\$416,955.05
54	2028	\$416,955.05	\$33,356.40	\$450,311.45	\$132,375.46	\$39,712.64	\$92,662.82	\$542,974.27
55	2029	\$542,974.27	\$43,437.94	\$586,412.21	\$144,856.57	\$43,456.97	\$101,399.60	\$687,811.81
56	2030	\$687,811.81	\$55,024.95	\$742,836.76	\$158,964.34	\$47,689.30	\$111,275.04	\$854,111.80
57	2031	\$854,111.80	\$68,328.94	\$922,440.74	\$175,214.03	\$52,564.21	\$122,649.82	\$1,045,090.56
58	2032	\$1,045,090.56	\$83,607.24	\$1,128,697.80	\$194,622.35	\$58,386.71	\$136,235.65	\$1,264,933.45
59	2033	\$1,264,933.45	\$101,194.68	\$1,366,128.13	\$219,923.26	\$65,976.98	\$153,946.28	\$1,520,074.41
60	2034	\$1,520,074.41	\$121,605.95	\$1,641,680.36	\$172,912.46	\$51,873.74	\$121,038.72	\$1,762,719.08

- (v) Given that the payout under Siegfried's ghost life expectancy is 12 years, ultimately, the taxable accounts under both instances are *exactly the same* (differences will arise on the unrealized gain on the investment portion).
- (vi) On the whole, the 10-Year Rule should be the better option, especially if the participant dies before reaching pay status. Further, it is not known as to what circumstances might arise or a change in tax rates, etc., so maximum deferral should usually be the better option. However, the purpose for the illustration is to state that the differences in deferral may not always be that significant a difference.

L. Conduit vs. Accumulation Trusts – Which is Better

(1) Conduit Trust

(a) Advantages

- (i) Many practitioners consider the Conduit Trust approach to be the easiest and simplest way to name a trust as the beneficiary, especially under SECURE.
- (ii) Although the issue is not present in Florida, if the plan involves a beneficiary who lives in a state that does not have the creditor protection feature for Inherited IRA's found in where the Inherited IRA is protected, having the IRA paid to a Conduit Trust will provide extended creditor protection.
- (iii) Because all Second and Third Tier beneficiaries are disregarded, the trust is unlimited in what it can provide.
- (iv) With younger beneficiaries, i.e., skip persons, RMD's and the eventual final distribution can be taxed at the younger beneficiary's tax rate.

(b) Disadvantages

- (i) Mandatory payments to the beneficiary. Under today's modern estate planning practices, most trusts (outside of QTIP trusts) are discretionary trusts. A Conduit Trust removes this feature because it requires the RMD to be paid on an annual basis.
- (ii) Conduit trusts are not the best for dynastic trusts – for DB's who are not EDB's, the account will be exhausted relatively quickly under the 10-Year Rule.
- (iii) Mandatory RMD payments to the beneficiaries are not ideal if the beneficiary is a special needs individual and if the beneficiary needs to qualify for governmental benefits.

### (2) Accumulation Trust

#### (a) Advantages

- (i) Ideal for dynastic trusts – the RMD is paid into the same trust that owns the IRA, so even under the 10-Year Rule, the Inherited IRA remains protected and the Trustee can control distributions to the beneficiary.
- (ii) No waste of any applicable exemption.

#### (b) Disadvantages

- (i) Second Tier beneficiary can potentially knock out the trust from being a See-Through Trust.
- (ii) Income taxes may be paid by the trust at a higher rate than if the RMD were paid directly to the beneficiary, especially under SECURE when the balance or all of the account (depending on the participant's status at the time of her/his death) is payable at the end of the 10-Year Rule.

### M. Charitable Remainder Trusts

- (1) One method of providing for both charity and family members is to leave an IRA (or portion thereof) to a charitable remainder trust (under §664, this must either be an annuity trust or a unitrust) (a "CRT").
- (2) Even though a non-individual is named as the beneficiary, there is no income tax recognition on the distribution to the CRT; the tax is paid subsequently on the annuity or unitrust payments to the beneficiary.
- (3) Income tax wise, a CRT is subject to the "tier" system under §664(b) regarding distributions, so that it is likely that on each unitrust or income payment, the amount that would have been taxed as income in respect of a decedent ("IRD") had the CRT not been a tax-exempt entity would come out as ordinary income to the annuitant or unitrust beneficiary.
- (4) Detrimental Effects
  - (a) Regardless of the investment structure, the class of income under the tier system remains based on the original classification. Thus, even if a CRT reinvests the entire IRA in tax-free municipal bonds, distributions to the annuitant or unitrust beneficiary will still be taxed as ordinary income to the extent that there is Tier 1 income available.
  - (b) Greatly diminished effect of the §691(c) deduction.

- (i) If an estate tax is paid by the participant's estate, ordinarily the beneficiary receives the §691(c) deduction; however, as set forth in PLR 19901023, with a CRT, the deduction applies, but only works to internally offset the Tier 1 income received within the CRT, and has no effect on the subsequent annuity or unitrust distribution.
- (ii) For example, suppose that an IRA of \$100,000 is distributed to a CRAT, and the §691(c) is \$20,000.
  - (A) If the distribution were made to an individual, the individual would be able to use the §691(c) deduction which offsets the current impact of the IRD recognition from the IRA distribution.
  - (B) However, with the CRT, the application of the §691(c) distribution works internally only to offset Tier 1 income, so that Tier 1 income of \$100,000 is reduced to \$80,000. If the annuity amount is \$30,000, all of it will be taxable currently to the annuitant.
  - (C) The effect of the §691(c) deduction will not be realized until all Tier 1 income has been exhausted, which could take several years.
- (5) A better plan? If the participant wishes to benefit a charity with a certain percentage of the IRA, it might be better for the participant to sever the IRA into separate accounts so that, upon death, one account is left to family members and the other is left to the charity.

### N. The Disclaimer Plan

- (1) Name the spouse as the primary beneficiary.
  - (a) This enables the spouse to be the point person for the planning based on the circumstances.
  - (b) Via the spousal rollover, the spouse has full access to the IRA.
- (2) Name trusts for the children as contingent or secondary beneficiaries.
  - (a) Should the spouse have sufficient assets, he or she can then disclaim the IRA so that it passes to the resulting trusts for children.
  - (b) Conduit or Accumulation Trusts? See above – this should be discussed with the client.

### O. Final Advice – Pay Attention to the Beneficiary Designation

- (1) Care and Concern
  - (a) Care and concern should be given to the naming of the beneficiaries.
  - (b) Failure to properly implement the designations could lead to a lack of a Beneficiary Designation and failure to maximize the payout of the IRA.
- (2) Step #1 – Discuss the Plan with the Client
  - (a) Look back to Example #1 at the beginning of the outline; the failure to consider the IRA led to a failure of the estate plan.

- (b) Like all other assets, the IRA should be discussed with the client.
  - (c) Should all IRA's have special planning designations? That depends on the client and the amount in the account.
    - (i) If the client is adamant that everything be left outright, then no special planning is needed for the account.
    - (ii) If the account has \$25,000, perhaps it is too small to expend the considerable time for extensive planning.
    - (iii) There is no real threshold for this determination – the practitioner should use his or her best judgment; that being said, six figure value is usually a starting place.
- (3) Step #2 - Obtain Pertinent Account Information
- (a) The client should be asked to provide copies of recent account statements, which will show the custodian, account number and, most importantly, the contact information for the custodian.
  - (b) If possible, the client should bring the custodian's pre-printed Beneficiary Designation form.
  - (c) With more investment firms increasing their online presence, the forms may be available on the firm's website.
- (4) Step #3 – Think Through the Plan
- (a) As planners, we prepare a great deal of documents as part of a standard estate plan, from trusts to health care documents to even flow charts. Before mindlessly preparing a beneficiary designation form, consider the process.
  - (b) Beneficiary Designations are time consuming – from preparing the forms to often negotiating back and forth with the custodian's representative, who, as many practitioners will attest, rarely accede to the planner's wishes.
  - (c) If the client has several IRA's, the practitioner may consider having the client execute a separate IRA Trust to act as the recipient of the accounts (more below).
  - (d) What type of trust does the client want? Conduit or Accumulation? If Accumulation, is it worth it to restrict the beneficiaries to obtain the full 10+ year payout?
  - (e) If the BBB Proposal passes, note that the full deferral may not be the best plan, for, based on the expected value of the share for the trust, it may make more sense to have periodic payouts in order to avoid certain additional taxes imposed on High Income Taxpayers.
- (5) Step #4 – Prepare the Designation and Rider
- (a) The preprinted form is easy to prepare; however, if any of the beneficiaries are going to be trusts, then a more detailed description is required.
  - (b) Rather than attempt to fill in all required information on the preprinted form, it is easier to provide a Rider.

- (c) The Rider should always have an “Acceptance” line for the custodian to sign and return; whether the custodian complies and sends back the signed Rider is unclear, but it doesn’t hurt to try.
  - (d) Rider Example #1 – Spousal Disclaimer Plan – See Exhibit C.
  - (e) Rider Example #2 – Non-Spousal Designation Plan – See Exhibit D.
- (6) Step #5 – Submit and Negotiate with Custodian
- (a) Submit the designation and rider with the custodian – be certain that all requirements are met.
  - (b) Most custodians will assign the designation to a transfer agent before showing it to legal counsel; tact must be used in negotiating with the transfer agent.
  - (c) Eventually, if the Rider is rejected, a conference should be requested with the custodian’s legal counsel.
  - (d) Problem: some custodians have their designations completed exclusively online or have very strict requirements as to the information to be contained on the designation (such as Fidelity, which does not allow riders).

Uniform Lifetime Table					
Attained age	Distribution Period	Attained age	Distribution Period	Attained age	Distribution Period
72	27.4	89	12.9	105	4.6
73	26.5	90	12.2	106	4.3
74	25.5	91	11.5	107	4.1
75	24.6	92	10.8	108	3.9
76	23.7	93	10.1	109	3.7
77	22.9	94	9.5	110	3.5
78	22.0	95	8.9	111	3.4
79	21.1	96	8.4	112	3.3
80	20.2	97	7.8	113	3.1
81	19.4	98	7.3	114	3.0
82	18.5	99	6.8	115	2.9
83	17.7	100	6.4	116	2.8
84	16.8	101	6.0	117	2.7
85	16.0	102	5.6	118	2.5
86	15.2	103	5.2	119	2.3
87	14.4	104	4.9	120+	2.0
88	13.7				

Single Life Expectancy Table							
Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy	Age	Life Expectancy
0	84.6	31	54.4	61	26.2	91	5.3
1	83.7	32	53.4	62	25.4	92	4.9
2	82.8	33	52.5	63	24.5	93	4.6
3	81.8	34	51.5	64	23.7	94	4.3
4	80.8	35	50.5	65	22.9	95	4.0
5	79.8	36	49.6	66	22.0	96	3.7
6	78.8	37	48.6	67	21.2	97	3.4
7	77.9	38	47.7	68	20.4	98	3.2
8	76.9	39	46.7	69	19.6	99	3.0
9	75.9	40	45.7	70	18.8	100	2.8
10	74.9	41	44.8	71	18.0	101	2.6
11	73.9	42	43.8	72	17.2	102	2.5
12	72.9	43	42.9	73	16.4	103	2.3
13	71.9	44	41.9	74	15.6	104	2.2
14	70.9	45	41.0	75	14.8	105	2.1
15	69.9	46	40.0	76	14.1	106	2.1
16	69.0	47	39.0	77	13.3	107	2.1
17	68.0	48	38.1	78	12.6	108	2.0
18	67.0	49	37.1	79	11.9	109	2.0
19	66.0	50	36.2	80	11.2	110	2.0
20	65.0	51	35.3	81	10.5	111	2.0
21	64.1	52	34.3	82	9.9	112	2.0
22	63.1	53	33.4	83	9.3	113	1.9
23	62.1	54	32.5	84	8.7	114	1.9
24	61.1	55	31.6	85	8.1	115	1.8
25	60.2	56	30.6	86	7.6	116	1.8
26	59.2	57	29.8	87	7.1	117	1.6
27	58.2	58	28.9	88	6.6	118	1.4
28	57.3	59	28.0	89	6.1	119	1.1
29	56.3	60	27.1	90	5.7	120+	1.0
30	55.3						

Joint Life Expectancy Table											
Ages	69	70	71	72	73	74	75	76	77	78	79
45	41.6	41.5	41.5	41.4	41.4	41.3	41.3	41.2	41.2	41.2	41.1
46	40.7	40.6	40.6	40.5	40.4	40.4	40.3	40.3	40.3	40.2	40.2
47	39.8	39.7	39.7	39.6	39.5	39.5	39.4	39.4	39.3	39.3	39.3
48	38.9	38.8	38.8	38.7	38.6	38.6	38.5	38.5	38.4	38.4	38.3
49	38.1	38.0	37.9	37.8	37.7	37.7	37.6	37.5	37.5	37.5	37.4
50	37.2	37.1	37.0	36.9	36.8	36.8	36.7	36.6	36.6	36.5	36.5
51	36.4	36.2	36.1	36.0	36.0	35.9	35.8	35.7	35.7	35.6	35.6
52	35.5	35.4	35.3	35.2	35.1	35.0	34.9	34.9	34.8	34.7	34.7
53	34.7	34.6	34.5	34.3	34.2	34.1	34.1	34.0	33.9	33.9	33.8
54	33.9	33.8	33.6	33.5	33.4	33.3	33.2	33.1	33.0	33.0	32.9
55	33.1	33.0	32.8	32.7	32.6	32.4	32.4	32.3	32.2	32.1	32.0
56	32.3	32.2	32.0	31.9	31.7	31.6	31.5	31.4	31.3	31.2	31.2
57	31.6	31.4	31.2	31.1	30.9	30.8	30.7	30.6	30.5	30.4	30.3
58	30.9	30.7	30.5	30.3	30.1	30.0	29.9	29.8	29.7	29.6	29.5
59	30.1	29.9	29.7	29.5	29.4	29.2	29.1	29.0	28.8	28.7	28.7
60	29.4	29.2	29.0	28.8	28.6	28.4	28.3	28.2	28.0	27.9	27.8
61	28.8	28.5	28.3	28.1	27.9	27.7	27.5	27.4	27.3	27.1	27.0
62	28.1	27.9	27.6	27.4	27.2	27.0	26.8	26.6	26.5	26.4	26.2
63	27.5	27.2	26.9	26.7	26.5	26.2	26.1	25.9	25.7	25.6	25.5
64	26.9	26.6	26.3	26.0	25.8	25.5	25.3	25.2	25.0	24.8	24.7
65	26.3	26.0	25.7	25.4	25.1	24.9	24.6	24.4	24.3	24.1	23.9
66	25.8	25.4	25.1	24.8	24.5	24.2	24.0	23.7	23.5	23.4	23.2
67	25.3	24.9	24.5	24.2	23.9	23.6	23.3	23.1	22.9	22.7	22.5
68	24.8	24.3	24.0	23.6	23.3	23.0	22.7	22.4	22.2	22.0	21.8
69	24.3	23.9	23.4	23.1	22.7	22.4	22.1	21.8	21.5	21.3	21.1
70	23.9	23.4	22.9	22.5	22.2	21.8	21.5	21.2	20.9	20.6	20.4
71	23.4	22.9	22.5	22.0	21.6	21.3	20.9	20.6	20.3	20.0	19.8
72	23.1	22.5	22.0	21.6	21.1	20.7	20.4	20.0	19.7	19.4	19.2
73	22.7	22.2	21.6	21.1	20.7	20.3	19.9	19.5	19.1	18.8	18.6
74	22.4	21.8	21.3	20.7	20.3	19.8	19.4	19.0	18.6	18.3	18.0
75	22.1	21.5	20.9	20.4	19.9	19.4	18.9	18.5	18.1	17.8	17.4

# “HELPING IRA PLAN HIS IRA FROM THE IRA” TESTAMENTARY PLANNING WITH INDIVIDUAL RETIREMENT ACCOUNTS

Oregon Tax Institute

Portland, Oregon  
June 2, 2022

**GEORGE D. KARIBJANIAN**

Franklin Karibjanian & Law, PLLC

150 East Palmetto Park Road, Suite 800  
Boca Raton, Florida 33432  
Direct Dial: (561) 208-1272

Washington, DC Office  
1101 Seventeenth Street, N.W., Suite 820  
Washington, D.C. 20036  
Direct Dial: (202) 495-2676

Fax: 202-463-3060  
gkaribjanian@fkl-law.com

## GEORGE D. KARIBJANIAN



Boca Raton  
Direct: (561) 208-1272  
DC  
Direct: (202) 495-2676  
gkaribjanian@fkl-law.com

George D. Karibjanian is a Founding Member of Franklin Karibjanian & Law, a national boutique law firm based in Washington, D.C., with additional offices in Boca Raton, Florida and Naples, Florida. George practices predominantly in the firm's Boca Raton office. George is Board Certified by the Florida Bar in Wills, Trusts & Estates and is a Fellow in the American College of Trust and Estate Counsel.

George divides his time between the Boca Raton and Washington offices, spending the majority of his time in Boca Raton. George is admitted to practice in Florida, the District of Columbia, Maryland and Virginia.

He earned his B.B.A. in Accounting from the University of Notre Dame in 1984, his J.D. from the Villanova University School of Law in 1987, and his LL.M. in Taxation from the University of Florida in 1988. George has practiced his entire legal career in South Florida (over 33 years), practicing exclusively in the areas of estate planning and probate and trust administration, and also represents numerous clients with respect to nuptial agreements. George has participated in over 200 formal presentations, either individually or as part of a panel discussion, to national, state-wide and local groups, and has over 80 publication credits in national and regional periodicals and journals. Born and raised in Vineland, New Jersey (in the heart of South Jersey), George has called Boca Raton home since 1988.

On the topic of the Uniform Voidable Transactions Act and its potential negative effect on estate planning, George has published many articles and has lectured in cities across the nation such as Las Vegas, Nashville, New York, Phoenix, Portland (Or.), San Diego, San Francisco, and Wilmington (Del.), and presented webinars to groups in South Dakota and Alaska. George has also presented on the topic in October 2016 at the 42nd Annual Notre Dame Tax and Estate Planning Institute in South Bend, Indiana.

On the topic of same-sex estate planning, George has lectured at various conferences and estate planning councils throughout the United States and has published numerous articles in publications such as Steve Leimberg's LSI Estate Planning Newsletters, Trusts & Estates Magazine and the Florida Bar Journal. George has also been quoted by several publications and websites.

George was presenter at the 48th Annual Heckerling Institute on Estate Planning in Orlando, Florida on January 15, 2014, speaking on a panel discussion titled, "Living and Working with the Uniform Principal and Income Act," focusing on the tax effects on the power to adjust trust principal to income, the power to convert an income trust to a unitrust, comparing the various unitrust statutes and focusing on potential litigation facing fiduciaries in this area.

George's other lectures have included topics such as Portability, Decanting, Trustee Selection and Duties, the Principal and Income Act, Current Developments in Estate Planning and Taxation, Representing a Client with Potential Capacity Issues, Whether a Supplemental 706 is Required, Inter-Vivos QTIP Planning, Prenuptial Agreements for the Estate Planner and the Advantages and Disadvantages of Domestic Asset Protection Trusts.

For the American Bar Association's Section of Taxation, he is a past Co-Chair of the Estate and Gift Tax Committee; was the Chairperson for the Section's 2016 Comments on the Basis Consistency Regulations, the Chairperson for a 2011-12 Section Task Force Subcommittee Advocating Changes to the Portability Provisions Added by the 2010 Tax Act; and a contributing draftsman to the Section's 2012 Comments on decanting.

For the American Bar Association's Section of Real Property Trusts & Estates, he is a current Co-Vice Chair of the Art & Collectibles Committee within the Section's Income and Transfer Tax Planning Group and is a member of the CLE Committee. He is a past Co-Chair of the ITPP Group's Estate and Gift Tax Committee.

Within the Florida Bar's Real Property & Trust Law Section, he is a past Chair for the Section's Asset Protection Committee; has been the Co-Vice Chair – Probate & Trust and National Events Editor for the Section's "ActionLine" publication since 2012; and was a Co-Chairperson of the RPPTL Ad Hoc Committee regarding potential statutory changes in light of a change in Florida's DOMA laws; a member of the Ad Hoc committee to study changes to Florida's decanting statutes (which led the 2018 legislation enacting the suggested changes); the Chairperson and primary draftsman of the Section's 2012 comments to the IRS on decanting; and a member of the RPPTL Ad Hoc Committee that drafted a statutory change in response to Florida's *Morey v. Everbank* decision. He is a current member to the Section's Executive Council.

George is also a member of the Greater Boca Raton Estate Planning Council and the South Palm Beach County Bar Association.

George currently serves on the Professional Advisory Committee for George Snow Memorial Scholarship Foundation. Previously, George served on the Professional Advisory Committee for the Boca Raton Museum of Art from 2011 to 2019 and served on the Board of Directors for the Palm Beach County Wealth & Estate Planning Seminar from January 2015 until its suspension in January 2019. George also served as President and a member of the Board of Directors of the Notre Dame Alumni Club of Boca Raton (1996-1997), a member of the St. Jude's Church (Boca Raton) Financial Education Council (1994-1996), and Vice President and a member of the Board of Directors of the Boca Raton Girls Fastpitch Softball Association (2004-2008).

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## The Importance of Estate Planning for IRAs

### ● Example 1

- Bojack is a 55 year old retired football player living in Eugene, Oregon. Bojack's assets are as follows:
  - Residence - \$2,000,000
  - Stocks, Bonds and other Tradeable Securities - \$1,000,000
  - IRA - \$15,000,000
  - Life Insurance - \$2,000,000

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## Individual Retirement Accounts – The Basics

- §408(a) - as a trust created or organized in the United States for the exclusive benefit of an individual or her/his beneficiaries.
- Governing instrument must meet 6 reqs.:
  - Contributions in Cash
  - Trustee must be a bank
  - No investments in life insurance
  - Balance is non-forfeitable
  - No commingling of funds
  - Distributions controlled under 401(a)(9)

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## Individual Retirement Accounts – The Basics

- The Power of Compounding
  - Example 2 – Liz and her \$100,000

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## Individual Retirement Accounts – The Basics

Chart 1 – Non-Tax Deferred

Growth Rate	6%					
Tax Rate	25%					
	Taxable Account			Tax Deferred Account		
Age	Int. & Growth	Taxes	Balance	Int. & Growth	Taxes	Balance
35			\$100,000.00			\$100,000.00
36	\$6,000.00	(\$1,500.00)	\$104,500.00	\$6,000.00	\$0.00	\$106,000.00
37	\$6,270.00	(\$1,567.50)	\$109,202.50	\$6,360.00	\$0.00	\$112,360.00
38	\$6,552.15	(\$1,638.04)	\$114,116.61	\$6,741.60	\$0.00	\$119,101.60
39	\$6,847.00	(\$1,711.75)	\$119,251.86	\$7,146.10	\$0.00	\$126,247.70
40	\$7,155.11	(\$1,788.78)	\$124,618.19	\$7,574.86	\$0.00	\$133,822.56
**	**	**	**	**	**	**
71	\$28,004.09	(\$7,001.02)	\$487,737.85	\$46,116.52	\$0.00	\$814,725.20

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## Individual Retirement Accounts – The Basics

Chart 2 –Tax Deferred

Growth Rate		8%					
Tax Rate		30%					
Taxable Account				Tax Deferred Account			
Age	Int. & Growth	Taxes	Balance	Int. & Growth	Taxes	Balance	
35			\$100,000.00			\$100,000.00	
36	\$8,000.00	(\$2,400.00)	\$105,600.00	\$8,000.00	\$0.00	\$108,000.00	
37	\$8,448.00	(\$2,534.40)	\$111,513.60	\$8,640.00	\$0.00	\$116,640.00	
38	\$8,921.09	(\$2,676.33)	\$117,758.36	\$9,331.20	\$0.00	\$125,971.20	
39	\$9,420.67	(\$2,826.20)	\$124,352.83	\$10,077.70	\$0.00	\$136,048.90	
40	\$9,948.23	(\$2,984.47)	\$131,316.59	\$10,883.91	\$0.00	\$146,932.81	
**	**	**	**	**	**	**	
71	\$53,867.54	(\$16,160.26)	\$711,051.50	\$118,282.75	\$0.00	\$1,596,817.18	

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## Individual Retirement Accounts – The Basics

- Asset Protection
  - Oregon
    - Mostly exempt under O.R.S. §18.358 (not fully exempt as to certain support orders)
    - Inherited IRA's not specifically stated as being exempt
  - Florida:
    - Exempt under Fla. Stat. §222.21(2)(a)
    - Inherited IRAs also exempt under Fla. Stat. §222.21(2)(c)
  - Compare with California and South Dakota

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## Individual Retirement Accounts – The Basics

- Contribution Limits (§219(b)(1)(A))
  - Shall not exceed the lesser of:
    - The deductible amount (\$5,000, adjusted for inflation), or
    - An amount equal to the compensation includible in the individual's gross income for such taxable year
    - Catch-up contributions for individuals 50 or older - deductible amount is increased by the applicable amount, which is \$1,000.
  - 2022 - \$6,000/\$6,500.

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## Individual Retirement Accounts – The Basics

- Non-Deductible Contributions (§219(g))
  - IRAs are supplemental retirement plans; therefore, they are secondary to other employer sponsored plans.
  - If the employee is an “active participant” in an employer retirement plan, the amount of the deduction for an IRA contribution is reduced, ultimately to \$0.
  - Maximum amount of any non-deductible contributions is limited to the otherwise-deductible amount (i.e., \$5,000 adjusted for inflation).

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## Individual Retirement Accounts – The Basics

- When are Contributions Prohibited?
  - Before the SECURE Act, contributions ceased once the owner went into “pay status.”
  - Under the SECURE Act, there is no age limitation for contributions, so an owner can continue to make contributions even if the owner is in “pay status.”

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## Individual Retirement Accounts – The Basics

- Rollovers (§408(d)(3))
  - Distributions are not taxable if they are rolled over in one of two ways:
    - The entire amount received is paid into an IRA or individual retirement annuity (other than an endowment contract) within 60 days; or
    - The entire amount received is paid into an eligible retirement plan within 60 days.

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## Individual Retirement Accounts – The Basics

### ● Distributions

- §408(e)(1) - the IRA plan itself is generally exempt from taxation; distributions from a plan, however, are included in the recipient's gross income under §408(d)(1).
- Not subject to the §1411 "net investment income" 3.8% tax. (§1411(c)(5))
- Exception - if the account contains non-deducted contributions, each distribution contains a proportionate amount of basis and the balance of the account (§72(e))

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## Individual Retirement Accounts – The Basics

### ● Post-Death Distributions

- §691 - "income in respect of a decedent"
- Example 3 - Lucille and her \$2,000,000 IRA – only 37.8% effectively pass through to the beneficiary
- No §2053 deduction for income taxes - debt is undetermined so is not deductible
- Some relief - the §691(c) Deduction

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## Individual Retirement Accounts – The Basics

- Qualified Charitable Distribution (§408(d)(8))
  - RMD is excluded from the participant's gross income, akin to a full deduction, as opposed to a deduction subject to an AGI limitation.
  - The amount of a qualified charitable distribution is limited to \$100,000 per year.
  - Under the SECURE Act, the distribution is reduced in any year where post-age 72 contributions are made.

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## Required Minimum Distribution Rules

- Required Beginning Date - Age 72 (changed under the SECURE Act from Age 70 ½)
- The IRA must be withdrawn at a minimum annual rate, which is determined under the IRS Uniform Life Table (note that effective 1/1/22, new tables are in effect)
- First Distribution Year - beneficiary is not required to withdraw the first RMD until April 1 of the following year
- Each Successive Year – withdraw by Dec. 31
- Multiple Accounts – withdraw from any account

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## Death of Account Participant

- Unpaid RMD – goes to beneficiary
- Designated Beneficiaries
  - Only individuals may be Designated Beneficiaries
  - Estates may NOT be Designated Beneficiaries
  - Trusts - Although a Trust is not an individual, it is possible to “look through” the trust and treat the individual trust beneficiaries as they were the Designated Beneficiaries

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## Death of Account Participant – Payout Rules

- Designated Beneficiary is surviving spouse – Rollover
  - The rollover election may be made at any time after the participant’s date of death, including after the surviving spouse’s own RBD.
  - There is no statute or regulation that gives instructions as to how to properly effect a rollover.
- Beneficiaries Other than Surviving Spouse – entire procedure has changed courtesy of the SECURE Act, and especially pursuant to the Proposed Regulations issued in February 2022

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## Death of Account Participant – Payout Rules

- Death Prior to Pay Status – Pre-SECURE Act
  - No Designated Beneficiary
    - 5 Year Rule
    - Could be 6 Year Deferral
    - Asset Protection Benefit
  - Beneficiary’s Life Expectancy
  - Election Deadline Options
    - Plan could provide for 5 Year Rule (not a “unilateral beneficiary” option – the plan MUST provide for the election)
    - Example 4 – Eleanor, Jason, Michael and the Election

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## Death of Account Participant

- Death During Pay Status – Pre-SECURE Act
  - No Designated Beneficiary
    - Remainder of participant’s remaining life expectancy
  - Designated Beneficiary
    - Single DB – longer of participant’s life expectancy and beneficiary’s life expectancy
    - Multiple DB’s
      - Multiple beneficiaries – life expectancy of oldest beneficiary.

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## Death of Account Participant

- Death During Pay Status – Pre-SECURE Act (cont.)
  - Multiple Beneficiaries and Separate Account Rule –
    - Separate Account Rule – must establish by 12/31 of year after year of participant's death
    - Is it definite that each separate account beneficiary can take payments over her/his life expectancy? Not certain – but this is clarified under the Proposed Regs.
  - Removing Beneficiaries – pay off by 9/30 of year after year of participant's death.

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## Death of Account Participant

- Death During Pay Status – Pre-SECURE Act (cont.)
  - Example 6 – Michael, George Michael and TBA
  - What about additional estate taxes? PLRs 200432027 and 200432029, the IRS conceded that the trust's contingent liability to pay additional estate taxes after the September 30 date did not disqualify the trust from having a Designated Beneficiary; however, no specific reasoning was given.

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## Death of Account Participant

- Death Under the SECURE Act
  - 3 Categories of Beneficiaries
    - Designated Beneficiaries (same as pre-SECURE Act)
    - Non-Designated Beneficiaries (same as pre-SECURE Act)
    - Eligible Designated Beneficiaries – special subset who have different distributions rules

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## Death of Account Participant

- Death Under the SECURE Act
  - Eligible Designated Beneficiaries are defined as:
    - The surviving spouse of the participant;
    - A person who is not more than 10 years younger than the participant;
    - A minor child of the participant;
    - A disabled individual; or
    - A chronically ill individual.

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## Death of Account Participant

- Death Under the SECURE Act – Before Pay Status
  - Regular DB's
    - “10-Year Rule” – payments are similar to the 5-Year Rule, but the time period is 10 Years
  - Non-DB's
    - 5-Year Rule still applies just as with pre-SECURE

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## Death of Account Participant

- Death Under the SECURE Act – Before Pay Status
  - Eligible Designated Beneficiaries
    - Generally, an EDB will receive distributions from the Inherited IRA by using the EDB's life expectancy
  - 10-Years Younger Beneficiary
    - 10 Years Younger is the floor – also includes beneficiaries who are older than the participant
    - Anomaly – under the “lesser of” rule, if the EDB is older than the participant, the EDB would be better off treated as a Regular DB because the payout would be longer

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## Death of Account Participant

- Death Under the SECURE Act – Before Pay Status
  - Minor Child
    - When SECURE was passed, the definition of “minor” was unclear – under Federal law, this could have meant someone who was under 26
    - Proposed Regs clarify that “minor” means 21
    - Minor Child can use her/his life expectancy until attains majority, after which the 10-Year Rule kicks in

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## Death of Account Participant

- Death Under the SECURE Act – Before Pay Status
  - Disabled and Chronically Ill
    - Under the Proposed Regs, both have specific definitions
    - Both must require documentation – chronically ill documentation includes a certification from a licensed health care practitioner
    - Status is determined as of the participant’s death, meaning a later disability or chronic illness would not allow the beneficiary to switch to the life expectancy method

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## Death of Account Participant

- Death Under the SECURE Act – After Pay Status
  - Initially, when SECURE was passed, it was believed by most practitioners that the payout rules were identical regardless of whether the participant died before or after the RBD.
  - Under the Proposed Regs, however, this is not the case! Rules are wildly different depending on the participant’s status at the time of her/his death.

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## Death of Account Participant

- Death Under the SECURE Act – After Pay Status
  - Surviving Spouse
    - The surviving spouse of a participant who died before 2020 (i.e., before SECURE's effective date) can wait until the deceased participant would have reached age 72 before commencing required distributions as her/his beneficiary, IF the deceased spouse was born after June 30, 1949.
    - Spouse must take RMD's under the “longer of” rule.

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## Death of Account Participant

- Death Under the SECURE Act – After Pay Status
  - Regular DB's
    - Proposed Reg Twist #1 – it was generally believed that the rules before and after pay status were the same for Regular DB's. Not the case!!!
    - 10-Year Rule sort of still applies in that the Inherited IRA is still required to be fully distributed by the 10-Year Deadline, but the Regular DB is required to take RMD's in each year based on the "longer of" rule of her/his life expectancy and the participant's ghost life expectancy.

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## Death of Account Participant

- Death Under the SECURE Act – After Pay Status
  - 10-Years Younger EDB
    - "Longer of" rule with EDB's life expectancy compared to the participant's ghost life expectancy.
  - Minor Child EDB
    - Provisions for a Minor Child EDB are the same regardless of whether the participant was in pay status.
  - Disabled or Chronically Ill EDB
    - Provisions are the same regardless of whether the participant was in pay status.

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## Death of Account Participant

- Death Under the SECURE Act – After Pay Status
  - What about Separate Shares? Proposed Regs clarify that if an account is separated into separate shares before September 30 of the year following the year of the participant's death, each separate share is treated as a separate Inherited IRA for payout purposes
  - This means that if one such separate share would be payable to an EDB, the EDB rules definitely apply to such share.

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## Death of Designated Beneficiary

- Pre-SECURE Act
  - RMD does not change – once the RMD is determined as to the Designated Beneficiary, the RMD calculations remain regardless of how many deaths occur and Successor Beneficiaries are named.
  - Example 8 – George Michael and Maeby

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## Death of Designated Beneficiary

- SECURE Act - Participant's Death Pre-Pay Status
  - Regular DB
    - 10-Year Deadline still applies regardless of how many successive beneficiaries inherit the Inherited IRA
  - 10-Years Younger or Chronically Ill / Disabled EDB
    - 10-Year Rule applies as of the EDB's death, with the payments based on the now-deceased EDB's life expectancy
  - Minor Child EDB
    - Payments continue by earlier of 10<sup>th</sup> year after the Minor Child EDB's death or the Minor Child EDB's 21<sup>st</sup> birthday

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## Death of Designated Beneficiary

- SECURE Act - Participant's Death After Pay Status
  - Surviving Spouse
    - 10-Year Rule applies as if the spouse were the participant
  - Regular DB
    - Inherited IRA must be distributed under the earlier of the 10-Year Deadline from the participant's death or the participant's ghost life expectancy

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## Death of Designated Beneficiary

- SECURE Act - Participant's Death After Pay Status
  - 10-Years Younger or Chronically Ill / Disabled EDB
    - Inherited IRA must be distributed by first to occur of 10-Year Deadline as to EDB, end of EDB's life expectancy or end of participant's ghost life expectancy
  - Minor Child EDB
    - Rules are the same as if pre-Pay Status

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## Charitable Beneficiaries

- Outright distributions to charity avoid income taxation on the distribution amount because the charity does not pay income tax, so its receipt of income in respect of a decedent is irrelevant.
- Distribution has to be either as a Separate Account or must be distributed to the charity no later than September 30 of the year following the year of death in order to prevent the IRA from suffering from a failure of the Designated Beneficiary rule.

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## Charitable Beneficiaries

- For individuals who are charitably inclined and want to benefit family members and descendants, the use of the IRA to pass to charity reduces the amount of IRD items that would pass to the family, thus allowing for a greater overall amount to pass to family members as the non-IRD items will not be subject to income tax on the distribution to family members.

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## Trusts as Beneficiaries

- Accounting Principles - UPAIA §409, UFIAPA §409 and Ore. Rev. Stat. §129.355
  - UPAIA
    - QTIP Trusts and Rev. Rul. 2006-26
    - 10% vs. actual income and principal
  - UFIAPA
    - Passed in July 2018
    - Now approaches retirements like regular investment accounts (if possible)
    - If not possible, then actuarially

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## Trusts as Beneficiaries

- Ore. Rev. Stat. §129.355
  - Modeled after UPAIA §409
- Compare to Fla. Stat. §738.602
  - When adopted in the 2002 legislative session, Fla. Stat. §738.602 was modeled after the uniform statute with the “10% Rule.”
  - In 2009, however, the legislature adopted revisions to Fla. Stat. §738.602 to remove the 10% Rule in favor of one of two methods for determining income already present under the principal and income act – traditional methods of income and principal allocation, or the unitrust methodology adopted by Fla. Stat. §738.1041

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## Trusts as Beneficiaries

- See-Through Trusts vs. Non-See-Through Trusts
  - See-Through: Trust Beneficiaries treated as DB’s
  - Non-See-Through: Treated as if no DB, meaning:
    - If the participant was not in pay status: the 5 Year Rule applies.
    - If the participant was in pay status: payments continue based on the participant’s life expectancy.

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## Trusts as Beneficiaries

- See-Through Trusts
  - Trust Beneficiaries treated as DB's
  - 5 Requirements
    - Valid under state law.
    - Irrevocable or become irrevocable upon participant's death
      - PLR 200537044 – trust protector's ability to amend administrative provisions is permissible

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## Trusts as Beneficiaries

- See-Through Trusts
  - 5 Requirements (cont.)
    - Trust must identify beneficiaries – general provisions OK (i.e., “issue”) so long as it is possible to identify the class member with the shortest life expectancy
    - Certain documentation must be provided to the plan administrator.
    - All trust beneficiaries must be individuals.

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## Trusts as Beneficiaries

- Conduit vs. Accumulation Trusts
  - Conduit Trust
    - RMD paid to beneficiary
    - Popular because all other beneficiaries are disregarded
    - Simple to create
  - Accumulation Trust
    - RMD paid to Trustee, but the Trustee is not required to pay it to the beneficiary.
    - Regular trust accounting rules apply

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## Trusts as Beneficiaries

- Proposed Regs and Trusts
  - Accumulation Trust is now defined!!!
  - Beneficiary Age Now Irrelevant
  - Pre-SECURE, the objective was always to attempt to use the longest life expectancy for payments to a trust; attention had to be given to remainder beneficiaries as well as permissible takers under a power of appointment.
  - For this reason, many practitioners preferred a Conduit Trust because only the income beneficiary was considered for RMD purposes; all others were disregarded.

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## Trusts as Beneficiaries

- Three-Tiers of Beneficiaries
  - First Tier – beneficiaries who are entitled to receive distributions upon the participant’s death (think “first line qualified beneficiaries” in Uniform Trust Code jurisdictions).
  - Second Tier – those who could receive amounts if not distributed to the First-Tier beneficiaries; in other words, the presumptive remainder beneficiaries or the “third line qualified beneficiaries” in UTC jurisdictions.
    - Never counted in Conduit Trusts
    - Always counted in Accumulation Trusts (with one exception)

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## Trusts as Beneficiaries

- Three-Tiers of Beneficiaries
  - Third Tier – those who could receive amounts if not distributed to Second Tier beneficiaries; in other words, the remote contingent beneficiaries of a trust.
    - Third Tier beneficiaries are always disregarded unless they are also Second Tier beneficiaries.
- Under the Tier-System, contingent remainder beneficiaries are disregarded (unless they are also Second-Tier), as are takers under powers of appointment.

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## Trusts as Beneficiaries

- Accumulation Trust Special Rule – outright distribution at age 31 causes the Tier-System to be disregarded – NOTE...in an asset protection environment, who would provide for this?
- Multiple Beneficiary Trusts are specifically authorized
  - As for the Conduit Trust, the Proposed Regs specially authorize trusts for several beneficiaries.
  - If all of the trust's beneficiaries are EDB's, much like the old rules with all DB's, the oldest EDB's life expectancy will be used in determining the payouts.
  - What if one is an EDB? Special rules for EDB's are disregarded, unless EDB is Minor Child EDB

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## Trusts as Beneficiaries

- Possible Trust Provisions for Flexibility
  - Allow Trust Advisor to change trust provisions to allow for Conduit Trust to become an Accumulation Trust and vice-versa
  - Limit debts and expenses payable from IRA to before September 30 of year after the year of death
  - Prevent Non-DB's from being beneficiaries of the trust

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## Trusts as Beneficiaries

- Beneficiary Designations
  - Separate Account Rule does NOT apply to a beneficiary designation where the revocable trust is the beneficiary as opposed to the separate trust created for the beneficiary
  - Severance has to be done at the designation level
  - Hope is that perhaps IRS will change this in the final regs after comments are received
  - Is it worth it? Example 14.

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## Trusts as Beneficiaries

- Conduit vs. Accumulation Trusts – Which to Use?
  - Conduit Trusts
    - Advantages
      - Limited creditor protection, especially if beneficiary lives in a state where Inherited IRA's are not protected.
      - Because all Second and Third Tier beneficiaries are disregarded, the trust is unlimited in what it can provide.
      - With younger beneficiaries, i.e., skip persons, RMD's and the eventual final distribution can be taxed at the younger beneficiary's tax rate.

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## Trusts as Beneficiaries

- Conduit vs. Accumulation Trusts – Which to Use?
  - Conduit Trusts
    - Disadvantages
      - Mandatory payments to the beneficiary goes against discretionary trust approach.
      - Not the best for dynastic trusts – for DB's who are not EDB's, the account will be exhausted relatively quickly under the 10-Year Rule which also wastes exemption
      - Mandatory RMD payments to the beneficiaries are not ideal if the beneficiary is a special needs individual and if the beneficiary needs to qualify for governmental benefits.

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## Trusts as Beneficiaries

- Conduit vs. Accumulation Trusts – Which to Use?
  - Accumulation Trusts
    - Advantages
      - Ideal for dynastic trusts – the RMD is paid into the same trust that owns the IRA, so even under the 10-Year Rule, the Inherited IRA remains protected and the Trustee can control distributions to the beneficiary.
      - No waste of any applicable exemption.

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## Trusts as Beneficiaries

- Conduit vs. Accumulation Trusts – Which to Use?
  - Accumulation Trusts
    - Disadvantages
      - Second Tier beneficiary can potentially knock out the trust from being a See-Through Trust.
      - Income taxes may be paid by the trust at a higher rate than if the RMD were paid directly to the beneficiary, especially under SECURE when the balance or all of the account (depending on the participant's status at the time of her/his death) is payable at the end of the 10-Year Rule.

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## Trusts as Beneficiaries – Char. Rem. Trusts

- Provides for family members and charity
- Even though a non-individual is named as the beneficiary, there is no income tax recognition on the distribution to the CRT; the tax is paid subsequently on the annuity or unitrust payments to the beneficiary.
- Problems:
  - Regardless of the investment structure, the class of income under the tier system remains based on the original classification.
  - Greatly diminished effect of the §691(c) deduction

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## Guidelines for the Beneficiary Designation

- 6 Steps to Consider
  - Step #1 – Discuss the Plan with the Client about Including the IRA
  - Step #2 - Obtain Pertinent Account Information
  - Step #3 – Think Through the Plan
  - Step #4 – Prepare the Designation and Rider
  - Step #5 – Submit and Negotiate with Custodian

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## Chapter 2

# The Road Between Subchapter C and Subchapter S—It May Be a Well-Traveled Two-Way Thoroughfare, but It Isn't Free of Potholes and Obstacles: Revisiting Choice of Entity in Light of Tax Changes on the Horizon

LARRY BRANT

Foster Garvey

Portland, Oregon

C. WELLS HALL, III

Nelson Mullins Riley & Scarborough LLP

Charlotte, North Carolina, and Charleston, South Carolina

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# The Road Between Subchapter C and Subchapter S – It May Be A Well-Traveled Two-Way Thoroughfare, But It Isn't Free of Potholes and Obstacles

## 1.01 INTRODUCTION/BACKGROUND.<sup>1</sup>

In 1954, President Eisenhower recommended the passage of legislation which would minimize the influence of Federal income tax laws on the selection of a form of entity by small businesses. It was not until 1958, however, that Congress acted upon the President's recommendation. In that year, as a part of the Technical Amendments Act of 1958, taxpayers saw the first version of Subchapter S enacted into law.

The original legislation was burdened with numerous flaws and traps that often caught the unwary, resulting in unwanted consequences. Among these flaws and traps existed intricate eligibility, election, revocation and termination rules; complex operational priorities and restrictions on distributions; a rule whereby net operating losses in excess of a shareholder's stock basis were lost forever without any carry forward; and a rule whereby excessive passive investment income caused a retroactive termination of the S election.

Intricate rules and hidden flaws contained in the original legislation led most accountants and tax attorneys to recommend use of Subchapter S only when absolutely necessary.<sup>2</sup> Subchapter S avoidance planning continued for decades.

Almost two and one-half (2½) decades after the birth of Subchapter S, however, Congress attempted the first major overhaul of Subchapter S when it enacted the Subchapter S Revision Act of 1982. As a result of this legislation, many principles of Subchapter K were extended to Subchapter S corporations and their shareholders; many potential abuses which existed under prior law were totally eliminated; the risk of inadvertent termination was lessened to a great degree; and entity audit procedures were established.

In 1986, Congress again enacted legislation which further refined Subchapter S. The Tax Reform Act of 1986 served to redirect Subchapter S back toward its original goal of treating shareholders of electing small business corporations like partners and the corporation like a partnership for Federal income tax purposes. Ironically, much of the impact of the Tax Reform

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<sup>1</sup> The information contained herein is to be used solely for educational purposes. It is not intended and may not be relied upon as legal advice.

<sup>2</sup> Unless otherwise indicated, all references to the Internal Revenue Code are made to the Internal Revenue Code of 1986, as amended. The Internal Revenue Code is referred to herein as the "IRC" or the "Code."

Act of 1986 on Subchapter S came from amendments to provisions outside of Subchapter S, including the inversion of the corporate-individual tax rate structure created by amendments to Code § 1; the repeal of the capital gains deduction contained in Code § 1202; the adoption of the passive loss rules set forth in Code § 469; and the repeal of the “General Utilities Doctrine.”

Historically, persons forming a new business automatically assumed it would take the form of a C corporation unless special circumstances made Subchapter S desirable. Following the enactment of the Tax Reform Act of 1986, which temporarily left us with an inversion of the corporate-individual tax rate structure, the S corporation clearly became the entity of choice for closely-held businesses.

Between 1986 and 2017, lawmakers continued to tinker with Subchapter S, which for the most part made it more desirable for many business taxpayers.

**[1] The Small Business Job Protection Act of 1996.**

Several legislative revisions to Subchapter S, which enhance the viability of Subchapter S, were enacted as part of the Small Business Job Protection Act of 1996 (“1996 Act”).<sup>3</sup> These legislative revisions include the following:

**[a] Number of Shareholders.**

Code § 1361 (b)(1)(A) was amended so that the maximum number of permitted S corporation shareholders was increased from thirty-five (35) to seventy-five (75).<sup>4</sup>

**[b] Tax Exempt Organizations.**

Code § 1361(b)(1)(B) was amended so that tax-exempt organizations described in Code §§ 401(a) and 501(c)(3) are eligible S corporation shareholders.<sup>5</sup>

**[c] Affiliated Group Prohibition.**

Code § 1361(b)(2) was amended so that an S corporation is allowed to own eighty percent (80%) or more of the shares of a C corporation.<sup>6</sup> A wholly-owned subsidiary of an S corporation can, if the S corporation parent so elects, be treated as a “Qualified Subchapter S Subsidiary” (“QSSS” or “QSub”).

**[d] Electing Small Business Trust (“ESBT”).**

Code § 1361(c)(2) was amended so that an additional type of trust, the ESBT, is eligible to become an S corporation shareholder.<sup>7</sup>

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<sup>3</sup> Public Law 104-188.

<sup>4</sup> § 1317(a) of the 1996 Act. Public Law 104-188.

<sup>5</sup> § 1316(a)(1) of the 1996 Act. Public Law 104-188.

<sup>6</sup> §§ 1308 and 1315 of the 1996 Act. Public Law 104-188.

<sup>7</sup> §§ 1302 and 1317(a) of the 1996 Act. Public Law 104-188.

**[e] Testamentary Trust Holding Period.**

Code § 1361(c)(2)(A)(ii) and (iii) were amended so that the allowable holding period of S corporation stock by testamentary trusts is now two (2) years rather than sixty (60) days.<sup>8</sup>

**[f] Debt Safe Harbor.**

The straight debt safe harbor was codified.<sup>9</sup> Consequently, debt is not treated as a second class of stock if four requirements are met, namely:

- There is a written unconditional promise to pay on demand or on a specified date a sum certain in money;
- The interest rate and interest payment dates are not contingent upon profits, the borrower's discretion or like factors;
- The debt is not convertible into stock; and
- The creditor is an individual, estate or trust which is otherwise an eligible S corporation shareholder, or a person actively and regularly engaged in the lending business.

**[g] Bank Eligibility.**

Code § 1361(b)(2) was amended to provide that a bank (as defined in Code § 581) is an eligible small business corporation and may make an S corporation election, provided it does not use a reserve method of accounting for bad debts.<sup>10</sup>

**[h] Untimely/Failure to File Relief.**

The Service has authority under Code § 1362(f) to waive the effect of an invalid S election created by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including QSST elections). Prior to the 1996 Act, the Service's legislative authority to waive untimely elections went no further. § 1305(b) of the 1996 Act added Code § 1362(b)(5).<sup>11</sup> This provision permits the Secretary to treat an election as timely filed that, for reasonable cause, was filed late or was never actually filed. The legislative history to the 1996 Act indicates that the Secretary, in exercising this discretion, may consider any relevant information. It is intended that the Service be reasonable and apply standards similar to those applied to inadvertent S corporation terminations. Strangely enough, this provision was given a retroactive effective date back to the effective date of the Subchapter S Revision Act of 1982. Consequently, this provision was effective for taxable years beginning after 1982.

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<sup>8</sup> § 1303 of the 1996 Act. Public Law 104-188.

<sup>9</sup> § 1304 of the 1996 Act. Public Law 104-188.

<sup>10</sup> § 1315 of the 1996 Act. Public Law 104-188.

<sup>11</sup> § 1305 of the 1996 Act. Public Law 104-188.

Under pre-1996 Act law, no extension of time to file an S election could be granted.<sup>12</sup> Failure to file, even though Form 2553 was filled out and properly executed, or if taxpayer relied on counsel to file, did not create a valid election if the form was not in fact filed with the IRS.<sup>13</sup> As a result of the 1996 Act, however, the Secretary was given authority to ignore a late filing or allow an election where no election was actually filed if reasonable cause exists. Congress clearly desires to make this area of Subchapter S more taxpayer friendly.

Revenue Procedure 97-40<sup>14</sup> expanded late filing leniency. In accordance with this revenue procedure, if a corporation failed to qualify as an S corporation solely because its election was not timely, and the due date of the corporation's first S corporation income tax return, excluding extensions, had not passed, the procedure for fixing the error was rather painless. Within six (6) months of the original due date for the S election, a representative of the corporation was required to file IRS Form 2553, signed by all shareholders who were shareholders (or deemed to have been shareholders) at any time during the period that began on the first day of the taxable year for which the election was to be effective and ending on the day of the election, and an officer of the corporation.

In 1998, the Service issued Revenue Procedure 98-55.<sup>15</sup> In this revenue procedure, the Service broadened the late filing leniency created under Revenue Procedure 97-40 by extending the six (6) month period to twelve (12) months. Consequently, late filers were required to catch their error within twelve (12) months of the original due date for the S corporation election, but in no event later than the due date for the income tax return (excluding extensions) for the first year the corporation intended to be an S corporation.

Effective June 9, 2003, the Service even further broadened the leniency for late S corporation election filers when it issued Revenue Procedure 2003-43.<sup>16</sup> This revenue procedure applies to S elections, the elections of ESBTs, the elections of QSSTs, and the elections of QSSSs. It supersedes Revenue Procedure 98-55.

The requirements are fairly simple:

- Late filing must be the sole defect.
- A request for relief must occur within twenty-four (24) months of the original due date of the election under Subchapter S.
- The request must contain a statement indicating why reasonable cause exists for the election to be untimely.

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<sup>12</sup> Rev. Rul. 60-183, 1960-1 C.B. 625.

<sup>13</sup> See e.g., *Helen S. Leather*, 1991 T.C.M. (P.H.) ¶ 91,534. See also, *Taylor v. Commissioner*, 1988 T.C.M. (P.H.) ¶ 87,399.

<sup>14</sup> Rev. Proc. 97-40, 1997-2 C.B. 488.

<sup>15</sup> Rev. Proc. 98-55, 1998-2 C.B. 645.

<sup>16</sup> Rev. Proc. 2003-43, 2003-1 C.B. 998.

- The application for relief must be filed within six (6) months after the due date (without extensions) of the corporation's income tax return for the first tax year in which the corporation intended to be an S corporation.
- No shareholder may have taken a return position inconsistent with the election.

At the top of IRS Form 2553, it must state: **“FILED PURSUANT TO REV. PROC. 2003-43.”** **In addition, attached to the IRS Form 2553 must be a statement explaining the reason for failure to file a timely S corporation election.** The Service is required to notify the corporation of the result of its reasonable cause determination. If the Service denies the entity relief or if the requirements above were not satisfied, the entity may still request relief from the Service through a private letter ruling. The procedures described in Revenue Procedure 2003-1<sup>17</sup> must be followed in making the request.

Effective for taxable years ending on or after December 31, 2007, the Service further simplified the method to request relief for late S corporation elections when it issued Revenue Procedure 2007-62.<sup>18</sup> If the five (5) requirements from Revenue Procedure 2003-43 (mentioned above) are satisfied and the entity has not filed a tax return for the first taxable year in which the election was intended, the entity requesting relief simply needs to file a completed Form 2553 with a Form 1120S for the first taxable year it intends to be an S Corporation. The Form 2553 must include a statement explaining the reason for failure to file a timely S corporation election.

Effective September 2, 2013, pursuant to Revenue Procedure 2013-30,<sup>19</sup> the requirements for obtaining relief became even more lenient and the process was further clarified.

Under Revenue Procedure 2013-30, if an S corporation that failed to make a timely election files Form 2553 within three (3) years and seventy-five (75) days of the date the election was to be effective, and the requirements of Revenue Procedure 2003-43 (mentioned above) are satisfied, it will be granted late filing relief. If a corporation has been filing Forms 1120S for all years it intended to be an S corporation, the Form 2553 is attached to the current year Form 1120S.

If the three (3) years and seventy-five (75) days has passed, Revenue Procedure 2013-30 still may provide relief, provided:

- The corporation is not also seeking a late entity classification;
- At least six (6) months have passed since the corporation timely filed its return for the first year it was to be treated as an S corporation; and
- Neither the corporation or the shareholders received notice from the IRS of a problem with the corporation's S status within six (6) months of the timely filing of its first Form 1120S.

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<sup>17</sup> Rev. Proc. 2003-1, 2003-1 I.R.B. 1.

<sup>18</sup> Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

<sup>19</sup> Rev. Proc. 2013-30, 2013-36 I.R.B. 173.

So, today there essentially is no time limit on how far back a corporation can make a late S election effective, provided it has always filed as an S corporation, the shareholders have reported the income as S corporation shareholders, and the IRS has not issued a notice that the election was not filed.

Revenue Procedure 2013-30 offers similar relief for late ESBT, QSST, QSSS and entity classification elections.

Revenue Procedure 2013-30 contains helpful flowcharts that will allow you to quickly determine if relief is available.

**[i] Termination Allocation Consent.**

Under pre-1996 Act law, if any S corporation shareholder terminated his or her interest during a taxable year, the corporation (with the consent of all shareholders) was allowed to elect to allocate items of income, deduction, credit or loss by closing its books on the date of termination rather than applying the normal per-share/per-day allocation rules. Code § 1377(a). Congress believed that the election should not require the consent of any shareholder whose tax liability is unaffected by the election.<sup>20</sup> Consequently, in accordance with § 1306 of the 1996 Act, only the terminating shareholder and the shareholder(s) to whom the shares are transferred must consent to the election to close the books. If the shares are transferred to a corporation (including a redemption by the S corporation), however, all persons who were shareholders of the S corporation during the taxable year must consent to the election. This provision was effective for taxable years beginning after December 31, 1996.

**[j] Inadvertent Termination Relief.**

As a result of the 1996 Act,<sup>21</sup> a corporation will continue to be treated as a Subchapter S corporation during a period of inadvertent termination, if:

- The election has been terminated, either because the corporation is disqualified as an electing small business corporation, or as a result of the passive investment income rule;
- The Service determines that the termination was inadvertent;
- The corporation promptly takes steps to correct the condition; and
- The corporation and the shareholders agree to treat the election as having been continuously in effect. Code § 1362(f).

Continuation of an S election following an inadvertent termination is ultimately within the Secretary's sole discretion. To obtain a determination of inadvertent termination, a ruling request must be filed with the IRS.<sup>22</sup> The Service routinely issues rulings in this area.

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<sup>20</sup> § 1306 of the 1996 Act. Public Law 104-188.

<sup>21</sup> § 1305 of the 1996 Act. Public Law 104-188.

**[2] The American Jobs Creation Act of 2004 (“AJCA”).**

The AJCA<sup>23</sup> contained many provisions which directly impacted Subchapter S corporations.

**[a] Family Election.**

Beginning in 2005, Code § 1361(c)(1) was amended so that “family” members may “elect” to be treated as one (1) shareholder for purposes of determining the number of shareholders of an S corporation.<sup>24</sup> For this purpose, “family” includes a common ancestor and all lineal descendants of the common ancestor, and spouses and former spouses of these persons. A few limitations apply:

- “Family” is limited to six (6) generations; and
- A spouse and former spouse are treated as the same generation as the person to whom the person is or was married.

Generally, any family member may make the election and it will remain effective until expressly terminated. Shares owned by a “family” may be held directly or indirectly (as a beneficiary of an ESBT or QSST).

The impetus to this provision was primarily lobbying efforts on behalf of family-owned rural banks which were bumping up against the seventy-five (75) shareholder limitation rules. Other than in the case of family-owned rural banks, it is rare that the seventy-five (75) shareholder rule is really an issue for S corporations.

**[b] Number of Shareholders.**

Again, likely due to lobbying on behalf of family-owned rural banks, another revision was made to Subchapter S relative to the number of eligible shareholders.<sup>25</sup> The AJCA amended Code § 1361(b)(1)(A) by increasing the maximum number of eligible shareholders of an S corporation from seventy-five (75) to one hundred (100). This change was effective for tax years beginning in 2005.

**[c] Electing ESBT Relief.**

Under pre-AJCA law, an ESBT could hold stock of an S corporation. For the portion of an ESBT consisting of S corporation stock, the normal pass-through rules did not apply. Rather, the trust was taxed at a flat rate of thirty-five percent (35%) on its taxable ordinary income as specifically computed and its capital gains were taxed at the preferential rates that applied to individuals. For purposes of determining the maximum number of S corporation shareholders, each person who may have been entitled to receive a distribution from the trust (commonly referred to as a potential current beneficiary) was treated as a shareholder. To avoid

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<sup>22</sup> Treas. Reg. § 1.1362-4(c).

<sup>23</sup> Public Law 108-357.

<sup>24</sup> § 231 of the AJCA. Public Law 108-357.

<sup>25</sup> § 232 of the AJCA. Public Law 108-357.

disqualification after an ineligible shareholder became a potential current beneficiary of an ESBT, it had sixty (60) days to dispose of the S corporation stock.

The AJCA eliminated some of the tax traps for the unwary created by these rules.<sup>26</sup> Beginning in 2005, for purposes of determining who the potential current beneficiaries of an ESBT are, all unexercised powers of appointment are ignored and disregarded. The AJCA increased the period in which the ESBT can dispose of S corporation stock after an ineligible shareholder becomes a potential current beneficiary from sixty (60) days to one (1) year. Again, this provision is the result, at least in part, due to lobbying efforts on behalf of family-owned rural banks.

**[d] Suspended Losses.**

Under pre-AJCA law, any loss or deduction that is not allowed to a shareholder of an S corporation because the loss exceeds the shareholder's basis in stock and debt of the corporation is treated as incurred by the S corporation with respect to that shareholder in subsequent tax years where adequate basis exists. Under pre-AJCA law, in accordance with Code § 1366(d)(2), suspended losses are not transferred from a shareholder to a new shareholder upon a transfer of shares. The AJCA amended Code § 1366(d)(2) so that such suspended losses are transferred with the shares provided the transfer is being made by a spouse or a former spouse incident to divorce.<sup>27</sup> This provision became effective in 2005.

**[e] Qualified Subchapter S Trust (“QSST”) Relief.**

A QSST is a trust which may only have one (1) current income beneficiary and which makes a separate election to qualify the trust as an S corporation shareholder. In general, the S corporation income is passed through to the QSST and is taxed to the beneficiary. Under pre-AJCA law, the trust, rather than the beneficiary, was treated as the owner of S corporation stock for purposes of determining the tax consequences of the disposition of the S corporation stock by the trust. Consequently, since a disposition of the S corporation stock was treated as a disposition by the trust and not the beneficiary of the trust, any suspended losses under Code § 465 (at-risk rules) or Code § 469 (passive activity loss rules) were lost upon a disposition of shares by a QSST. The AJCA changed this outcome and provided that, upon the disposition of S corporation stock by a QSST, for purposes of only Code §§ 465 and 469, the disposition will be treated as a disposition by the beneficiary.<sup>28</sup> This means that the QSST beneficiary may deduct losses which were suspended under the at-risk rules of Code § 465 and the passive activity loss rules of Code § 469 when the QSST disposes of the S corporation stock. This provision became effective in 2005.

**CAVEAT:** This provision applies only for purposes of the at-risk rules and the passive activity loss rules. The QSST, rather than the beneficiary, is treated as the owner of the S corporation stock for purposes of determining the tax consequences of the disposition of the stock by the trust and for all other purposes.

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<sup>26</sup> § 234 of the AJCA. Public Law 108-357.

<sup>27</sup> § 235 of the AJCA. Public Law 108-357.

<sup>28</sup> § 236 of the AJCA. Public Law 108-357.

**[f] Individual Retirement Accounts (“IRAs”).**

Under pre-AJCA law, only U.S. citizens and resident individuals, estates, tax exempt charities and retirement plans, and certain types of trusts could be eligible S corporation shareholders. IRAs or Roth IRAs were not allowed as eligible S corporation shareholders. Under the AJCA, an IRA or Roth IRA may hold shares of an S corporation that is a bank, as defined in Code § 581, but only to the extent of the shares held in the IRA or Roth IRA in the bank on the date of enactment.<sup>29</sup> Where the shares are held by an IRA or Roth IRA, the individual beneficiary of the IRA or Roth IRA will be treated as the shareholder. Consequently, the individual beneficiary must be a U.S. citizen or resident.

**CAVEAT:** Because these rules are limited to shares held on the date of enactment (October 22, 2004), these rules only allow a limited number of banks, whose shareholders previously held their shares in IRAs, to elect S corporation status. This provision of the AJCA is likely another result of the lobbying efforts of family-owned rural banks.

**[g] QSSS Relief.**

When an S corporation owns all the stock of a subsidiary, it may elect for the subsidiary to be treated as a QSSS. In such case, the assets, liabilities and items of income, deduction, loss and credit of the subsidiary are treated as assets, liabilities, and items of the parent S corporation. Under pre-AJCA law, the Service had authority to waive inadvertently invalid S corporation elections and terminations, but it was given no specific authority to waive inadvertently invalid QSSS elections and terminations.

The AJCA remedied this problem. The Service was given authority to waive inadvertently invalid QSSS elections or terminations.<sup>30</sup> In order to obtain such relief, the QSSS and its shareholders (the S corporation parent) must:

- Within a reasonable period after discovering the circumstances causing the invalidity take steps so that the corporation qualifies as a QSSS; and
- Agree to IRS prescribed adjustments consistent with treatment of corporations as a QSSS during the relevant period.

In addition, this provision gives the Service authority to waive inadvertently invalid elections or terminations of elections to treat family members as one shareholder.

The AJCA also gave the Service additional authority relative to QSSSs. It was given the specific authority to require a QSSS to file informational tax returns.<sup>31</sup>

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<sup>29</sup> § 233 of the AJCA. Public Law 108-357.

<sup>30</sup> § 238 of the AJCA. Public Law 108-357.

<sup>31</sup> § 239 of the AJCA. Public Law 108-357.

**[3] Economic Growth and Tax Relief Act of 2001.**

Code § 4975 was amended by Congress in 2001 as part of the Economic Growth and Tax Relief Act of 2001.<sup>32</sup> Following the amendment, loans from qualified retirement plans to S corporation shareholders owning more than five percent (5%) of the corporation were no longer prohibited transactions and were no longer subject to the excise tax or potential plan disqualification.

**[4] IRS Notice 2008-1.**

IRS Notice 2008-1<sup>33</sup> provides rules relating to an above-the-line deduction for health insurance premiums paid by or on behalf of more than two percent (2%) shareholder-employees of S corporations. The notice discusses two basic rules:

- A self-employed individual can deduct, in accordance with Code § 162(l)(1), as an above-the-line deduction, the amount paid for medical insurance (including spouse and dependent care). The Service has concluded this rule applies regardless of whether the insurance is purchased in the individual's name or in the business's name.<sup>34</sup>
- Amounts paid by an S corporation for medical insurance for its more than two percent (2%) shareholders (including spouse and dependent care) are considered compensation to the subject shareholders. Code § 1372. As such, the amounts are deductible by the S corporation as compensation and includable on the subject shareholders' W-2s. Nevertheless, a more than two percent (2%) S corporation shareholder is considered a self-employed person under Code § 1372, and as such may deduct these amounts as an above-the-line deduction under Code § 162(l)(5).

IRS Notice 2008-1 states that to be eligible for the above-the-line deduction, the more than two percent (2%) shareholder must be covered by a medical insurance policy established by the S corporation. A medical insurance plan is established by the S corporation if either of the following criteria is satisfied:

- The S corporation makes the premium payments for the accident and health insurance policy covering the two percent (2%) shareholder-employee (and his or her spouse or dependents, if applicable) in the current taxable year; or
- The two percent (2%) shareholder makes the premium payments and furnishes proof of the payments to the S corporation and then the S corporation reimburses the two percent (2%) shareholder-employee for the premium payments in the current taxable year.

If the premiums are not paid or reimbursed by the S corporation and included in the more than two percent (2%) shareholder's gross income, the medical insurance policy is not established by

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<sup>32</sup> § 612 of the 2001 Act. Public Law 107-16.

<sup>33</sup> 2008-2 I.R.B. 251 (2007).

<sup>34</sup> I.R.S. C.C.A. 200524001 (2005).

the S corporation and the more than two percent (2%) shareholder is not allowed an above-the-line deduction under Code § 162(l). This situation occurs frequently in small closely-held S corporations.

For many reasons, including having too few employees, small corporations find it difficult to find economically reasonable group health insurance. Therefore, as an alternative, the shareholder-employees end up purchasing individual medical insurance in their names independently of the corporation. In the past, this meant Code § 1372 would not come into play and the shareholder was limited to taking an itemized deduction for premiums paid on the policy, subject to an adjusted gross income limitation.

This unfavorable result can now be avoided under the parameters of IRS Notice 2008-1. If the shareholder-employee is unable or does not wish to have the medical insurance policy placed in the name of the S corporation, the shareholder-employee can purchase the policy in his/her own name, make the premium payments, furnish proof of the payments to the S corporation, and have the S corporation reimburse him/her for the premium payments. So long as the S corporation reports the amount of the reimbursements as wages and the shareholder-employee reports that amount as gross income, the shareholder-employee may take the above-the-line deduction.

Alternatively, in the case of a business where the sole owner is the only employee of the company, the owner could consider the limited liability company alternative as the form of entity for the business rather than an S corporation. A single-member limited liability company is generally disregarded under the check-the-box regulations and the sole member would be treated as a sole proprietor. In accordance with advice issued by IRS Chief Counsel,<sup>35</sup> amounts paid for the insurance policy, regardless of whether the insurance is purchased in the name of the business, would generate an above-the-line deduction.

#### **[5] American Recovery and Reinvestment Tax Act of 2009 – Built-in Gains Tax Relief.**

§ 1251(a) of the American Recovery and Reinvestment Tax Act of 2009 amended Code § 1374(d)(7) to exempt an S corporation from the built-in gains tax for taxable years beginning in 2009 and 2010, if the *seventh* taxable year in the recognition period preceded such taxable year.<sup>36</sup> This rule applies separately with respect to any asset acquired from a C corporation in a carryover basis transaction.<sup>37</sup>

§ 2014(a) of the Small Business Jobs Act of 2010 further amended Code § 1374(d)(7) to exempt an S corporation from the built-in gains tax for taxable years beginning in 2011 if the *fifth* taxable year in the recognition period preceded the 2011 tax year.<sup>38</sup>

§ 326(a)(2) of the 2012 Taxpayer Relief Act even further amended Code § 1374(d)(7) to exempt an S corporation from the built-in gains tax for taxable years beginning in 2012 if the *fifth*

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<sup>35</sup> I.R.S. C.C.A. 200524001 (2005).

<sup>36</sup> Public Law 111-5.

<sup>37</sup> See I.R.C. § 1374(d)(8).

<sup>38</sup> Public Law 111-240.

taxable year in the recognition period preceded the 2014 tax year.<sup>39</sup> So, this provision applies to tax years 2012 and 2013. For tax years beyond 2013, unless Congress acted, we would have reverted to a ten (10) year recognition period.

Finally, as part of the Protecting Americans from Tax Hikes Act of 2015, Congress made the five-year recognition period permanent.<sup>40</sup> Today, the built-in gains tax recognition is five (5) years.

#### **[6] COD Income Excluded from Gross Income under Code § 108.**

In October 2009, Treasury issued a final treasury regulation effective October 30, 2009.<sup>41</sup> The regulation provides special rules for S corporations which exclude cancellation of debt (“COD”) income from gross income pursuant to Code § 108 because the S corporation is bankrupt or insolvent, or the debt discharged was qualified farm debt.

Code § 108(d)(7)(A) states the amount of COD income excluded from gross income must be applied to reduce the S corporation’s tax attributes under Code § 108(b)(2). The reduction of tax attributes occurs after determining the S corporation’s tax liability for the taxable year of the discharge.<sup>42</sup>

The S corporation’s tax attributes must be reduced in the order specified by Code § 108(b)(2). Net operating losses (NOLs) are first on the list. Although S corporations do not have NOLs (the S corporation’s losses pass through to the shareholders under Code § 1366(d)(1)), Treasury Regulation § 1.108-7(d) treats any loss or deduction disallowed under Code § 1366(d)(1) and any carryover losses from prior years under Code § 1366(d)(3) as a “deemed NOL” which is reduced under Code § 108(b)(2).

If the S corporation’s deemed NOL exceeds the amount of the S corporation’s COD income excluded under Code § 108, the excess deemed NOL is allocated to the shareholder(s) of the S corporation as a loss or deduction that is disallowed under Code § 1366(d) for the taxable year of the discharge. This may seem simple enough, but for S corporations with more than one shareholder, application of this rule involves the following tricky, two-step calculation:

- The S corporation must first calculate each shareholder’s “excess amount”—the amount (if any) by which the shareholder’s losses or deductions disallowed under Code § 1366(d)(1) (before any reduction of attributes) exceed the amount of COD income that would have been taken into account by that shareholder under Code § 1366(a) had the COD income not been excluded under Code § 108(a); and
- Any shareholder with an “excess amount” must be allocated an amount equal to the S corporation’s excess deemed NOL multiplied by a fraction, the numerator of which is the shareholder’s excess amount and the denominator

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<sup>39</sup> Public Law 112-240.

<sup>40</sup> Public Law 114-113.

<sup>41</sup> Treas. Reg. § 1.108-7(d).

<sup>42</sup> I.R.C. § 108(b)(4)(A).

of which is the sum of all shareholders' excess amounts. For any shareholder who does not have an excess amount, none of the S corporation's excess deemed NOL is allocated to that shareholder.

Treasury Regulation § 1.108-7(d) also provides the character of the S corporation's excess deemed NOL allocated to a shareholder consists of a proportionate amount of each item of the shareholder's loss or deduction that was disallowed under Code § 1366(d)(1) in the year of discharge.

**[7] The Worker, Homeownership, and Business Assistance Act of 2009 Creates an Increased Penalty for Failure to File S Corporation Return.**

The Worker, Homeownership, and Business Assistance Act of 2009 (November 6, 2009)<sup>43</sup> increased the penalty for failure to file an S corporation return to \$195 per shareholder per month, up to a maximum of twelve (12) months. The beefed-up penalty was made effective for tax years beginning after December 31, 2009.

**[8] The Patient Protection and Affordable Care Act Creates a 3.8% Medicare Tax on Net Investment Income.**

The Patient Protection and Affordable Care Act,<sup>44</sup> as modified by the Health Care and Education Reconciliation Act of 2010,<sup>45</sup> imposes a three and eight-tenths percent (3.8%) Medicare tax on the lesser of the taxpayer's "net investment income" or the excess of modified adjusted gross income over a "threshold amount" (generally \$250,000 for taxpayers filing a joint return, \$125,000 for married taxpayers filing a separate return, and \$200,000 in all other cases). Net investment income generally means the excess of (i) interest, dividends, capital gains, annuities, royalties, rents, income from passive activities, and income from trading financial instruments, over (ii) allowable deductions properly allocable to such income. Some types of income are exempt from the tax, including income from the disposition of the shares of an S corporation.

One interesting provision in the legislation provides that non-passive income from a taxpayer's active participation in an S corporation is not subject to the tax. (The tax applies to passive income and income from a trade or business of trading financial instruments or commodities.) By contrast, investment income from C corporations is subject to the tax, and self-employment income on wages and dividends from a partnership is subject to nine tenths of one percent (0.9%) Medicare tax increase. This slight tax advantage is potentially a planning opportunity for taxpayers considering making an S corporation election.

These changes went into effect on January 1, 2013.

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<sup>43</sup> Public Law 111-92.

<sup>44</sup> Public Law 111-148.

<sup>45</sup> Public Law 111-152.

**[9] Extension of 1367(a)(2).**

§ 325 of the American Taxpayer Relief Act of 2012 briefly extended the life of the Code 1367(a)(2).<sup>46</sup> This provision, originally added to the Code in 2006, allowed shareholders of an S corporation to reduce their share basis by the adjusted basis of property contributed to a charity by the S corporation, even though the full fair market value of the property passed through to the shareholder as a charitable contribution. The statute, which was originally given life for contributions made in tax years beginning before January 1, 2012, was extended to contributions made in tax years beginning before January 1, 2014. So, Code § 1367(a)(2) was given two more years of life. Unfortunately, Congress did not further extend it. So, Code § 1367(a)(2) is no longer viable today. It lived a short, but patriotic life.

**[10] A Corporation to Which an Election under Code § 936 Applies (A Corporation Electing the Puerto Rico or Possessions Tax Credit).**

Prior to 2018, a corporation to which an election under Code § 936 applies was an ineligible corporation.<sup>47</sup> The 2018 Tax Technical Corrections Act changed that rule. After March 23, 2018, a corporation to which an election under Code § 936 applies (a corporation electing the Puerto Rico or possessions tax credit) is an eligible corporation.<sup>48</sup>

**[11] The Tax Cuts and Jobs Act.**

The Tax Cuts and Jobs Act (“TCJA”),<sup>49</sup> signed into law by President Donald Trump on December 22, 2017, changes the picture a bit. Like the Tax Reform Act of 1986, most of the impact of the TCJA on Subchapter S comes from amendments to Code provisions outside of Subchapter S, including:

- Amendment to Code § 1, decreasing the highest individual income tax rate down from 39.6% to 37%.<sup>50</sup>
- Amendment to Code § 11, changing the historically tiered corporate tax rate structure (ranging from 15% to 35%) to a single level flat 21% tax.<sup>51</sup>
- Creation of Code § 199A, creating a possible 20% deduction for owners of pass-through entities, including sole proprietorships.<sup>52</sup>
- Elimination of personal property exchanges under Code § 1031.<sup>53</sup>
- Elimination of the corporate alternative minimum tax.<sup>54</sup>

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<sup>46</sup> Public Law 112-240.

<sup>47</sup> Code § 1361(b)(2).

<sup>48</sup> § 401(d)(1) of Public Law 115-441.

<sup>49</sup> Public Law 115-97.

<sup>50</sup> § 11001 of the TCJA. Public Law 115-97.

<sup>51</sup> § 13001 of the TCJA. Public Law 115-97.

<sup>52</sup> § 11011 of the TCJA. Public Law 115-97.

<sup>53</sup> § 13303 of the TCJA. Public Law 115-97.

- Retention of the individual alternative minimum tax.<sup>55</sup>

Today, with the highest individual income tax rate higher than the flat corporate income tax rate, however, the desirability of the S corporation may not be so vivid.<sup>56</sup> Making the desirability of the S corporation even less clear has been the creation of other business entities, namely the limited liability company and the limited liability partnership.

While some tax practitioners may believe, especially as a result of the TCJA, the S corporation may become extinct like the dinosaur, given that our laws are not static, that may not be an accurate conclusion. The laws may very well change down the road, making the S corporation again the entity of choice.

It may be true that many (not all) newly created business entities today will not initially take the S corporation form, but tax practitioners cannot lose site of the possibility that these same entities may decide, due to changes in our tax laws or taxpayer circumstances, to convert to S corporation status down the road. We need to keep in mind the fact that many of the taxpayer friendly provisions of the TCJA are temporary in nature. Without further Congressional action, numerous provisions of the TCJA, including most of the provisions referenced above, sunset at the end of 2025.

The road between Subchapter C and Subchapter S today is definitely a two-way thoroughfare. Historically, the road was traveled more commonly in the direction going from Subchapter C to Subchapter S. It was much rarer to see significant traffic traveling from Subchapter S to Subchapter C.

Given the changes in our tax laws created by the TCJA, we will likely see greater traffic on the road in the direction from Subchapter S to Subchapter C. Although the drive will generally be pleasant and complete with beautiful scenery, expect traffic delays and congestion! Be on the lookout for accidents. The road contains obstacles, barriers and traps for inexperienced drivers!

Be aware – if our tax laws and/or taxpayer circumstances change, the road in the direction from Subchapter C to Subchapter S could have these same driving conditions. A thorough knowledge of the law and client circumstances is absolutely required.

The road, in both directions, is not without potholes, obstacles and even accidents that can hinder unwary travelers. While it is not a road that should necessarily be avoided if the facts and circumstances warrant, caution and care are necessary.

This paper, *The Road Between Subchapter C And Subchapter S – It May Be A Well-Traveled Two-Way Thoroughfare, But It Isn't Free of Potholes And Obstacles*, is written to provide tax

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<sup>54</sup> § 12001 of the TCJA. Public Law 115-97.

<sup>55</sup> *Id.*

<sup>56</sup> In accordance with Code § 1(a), the highest individual income tax rate is currently thirty-seven percent (37%). Code § 11(b) now provides a flat corporate income tax rate of twenty-one percent (21%).

practitioners with a thorough overview of the potholes and obstacles that may hinder travel in either direction on this road.<sup>57</sup>

Potholes and obstacles that may exist on the road when traveling in the direction of Subchapter C include unreasonable compensation, personal holding company status, limitations on bailing out the accumulated adjustments account, and excessive accumulated earnings. In the direction of Subchapter S, travelers on this road may be faced with election and re-election issues, eligibility requirements, the built-in-gains tax, LIFO recapture, the loss of Subchapter C tax attributes due to atrophy, and the impact of excessive passive income.

Comedian Jerry Seinfeld is accredited with saying:

**“Sometimes the road less traveled is less traveled for a reason.”**

After the enactment of the TCJA, tax practitioners, likely more than ever before, need to pay attention to this statement. Traveling back and forth between Subchapter S and Subchapter C could be a meandering and treacherous road for the unwary. Careful planning and a good roadmap or global positioning unit (“GPS”) are clearly necessary.

## **1.02 THE TAX CUTS AND JOBS ACT – SEVERAL PROVISIONS DIRECTLY IMPACT THE DRIVING CONDITIONS ON THE ROAD IN THE DIRECTION OF SUBCHAPTER S.**

Before we can get on the road to travel toward Subchapter S, we need to have a full understanding of the provisions of the TCJA that could impact driving conditions.

While the TCJA spans over 500 pages and contains a plethora of provisions impacting almost every aspect of the Code, it only contains a few provisions that directly impact Subchapter S. The provisions of the TCJA that directly impact Subchapter S come in four (4) flavors, namely:

- Changes to the beneficiary eligibility requirements for an ESBT.
- Changes to the manner in which charitable deductions made by an ESBT are claimed.
- Adoption of an additional limitation on an S corporation shareholder’s ability to use losses passing through from the corporation.
- Additional rules relating to the impact of the termination of an S election.

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<sup>57</sup> This paper focuses on the domestic Federal income tax issues relating to the road between Subchapter S and Subchapter C. The state and local, as well as international income tax issues, have been purposely omitted. They are beyond the scope of this paper.

**[1] Electing Small Business Trusts.**

**[a] Background.**

In 1996, Congress amended Code § 1361, adding an additional type of shareholder that is eligible to become an S corporation shareholder, the ESBT.<sup>58</sup> The ESBT was the first new entity to join the list of eligible S corporation shareholders in many years.

The ESBT is an interesting creature of statute. For reasons discussed below, its use is generally limited.

**[b] Eligibility, Election, Revocation and Operating Characteristics.**

Originally, to qualify as an ESBT, all beneficiaries, current, contingent and remainder, had to be individuals or estates. Provided, however, charitable organizations described in Code § 170(c)(2) through (5) were initially allowed to hold contingent remainder interests. After December 31, 1997, such charitable organizations were allowed to hold current interests.<sup>59</sup> Additionally, an organization described in Code § 170(c)(1)<sup>60</sup> may hold a contingent interest in an ESBT, but it may not be a potential current beneficiary of the trust.<sup>61</sup>

No interest in an ESBT may have been acquired by “purchase.” For this purpose, purchase means any acquisition if the basis of the property is determined under Code § 1012.<sup>62</sup> In other words, if a person acquires an interest in a trust, and any portion of the person’s basis in the acquired interest in the trust is determined under Code § 1012, such interest is considered to be acquired by purchase.<sup>63</sup> This includes a net gift of a beneficial interest in the trust where the person acquiring the interest pays the gift tax.<sup>64</sup> The ESBT itself is not prohibited from acquiring S corporation stock or other property by purchase.<sup>65</sup>

An ESBT may not be a foreign trust.<sup>66</sup> It also cannot be a QSST with respect to which an election under Code § 1361(d)(2) is in effect.<sup>67</sup> Likewise, an ESBT cannot be a trust which is tax-exempt under Subtitle A of the Code.<sup>68</sup> Last, an ESBT cannot be a charitable remainder annuity trust or a charitable remainder uni-trust as defined in Code § 664(d).<sup>69</sup>

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<sup>58</sup> §§ 1302 and 1317(a) of the 1996 Act. Code § 1361(e).

<sup>59</sup> Code § 1361(e) and §§ 1314 and 1302(c) of the 1996 Act.

<sup>60</sup> Code § 170(c)(1) organizations include states, possessions of the United States, or any political subdivision of the foregoing, the United States or the District of Columbia).

<sup>61</sup> Code § 1361(e)(1)(A)(i).

<sup>62</sup> Code § 1361 (e)(1)(C) and § 1302(c) of the 1996 Act.

<sup>63</sup> Treas. Reg. § 1.1361-1(m)(1)(iii).

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> Code § 1361(c)(2)(A)(v).

<sup>67</sup> Code § 1361(e)(1)(B)(i).

<sup>68</sup> Code § 1361(e)(1)(B)(ii).

<sup>69</sup> Code § 1361(e)(1)(B)(iii).

An ESBT must affirmatively elect to be treated as an ESBT.<sup>70</sup> The election is made by the trustee and is effective for the taxable year of the trust in which the election is made and all subsequent years unless the election is revoked with the Commissioner's consent.<sup>71</sup>

The same due dates for filing QSST elections generally apply to ESBT elections.<sup>72</sup> This means that the ESBT election usually must be filed with the IRS within the two-month-and-16-day period beginning on the date of the trust's receipt of the S corporation stock.<sup>73</sup>

An ESBT election is made by filing a statement with the IRS Service Center where the S corporation files its income tax returns.<sup>74</sup> Interestingly, IRS Form 2553, which is used for filing an S election, a Qualified Subchapter S Trust election and a request for late election relief in certain circumstances, does not contain the necessary statement for an ESBT election. The Service has not issued a separate form of ESBT election.

The ESBT election statement must include:

- The name, address, and taxpayer identification number of the ESBT, each of the potential income beneficiaries and the S corporation(s) in which the trust currently holds stock.<sup>75</sup>
- If the trustee of the ESBT has the power to make distributions from the trust to certain tax-exempt organizations (described in Code § 1361(c)(6)), a statement that such power exists must be reflected in the election statement.<sup>76</sup>
- A clear statement to identify the document as an ESBT election.<sup>77</sup> A statement at the top of the document along the lines of the following will likely suffice:

**ELECTING SMALL BUSINESS TRUST ELECTION MADE  
PURSUANT TO CODE SECTION 1361(e)(3)**

- The first date upon which the ESBT owned stock in each S corporation.<sup>78</sup>
- The date upon which the election is to be effective.<sup>79</sup>
- An express representation of the trustee(s) that the trust meets the definitional requirements under Code § 1361(e)(1) and that all potential current

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<sup>70</sup> Code § 1361(e)(3).

<sup>71</sup> *Id.*

<sup>72</sup> Treas. Reg. § 1.1361-1(m)(2)(iii).

<sup>73</sup> Treas. Reg. §§ 1.1361-1(m)(2)(iii) and 1.1361-1(j)(6)(iii).

<sup>74</sup> Treas. Reg. § 1.1361-1(m)(2)(i).

<sup>75</sup> Treas. Reg. § 1.1361-1(m)(2)(ii)(A).

<sup>76</sup> *Id.*

<sup>77</sup> Treas. Reg. § 1.1361-1(m)(2)(ii)(B).

<sup>78</sup> Treas. Reg. § 1.1361-1(m)(2)(ii)(C).

<sup>79</sup> Treas. Reg. § 1.1361-1(m)(2)(ii)(D).

beneficiaries of the ESBT meet the requirements to be a shareholder of an S corporation under Code § 1361(b)(1).<sup>80</sup>

There are several interesting aspects of an ESBT election, including:

- If the ESBT has more than one trustee, the trustee or trustees with authority to legally bind the trust must sign the election statement.<sup>81</sup>
- If any one of the trustees of an ESBT that has more than one trustee can bind the trust, only one trustee must sign the election statement.<sup>82</sup>
- As a general rule, only one election is made for an ESBT, regardless of the number of S corporations whose stock is held by the trust.<sup>83</sup>
- If an ESBT holds stock in multiple S corporations and all of the S corporations do not file income returns with the same IRS Service Center, the initial ESBT election statement must be filed with all of the IRS Service Centers where the S corporations file income tax returns.<sup>84</sup> If, however, an ESBT that has already filed its election with the appropriate IRS Service Center(s) later acquires stock in an S corporation which files its income tax returns at a different IRS Service Center, a new ESBT election is not required.<sup>85</sup>
- A trust is not allowed to make a protective ESBT election in which its effectiveness is conditioned upon it failing to meet the eligible trust requirements of Code § 1361(c)(2)(A)(i) through (iv).<sup>86</sup> Such an election is ineffective.<sup>87</sup>

### [c] Late ESBT Elections.

If an ESBT election is late, relief may be available.

As discussed above, the 1996 Act,<sup>88</sup> added Section 1362(b)(5) to the Code which gives the Service has authority to treat late elections or elections that were never filed as timely if reasonable cause exists. The provision was given a retroactive effective date back to tax years beginning after 1982, which coincides with the effective date of the last major overhaul of Subchapter S via the Subchapter S Revision Act of 1982.

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<sup>80</sup> Treas. Reg. § 1.1361-1(m)(2)(v).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

<sup>86</sup> Treas. Reg. § 1.1361-1(m)(2)(ii)(E)(1).

<sup>87</sup> *Id.*

<sup>88</sup> § 1305(b) of P.L. 104-188.

The Service has been very lenient deciding whether reasonable cause exists. Almost anything seems to work—either the dog ate the IRS Form 2553, or I simply forgot to file the IRS Form 2553 seems to work. Taxpayers falling on their swords works in this one instance.

Under Revenue Procedure 2003-43,<sup>89</sup> relief is available for late S elections, ESBT elections, QSST elections and QSub elections. The requirements for relief are simple and straight forward:

- Late or non-filing can be your only defect;
- The request for forgiveness must be made within twenty-four (24) months of the original due date of the election;
- The request must state why reasonable cause exists; almost anything seems to constitute reasonable cause;
- The request must be filed within six (6) months of the due date without extensions of the corporation's first S year tax return; and
- No shareholder may have taken a filing position that is inconsistent with the election having been in place.

The request for relief must be filed with the IRS Service Center where the S corporation files its income tax returns. It is to be filed with a fully completed and executed Form 2553 that is marked at the top in bold letters:

**FILED PURSUANT TO REVENUE PROCEDURE 2003-43.**

If a taxpayer does not meet any of these requirements or the Service denies the request, the taxpayer can always file for a private letter ruling. The downside to the ruling process is obvious—the time and expense can be significant.

If a taxpayer meets the Revenue Procedure 2003-43 requirements but has not yet filed the first S corporation return, Revenue Procedure 2007-62<sup>90</sup> makes obtaining relief even easier—the taxpayer simply files the Form 2553 and includes a statement requesting forgiveness along with the IRS Form 1120S.

Revenue Procedure 2013-30<sup>91</sup> was issued in late 2013. It expanded the relief available to taxpayers that experience late S corporation election problems. Specifically, Revenue Procedure 2013-30 does two major things for taxpayers:

- It retains the same requirements of Revenue Procedure 2003-43, but it removes the timing requirements and grants relief for elections that are up to three years and seventy-five (75) days late; and

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<sup>89</sup> Rev. Proc. 2003-43, 2003-1 C.B. 998.

<sup>90</sup> Rev. Proc. 2007-62, 2007-2 CB 786.

<sup>91</sup> Rev. Proc. 2013-30, 2013-36 I.R.B. 1.

- If a taxpayer is beyond that time period when the problem is discovered, if the taxpayer always filed as an S corporation, Revenue Procedure 2013-30 still fixes the defect. So, if the taxpayer meets the other Revenue Procedure 2003-43 requirements, has always filed as an S corporation, and is beyond the time requirements of the old Revenue Procedure, relief under this new Revenue Procedure is available.

**Life is good!** Relief is easy and inexpensive; no filing fees are required. No private letter ruling request is needed.

Revenue Procedure 2013-30 contains user-friendly flowcharts that walk tax practitioners through every possible scenario and provides step by step instructions on how to obtain late or non-filing relief. The flowcharts should be used by tax practitioners as a desk reference.

Revenue Procedure 2013-30 is not limited to S elections. It also applies to QSub elections, QSST elections and ESBT elections.

#### **[d] Potential Current Beneficiaries of ESBTs.**

Each potential current beneficiary of the trust is treated as a shareholder of the S corporation.<sup>92</sup> Provided, however, if there is no potential current beneficiary during any period, the trust itself is treated as a shareholder of the corporation during that period.<sup>93</sup>

“Potential current beneficiary” means any person who is entitled to, or at the discretion of the trustee may receive, a distribution of the income or principal of the trust.<sup>94</sup> No person is treated as a potential current beneficiary solely because that person holds a future interest in the trust.<sup>95</sup> Also, a person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (e.g., the death of the holder of a power of appointment) is not a potential current beneficiary until specified time or occurrence arises.<sup>96</sup>

#### **[e] Taxation of ESBTs.**

The tax attributable to shares of an S corporation held by an ESBT is determined in accordance with special rules.<sup>97</sup> These rules are not very taxpayer friendly.

The portion of the trust holding S corporation stock is treated as a separate taxable trust. The tax on the separate trust is determined under normal rules applicable to trusts, with the addition and/or exception of the following:

- The highest individual tax rate is applied.
- The exemption amount under Code § 55(d) is zero.

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<sup>92</sup> Code § 1361(e)(2).

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> Treas. Reg. § 1.1361-1(m)(4)(i).

<sup>96</sup> Treas. Reg. § 1.1361-1(m)(4)(v).

<sup>97</sup> Code § 641(d) and § 1302(d) of the 1996 Act.

- Capital losses are only allowed to the extent of capital gains.
- The only items of income, loss, deduction or credit taken into account are those items required to be taken into account under Code § 1366, any gain or loss from the disposition of the S corporation stock and (to the extent prescribed in Regulations) state/local taxes and administrative expenses.
- If the trust terminates, the loss carryovers or excess deductions are applied to the entire trust.

**QUERY:** Given the tax attributes and operating rules, all of which are discussed above, why would the trustee(s) of a trust ever want to make an ESBT election? The answer appears to be that the ESBT may be a solution where the trust created or that springs into life on the death of the grantor does not meet the QSST requirements and holds the stock of an S corporation. In such instance, the trustee(s) may have no alternative without jeopardizing the S corporation election than making an ESBT election. The ESBT election, of course, comes with a tax cost (as illustrated above). That tax cost may, however, be much less than the cost of terminating the S corporation election. A QSST is usually preferable to an ESBT because the income flows through and is taxed directly to the beneficiary. An ESBT's taxable income is trapped within the trust for tax purposes, even if it is actually distributed out to the beneficiaries. The portion of an ESBT holding S corporation stock also gets taxed automatically at the highest individual income tax rate and is unable to take advantage of the graduated rate structure or the exemption allowed for trusts. This is a definite disadvantage for an ESBT that has very little or no other taxable income aside from the income from the part of the trust holding S corporation stock.

**[f] Nonresident Aliens.**

As discussed above, in accordance with Code § 1361(e)(3), each potential current beneficiary of an ESBT is treated as a shareholder of the S corporation. Consequently, since nonresident aliens are ineligible shareholders of an S corporation,<sup>98</sup> prior to the TCJA (discussed below), they could not be potential current beneficiaries of an ESBT. Also, each potential current beneficiary is counted for purposes of complying with the 100 shareholder limitation contained in Code § 1361(b)(1)(A).

**[g] Revocation Exception Applicable to ESBTs.**

As mentioned earlier, an ESBT election generally may only be revoked with the consent of the Commissioner of the IRS. The application for consent unfortunately must be submitted to the Service in the form of a letter ruling request.<sup>99</sup> Along with the formality of the request comes the cost of a tax practitioner to prepare it and the IRS filing fee.

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<sup>98</sup> Code § 1361(b)(1)(C).

<sup>99</sup> Treas. Reg. § 1.1361-1(m)(6).

There is an exception to the general ESBT revocation rule. A request to revoke an ESBT election is deemed automatically granted by the Commissioner if the trust makes a qualifying election to convert to a QSST.<sup>100</sup> Specific requirements, however, must be met:

- The trust must meet the QSST eligibility requirements contained in Code § 1361(d). This means that: (i) the trust instrument must provide that there can only be one income beneficiary during the life of the current income beneficiary, any corpus distributed during the life of the current income beneficiary may only be distributed to such beneficiary, the income interest of the current income beneficiary must terminate on the earlier of such beneficiary's death or the termination of the trust, and if the trust terminates during the life of the current income beneficiary, all assets must be distributed to such beneficiary; and (ii) all income is distributed or required to be distributed currently to one individual who is a citizen or resident of the United States.<sup>101</sup>
- The trustee(s) and the current income beneficiary of the trust execute a QSST election and the election is filed with the IRS Service Center where the S corporation files its income tax returns.<sup>102</sup>
- The QSST election must state at the top of the document: **ATTENTION ENTITY CONTROL – CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1(m).**<sup>103</sup>
- The QSST election must include all information otherwise required for a QSST election under Treasury Regulation § 1.1361-1(j)(6).<sup>104</sup>
- The trust had not converted from a QSST to an ESBT within the 36-month period immediately preceding the effective date of the new QSST election.<sup>105</sup>
- The effective date of the QSST election cannot be effective more than fifteen (15) days and two (2) months prior to the date on which the election is filed, and it cannot be more than twelve (12) months after the date on which the election is filed.<sup>106</sup> Like an S election, if a QSST election specifies an effective date that is more than fifteen days and two months prior to the date on which the election is filed, it will be deemed effective on the day that is fifteen (15) days and two (2) months prior to the date on which it is filed, and if a QSST election specifies an effective date that is more than twelve (12)

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<sup>100</sup> Treas. Reg. § 1.1361-1(m)(7).

<sup>101</sup> Code § 1361(d)(3).

<sup>102</sup> Treas. Reg. § 1.1361-1(m)(7)(ii).

<sup>103</sup> *Id.*

<sup>104</sup> *Id.*

<sup>105</sup> Treas. Reg. § 1.1361-1(m)(7)(iii).

<sup>106</sup> Treas. Reg. § 1.1361-1(m)(7)(iv).

months after the date on which the election is filed, it will be deemed effective on the day that is twelve (12) months after the date on which it is filed.<sup>107</sup>

If the aforementioned requirements are met, the ESBT election is revoked upon the effective date of the QSST election. In all other cases, revocation of an ESBT election requires the consent of the Commissioner.

**[h] TCJA Change/Eligible ESBT Beneficiaries.**

The TCJA expressly amended Code § 1361(c)(2)(B)(v) by adding a new sentence: “This clause shall not apply for purposes of subsection (b)(1)(C).”<sup>108</sup> The result is simple: effective January 1, 2018, a nonresident alien may be a potential current beneficiary of an ESBT.

Aside from being a potential current beneficiary of an ESBT, a nonresident alien still may not be a shareholder of an S corporation.<sup>109</sup> Additionally, a nonresident alien still may not be a beneficiary of a QSST.<sup>110</sup>

**QUERY:** Why does Congress care whether a nonresident alien is a shareholder of an S corporation or a QSST, but finds it otherwise acceptable for a nonresident alien to be a potential current beneficiary of an ESBT? A nonresident alien is a person who is neither a citizen of the United States nor a resident alien.<sup>111</sup> A person qualifies as a “resident alien” if the person is “a lawful permanent resident of the United States,” fulfills the “substantial presence test,” or fulfills the “first-year election” requirements.<sup>112</sup> The fear of allowing nonresident aliens to be shareholders of S corporations or beneficiaries of QSSTs is obvious – nonresident aliens generally do not have to file income tax returns in the United States, which could allow corporations to distribute money without United States taxation. The fear does not exist in the case of ESBTs since the trust, not the beneficiary pays the tax resulting from the S corporation in which it holds shares.

**PRACTICE ALERT:** S corporations that wish to allow a nonresident alien to benefit from ownership of the corporation could use an ESBT to accomplish the goal. As mentioned above, however, there is a tax cost that comes with using an ESBT as an S corporation ownership vehicle.

**PRACTICE ALERT:** If a nonresident alien is a potential current beneficiary of an ESBT, extreme caution is required. If the stock of the S corporation is ever distributed (directly or constructively) to the nonresident alien beneficiary, the corporation’s S election will be terminated as of the date of the distribution.<sup>113</sup> While the rules surrounding the eligibility of ESBT beneficiaries may have been liberalized, it comes with a potential peril. Extreme caution must be exercised.

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<sup>107</sup> *Id.*

<sup>108</sup> § 13541 of the TCJA. Public Law 115-97.

<sup>109</sup> Code § 1361(b)(1)(C).

<sup>110</sup> Code § 1361(d)(3)(B).

<sup>111</sup> Code § 7701(b)(1)(B).

<sup>112</sup> Code § 7701(b)(1)(A).

<sup>113</sup> Code §§ 1361(b)(1)(C) and 1362(d)(2).

**[i] TCJA Change/Charitable Contribution Deductions by ESBTs.**

An S corporation generally computes and reports to its shareholders, in addition to its non-separately computed income and loss, their pro-rata share of separately stated items of income (including tax exempt income), loss, deduction, loss and credit of the corporation.<sup>114</sup> The separately stated items include charitable contributions made by the S corporation. The ultimate tax treatment of charitable contributions made by the corporation, however, depends upon the tax status of each of the shareholders.

Prior to the TCJA, if a trust made a charitable contribution, the tax treatment of the charitable contribution and the corresponding deduction were handled one way, and if an individual made a charitable contribution, the tax treatment of the charitable contribution and the corresponding deduction were handled another way.

A trust is generally allowed a deduction for any amount of gross income, without limitation, which pursuant to the terms of a governing instrument is paid for a charitable purpose. No carryover of excess deductions is allowed. In contrast, the charitable contribution deduction applicable to individuals is limited to certain percentages of adjusted gross income<sup>115</sup> and excess deductions may generally be carried forward up to five years<sup>116</sup> and used in future years when adjusted gross income is sufficient to utilize the deductions.

The TCJA directly impacts ESBTs in another interesting manner. Prior to the enactment of the TCJA, the deduction for charitable contributions applicable to trusts, rather than the deduction applicable to individuals, applied to ESBTs.<sup>117</sup> So, an ESBT was allowed a charitable deduction for charity contributions (assuming the governing instrument so allowed the contribution) without a limitation pegged to adjusted gross income, but it did not have the ability to carryover unused charitable deductions due to insufficient income – the deductions were forever lost.

§ 13542 of the TCJA changes the landscape a bit. For tax years beginning after December 31, 2017, the deduction for charitable contributions applicable to individuals applies to ESBTs. In particular, the rules applicable to individuals apply to the portion of an ESBT holding S stock for the purpose of determining and applying the deduction for charitable contributions made by the S corporation. So, the adjusted gross income limitations applicable to individuals now apply to the portion of ESBTs holding S corporation stock. Likewise, the ability to carryover excess charitable deductions for a period of five years is also available to the portion of ESBTs holding S corporation stock.

The Joint Committee on Taxation estimates the changes discussed above relative to eligible beneficiaries and charitable deductions will decrease tax revenue by \$300 million over the next ten years.

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<sup>114</sup> Code § 1366(a).

<sup>115</sup> Code § 170(d)(1)(A).

<sup>116</sup> *Id.* Qualified conservation contributions may be carried forward up to fifteen years. Code § 170(b)(1)(E)(ii).

<sup>117</sup> Code § 641(c) as cross referenced by Code § 1361(e)(4).

**[2] Excess Business Losses.**

In general, S corporation shareholders, like the owners of entities taxed as partnerships, are allocated their share of the entity's losses for the taxable year. A number of rules, however, may limit the ability of the owners to deduct these losses.

For one, the aggregate amount of losses taken into account by an S corporation shareholder cannot exceed: (a) the shareholder's adjusted stock basis; plus (b) the shareholder's adjusted basis of any indebtedness owed by the corporation to the shareholder.<sup>118</sup>

Additionally, the losses being passed through to an S corporation shareholder must be tested under the at-risk<sup>119</sup> and then the passive activity loss<sup>120</sup> rules before the losses may be used by the shareholder in determining his/hers/its taxable income. Losses that are disallowed under either the at-risk or the passive activity loss rules are generally suspended and carried forward indefinitely until the shareholder has sufficient amounts at-risk, sufficient passive income or disposes of the shares of the S corporation. If a loss is not limited by these rules, however, it may be applied against the shareholder's other income.

**[a] TJCA Additional Limitation.**

The TCJA imposes an additional limitation on an S corporation shareholder's ability to use losses passing through from the corporation.<sup>121</sup> To create this additional limitation, the TCJA amends Code § 461 which imposes certain limitations on the amount of any deduction allowable for the taxable year.

**PRACTICE ALERT:** These new rules equally apply to other non-corporate taxpayers such as entities taxed as sole proprietorships and partnerships.

For taxable years beginning after December 31, 2017, Code § 461(l) disallows something called "excess business losses" which are passed through to an S corporation shareholder.<sup>122</sup>

For this purpose, an "excess business loss" for the taxable year in the case of an S corporation is the excess of the shareholder's aggregate deductions attributable to all of the shareholder's trades or businesses for the year, over the sum of the shareholder's aggregate gross income or gain for the year, plus \$250,000 (or \$500,000 in the case of a joint return).<sup>123</sup>

The limitation imposed by Code § 461(l) is to be applied after the passive activity loss limitations under Code § 469.<sup>124</sup> It is applied at the shareholder level.<sup>125</sup>

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<sup>118</sup> Code § 1366(d). The rules applicable to entities taxed as partnerships are much more liberal.

<sup>119</sup> Code § 465.

<sup>120</sup> Code § 469.

<sup>121</sup> § 11012 of the TCJA. Public Law 115-97.

<sup>122</sup> These rules also apply to owners of entities taxed as partnerships.

<sup>123</sup> Code § 461(l)(3)(A). This amount is to be adjusted after 2018 for inflation. Code § 461(l)(3)(B).

<sup>124</sup> Code § 461(l)(6).

<sup>125</sup> Code § 461(l)(4).

**PRACTICE ALERT:** There is a new trap lurking in the Code that may catch the unwary if they are not careful. An S corporation shareholder may have losses that have been historically suspended from use due to the application of the at-risk or the passive activity loss rules that are now (after December 31, 2017) available for use (no longer suspended) but may continue in suspension due to the application of Code § 461(l). Taxpayers planning for losses suspended by Code §§ 465 and 469 now need to consider the limits arising from the application of Code § 461(l). The moral to this story is simple – just because losses are no longer suspended under Code §§ 465 and 469 does not mean they are available for use against other income – Code § 461(l) needs to be considered. It cannot be ignored in tax planning.

While the new loss limitation imposed by Code § 461(l) may put a monkey wrench in any S corporation shareholder's day, there is some relatively good news. Any loss disallowed as a result of Code § 461(l) may be carried forward to the following taxable year under Code § 172.<sup>126</sup>

**PRACTICE ALERT:** Code § 172 imposes a limitation on the deductibility of loss carryovers of eighty percent (80%) of taxable income computed without regard of such losses.

**QUERY:** Do losses carried over to the next taxable year, subject to the eighty percent (80%) limitation of Code § 172, go through the gauntlet of Code § 461(l) again in such subsequent taxable year? Unfortunately, the Code is not clear. Hopefully, Treasury will issue guidance on the matter in the form of Treasury Regulations to answer this query. We should assume the answer is yes absent guidance to the contrary.

**QUERY:** Are losses carried forward to future taxable years due to this new rule allowable in the taxable year in which the shareholder disposes of the shares of the S corporation without application of the Code § 461(l) limits? Unfortunately, the Code is not clear. Hopefully, Treasury will issue guidance on the matter in the form of Treasury Regulations to answer this query.

Code § 461(l)(5) gives the Secretary authority to prescribe additional reporting requirements as it deems necessary to carry out the purposes of this new addition to the Code.

#### **[b] Good News.**

As a general rule, some good news (if we look hard and long enough) accompanies bad news. Code § 461(l) is **not** an exception to this general rule. Unless Congress acts, Code § 461(l) expires on December 31, 2025. **It is not a permanent provision of the Code.**

#### **[c] Revenue Impact.**

The Joint Committee on Taxation estimates new Code § 461(l) will increase tax revenue by \$149.7 million over the next ten years.

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<sup>126</sup> Code § 461(l)(2).

**[3] TCJA Changes Impacting S Corporation Election Terminations and Revocations.**

Congress envisioned with the passage of the TCJA, including amendments made to Code § 11 (reducing the corporate tax rate to a flat 21%), many S corporations would be inclined to terminate their S elections. Accordingly, lawmakers included two provisions of the TCJA that focus on terminated S corporations.<sup>127</sup> Both of these provisions are generally favorable to terminated S corporations.

**[a] Method of Accounting.**

The first provision of the TCJA impacting terminated S corporations deals with the method of accounting for income tax purposes.

The cash method of accounting generally requires taxpayers to recognize items of income when they actually or constructively receive them and allows taxpayers to deduct expenses when they actually pay them. This method of accounting is relatively simple to administrate by taxpayers. Additionally, it likely provides the greatest flexibility in terms of the timing of income recognition.

The accrual method of accounting, on the other hand, generally requires taxpayers to recognize items of income when the amount of income can be determined with reasonable accuracy and all of the events that fix their right to receive the income have occurred.<sup>128</sup> Likewise, expenses only become deductible when all events have occurred that fix the obligation, the amount of the obligation may be determined with reasonable accuracy and economic performance has occurred.<sup>129</sup>

**[i] Pre-TCJA.**

Prior to the passage of the TCJA, in general, a C corporation or an entity taxed as a partnership that had a C corporation partner, could not use the cash method of accounting for income tax purposes.<sup>130</sup> An exception to this rule existed – If average gross receipts did not exceed \$5 million for all prior years (the “gross receipts test”), these entities were excepted from the general rule and were allowed to use the cash method of accounting for income tax purposes.<sup>131</sup>

**[ii] Post-TCJA.**

The TCJA changes the landscape in at least two respects.<sup>132</sup> First, the gross receipts test limitation is increased from \$5 million to \$25 million. Second, the test is applied looking back at the prior three-year period (rather than all periods).<sup>133</sup> Accordingly, more C corporations and

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<sup>127</sup> § 13543 of the TCJA. Public Law 115-97.

<sup>128</sup> Code § 451.

<sup>129</sup> Code § 461.

<sup>130</sup> Exceptions for qualified personal service corporations and certain farming corporations existed, allowing them to sue the cash method of accounting for income tax purposes.

<sup>131</sup> Code § 448(b)(3) prior to the TCJA.

<sup>132</sup> § 13102 of the TCJA. Public Law 115-97.

<sup>133</sup> Code § 448(b)(3) after the TCJA.

partnerships with C corporation partners should be eligible to use the cash method of accounting for income tax purposes following the passage of the TCJA.

**PRACTICE ALERT:** An S corporation that fails the gross receipts test, like pre-TCJA law, remains eligible under the TCJA to use the cash method of accounting for income tax purposes. If that same corporation (that fails the gross receipts test), however, loses its S election due to a technical termination or a voluntarily revocation, it would, upon the effective date of its termination or revocation of S status, become a C corporation that is otherwise ineligible to use the cash method of accounting for income tax purposes. In such circumstance, a change in accounting method governed by Code § 481 would occur.

Prior to the passage of the TCJA, Code § 481 required when taxable income of a taxpayer is computed under a different method than income in the prior year was computed that the taxpayer take into account adjustments necessary to prevent items of income or expense from being duplicated or omitted. This makes perfect sense. Unfortunately, its application was not always so logical or simple.

Generally, the net adjustments were taken into account: (i) in the case where they resulted in a decrease in taxable income, during the taxable year of the change, and (ii) in the case where they resulted in an increase in taxable income, ratably over the four-year period beginning with the year in which the change occurred.<sup>134</sup>

**PRACTICE ALERT:** The TCJA changes the income inclusion rule.<sup>135</sup>

For “eligible terminated S corporations,” any net adjustments resulting in an increase in taxable income, are taken into account ratably over the six-year period (rather than four-year) beginning with the year in which the change occurred.<sup>136</sup>

An “eligible terminated S corporation” is defined as any C corporation which:

- Was an S corporation on the day before the TCJA was enacted into law (i.e., December 22, 2017);
- During the two-year period beginning on the day of enactment of the TCJA (i.e., December 22, 2017) it revokes its S election under Code § 1362(a); **and**
- All shareholders on the date of revocation are the same (in identical proportions) as they were on the date of the enactment of the TCJA (i.e., December 22, 2017).

**QUERY:** Is an S corporation which otherwise qualifies as an “eligible terminated S corporation” that had its S election terminated by ceasing to be a qualifying small business corporation meet the “eligible terminated S corporation” criteria and able to benefit from the six-year rule? Code § 481(d) speaks in terms of a corporation revoking its S election; it does not

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<sup>134</sup> Code § 481(a); *see e.g.*, Rev. Proc. 2015-13, 2015-5 IRB 419.

<sup>135</sup> § 13543 of the TCJA added Code § 481(d).

<sup>136</sup> Code § 481(d).

appear to envision a termination caused by a corporation ceasing to meet the small business requirements (e.g., it later has over 100 shareholders or has shares transferred to a nonresident alien). It certainly seems logical that Code 481(d)'s use of the term “revokes” encompasses both revocations and terminations, but caution is advised. Application of the rule in both instances may not be advisable until and if Treasury issues guidance supporting that interpretation of the Code.

**[iii] Revenue Procedures.**

The IRS periodically issues a revenue procedure containing an updated comprehensive list of procedures necessary for taxpayers to change permissible methods of accounting. Revenue Procedure 2018-31<sup>137</sup> is an example of such guidance. The Service modified Revenue Procedure 2018-31 on August 22, 2018 when it issued Revenue Procedure 2018-44.<sup>138</sup> This revenue procedure provides guidance relative to cash to accrual method of accounting changes made by “eligible terminated S corporations.” It modifies Revenue Procedure 2018-31 to specifically reflect the introduction of Code § 481(d) by the TCJA.

Revenue Procedure 2018-44 requires that an “eligible terminated S corporation” make a positive or negative Code § 481(a) adjustment ratably over six (6) years beginning with the year of the change if the corporation:

- Must change from the cash method of accounting for income tax purposes to an accrual method of accounting for income tax purposes as a result of a revocation of its S corporation election; and
- Makes the method change for the first taxable year as a C corporation.

In the alternative, the revenue procedure allows (but does not require) an “eligible terminated S corporation” make a positive or negative Code § 481(a) adjustment ratably over six (6) years if it is otherwise:

- Permitted to continue using the cash method of accounting for income tax purposes after the revocation of its S election; and
- Changes to the accrual method of accounting for income tax purposes for the first taxable year as a C corporation.

**PRACTICE ALERT:** The six (6) year inclusion rule only applies to “eligible terminated S corporations.” For those S corporations that were not S corporations the day before the TCJA was enacted, did not revoke their S election within two (2) years following the enactment of the TCJA, and/or had a change in shareholders between the enactment of the TCJA and the effective date of the revocation of the S election, Code § 481(d) is unavailable. Accordingly, those taxpayers must revert back to the general rule – the net adjustments are taken into account: (i) in the case where the adjustments result in a decrease in taxable income, during the taxable

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<sup>137</sup> 2018-22 I.R.B. 637.

<sup>138</sup> 2018-37 I.R.B.

year of the change, and (ii) in the case where the adjustments result in an increase in taxable income, ratably over the four-year period beginning with the year in which the change occurred

**[b] Post-Termination Distributions.**

The second provision of the TCJA impacting S corporation terminations deals with post-termination distributions.

**[i] Pre-TCJA.**

Prior to the passage of the TCJA, in the instance of an S corporation that converted to a C corporation, distributions of cash (as opposed to in kind distributions) by the C corporation to its shareholders during the “post-termination period” to the extent of the amount of the accumulated adjustments (“AAA”) account were tax free to the shareholders. Such distributions served to reduce the adjusted basis of the shareholders’ stock.<sup>139</sup> Distributions in excess of the AAA account were treated as coming from C earnings and profits.

For this purpose, the “post-termination period” was generally the one-year period immediately following the effective date of the S election termination.<sup>140</sup> Under the old law, after the “post-termination period,” all distributions from the former S corporation were charged to C earnings and profits.

In essence, the old law gave former S corporations a year to distribute its AAA to shareholders free of tax. In cases where it took a while for the corporation to compute its AAA, the post-termination period was quite helpful. Once the post-termination period expired, the AAA was lost forever. So, even if the corporation re-elected S status down the road, its former AAA was gone in the ether, never to be resurrected. The IRS in Chief Counsel Advice recently confirmed this conclusion.<sup>141</sup> It concludes that AAA is forever gone once the post-termination period expires; it does not reappear if a subsequent S election is made. In fact, Chief Counsel specifically stated:

**“[We] conclude that an S corporation’s AAA is reset to zero after the [post-termination period] and remains zero into a subsequent S period.”<sup>142</sup>**

**QUERY:** Why would a former S corporation not distribute all of its AAA during the post-termination period? There are likely many reasons, other than pure oversight, error or neglect, why former S corporations fails to distribute all of their AAA during the post-distribution period. The most common reasons likely include:

- Insufficient cash.
- Lender restrictions (e.g., negative covenants on distributions).

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<sup>139</sup> Code § 1371(e).

<sup>140</sup> Code § 1377(b).

<sup>141</sup> Chief Counsel Advice 201446021 (November 14, 2014).

<sup>142</sup> *Id.*

- Regulatory restrictions (e.g., capital requirements).
- Business needs.

Likely, many former S corporations are presented with this predicament. To distribute or not to distribute is one of many questions that these entities faced.

**PRACTICE ALERT:** A tax-free reorganization under Code § 368(a)(1)(F), a F reorganization, could have possibly saved the day (or at least the AAA) for these corporations.

**EXAMPLE:** Corporation X is an S corporation with AAA of \$25,000,000. For business reasons, it desires to revoke its S election. Due to negative bank covenants and other business limitations, Corporation X will clearly **not** be able to distribute cash to its shareholders during the post-termination period sufficient to reduce the AAA to zero. Prior to revoking its S election, Corporation X could consider causing a new corporation (Corporation Y) to be formed which would make a timely S election, and the shares of Corporation X would be contributed to Corporation Y (making Corporation X its QSub). The result of this reorganization, which should be tax-free under Code § 368(a)(1)(F), is that Corporation X becomes a disregarded entity, and the AAA of Corporation X is transferred to its parent in accordance with Treasury Regulation § 1.1368-2(d)(2). Following the reorganization, the QSub status of Corporation X could be revoked to allow it to be taxed as a C corporation. Of course, the revocation of QSub status would need to be carefully reviewed to ensure it is a tax-free transaction. Corporation Y, an S corporation, would own 100% of the shares of Corporation X, now a C corporation. In such instance, the AAA of former Corporation X should remain at the parent level (Corporation Y). If the QSub status of Corporation X is reestablished after five (5) years, as required by Code § 1361(b)(3)(D), the AAA would be still available.

### [ii] Post-TCJA.

The TCJA changes the rules for distributions of money following the “post-termination period” for “eligible terminated S corporations.” It provides that such distributions made after the “post-termination period” (but only for “eligible terminated S corporations”) will be chargeable to the AAA account in the same ratio as the amount of AAA bears to the amount of accumulated earnings and profits. Thus, part of a distribution made following the “post-termination period” could still be tax-free.

**EXAMPLE:** Corporation X has been an S corporation for many years. It is a calendar year taxpayer. For business reasons, it desires to revoke its S election. Due to negative bank covenants and other business limitations, Corporation X will clearly **not** be able to distribute cash to its shareholders during the post-termination period sufficient to reduce the AAA to zero. It revokes its S election. On the effective date of the revocation, January 1, 2018, it had AAA of \$3,000,000. It is an “eligible terminated S corporation.” During taxable year 2018, Corporation X distributes \$1,000,000 in cash to its shareholders. At the end of taxable year 2019, Corporation X had \$2,000,000 of earnings and profits. During taxable year 2019, Corporation X distributed \$1,000,000 of cash to its shareholders. As a result of the TCJA, the 2018 distribution of \$1,000,000 served to reduce AAA of Corporation X to \$2,000,000. To the extent of shareholder basis, the distribution was tax-free. Likewise, as a result of the TCJA, the 2019

distribution of \$1,000,000, which was outside of the “post-termination period,” served to reduce AAA of Corporation X by \$500,000 (the same ratio that the AAA bears to accumulated earnings and profits) and reduce the earnings and profits of Corporation X by \$500,000. To the extent of shareholder basis, \$500,000 of the distribution would be treated as a tax-free distribution of AAA, and the remaining \$500,000 of distribution would be treated as a dividend.

**PRACTICE ALERT:** The TCJA’s new distribution rules appear to only apply to S corporations that revoke their S elections. As discussed above, Code § 481(d), in reference to “eligible terminated S corporations,” speaks in terms of a corporation revoking its S election; it does not appear to envision a termination caused by a corporation ceasing to meet the small business requirements (e.g., it later has over 100 shareholders or has shares transferred to a nonresident alien). It certainly seems logical that Code § 481(d)’s use of the term “revokes” encompasses both revocations and terminations, but caution is advised. Application of the rule in both instances may not be advisable until and if Treasury issues guidance supporting that interpretation of the Code.

**[iii] Effective Date.**

Both of the provisions discussed above impacting S election terminations or revocations were effective on December 22, 2017. They both appear to be permanent changes to the Code. So, they will not sunset on December 31, 2025 like many of the provisions of the TCJA.

**[iv] Revenue Impact.**

The Joint Committee on Taxation estimates these changes applicable to “eligible terminated S corporations” will decrease tax revenue by \$6.1 billion over the next ten years.

**1.03 THE TAX CUTS AND JOBS ACT – SEVERAL PROVISIONS OUTSIDE OF SUBCHAPTER S IMPACT THE DRIVING CONDITIONS ON THE ROAD IN THE DIRECTION OF SUBCHAPTER C.**

Many of the provisions of the TCJA that do not directly impact S corporations, nonetheless they affect the owners of business entities and their decisions, including:

- Whether to form a newly organized business as an S corporation.
- Whether to continue or revoke the S election of an existing business.
- Whether to convert an existing business entity, a C corporation, a partnership, or a sole proprietorship, to an S corporation.

The Code, after the enactment of the TCJA, is more complex than ever before. One of the results is that the choice of entity for many businesses is extremely challenging and must be revisited periodically. Many of the provisions of the TCJA complicate matters and require careful attention. Unfortunately, as historically was the case, there is no one-size fits all solution. Careful consideration of all facts and circumstances, past, present and future, including taxation, need to be a part of the analysis.

The following is a list of some of the Code provisions that require, especially post-TCJA, careful attention. The list is not intended to be exhaustive, but should serve as a good starting point for the required analysis.

**[1] Individual Tax Rates.**

The TCJA changed the individual income tax rate structure under Code § 1. Prior to the TCJA, there were seven (7) individual graduated tax rates, namely 10%, 15%, 25%, 28%, 33%, 35% and 39.6%. The TCJA retains the seven (7) tier structure, but it modifies the graduation a bit and sets the rates at 10%, 12%, 22%, 24%, 32%, 35% and 37%. Post TCJA, the top individual rate for married filing jointly taxpayers and single taxpayers kicks in at taxable income over \$600,000 and \$500,000, respectively, whereas under the prior law, the top rate for these taxpayers kicked in at taxable income over \$480,050 and \$426,700, respectively.

The new individual income tax rate structure is temporary. Unless Congress acts, it is scheduled to sunset on December 31, 2025.

**[2] Individual Alternative Minimum Tax.**

The TCJA retains an individual alternative minimum tax (“AMT”). The TCJA does, however, increase the exemption amounts and phase-out thresholds a bit.

Prior to the TCJA, subject to phase-out, the individual AMT exemption amount was \$84,500 in the case of married taxpayers filing jointly, \$54,300 in the case of unmarried taxpayers, and \$42,250 in the case of married individual taxpayers filing separately.<sup>143</sup> The TJCA increased the exemption amounts to \$109,400, \$70,300, and \$54,700, respectively.<sup>144</sup>

The individual taxpayer AMT exemption amount is phased-out based upon levels of alternative taxable income. Prior to the TCJA the phase-out thresholds were \$160,900 in the case of married taxpayers filing jointly, \$120,700 in the case of unmarried taxpayers, and \$80,450 in the case of married individual taxpayers filing separately.<sup>145</sup> The TJCA increased the exemption amounts to \$1,000,000 in the case of married taxpayers filing jointly, and \$500,000 for all other individual taxpayers.<sup>146</sup>

These changes to Code § 55 and the individual AMT may be good, but the changes clearly fall short of a total repeal of the individual AMT. Further, these changes, which are indexed for inflation, sunset on December 31, 2025, unless Congress extends their life.

**[3] New Code § 199A Pass-Through Deduction.**

The TCJA created new Code § 199A.<sup>147</sup> It offers individuals who are owners of entities taxed as S corporations, partnerships and sole proprietorships a deduction potentially equal to 20% of their pass-through income. The new Code provision is quite complex and comes with several

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<sup>143</sup> Code § 55(d) (1).

<sup>144</sup> Code § 55(d)(4)(i).

<sup>145</sup> Code § 55(d) (2).

<sup>146</sup> Code § 55(d)(4)(ii).

<sup>147</sup> § 11011 of the TCJA. Public Law 115-97.

qualifiers and limitations. In many cases, the exceptions and limitations serve to disqualify taxpayers from any tax benefit. While a thorough review and discussion of Code § 199A is beyond the scope of this paper, suffice it to say, the Code provision itself, and the newly proposed Treasury Regulations,<sup>148</sup> leave many questions unanswered about the application of the provision. Careful analysis of each taxpayer situation is required. In many cases, depending upon the nature of the taxpayer's business, total wages paid by the business, the unadjusted basis of certain assets of the business, and the taxpayer's taxable income, the benefit of Code § 199A will be reduced or eliminated.

Code § 199A is temporary. It is scheduled to sunset on December 31, 2025.<sup>149</sup>

#### **[4] Elimination of the Corporate AMT.**

The TCJA totally eliminates the corporate AMT.<sup>150</sup> Further, it allows taxpayers with corporate AMT credit carryovers to use them against regular income taxes, with the ability to possibly obtain refunds with respect to unused credit carryovers in excess of taxable income.<sup>151</sup>

This provision of the TCJA is a so-called permanent provision. It has no sunset date.

#### **[5] Corporate Tax Rates.**

The TCJA eliminated the tiered corporate income tax rate structure which ranged from 15% to 35%. Its replacement is a flat 21% rate.<sup>152</sup>

The new 21% flat income tax rate also replaces the 35% flat income tax rate that used to apply to personal service corporations.<sup>153</sup> For many personal service corporations, this change to the Code is good news.

The new flat 21% income tax rate for C corporations, along with the elimination of the corporate AMT, makes C corporations more attractive than we have seen in recent history. For personal service corporations, the 21% flat income tax is quite luring.

The new corporate income tax rates do not sunset. They are so-called permanent provisions.

#### **[6] Dividend Received Deduction.**

As part of the corporate income tax rate reduction, the TCJA tinkered with the dividend received deduction ("DRD") under Code § 243.<sup>154</sup> Under prior law, corporations received an 80% DRD for dividends received from 20% owned corporations, and a 70% DRD for dividends received

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<sup>148</sup> Proposed Treasury Regulations (REG-107892-18).

<sup>149</sup> § 11011 of the TCJA. Public Law 115-97.

<sup>150</sup> § 12001 of the TCJA. Public Law 115-97.

<sup>151</sup> *Id.*

<sup>152</sup> § 13001 of the TCJA. Public Law 115-97.

<sup>153</sup> *Id.*

<sup>154</sup> § 13002 of the TCJA. Public Law 115-97.

from less than 20% owned corporations.<sup>155</sup> The TCJA reduced the DRD for these corporations to 65% and 50%, respectively.<sup>156</sup>

Like the corporate income tax rate reduction provision, this provision is a so-called permanent provision. It does not sunset.

#### **1.04 TRAVELING THE ROAD FROM SUBCHAPTER C TO SUBCHAPTER S – THERE ARE MANY UGLY PROVISIONS OF THE CODE THAT SHOULD NOT BE FORGOTTEN OR IGNORED.**

The TCJA, as discussed above, adds some interesting provisions that may entice S corporations to revoke existing S elections, or cause new entities to commence life as C corporations. The provisions beguiling these taxpayers to enter life or continue life outside of Subchapter S may be short-lived as they have a limited statutory shelf life or Congress acts to amend them. Alternatively, these taxpayers may find life as a C corporation is not what it is cracked up to be. In either case, they may find themselves down the road wanting to rejoin the life of a Subchapter S corporation. In such cases, it is imperative that tax practitioners carefully guide these taxpayers so that they can avoid the many traps that remain for the unwary. The following discussion, albeit not absolutely complete, contains many of the major provisions that need to be recognized and considered in any plan to convert from C corporation status to S corporation status.

##### **[1] General Eligibility.**

The Code defines an S corporation as a “small business corporation” for which an election under Code § 1362(a) is in effect.<sup>157</sup> A “small business corporation” is defined in § 1361 (b) as a domestic corporation which is not an ineligible corporation, and which does not:

- Have greater than one hundred (100) shareholders.
- Have a shareholder that is not an individual, estate, specified type of trust or a specified type of tax-exempt organization.
- Have a nonresident alien as a shareholder.
- Have more than one class of stock.

##### **[a] Must Be a Domestic Corporation.**

A domestic corporation is a corporation that is:

- Created or organized in the United States or under the laws of the United States or of any state or territory.<sup>158</sup>

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<sup>155</sup> *Id.*

<sup>156</sup> *Id.*

<sup>157</sup> Code § 1361(a)(1).

<sup>158</sup> Treas. Reg. § 1.1361-1A(c); *See also* Code § 7701 (a)(3).

- A corporation existing under the laws of a foreign jurisdiction will not qualify, even though it owns property or does business in the United States.<sup>159</sup>

The term “corporation” has been held to include unincorporated organizations which are otherwise treated as corporations under the Federal tax laws.<sup>160</sup> For this purposes, a business trust may be an S corporation.<sup>161</sup> Likewise, a cooperative housing corporation may be an S corporation.<sup>162</sup>

**[b] May Not Be an Ineligible Corporation.**

The 1996 Act amended Code § 1361(b)(2) so that an S corporation is allowed to own eighty percent (80%) or more of the shares of a corporation. Also, a wholly-owned subsidiary of an S corporation can, if the S corporation parent so elects, be treated as a QSSS. Prior to the 1996 Act, a corporation was ineligible if it was a member of an affiliated group, regardless of whether the group could or ever filed a consolidated income tax return.<sup>163</sup>

**[i] Banks.**

Under pre-1996 Act law, mutual savings banks, domestic building and loan associations, and cooperative banks (without capital stock organized and operated for mutual purposes and without profit), were ineligible corporations. Effective for taxable years beginning after December 31, 1996, as discussed earlier, a bank is an eligible corporation, provided it does not use a reserve method of accounting for bad debts.

**[ii] Insurance Companies.**

Insurance companies that are qualified stock casualty insurance companies taxable under Code § 831(a) are eligible if:

- It was a Subchapter S casualty insurance company on July 12, 1982;
- It was formed before April 1, 1982, and proposed via a written private offering first circulated before that date to elect Subchapter S and be operated on an established insurance exchange; or
- It was approved for membership on an established insurance exchange before December 31, 1982 via written agreement and began the casualty insurance business before December 31, 1984.<sup>164</sup>

All other insurance companies subject to tax under Subchapter L are ineligible.<sup>165</sup>

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<sup>159</sup> *Id.*

<sup>160</sup> Treas. Reg. § 301.7701.

<sup>161</sup> See PLR 8534099.

<sup>162</sup> See GCM 39289 (May 24, 1984).

<sup>163</sup> See *O.E. Qualley*, 35 T.C.M. 887 (1976).

<sup>164</sup> See Rev. Rul. 74-437, 1974-2 CB 274.

**[iii] A DISC or former DISC.**

DISCs and former DISCs are ineligible corporations.<sup>166</sup>

**[c] May Not Have More Than One Hundred (100) Shareholders.**

In accordance with the definition of small business corporation, an S corporation may not have more than 100 shareholders.<sup>167</sup>

**[i] Spouses.**

For purposes of the 100-shareholder limitation, spouses (and their estates) are treated as one shareholder, but only valid as long as they are married. If one spouse is a nonresident alien, their joint ownership will render them to be an ineligible shareholder.<sup>168</sup>

**EXAMPLE 1:** H and W own stock in S corporation. They are treated as one shareholder. H dies and the stock goes to his estate. W and H's estate constitute one shareholder. If both die and the stock goes to their respective estates, their estates are treated collectively as one shareholder.

**EXAMPLE 2:** S corporation is owned by one hundred (100) shareholders two hundred (200) shares, one hundred ninety-eight (198) shares of which are owned equally by ninety-nine (99) married couples and two (2) shares of which are owned by a single person). One of the couples is divorced and each spouse ends up with one share of S corporation. **Result:** The S corporation has one hundred one (101) shareholders and its S election is thereby terminated. **CAVEAT:** An exception exists if an election was made under "family" election rules of the AJCA.

**[ii] Estates.**

As a general rule, an estate holding stock in an S corporation is considered one shareholder.

**CAVEAT:** This is only true as long as the stock remains in the estate; once it is distributed, each beneficiary becomes a shareholder. If the estate's administration is unduly prolonged, the Service may assert constructive distribution.

**[iii] Joint Tenancy.**

Joint ownership of S corporation stock by persons other than Husband and Wife results in each owner being counted as a separate shareholder.

**[iv] Agency.**

When stock of an S corporation is held by an agent, nominee, guardian or custodian, the real owner(s) will be considered the shareholder(s). The Service has asserted in several cases that a

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<sup>165</sup> Code § 1361(b)(2)(B).

<sup>166</sup> Code § 1361(b)(2)(C).

<sup>167</sup> Code § 1361 (b)(1)(A).

<sup>168</sup> Code § 1361 (c)(1).

partnership (not the partners) is the shareholder for purposes of Code § 1361(b)(1)(A).<sup>169</sup> The Final Treasury Regulations corresponding to Code § 1361 (published on July 20, 1995) overrule these cases and provide that a partnership is the nominee for its partners. Accordingly, the partners, not the partnership, will be the shareholders of the S corporation.

**[v] Family Members.**

As stated above, beginning in 2005, Code § 1361(c)(1) was amended so that “family” members may “elect” to be treated as one shareholder for purposes of determining the number of shareholders of an S corporation. For this purpose, “family” includes a common ancestor and all lineal descendants of the common ancestor, and spouses and former spouses of these persons. A child that is legally adopted, lawfully placed with an individual for legal adoption, and an eligible foster child of an individual as defined by Code § 152(f)(1)(C) shall be treated as a child of such individual by blood.<sup>170</sup>

A few limitations apply:

- “Family” is limited to six generations; and
- A spouse and former spouse are treated as the same generation as the person to whom the person is or was married.

**[vi] Trusts.**

Certain trusts are eligible S corporation shareholders. (Eligible trusts are discussed in further detail below.) For this purpose, some general rules apply:

- Each beneficiary of a voting trust is treated as a shareholder.
- The grantor/owner of a grantor or Code § 678 trust (not the trust) is treated as the shareholder.
- The estate in the case of a testamentary trust is treated as the shareholder.
- The beneficiary of a QSST (by definition there can only be one beneficiary) is treated as the shareholder.
- Subject to the exception created by the TCJA (discussed above), each potential current income beneficiary of an ESBT is treated as a shareholder.

**[2] May Not Have Greater Than One Class of Stock.**

In accordance with Code § 1361(b)(1)(D), an S corporation may not have greater than one class of stock. The key to only having one class of stock is generally to make sure that all shares have

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<sup>169</sup> See *Kates v. Commissioner*, T.C. Memo. 1968-264; see also, PLR 8527081; PLR 8536017; but see Rev. Rul. 77-220, 1977-1 CB 263.

<sup>170</sup> Code § 1361(c)(1)(C).

identical rights to distribution and liquidation proceeds. That general rule may be easily said, but it may be extremely difficult to implement and follow.

**[a] Voting Rights.**

Differences in voting rights standing alone will not create a second class of stock.<sup>171</sup> Multiple voting rights will permit greater latitude in structuring management control and in shifting ownership for estate planning purposes.

**EXAMPLE 1:** Corporation desires to make an S election. It issues voting stock to management/shareholders and nonvoting to outside investor/shareholders. It is still be eligible to make an S election.

**EXAMPLE 2:** The sole shareholder of Corporation, an S corporation, gifts his or her annual gift tax exclusion amount or all or part of his or her lifetime estate/gift exclusion amount in the form of nonvoting stock to each of his or her children, thereby shifting value without giving up control. Assuming the Articles of Incorporation authorize the issuance of nonvoting stock and the children are otherwise eligible S corporation shareholders, the gifts will not impact the S election of Corporation.

**[b] Preferences.**

There may not be dividend or liquidation preferences which impact the economic rights of the shareholders – such is considered a second class of stock.<sup>172</sup>

**[c] Redemption Rights.**

Redemption rights contained in the corporation's bylaws or shareholder agreements will generally not create a second class as long as the restrictions attached thereto do not affect the rights of holders in the corporation's profits and assets during their terms as shareholders.<sup>173</sup> There have been several cases and rulings in this area.<sup>174</sup> **Caution is advised.**

**[d] Warrants, Etc.**

Warrants, options and convertible debentures do not alone create a second class of stock.<sup>175</sup>

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<sup>171</sup> Code § 1361(c)(4).

<sup>172</sup> See PLR 8528049; Treas. Reg. § 1.1371-1(g) (adopted under former Code § 1371).

<sup>173</sup> See PLR 8528049; PLR 8407011; PLR 8506114; see also, Blau, Rohman & Lemons, *Shareholder Agreements and the Single Class of Stock Requirement*, Journal of Taxation, 238 (April 1988).

<sup>174</sup> Additional capital and loan obligations upheld. PLR 8506114. Buy/sell provision upheld. PLR 8627015; see also PLR 8650025. Liquidation preferences are not allowed. *Paige v. United States*, 580 F2d 960 (9th Cir. 1978). Transfer restrictions, formula price for stock repurchases, and dividend reinvestment provisions ruled not to constitute a second class of stock. See PLR 8407011; PLR 8528049; PLR 8506114; PLR 8907016.

<sup>175</sup> Rev. Rul. 67-269, 1967-2. CB 209.

**[e] Debt.**

Debt may be considered a second class of stock. The Service has consistently asserted that shareholder loans are a second class of stock. The courts, however, have routinely rejected the Service's argument.<sup>176</sup>

Code § 1361(c)(5) provides a straight debt safe harbor. In order to be assured debt does not create a second class of stock, the following requirements must be met:

- The instrument must be in writing;
- Be an unconditioned promise to pay on demand or on a specific date a sum certain in money;
- Have an interest rate and interest payment dates not contingent upon profits, the borrower's discretion or any similar factors;
- Not be convertible directly or indirectly into stock; and
- Due to a creditor which would be a permitted shareholder, or (as added by the 1996 Act) a person actively and regularly engaged in the lending business.

**CAVEAT:** Treasury Regulation § 1.1371-1(g) (corresponding to old Code § 1371) provided that pro-rata shareholder debt does not constitute a disqualifying second class of stock even though the debt actually represents equity capital. The addition of Code § 1361(c)(5) (straight debt safe harbor) undoubtedly invalidates this regulation.

**CAVEAT:** Use caution in this area; all shareholder agreements and like agreements need careful review.

**[3] Must Only Have Eligible Shareholders.**

In accordance with Code § 1361(b), (c) and (d), all shareholders of an S corporation must be eligible shareholders. Several rules accompany this requirement.

**[a] Eligibility In General.**

Each shareholder must be an individual, a decedent's estate, a bankrupt's estate under Title 11 of the U.S. Code, a specified trust, a Code §§ 401(a) or 501(c)(3) organization, or a Code § 501(a) organization. No foreign trusts or nonresident aliens may be shareholders of an S corporation.

**[b] Individuals.**

Individuals are eligible shareholders.<sup>177</sup> Nonresident aliens, however, are ineligible shareholders.<sup>178</sup> For this purpose, an alien resident of Puerto Rico was held ineligible.<sup>179</sup>

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<sup>176</sup> See *Shores Realty Co., Inc. v. United States*, 468 F2d 572 (5th Cir. 1972); *Portage Plastics Company, Inc.*, 486 F2d 632 (7th Cir. 1973).

**CAVEAT:** Be careful where community property laws apply. In *Ward v. United States*,<sup>180</sup> a shareholder's spouse (a citizen and resident of Mexico) who had a community property interest in the stock of an S corporation, caused the corporation to lose its S election. Even the "family" election under the provisions added to Subchapter S by the AJCA would not change this result.

**CAVEAT:** It is not clear whether "nonresident alien" applies only to individuals or whether it extends to alien estates.<sup>181</sup> The Code, however, specifically labels foreign trusts as ineligible.<sup>182</sup>

**[c] Trusts.**

Certain trusts may be eligible shareholders.<sup>183</sup> Code § 1361(c)(2)(A) describes five (5) types of trusts which may own stock in a Subchapter S corporation.<sup>184</sup> They are as follows:

- A trust which is treated under Code §§ 671-678 (Subpart E of Part I of Subchapter J) as totally owned by an individual who is a citizen or resident of the United States is an eligible Subchapter S corporation shareholder.<sup>185</sup>
- A trust meeting the requirements of paragraph one above immediately before the death of the owner is an eligible Subchapter S corporation shareholder, but only for two (2) years post date of death.<sup>186</sup>
- A trust in which stock is transferred to it pursuant to the terms of a will is an eligible Subchapter S corporation shareholder, but only for two (2) years following the transfer.<sup>187</sup>
- A trust created primarily as a voting trust is an eligible Subchapter S corporation shareholder.<sup>188</sup> Treasury Regulation § 1.1361-1A(h)(3)(ii) requires that a voting trust be in writing, delegate the right to vote to the trustee, require all payments be made to or on behalf of the beneficial owners, require that title of the stock be delivered to the beneficial owners on termination, and must terminate by local law or by the agreement on or before a specific date or event.
- An ESBT, provided that all beneficiaries must be individuals or estates. Prior to January 1, 1998, charitable organizations described in Code § 170(c)(2)-(5) could only hold contingent remainder interests. Thereafter, such beneficiaries

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<sup>177</sup> Code § 1361(b).

<sup>178</sup> Code § 1361(b)(1)(c).

<sup>179</sup> Rev. Rul. 73-478, 1973-2 CB 310.

<sup>180</sup> 661 F2d 226 (Ct. Cl. 1981).

<sup>181</sup> See Eustice & Kuntz, *Federal Income Taxation of S Corporations*, ¶ 3.03(2) (1985).

<sup>182</sup> Code § 1361(c)(2)(A).

<sup>183</sup> Code § 1361(c)(2).

<sup>184</sup> Amended by the 1996 Act.

<sup>185</sup> Code § 1361(c)(2)(A)(i).

<sup>186</sup> Amended by the 1996 Act. Also note the Service's ruling in PLR 20022603.

<sup>187</sup> *Id.*, See also, Code § 1361(c)(2)(A)(iii).

<sup>188</sup> Code § 1361(c)(2)(A)(iv).

are allowed to hold current income interests. No interest in such a trust may be acquired by “purchase.” Unlike QSSTs, ESBTs may have more than one (1) current income beneficiary.

**[d] Subpart E Trusts.**

As stated above, pursuant to Code § 1361(c)(2)(A)(i), a trust treated under Code §§ 671-678 (Subpart E of Part I of Subchapter J) as totally owned by an individual who is a citizen or resident of the United States is an eligible Subchapter S corporation shareholder. The following is a general overview of the operative provisions contained in that subpart:

- Subject to several exceptions enumerated in Code § 673(b), for transfers in trust made on or before March 1, 1986, the grantor shall be treated as the owner of any portion of the trust in which he has a reversionary interest which, at the inception of that portion of the trust, is reasonably expected to take effect within ten years from the date of transfer to said trust.<sup>189</sup> The grantor, however, is not the owner of any portion of the trust where his or her reversionary interest in such portion is not to take effect until the death of the persons to whom income therefrom is payable.<sup>190</sup> For transfers made after March 1, 1986, the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest which, at the inception of that portion of the trust, the value of such interest exceeds 5% of the value of such portion of the trust.<sup>191</sup> The grantor is not, however, treated as the owner where the beneficiary is a lineal descendant, holds all of the present interest in a portion of the trust, and the grantor retains a reversionary interest in said portion to take effect should the beneficiary die before attaining age 21.<sup>192</sup>
- The grantor shall be treated as the owner of any portion of the trust in which the beneficiary’s enjoyment of corpus or income is subject to a power of disposition, exercisable by the grantor or a non-adverse party (or both) without the approval of any adverse party (defined in Code § 672(2) as a party who has a substantial beneficial interest in the trust which would be affected by the exercise of the power).<sup>193</sup> A power of disposition includes, but is not limited to, a fiduciary power, or a power of appointment.<sup>194</sup> This rule does not apply to powers solely exercisable by a trustee, who is not a grantor or a spouse living with a grantor, to distribute, apportion or accumulate income if such person is limited by a reasonable standard set forth in the trust instrument.<sup>195</sup> Moreover, testamentary powers held by anyone other than the

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<sup>189</sup> Code § 673(a).

<sup>190</sup> Code § 673(c); Treas. Reg. §§ 1.673(a)-1(a)(1) and 1(b).

<sup>191</sup> Code § 673(a).

<sup>192</sup> Code § 673(b).

<sup>193</sup> Code § 674(a).

<sup>194</sup> Treas. Reg. § 1.674(a).

<sup>195</sup> Code § 674(d).

grantor are exempted from this rule. As well, if the trustee is not the grantor, sprinkle powers are likewise exempted.<sup>196</sup>

- A grantor shall be treated as the owner of any portion of a trust in which:
  - The grantor or non-adverse party (or both) without consent of an adverse party has a power to deal with corpus or income for less than full consideration;
  - The grantor or a non-adverse party (or both) have a power to borrow corpus or income without adequate provisions for security and interest;
  - The grantor has directly or indirectly borrowed trust funds and not completely repaid the loan; or
  - The grantor or other person, in a non-fiduciary role, has administrative powers to affect the trust corpus (*i.e.*, vote stock, invest funds, or reacquire trust corpus by substituting property of equal value).
- The grantor shall be treated as the owner of any portion of a trust in which there exists a power, exercisable by the grantor or a non-adverse party (or both), to re-vest title in the grantor.<sup>197</sup> For transfers occurring on or before March 1, 1986, if the power affects the beneficial enjoyment of income only after the expiration of ten years, said power will not make the grantor the owner of any portion of the trust.<sup>198</sup> For transfers occurring after March 1, 1986, if the power affects an interest, which at the inception of the trust, the value of such reversionary interest does not exceed 5% of the value of such portion of the trust, said power will not make the grantor the owner of any portion of the trust.<sup>199</sup>
- In general, the grantor will be treated as the owner of any portion of a trust in which income is held, accumulated, or distributed for the benefit of the grantor or his spouse, or to pay life insurance premiums for the grantor or his spouse.<sup>200</sup>
- Persons other than the grantor may 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 corpus or income therefrom in himself; or such person has previously released or otherwise modified such power.<sup>201</sup>

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<sup>196</sup> Treas. Reg. § 1.674(a)-3.

<sup>197</sup> Code § 676(a).

<sup>198</sup> Code § 676(b).

<sup>199</sup> Code § 676(b).

<sup>200</sup> Code § 677.

<sup>201</sup> Code § 678.

[e] QSSTs.

Code § 1361(d) provides that a QSST is also an eligible Subchapter S corporation shareholder. Pursuant to Code § 1361(d)(1)(A), a QSST is treated as a trust meeting the requisites of Code § 1361(c)(2)(A)(i). A QSST is a trust with the following characteristics:

- The trust terms must require: (i) During the life of the current income beneficiary, there can only be one income beneficiary; (ii) Corpus distributions during the current income beneficiary's life can only be made to that beneficiary; (iii) The current income beneficiary's interest must terminate on the earlier of his or her death, or termination of the trust; and (iv) If the trust terminates during the current income beneficiary's life, all assets must be distributed to that beneficiary.<sup>202</sup>
- All of the trust's income (as defined under Code § 643(b)) must either be distributed or required to be distributed currently to an individual who is a citizen or a resident of the United States.<sup>203</sup> Section 643 defines "income" as the amount of trust income for the year determined under the Trust Agreement and local law.
- In order for a trust which meets the requisites of Code § 1361(e)(3) to qualify as a Subchapter S corporation shareholder, the current income beneficiary (or his legal representative) must file an election with the Internal Revenue Service.<sup>204</sup> The election is retroactive for up to 75 days prior to the filing.<sup>205</sup> It must be filed with the Service Center with which the corporation files its Federal income tax returns. No particular type of form is required. A statement with the following information will suffice: Name, address, and taxpayer identification number of the current income beneficiary, the trust and the corporation; reference that the filing is an election under Code § 1361(d)(2); the date on which the election is to be effective; and information sufficient to show that the QSST requirements have been met.<sup>206</sup>
- The election, once made, can only be revoked with the Secretary's consent.<sup>207</sup> Moreover, the election must be made separately with respect to each Subchapter S corporation in which the trust holds stock.<sup>208</sup>
- Should a QSST fail to meet the requisites of Code § 1361(d)(3)(A) (described above) after an election becomes effective, it immediately loses its qualified status.<sup>209</sup> Should a QSST fail to meet the requisites of Code § 1361(d)(3)(B)

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<sup>202</sup> Code § 1361(d)(3)(A).

<sup>203</sup> Code § 1361(d)(3)(B). *See also*, Treas. Reg. § 1.1361-1A(i)(1)(i); Rev. Rul. 86-110.

<sup>204</sup> Code § 1361(d)(2).

<sup>205</sup> Code § 1361(d)(2)(D). *See also*, House Committee Report on P.L. 98-369.

<sup>206</sup> Treas. Reg. § 1.1361-1A(i)(3).

<sup>207</sup> Code § 1361(d)(2)(C).

<sup>208</sup> Code § 1361(e)(2)(B).

<sup>209</sup> Code § 1361(d)(4)(A).

(described above), however, it will not lose its qualified status until the first day of the first taxable year beginning after the tax year for which it failed to meet said requirements.<sup>210</sup>

Examples of trusts eligible to be QSSTs include: a QTIP marital deduction trust under Code § 2056(b)(7); a marital deduction trust under Code § 2056(b)(5), providing for all income for life with a power of appointment in the entire estate; a trust which will terminate when the beneficiary reaches a certain age; a trust which gives the beneficiary income for life;<sup>211</sup> and a revocable intervivos trust after the death of the trustor.<sup>212</sup> A trust otherwise meeting the QSST requirements will not be invalidated solely because a court requires income distributions to greater than one (1) person. A voluntary current income payment to greater than one (1) person (e.g. payment to ex-spouse as alimony) will invalidate a QSST. For this purpose, spouses, if both are residents and file joint returns, are considered to be one (1) current income beneficiary (as long as they are married and file joint returns).

Examples of trusts which are ineligible to be QSSTs include: a foreign trust;<sup>213</sup> an irrevocable reversionary trust, Clifford Trusts<sup>214</sup> and certain retirement plan trusts.<sup>215</sup>

#### [f] Estates.

A decedent's estate is generally an eligible shareholder of an S corporation.<sup>216</sup>

**CAVEAT:** Unduly prolonged administration for purposes of Subchapter S may cause the estate to be converted into a testamentary trust and trigger the rules discussed above.<sup>217</sup>

A bankruptcy estate of an individual under Title 11 of the United States Code is an eligible shareholder.<sup>218</sup>

The status of a legal life estate or usufruct has been uncertain and subject to changing rules. Proposed Treasury Regulation § 1-1361-1A(f)(2) and (3), published on October 7, 1986, distinguished between such interests which were created before and after January 1, 1983. Under the proposed regulations, those legal life estates and usufruct interests created before January 1, 1983 were eligible shareholders. An interest created by a will executed before January 1, 1983, however, was only considered created before January 1, 1983 if the decedent died before January 1, 1986 and did not republish the will after December 31, 1982. Those legal life estates and usufruct interests created on or after January 1, 1983 were considered eligible

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<sup>210</sup> Code § 1361(d)(4)(B).

<sup>211</sup> See PLR 860702; PLR 8424096; PLR 8336069.

<sup>212</sup> See PLR 8404086.

<sup>213</sup> Code § 1361(c)(2)(A).

<sup>214</sup> Code §§ 673 and 676.

<sup>215</sup> Prior to the 1996 Act, ESOPs were ineligible S corporation shareholders. § 1316(a)(1) of the 1996 Act amended Code § 1361(b)(1)(B) so that certain tax-exempt organizations, including ESOPs, are eligible S corporation shareholders.

<sup>216</sup> Code § 1361(b)(1)(B). See Rev. Rul. 66-266, 1966-2 CB 356.

<sup>217</sup> See *Old Virginia Brick Co.*, 367 F2d 276 (4th Cir. 1966), *aff'g* 44 TC 724 (1965); Treas. Reg. § 1.641(b)-3(a); see also Rev. Rul. 76-23, 1976-1 CB 264 (Estate kept open for 15 years); PLR 7951131 (Service may allow estate to be kept open pending completion of audit).

<sup>218</sup> Code § 1361(c)(3).

shareholders provided: the interest was owned by only one individual who was a citizen or resident of the United States; the individual for whom the interest was created had not transferred the interest; and the interest terminated on the death of the individual for whom it was created.

**CAVEAT:** The Treasury Regulations were finalized on July 20, 1995. These rules on legal life estate and usufruct interests were withdrawn. Accordingly, holders of these interests are not eligible shareholders any longer.

**[g] Corporations and Partnerships.**

Corporations and partnerships are ineligible S corporation shareholders.<sup>219</sup> With the exception in the case of a QSSS, corporations and partnerships are expressly excluded from the definition of an eligible shareholder. A partnership may be able to hold shares as a nominee for its partners.

**[4] Election.**

An eligible corporation must elect to be an S corporation.<sup>220</sup> An election is made by filing IRS Form 2553, containing all information required by that form, together with consents from all of the shareholders. IRS Form 2553 is filed with the Internal Revenue Service Center where the S corporation files (or will file) its Federal income tax return.<sup>221</sup> The election should be sent certified mail, return receipt requested and a copy retained in order to substantiate timely filing should the Service misplace Form 2553. The burden of proof is on the taxpayer. Care should be used when preparing IRS Form 2553. Even if the Service accepts the filing, it is not precluded from later asserting that the election is invalid for failing to have met the eligibility requirements of Subchapter S when IRS Form 2553 was originally filed.

**PRACTICE ALERT:** Once an election year is closed, the election is still subject to challenge and deficiencies may still be assessed for the three most recent tax years. If an election is challenged or there is uncertainty as to its validity, consideration should be given to filing a protective election. A protective election may raise red flags about the validity of any prior elections. The validity of an S corporation's election (assuming no fraud or substantial underpayment) would be barred by the statute of limitations only after the corporation ceased filing S corporation returns (IRS Form 1120S) for three tax years.

Minor errors on IRS Form 2553 not relevant to the corporation's eligibility will not generally cause the election to be invalidated.<sup>222</sup>

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<sup>219</sup> See Treas. Reg. § 1.1361-1A(f)(1).

<sup>220</sup> Code § 1361(a)(1).

<sup>221</sup> Treas. Reg. § 1.1362-6.

<sup>222</sup> See *Thompson v. C.I.R.*, 66 TC 737 (1976) (erroneous effective date did not invalidate election); Rev. Rul. 74-150, 1974-1 CB 241 (election not invalidated because fewer shares than indicated on Form 2553 were actually issued); PLR 8803061 (IRS ruled that failure to include consent of shareholder who owned stock as a trustee when his consent was included in his individual capacity was a minor error – election not invalidated); PLR 8835011 (failure to include effective date of election not fatal). Be careful – the Tax Court held in *Smith v. Commissioner*, T.C.M. 1988-18 that an S election was invalid because IRS Form 2553 did not contain a corporate officer's signature.

**PRACTICE ALERT:** Some states require a separate state filing, including Arkansas, New York, New Jersey and Pennsylvania.

**[a] Shareholder Consent.**

To make a valid S corporation election, Code § 1362(a)(2) requires all persons who are shareholders of the corporation on the day on which the election is made to consent to the election. The required consents may be made either directly on IRS Form 2553 or on a separate statement signed by the shareholder and attached to the election form.<sup>223</sup> The consent should contain: The shareholder's name, address, taxpayer ID number, number of shares held, dates of acquisition, shareholder's fiscal year and the consent to the election.

If the election is to be effective for the current year in which it is made, each person who was a shareholder at any time during the year prior to the date of the election must consent even though no longer a shareholder.<sup>224</sup> Consent must be obtained from:

- Individuals.
- Joint owners – each is treated as a separate shareholder and must consent.
- Tenants in common – each must consent.
- Community property – each member of the community must consent.<sup>225</sup>
- Husband and wife – if owned as tenants by the entirety, both spouses must consent.
- Minors or incompetent individuals – the guardian or legal representative must consent. The natural or adoptive parent may consent for a minor if no legal representative has been appointed.
- Decedent's estate – the executor or administrator must consent, even if title is passed directly to the heirs under local law.<sup>226</sup> Voting trust – each beneficiary must consent.
- Testamentary trust – the executor must consent.
- Subpart E trusts – the deemed owner must consent.
- Subpart E trusts after the death of the deemed owner – the executor or administrator of the deemed owner's estate must consent.
- QSSTs – the beneficiary of the deemed owner must consent.

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<sup>223</sup> Treas. Reg. § 1.1362-6.

<sup>224</sup> *Id.*

<sup>225</sup> See *John M. Seely*, 51 T.C.M. 1087 (1986).

<sup>226</sup> Rev. Rul. 62-116, 1962-1 CB 207.

- QSSTs after the death of the deemed owner beneficiary – the executor or administrator of the beneficiary’s estate must consent.
- Bankruptcy estate – the administrator must consent.
- A person who owns stock both directly and as the beneficiary of a trust must consent in both capacities.<sup>227</sup>
- ESBTs – all potential income beneficiaries must consent.

Consent is binding and cannot be withdrawn after a valid election by the corporation.

Under the 1996 Act, if an election is not effective because of failure to obtain shareholder consents, the Secretary has authority (effective after 1982) to treat the election as valid if:

- The failure was inadvertent.
- Within a reasonable time after discovering the issue, steps are taken to obtain the required consents.
- The corporation and all shareholders (during the ineffective period) agree to make any adjustments consistent with S corporation status that the Secretary requires.

This same relief may be given in the event of a corporation which did not qualify during any period because it failed to qualify as a small business corporation.

**[b] Time of Election/Effective Date.**

An election may be effective for the current year only if three conditions are met: the election is made on or before the 15th day of the third month; the corporation meets all eligibility requirements for all days of the year; and all persons who have held stock during the year up to the date of election consent to the election.

An election is treated as made for the following year if: eligibility requirements are not met for the entire period prior to the election date; if the consent of all shareholders who disposed of their stock prior to the election date is not obtained; or if the election is made after the 15th day of the third month.<sup>228</sup>

**[c] Filing an Extension.**

Under pre-1996 Act law, no extension of time to file could be granted.<sup>229</sup> Failure to file, even though Form 2553 was filled out and properly executed, or if taxpayer relied on counsel to file, did not create a valid election if the form was not in fact filed with the IRS.<sup>230</sup> As a result of the

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<sup>227</sup> PLR 8506029.

<sup>228</sup> Treas. Reg. § 1.1362-6(a)(2).

<sup>229</sup> Rev. Rul. 60-183, 1960-1 CB 625.

<sup>230</sup> See *Helen S. Leather*, 1991 T.C.M. P.H. ¶ 91,534 and *Taylor v. Commissioner*, 1988 T.C.M. P.H. ¶ 87,399.

provisions of the 1996 Act, however, the Secretary may ignore a late filing or allow an election where no election was actually filed if reasonable cause exists. Congress desires to make this area of Subchapter S more taxpayer friendly.

**[d] Interim Disqualification.**

Interim disqualification will not invalidate an election.

**EXAMPLE:** If **Corporation** qualifies on the date of election (June 9, 2018) and on the first day of the next year (January 1, 2019) (effective date), the election for the following year (2019) will be effective even though the S corporation qualification requisites were not met on other days prior to the first day of the following year (2019).<sup>231</sup>

**[e] Virgin S Corporation.**

New corporations should file within 2½ months from the beginning of the corporation's first taxable year in order for the election to be considered effective as of the first day of the corporation's existence. A new corporation's taxable year begins at the earlier of the point when it has shareholders, acquires assets or begins doing business. Corporate existence is generally established as of the effective date of the filing of Articles of Incorporation.<sup>232</sup> The existence of shareholders generally occurs upon the signing of a subscription agreement.<sup>233</sup> The acquisition of assets generally occurs upon the leasing of assets or entering into purchase agreements or loan agreements to finance the purchase of assets.<sup>234</sup> Beginning to do business generally occurs when the entity commences the activities for which the corporation was formed.<sup>235</sup>

**[f] Extension of Time for Shareholder Consents.**

An extension of time for obtaining shareholder consents may be granted in cases where: there is reasonable cause for the failure to file such consent; and the interest of the government will not be jeopardized by treating the election as valid or as not having been terminated.<sup>236</sup>

**EXAMPLE:** **Corporation** does not have shareholders when it is first required to make an election because the incorporators had not yet agreed upon who will have shares in the entity. An extension should be requested.

**PRACTICE ALERT:** Even if an extension of time for shareholder consents is not obtained, as discussed earlier, the Secretary has authority to ignore a late filing.

**[5] Re-election.**

If a corporation has made an S election and that election has been revoked or terminated, the corporation cannot re-elect for five (5) tax years following the tax year in which the revocation

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<sup>231</sup> Treas. Reg. § 1.1362-6(a).

<sup>232</sup> *J. William Frentz*, 375 F.2d 662 (6th Cir. 1967), *aff'g* 44 TC 485 (1965).

<sup>233</sup> Rev. Rul. 72-257, 1972-1 CB 270.

<sup>234</sup> *Calhoun v. United States*, 370 F.Supp. 434 (W.D. Va. 1973).

<sup>235</sup> *T. H. Campbell and Bros.*, 34 T.C.M. 695 (1975).

<sup>236</sup> Treas. Reg. § 1.1362-6(b)(3).

or termination became effective.<sup>237</sup> The Commissioner may consent to a re-election prior to the expiration of the five (5) years prescribed in Code § 1362(g). In fact, the Service routinely grants these consents. Examples include:

**[a] Private Letter Ruling 8842007.**

The IRS accepted a corporation's Subchapter S election on January 1, 1988 even though the same corporation had elected S corporation status effective January 1, 1987, then revoked the election in early 1987 due to adverse consequences which the election would have had on the corporation's profit sharing plan. The IRS emphasized that the corporation had never benefited from or been subject to S corporation rules and therefore no abuse or tax avoidance was involved in the revocation or reelection. Therefore, the corporation was not forced to sit on the bench during the five-year waiting period and was allowed to rejoin the S Club.

**[b] Private Letter Rulings 8844005, 8831048 and 8828050.**

The Service consented to new S elections within five years following the termination of prior S elections in three individual cases. The facts presented in each case are the same. The prior S election was never given effect in each instance because it was revoked within the first seventy-five (75) days of the corporation's taxable year, thus terminating the election effective as of the first day of the first taxable year the election would have gone into effect. The IRS concluded that the five-year rule was intended to prevent taxpayers from electing in and out of S corporation status depending upon the availability of tax benefits. Given these corporations never received any tax benefit from their S elections, and never were subject to S corporation rules, permission was granted to make a new S election in each case without waiting five years post-revocation.

The theme to these rulings is simple: No tax abuse or tax avoidance existed.

**PRACTICE ALERT:** It is very unlikely that the Service will grant consent to rejoin the S Club prior to the expiration of the statutory five (5) year wait in the event a corporation revokes its S election in order to take advantage of the new corporate flat tax rate under Code § 11 and then changes its mind because issues such as unreasonable compensation or accumulated earnings has raised their ugly heads. Tax avoidance in such case was undoubtedly the reason for the revocation.

**[6] The Built-In Gains Tax.**

The built-in gains tax under Code § 1374 cannot be forgotten, especially for corporations converting from C corporation status to S corporation status.

In 1986, lawmakers made vast changes to the Code. As Martin Luther is attributed as saying:

**“If you want to change the world, pick up your pen and write.”<sup>238</sup>**

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<sup>237</sup> Code § 1362(g).

<sup>238</sup> Martin Luther was a German monk, educator, and theologian. He lived from 1483 to 1546.

Congress did just that with its passage of the Tax Reform Act of 1986.<sup>239</sup> One of the many significant changes made to the Code by this legislation was the extension of the principle of double taxation to all distributions of appreciated property by C corporations outside corporate solution with the repeal of the General Utilities Doctrine.

The repeal of the General Utilities Doctrine did not, however, prevent shareholders of certain closely-held C corporations from circumventing the corporate level tax on liquidating distributions by converting their corporations to S corporation status, waiting three years to avoid the application of the then existing Code § 1374, and then liquidating. Code § 1363(d) would require recognition of gain on distributions of appreciated property at the S corporation level. Only one level of tax would be imposed because the distributee shareholders are allowed to increase the basis of their stock pursuant to Code § 1367(a) by the amount of the gain recognized at the S corporation level.

To prevent this perceived abuse, Congress enacted a beefed-up version of Code § 1374 to impose a built-in gains tax on the disposition of certain appreciated assets held by the former C corporation during the first ten years of the S corporation's operation.

On December 8, 1992, Treasury issued proposed regulations for Code § 1374.<sup>240</sup> The regulations were made final on December 23, 1994.

If an S corporation has a “net recognized built-in gain” during the “recognition period,” the built-in gains tax will be imposed.<sup>241</sup>

The built-in gains tax is equal to the highest corporate rate in effect under Code § 11(b), multiplied by the “net recognized built-in gain.”<sup>242</sup> Immediately prior to 2018, that rate was 35%. Today, as a result of the TCJA, that rate is 21%.

The “net recognized built-in gain” is reduced by any net operating losses carryforward arising from the S corporation's prior C corporation taxable years.<sup>243</sup> In addition, the built-in gains tax itself is reduced by any Code § 39 business credit carryforward and Code § 53 minimum tax credit arising from the S corporation's prior C corporation taxable years.<sup>244</sup>

Code § 1374 generally is not applicable to virgin S corporations (e.g., corporations that have always been S corporations).<sup>245</sup> If, however, a virgin S corporation acquires any asset(s) and its basis in such asset(s) is determined in whole or part by reference to the basis of the asset(s) in the

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<sup>239</sup> The General Explanation of the Tax Reform Act of 1986, prepared by the Joint Committee on Taxation, dated May 4, 1987, spanned 1395 pages.

<sup>240</sup> All references to Code § 1374 from this point forward are made to Code § 1374, as amended by the Tax Reform Act of 1986, unless expressly provided otherwise.

<sup>241</sup> Code § 1374(a).

<sup>242</sup> Code § 1374(b)(1).

<sup>243</sup> Code § 1374(b)(2).

<sup>244</sup> Code § 1374(b)(3)(B).

<sup>245</sup> Code § 1374(c)(1).

hands of a C corporation (e.g., as a result of a merger), Code § 1374 is applicable with respect to such asset(s).<sup>246</sup>

Another limitation on the application of Code § 1374 exists. The amount of “net recognized built-in gain” for any taxable year can never exceed the “net unrealized built-in gain” less the aggregate “net recognized built-in gain” for the prior taxable years within the “recognition period.”<sup>247</sup>

Code § 1374 contains at least five key terms.

**“Net unrealized built-in gain”** means the amount, if any, by which the aggregate fair market value of the corporation’s assets exceeds the aggregate adjusted basis of such assets on the effective date of the S election.<sup>248</sup>

**“Net recognized built-in gain”** means with respect to any taxable year during the “recognition period” the lessor of the taxable income of the corporation if only built-in gains and built-in losses were taken into account, or the corporation’s taxable income (ignoring the built-in gains and losses).<sup>249</sup> In other words, a corporation’s net recognized built-in gain for a taxable year cannot exceed its taxable income (without the built-in gains or losses being considered). Amounts not recognized because of this limitation are carried over to future years, but not beyond the “recognition period.”<sup>250</sup>

**“Recognized built-in gain”** means any gain recognized during the “recognition period” on the disposition of asset(s) of the corporation, but only to the extent of gain existing in such asset(s) as of the beginning of the corporation’s first taxable as an S corporation.<sup>251</sup>

**“Recognized built-in loss”** means any loss recognized during the “recognition period” on the disposition of asset(s) of the corporation, but only to the extent the loss existing in such asset(s) as of the beginning of the corporation’s first taxable years as an S corporation.<sup>252</sup>

**“Recognition period”** means the five-year period beginning with the first day of the first taxable year for which the corporation was an S corporation.<sup>253</sup>

Code § 1374 imposes a corporate level tax on an S corporation’s recognized net built-in gains that are recognized during the “recognition period.” As stated above, Code § 1374(d)(7) originally defined the term “recognition period” as the ten-year period beginning with the first day of the first taxable year for which the corporation was an S corporation. Today, the recognition period is the five-year period beginning on the first day of the first taxable year for which the corporation was an S corporation.

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<sup>246</sup> Code § 1374(d)(8).

<sup>247</sup> Code § 1374(c)(2)(A) and (B).

<sup>248</sup> Code § 1374(d)(1); Treas. Reg. § 1.1374-3.

<sup>249</sup> Code § 1374(d)(2)(A).

<sup>250</sup> Code § 1374(d)(2)(B).

<sup>251</sup> Code § 1374(d)(3).

<sup>252</sup> Code § 1374(d)(7)(A).

<sup>253</sup> Code § 1374(d)(2)(A).

Code § 1374 does **not** apply to S corporations that were not formerly C corporations and that have not acquired property from a C corporation in a carry-over basis transaction.<sup>254</sup> If an S corporation, however, acquires an asset, the basis of which in the hands of the S corporation is determined in whole or part by reference to the basis of the asset in the hands of a C corporation, Code § 1374 could apply to any built-in gains attributable to such asset.<sup>255</sup>

Computing the built-in gains tax under Code § 1374 involves a four-step process as set forth in the Treasury Regulations:<sup>256</sup>

**Step One:**

Determine the “net recognized built-in gain” of the corporation for the taxable year under Code § 1374(d) and Treasury Regulation § 1.1374-2.<sup>257</sup>

**Step Two:**

Reduce the “net recognized built-in gain” (but not below zero) by any net operating loss or capital loss carry forward allowed under Code § 1374(b)(2) and Treasury Regulation § 1.1374-5.<sup>258</sup>

**Step Three:**

Compute a “tentative tax” by applying rate of tax determined under Code § 1374(b)(1) for the taxable year to the amount determined in **Step Two**.<sup>259</sup>

**Step Four:**

Compute the “final tax” by reducing the “tentative tax” (but not below zero) by any credit allowed under Code § 1374(b)(3) and Treasury Regulation § 1.1374-6.<sup>260</sup>

The potential built-in gain subject to tax under Code § 1374 is the *net unrealized built-in gain* at the time the S election becomes effective. In other words, it is the amount of appreciation associated with the C corporation’s assets as of the first day of the first tax year of the S corporation.

The amount of appreciation is measured by the difference between the **aggregate** fair market value and the **aggregate** adjusted basis of a corporation’s assets on the first day its S corporation election becomes effective. The total net recognized gain reported by the S corporation on built-in gains during the “recognition period” cannot exceed the total amount of appreciation existing on the first day the S election was effective. Thus, any gain recognized by an S corporation that is attributable to assets acquired on or after the beginning of the corporation’s first taxable year

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<sup>254</sup> Code §§ 1374(c)(1) and 1374(d)(8); *see also* IRS Announcement 86-128.

<sup>255</sup> Treas. Reg. § 1.1374-1(e).

<sup>256</sup> Treas. Reg. § 1.1374-1(a).

<sup>257</sup> Treas. Reg. § 1.1374-1(a)(1).

<sup>258</sup> Treas. Reg. § 1.1374-1(a)(2).

<sup>259</sup> Treas. Reg. § 1.1374-1(a)(3).

<sup>260</sup> Treas. Reg. § 1.1374-1(a)(4).

as an S corporation is not subject to Code § 1374. Likewise, any gain associated with appreciation accruing after the effective date of the S election, even if the assets were held by the corporation prior to the S election, is not subject to Code § 1374.

**PRACTICE ALERT:** It is presumed that all of an S corporation’s gain or income recognized during the “recognition period” is recognized built-in gain, unless the corporation can prove either: (i) that the gain or income is attributable to an asset which was acquired after the beginning of the first taxable year in which the corporation became an S corporation; or (ii) that all or a portion of the gain or income is attributable to appreciation arising after the beginning of the first taxable year in which the corporation became an S corporation.<sup>261</sup>

A corporation should obtain a written appraisal of its assets at the time an S election becomes effective, otherwise it may face a significant problem in establishing that all or a portion of the corporation’s income or gain is not recognized built-in gain. The burden of proof could be particularly onerous if the assets are sold years after conversion.

To value a corporation’s assets at the effective S election date without a costly professional appraisal it would seem, at a minimum, that the taxpayer should compile a written memorandum setting out not only the fair market value of each asset, but also the method used to arrive at those values. Hindsight is not usually a convincing argument.

It should always be kept in mind that the built-in gains tax of Code § 1374 applies to all assets, including **intangible assets** and **goodwill**. It is not limited to capital assets.

#### [a] Computation of the Built-in Gains Tax.

Net recognized built-in gain is taxed at the highest corporate tax rate in effect for the taxable year.<sup>262</sup>

- An S corporation’s net recognized built-in gain for any tax year will be reduced by any net operating loss carry-forwards arising from a prior C corporation taxable year.<sup>263</sup>
- The built-in gains tax can also be reduced by any general business credit carry-over arising from a prior C corporation taxable year.<sup>264</sup>
- The S corporation’s taxable income which is passed through to its shareholders under Code § 1366(a) is reduced by each shareholder’s proportionate share of the built-in gains tax.<sup>265</sup>

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<sup>261</sup> Code § 1374(d)(3)(A) and (B).

<sup>262</sup> Code § 1374(b)(1).

<sup>263</sup> Code § 1374(b)(2).

<sup>264</sup> Code § 1374(b)(3)(B).

<sup>265</sup> Code § 1366(f)(2).

Any recognized built-in gain can be reduced by any built-in loss recognized during the same taxable year.<sup>266</sup> This provision was enacted as part of Technical and Miscellaneous Revenue Act of 1988, and allows a netting which was not permissible prior to January 1, 1987.

An S corporation has a recognized built-in loss in any year if a loss is recognized during the “recognition period” to the extent the S corporation establishes that the asset was held by the corporation on the beginning of its first S corporation taxable year and that the loss does not exceed the excess of the tax basis over the fair market value of the asset on that date.<sup>267</sup>

The following example illustrates the foregoing:

**EXAMPLE: Corporation**, formerly a C corporation, has the following assets on February 1, 2017, the first day of the first taxable year it was an S corporation.

	<u>Tax Basis</u>	<u>Fair Market Value</u>
Real Estate	\$300,000	\$ 900,000
Inventory	\$ 50,000	\$ 100,000
Equipment	<u>\$300,000</u>	<u>\$ 150,000</u>
<b>TOTAL:</b>	\$650,000	\$1,150,000

**Corporation’s** net unrealized built-in gain is \$500,000 (\$1,150,000 minus \$650,000).

If **Corporation** sold the real estate in 2017 for \$900,000, its net recognized built-in gain would be \$500,000. While **Corporation** actually realized built-in gain of \$600,000 on the disposition of the real estate, its net recognized built-in gain is limited by the net unrealized built-in gain (the aggregate unrealized appreciation in the assets of the corporation on the effective date of the S election) of \$500,000. If **Corporation**, however, sold both the real estate and equipment during 2017, the \$150,000 loss on the equipment would reduce the gain on the real estate so that the net recognized built-in gain for 2017 would be \$450,000 (\$600,000 minus \$150,000).

Because loss assets owned by the C corporation at the time of conversion to S corporation status will serve to reduce the corporation’s exposure to the built-in gains tax, shareholders of corporations planning to become S corporations may have the incentive to transfer loss assets to the corporation immediately prior to conversion.

In 1988, the Service threatened that Treasury would issue regulations providing that the contribution of loss assets to a corporation in contemplation of its conversion to S corporation status shall not reduce the corporation’s net unrealized built-in gain when tax avoidance motivated the transfer. Contributions of loss assets within two years prior to the earlier of the date of conversion or the filing date of the S corporation’s election shall be presumed tax

<sup>266</sup> Code § 1374(d)(2)(A).

<sup>267</sup> *Id.*

avoidance motivated unless the taxpayer can show a “clear and substantial” relationship between the loss property and the current or future business of the corporation.

The Service kept its threat. Final regulations on this subject were issued on December 23, 1994.<sup>268</sup> The rules contained in these regulations are commonly collectively referred to as the built-in gains tax anti-stuffing rule.

The anti-stuffing Treasury Regulations provide:

**“If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the tax imposed under Code § 1374, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is disregarded in determining the S corporation’s pre-limitation amount, taxable income limitation, net unrealized built-in gain limitation, deductions against net recognized built-in gain, and credits against the Code § 1374 tax.”<sup>269</sup>**

**“If a built-in loss asset (that is, an asset with an adjusted tax basis in excess of its fair market value) is contributed to a corporation within 2 years before the earlier of the beginning of its first taxable year as an S corporation, or the filing of its S election, the loss inherent in the asset will not reduce net unrealized built-in gain, as defined in Code § 1374(d)(1), unless the taxpayer demonstrates a clear and substantial relationship between the contributed property and the conduct of the corporation’s current or future business enterprises. This paragraph (b)(3) applies as of the effective date of Code § 1374, unless the recognition period with respect to the contributed asset is pursuant to an S election or a Code § 1374(d)(8) transaction occurring on or after December 27, 1994.”<sup>270</sup>**

**PRACTICE ALERT:** Since an S corporation has net recognized built-in gain only to the extent of net appreciation in its assets on the first day of its election to convert from C corporation status to S corporation status, gains recognized by an S corporation during the “recognition period” are not subject to the penalty tax if: (i) the corporation was incorporated as an S corporation (virgin S corporation), and does not subsequently acquire assets from a C corporation in a carry-over basis transaction; (ii) the appreciated assets creating the gain were acquired after the S election was effective; or (iii) the gain is attributable to appreciation arising after the effective date of the S election. Again, corporations electing S corporation status are advised to obtain a written appraisal of their assets at the time of conversion to S corporation status, and to maintain accurate records indicating when other assets of the corporation were acquired.

Code § 1374 places limitations on the amount of net recognized built-in gain which may be subject to tax in any taxable year. For one, only built-in gain recognized during the “recognition period” is taxed under Code § 1374. Any built-in gain recognized after the “recognition period” is not subject to the built-in gains tax of Code § 1374. Also, the net recognized built-in gain taken into account for any taxable year cannot exceed the excess (if any) of the S corporation’s net unrealized built-in gain over the net recognized built-in gain for prior taxable years beginning

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<sup>268</sup> Treas. Reg. §§ 1.1374-9 and 10(b)(3).

<sup>269</sup> Treas. Reg. § 1.1374-9.

<sup>270</sup> Treas. Reg. § 1.1374-10(b)(3).

in the “recognition period.”<sup>271</sup> Net unrealized built-in gain means the excess (if any) by which the fair market value of the corporation’s assets at the beginning of its first taxable year as an S corporation exceeds the aggregate adjusted basis of its assets at that time.

The significance of this limitation is that it is only the **aggregate** net unrealized appreciation in a corporation’s assets as of the beginning of its first S corporation year which will be subject to the built-in gains tax. As soon as that appreciation is recognized and taxed, the built-in gains tax is no longer applicable.

The following example illustrates the foregoing:

**EXAMPLE: Corporation** is a calendar year C corporation, which elects to be taxed as an S corporation effective January 1, 2017. On that date, **Corporation** has the following assets:

	<u>Tax Basis</u>	<u>Fair Market Value</u>
Real Estate	\$100,000	\$500,000
Stock	\$ 50,000	\$ 10,000
Equipment	<u>\$100,000</u>	<u>\$ 40,000</u>
<b>TOTAL:</b>	\$250,000	\$550,000

**Corporation’s** net unrealized built-in gain is \$300,000 (\$550,000 minus \$250,000). If **Corporation** sells the real estate on March 15, 2017 for \$500,000, the net recognized built-in gain cannot exceed \$300,000. So, while **Corporation** had a realized built-in gain of \$400,000 (\$500,000 minus \$100,000), its 2017 net recognized built-in gain is limited to \$300,000.

The net recognized built-in gain cannot exceed the S corporation’s taxable income for the taxable year determined as if it were a C corporation.<sup>272</sup> Thus, if the excess of the corporation’s recognized built-in gain over the recognized built-in loss for the taxable year exceeds its taxable income, the amount subject to the penalty tax under Code § 1374 will be limited to the taxable income of the corporation.

The taxable income limitation places a premium on creating deductions in the year in which built-in gain is recognized by an S corporation. If the corporation’s taxable income can be reduced to zero, no built-in gains tax will be imposed. Consequently, accelerating deductions in the years that built-in gain is recognized can eliminate or reduce taxable income upon which the calculation of the tax is based. Payments of compensation, as an alternative to distributions, create deductions and thereby reduce taxable income. However, the success of this strategy depends upon compensation payments being “reasonable.”<sup>273</sup>

<sup>271</sup> Code §§ 1374(a)(2) and 1374(d)(1).

<sup>272</sup> Code § 1374(d)(2)(A)(ii).

<sup>273</sup> See Code § 162(a)(1).

The Technical and Miscellaneous Revenue Act of 1988 restricted, however, the usefulness of the taxable income limitation for S corporations whose S election was made after March 31, 1988.<sup>274</sup> In accordance with Code § 1374(d)(2)(B), if the taxable income limitation applies in any taxable year and the S election was filed after March 31, 1988, then the excess of the corporation's net recognized built-in gain over its taxable income is treated as recognized built-in gain in the succeeding taxable year(s) (provided the succeeding year(s) is within the "recognition period"). An S corporation whose election was filed prior to April 1, 1988 is not subject to this carry-over rule. Thus, any built-in gain eliminated by the taxable income limitation for a taxable year for these corporations would escape the penalty tax forever.

The following example illustrates the foregoing:

**EXAMPLE: Corporation**, formerly a C corporation, elects S status on January 1, 2017. Corporation has two assets on that date: one with a fair market value of \$100,000 and a basis of \$10,000; the other with a fair market value of \$20,000 and a tax basis of \$30,000. Therefore, "net unrealized built-in gain" of **Corporation** is \$80,000. If **Corporation** sells both assets on January 2, 2017, its net recognized built-in gain would be \$80,000. Assuming, however, that because of other deductions, **Corporation's** taxable income in 2017 is reduced to zero, no penalty tax would be imposed in 2017. The \$80,000 of built-in gain would be carried over and treated as recognized built-in gain in 2018 or future taxable years within the "recognition period," provided **Corporation** has sufficient taxable income in such year(s). If **Corporation** had filed its S election prior to April 1, 1988, **Corporation** would not have been subject to any built-in gains tax because the taxable income limitation in the taxable year when the gain was realized would have wiped out the built-in gains tax forever.

**PRACTICE ALERT:** In the above example, if **Corporation** was not subject to the built-in gains tax in 2017 due to the taxable income limitation and it terminated its S election, effective January 1, 2018, it could possibly escape the built-in gains tax altogether. C corporations are not subject to the built-in gains tax. Of course, if a corporation has made an S election and that election has been revoked or terminated, the corporation cannot generally re-elect S corporation status for five (5) taxable years following the tax year in which the revocation or termination became effective.<sup>275</sup> The Commissioner of the IRS may consent to a re-election prior to the expiration of the five years. In fact, the Service has issued several rulings, allowing a re-election prior to the expiration of the five-year period.<sup>276</sup> In each of these rulings, however, a finding that the corporation had never benefited from or had never been subject to S corporation rules and therefore no abuse or tax avoidance was involved in the revocation or reelection was required. In this situation, it is unlikely that Corporation would be entitled to an early reelection because a finding of abuse would surely be found.

In any event, under current law, if an S corporation's taxable income can reasonably be reduced to zero for each taxable year during the recognition period, the carry-over built-in gains tax will be eliminated in the sixth year after the S election is in effect.

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<sup>274</sup> See Code § 1374(c)(2)(B).

<sup>275</sup> Code § 1362(g).

<sup>276</sup> See e.g., PLR 8842007; 8844005; 8831048; and 8828050.

Code § 481 adjustments taken into account during the “recognition period” will be recognized as built-in gain or built in loss for purposes of Code § 1374. The Treasury Regulations provide in part:

**“Any § 481(a) adjustment taken into account in the recognition period is recognized built-in gain or loss to the extent the adjustment relates to items attributable to periods before the beginning of the recognition period under the principles for determining recognized built-in gain or loss in this §. The principles for determining recognized built-in gain or loss in this § include, for example, the accrual method rule under paragraph (b) of this §.”**<sup>277</sup>

**EXAMPLE 1: Corporation** is a C corporation that timely and properly elects to become an S corporation effective January 1, 2016. It improperly capitalizes repair costs and recovers the costs through depreciation of the related assets. In 2019, **Corporation** properly changes to deducting repair costs as they are incurred. Under Code § 481(a), the basis of the related assets are reduced by an amount equal to the excess of the repair costs incurred before the year of change over the repair costs recovered through depreciation before the year of change. In addition, **Corporation** has a negative Code § 481(a) adjustment equal to the basis reduction. Under Treasury Regulation § 1.1374-4(d)(1), the portion of its negative Code § 481(a) adjustment relating to the repair costs incurred before the “recognition period” is recognized built-in loss because those repair costs are items attributable to periods before the beginning of the “recognition period” under the principles for determining recognized built-in gain or loss.<sup>278</sup>

**EXAMPLE 2: Corporation** is a C corporation that timely and properly elects to become an S corporation effective January 1, 2016. It improperly uses an accrual method of accounting without regard to the economic performance rules of Code § 461(h) to account for worker’s compensation claims. As a result, **Corporation** takes deductions when worker compensation claims are filed. In 2019, it properly changes to an accrual method with regard to the economic performance rules under Code § 461(h)(2)(C) for worker’s compensation claims. As a result, **Corporation** takes deductions when claims are paid. The positive Code § 481(a) adjustment resulting from the change is equal to the amount of claims filed, but unpaid, before the year of change. Under Treasury Regulation § 1.1374-4(b)(2), the deduction allowed in the “recognition period” for claims filed, but unpaid, before the “recognition period” is recognized built-in loss because a deduction was allowed for those claims before the “recognition period” under an accrual method without regard to Code § 461(h)(2)(C). In accordance with Treasury Regulation § 1.1374-4(d)(1), the portion of **Corporation’s** positive Code § 481(a) adjustment relating to claims filed, but unpaid, before the “recognition period” is recognized built-in gain because those claims are items attributable to periods before the beginning of the “recognition period” under the principles for determining recognized built-in gain or loss.<sup>279</sup>

Income taken into account under Code § 995 during the “recognition period” may be built-in gain. The Treasury Regulations provide:

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<sup>277</sup> Treas. Reg. § 1.1374-4(d)(1).

<sup>278</sup> Treas. Reg. § 1.1374-4(d)(2).

<sup>279</sup> *Id.*

**“Any item of income properly taken into account during the recognition period under § 995(b)(2) is recognized built-in gain if the item results from a DISC termination or disqualification occurring before the beginning of the recognition period.”<sup>280</sup>**

Income taken into account as discharge of indebtedness or bad debt during the “recognition period” may constitute built-in gain or built-in loss. The Treasury Regulations provide:

**“Any item of income or deduction properly taken into account during the first year of the recognition period as discharge of indebtedness income under Code § 61(a)(12) or as a bad debt deduction under Code § 166 is recognized built-in gain or loss if the item arises from a debt owed by or to an S corporation at the beginning of the recognition period.”<sup>281</sup>**

**EXAMPLE 1: Corporation** is a C corporation that timely and properly elects to become an S corporation effective January 1, 2016. As of the last day of its C corporation status, **Corporation** owed \$200,000 to an unrelated party. In January 2019, the unrelated party determined that the debt from **Corporation** was uncollectible. It wrote off the debt. **Corporation** has \$200,000 of realized built-in gain. Of course, recognition of the built-in gain is subject to the income limitation and the net unrecognized built-in gain ceiling.

**EXAMPLE 2:** Same facts as Example 1, except **Corporation**, rather than owing money as of the last day of its C corporation status, was owed \$200,000 by an unrelated party. In January 2019, **Corporation**, after exhausting collection efforts, determined the debt was uncollectible. It wrote off the debt. **Corporation** has realized built-in loss that it can potentially use to offset built-in gain.

Careful attention must be given when an electing S corporation has been using the completion of contract method of accounting for its long term contracts. The applicable provisions of the Treasury Regulations provide:

**“Any item of income properly taken into account during the recognition period under the completed contract method (as described in § 1.460-4(d)) where the corporation began performance of the contract before the beginning of the recognition period is recognized built-in gain if the item would have been included in gross income before the beginning of the recognition period under the percentage of completion method (as described in § 1.460-4(b)). Any similar item of deduction is recognized built-in loss if the item would have been allowed as a deduction against gross income before the beginning of the recognition period under the percentage of completion method.”<sup>282</sup>**

§ 460 of the Code generally requires that taxpayers determine taxable income from a long-term contract using the percentage-of-completion method of accounting. A taxpayer using this method generally includes a portion of the total contract price in income for each taxable year that the taxpayer incurs costs allocable to the long-term contract. More specifically, to determine the income from a long-term contract, the taxpayer first computes the completion factor for the contract, which is the percentage of the estimated total allocable contract costs that the taxpayer

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<sup>280</sup> Treas. Reg. § 1.1374-4(e).

<sup>281</sup> Treas. Reg. § 1.1374-4(f).

<sup>282</sup> Treas. Reg. § 1.1374-4(g).

has incurred (based on the all events test of Code § 461, including economic performance, regardless of the taxpayer's method of accounting) through the end of the taxable year. Second, the taxpayer computes the amount of cumulative gross receipts from the contract by multiplying the completion factor by the total contract price, which is the amount that the taxpayer reasonably expects to receive under the contract. Third, the taxpayer computes the amount of current-year gross receipts, which is the difference between the cumulative gross receipts for the current taxable year and the cumulative gross receipts for the immediately preceding taxable year. This difference may be a loss (a negative number) based on revisions to estimates of total allocable contract costs or total contract price. Last, the taxpayer takes into account both the current-year gross receipts and the amount of allocable contract costs actually incurred during the taxable year. To the extent any portion of the total contract price has not been included in taxable income by the completion year, Code § 460(b)(1) requires that the taxpayer include that portion in income for the taxable year following the completion year.<sup>283</sup>

Accordingly, if an electing S corporation has been using the percentage of completion method of accounting for its long-term contracts that it entered into prior to the effective date of the S election, it needs to analyze the impact that the method of accounting will have on the built-in gains tax under Code § 1374. Its income and loss recognized from this method of accounting during the “recognition period” may constitute built-in gain or built-in loss.

Inventory creates special problems for calculating an S corporation's built-in gain. Inventory must be valued and aggregated with all of the corporation's assets for purposes of computing net recognized built-in gain.<sup>284</sup> Unfortunately, after the enactment of the Tax Reform Act of 1986, neither Code § 1374, the legislative history, nor the applicable Treasury Regulations provided an abundance of guidance on the proper method of valuing inventory.

In accordance with the limited available regulatory guidance, we are told that the fair market value of the inventory of an S corporation on the first day of the “recognition period” is determined by looking at the amount a willing buyer would pay a willing seller for the inventory in a purchase of all of the corporation's assets in a non-liquidation setting (i.e., the buyer has the intent to continue to operate the corporation's business).<sup>285</sup> For this purpose, the fictitious buyer and seller are presumed to have a “reasonable knowledge” of all relevant facts surrounding the inventory and not to be under any compulsion to buy or sell the inventory.<sup>286</sup>

In order to determine whether inventory disposed of by an S corporation was inventory it held on the first day of the “recognition period” and thus potentially subject to the built-in gains tax, the S corporation must use the inventory method it uses for income tax purposes.<sup>287</sup>

**PRACTICE ALERT:** If a corporation changes its method of accounting for inventory with a principal purpose of avoiding the built-in gains tax, it will be required to use its former method of accounting for purposes of applying Code § 1374.

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<sup>283</sup> Code § 460.

<sup>284</sup> Code § 1374(d)(2)(a)(i).

<sup>285</sup> Treas. Reg. § 1.1374-7(a).

<sup>286</sup> *Id.*

<sup>287</sup> Treas. Reg. § 1.1374-7(b).

There are at least two methods for valuing inventory, namely at its retail price or at its wholesale price. Using the retail valuation methodology entails appraising the inventory on an asset-by-asset basis. Using a wholesale valuation methodology, however, requires that the inventory be valued in bulk.

In 1986, most commentators asserted that the wholesale approach was the proper methodology for valuing inventory. Unfortunately, the Final Treasury Regulations published in 1994 fail to directly address the issue. The regulations do, however, provide some indirect support for the position that the use of the wholesale method is correct in that Treasury specifically refers to a purchase of **all** of the items comprising the inventory (i.e., a bulk purchase).<sup>288</sup> The regulations do not go any farther in this regard.

As discussed in more detail below, in the case of LIFO inventory, if the S election was made after December 17, 1987, Code § 1363(d) requires recapture of the LIFO reserve on the last C corporation return prior to the effective date of the S election. For elections made prior to December 17, 1987, no built-in gains will be recognized with respect to LIFO inventory until a LIFO layer existing on the last day of the last C year is invaded.<sup>289</sup> That said, as indicated above, the inventory method (FIFO or LIFO) used by the S corporation will determine whether goods were held at the time of the effective date of the S election.<sup>290</sup>

### **[b] Built-in Gain and Loss Arising from Receivables and Payables.**

The Technical and Miscellaneous Revenue Act of 1988 provided special rules which clarified the treatment of cash basis receivables and cash basis payables when computing the built-in gains tax. Under these rules, an S corporation is required to treat as recognized built-in gain any income item recognized during the recognition period to the extent it was earned or attributable to any prior C corporation year.<sup>291</sup>

Income items include: accounts receivable, work in progress and contract rights. The portion of an income item attributable to a prior C year is the excess of the item's fair market value over its adjusted basis as of the beginning of the first taxable year for which the corporation's S election is in effect.

A cash basis C corporation which converts to S corporation status and has cash basis accounts receivable with a fair market value of \$50,000 and a tax basis of zero would have \$50,000 of recognized built-in gain during its first taxable year as an S corporation, provided the receivables were collected during that year. Similarly, a deduction or expense claimed by an S corporation attributable to a prior C corporation year is treated as a recognized built-in loss for the taxable year it is allowed as a deduction.<sup>292</sup> Accordingly, cash basis accounts payable which are attributable to a prior C corporation year, but are paid during a taxable year after the corporation elected S corporation status would be treated as a recognized built-in loss for that year.

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<sup>288</sup> Treas. Reg. § 1.1374-7(a).

<sup>289</sup> See IRS Announcement 86-128, 1986-51, IRB 22; *see also*, Treas. Reg. § 1.1374-10(b)(2).

<sup>290</sup> See Treas. Reg. § 1.1374-7(b).

<sup>291</sup> Code § 1374(d)(5)(A).

<sup>292</sup> Code § 1374(d)(5)(B).

**PRACTICE ALERT:** As a practical matter, it may be beneficial for a cash basis C corporation contemplating conversion to S corporation status to attempt to identify and accrue expenses during its final C corporation year, which will be paid and deducted during its first S corporation year. It should be noted, however, that in order to constitute a built-in loss and be deductible in the subsequent S corporation year, the expense must actually be attributable to the C corporation year. This means the expense must be an ordinary and necessary expense in that year. The Service will likely closely scrutinize any accounts payable existing at the time of the effective date of an S election by a cash basis corporation. **Caution is advised!**

**[c] Property Acquired from C Corporations and Other Carry-Over Basis Property.**

If an S corporation acquires and subsequently disposes of any assets it received from a corporation in a carry-over basis transaction (e.g., a tax-free reorganization or tax deferred exchange), the unrealized appreciation (but not the built-in loss) in such asset on the acquisition date will be subject to the built-in gains tax.<sup>293</sup> The built-in gains tax will be imposed if the unrealized appreciation is recognized during the “recognition period” beginning on the acquisition date.

The Treasury Regulations provide in part:

**“If any S corporation acquires any asset in a transaction in which the S corporation’s basis in the asset is determined (in whole or in part) by reference to a C corporation’s basis in the assets (or any other property) (a § 1374(d)(8) transaction), § 1374 applies to the net recognized built-in gain attributable to the assets acquired in any § 1374(d)(8) transaction.”**<sup>294</sup>

The following example illustrates the foregoing:

**EXAMPLE:** **Corporation** has been an S corporation since it was formed on July 1, 2017. On August 1, 2017, **Corporation** acquired assets with a fair market value of \$100,000 and a tax basis of zero in a tax-free merger with a C corporation. On September 1, 2017, **Corporation** sells those assets and recognizes a \$100,000 gain. Even though **Corporation** has always been an S corporation and not otherwise subject to the built-in gains tax, the \$100,000 gain is attributable to assets acquired from a C corporation in a carry-over basis transaction and, therefore, subject to the penalty tax.

A similar rule applies if any asset held by an S corporation which is subject to the built-in gains tax is exchanged for another asset in a tax-free transaction.<sup>295</sup> In that case, the newly acquired asset has the built-in gains taint of the exchanged asset.

The following example illustrates the foregoing:

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<sup>293</sup> Code § 1374(d)(8)(A).

<sup>294</sup> Treas. Reg. § 1374-8(a).

<sup>295</sup> Code § 1374(d)(6).

**EXAMPLE: Corporation**, an S corporation which was formerly a C corporation, has a parcel of real estate with \$50,000 of unrealized built-in gain subject to Code § 1374. The real estate is exchanged in a tax-free Code § 1031 exchange for another parcel of real estate. Even though the parcel of real estate was **not** held by **Corporation** when it converted to S status, it will still be subject to Code § 1374 if it is sold during the “recognition period.”

**[d] Code § 1374(d)(2)(B).**

S corporations without taxable income during a given taxable year will not recognize any built-in gain for that tax year. But, pursuant to Code § 1374(d)(2)(B), unrecognized built in gain will carry-over to future tax years during the “recognition period.” This provision only applies to corporations with S elections made post March 30, 1988.

**[e] Treasury Regulation § 1.1374-4(h)(1).**

Treasury Regulation § 1.1374-4(h)(1) expressly provides that a gain from built-in gain assets sold within the “recognition period” or prior thereto may be subject to Code § 1374 after the “recognition period” if the gain is reported under the Code § 453(a) installment method. Thus, taxpayers cannot avoid the built-in gains tax by deferring a portion of payments beyond the “recognition period.”

**PRACTICE ALERT:** Unlike Code § 1374 prior to the 1986 Act, an installment sale may not be fruitful to avoid the application of Code § 1374.<sup>296</sup>

**[f] Basic Illustration of the Built-In Gains Tax.**

**Corporation** has three assets:

<u>Asset</u>	<u>Tax Basis</u>	<u>Fair Market Value</u>
Asset 1	\$10,000	\$30,000
Asset 2	\$20,000	\$30,000
Asset 3	<u>\$30,000</u>	<u>\$15,000</u>
<b>TOTAL:</b>	\$60,000	\$75,000

The potential amount of built-in gain of **Corporation** (the “recognized built-in gain”) is \$15,000. The contribution of loss assets, however, to reduce the net unrealized gain computation will generally be ineffective if done within a two-year period of the election.<sup>297</sup>

**EXAMPLE 1: Corporation** sells Asset 2 for \$29,000. \$9,000 is built-in gain (“recognized built-in gain”) and will be taxed to the corporation (assuming the corporation has taxable income) before such income is deemed distributed to the shareholders. Assuming the sale occurred in 2018, the Federal tax on the built-in gains would be \$1,890 (\$9,000 x 21%). In

<sup>296</sup> See a more detailed discussion of the installment method and its impact on Code § 1374 below.

<sup>297</sup> See IRS Announcement 86-128, 1986-51 IRB 22 and Treas. Reg. § 1.1374-10(b)(3).

accordance with Code § 1366(f)(2), the tax would be treated as a loss, thereby reducing the income passing through to the shareholders.

**EXAMPLE 2:** Same facts as Example 1, except **Corporation** has taxable income for the taxable year of \$1,000. Consequently, **Corporation** has “net recognized built-in gain” of \$1,000 due to the taxable income limitation. It also has \$8,000 of built-in gain to carryover and which is potentially subject to taxation in future years within the remaining “recognition period.”

**EXAMPLE 3:** **Corporation** sells Asset 2 for \$32,000 within the “recognition period.” The gain realized is \$12,000. However, only \$10,000 of the gain is attributable to built-in gain. Thus, only \$10,000 will be taxed at the corporate level under Code § 1374 before the income is deemed distributed to the shareholders.

**EXAMPLE 4:** **Corporation** sells Asset 1 for \$32,000 within the “recognition period.” The gain realized is \$22,000. Since the net unrealized built-in gain at the time of conversion was only \$15,000, only \$15,000 will be subject to the built-in gains tax. The built-in gain recognized during any taxable year cannot exceed the net unrealized built-in gain at the effective date of the S election, less the aggregate recognized built-in gain from prior taxable years within the “recognition period.”

**EXAMPLE 5:** **Corporation** sells Asset 1 for \$32,000 after selling Asset 2 for \$32,000. Asset 2 had a \$12,000 gain realized, of which \$10,000 was built-in gain. Asset 1 has a gain of \$22,000, but now only \$5,000 is built-in gains since \$10,000 of the built-in gains had already been recognized on the sale of Asset 2.

### [g] Potential Code § 1374 Triggers.

Without careful planning and due diligence, the built-in gains tax under Code § 1374 can be triggered and unsuspecting taxpayers may get hit with a large tax liability. The following discussion, while not exhaustive, is illustrative of the potential ways Code § 1374 can come into play. Some of the potential triggers of the built-in gains tax are obvious. Other triggers, however, are not readily evident. If tax practitioners are not keenly aware of these not so obvious triggers, they may catch them off guard.

### [i] Code § 1031.

In accordance with Code § 1031, “[n]o gain or loss shall be recognized on the exchange of property held for productive use in a **trade or business or for investment** if such a property is **exchanged** solely for property of **like kind** which is to be held either for productive use in a **trade or business or for investment** (emphasis added).”<sup>298</sup>

In order to obtain absolute deferral, several requirements must be met:

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<sup>298</sup> Code § 1031(a)(1).

- Both the property surrendered and the property received must be held for a productive use in a trade or business or for investment.<sup>299</sup>
- The property surrendered must be “exchanged” for the property received in order for a transaction to qualify for tax deferral under Code § 1031.<sup>300</sup> Treasury Regulation § 1.1002-1(d) provides that an exchange is a reciprocal transfer of property, as distinguished from a transfer of property for money consideration only. A sale coupled with a reinvestment of the sale proceeds in like kind property does **not** constitute an exchange.
- Both the property surrendered and the property received must be “like kind.”<sup>301</sup> Treasury Regulation § 1.1031(a)-1(b) provides that the term like kind refers to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. Whether real estate is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its nature or character. Provided, however, an exchange of personal property for real property is disallowed because the nature or character of the properties are not like kind. Guidance as to what constitutes like kind property is primarily provided by the courts and applicable Treasury Regulations which were finalized in April, 1991.
- Prior to 2018, both the property surrendered and the property received had to be tangible property – it could not consist of the types of property specifically enumerated in Code § 1031(a)(2). These types of property (commonly referred to as “tainted property”) included:
  - Stock in trade or property held for sale (i.e. inventory).<sup>302</sup>
  - Stocks, bonds or notes.<sup>303</sup>
  - Other securities or evidences of indebtedness.<sup>304</sup>
  - Partnership interests.<sup>305</sup> There is an exception for interests in partnerships which have a valid Code § 761 election in effect.
  - Trust certificates or beneficial interests in property.<sup>306</sup>
  - Choses in action.<sup>307</sup>

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<sup>299</sup> *Id.*

<sup>300</sup> *Id.*

<sup>301</sup> *Id.*

<sup>302</sup> Pre-TCJA Code § 1031(a)(2)(A).

<sup>303</sup> Pre-TCJA Code § 1031(a)(2)(B).

<sup>304</sup> Pre-TCJA Code § 1031(a)(2)(C).

<sup>305</sup> Pre-TCJA Code § 1031(a)(2)(D).

<sup>306</sup> Pre-TCJA Code § 1031(a)(2)(E).

As a result of the TCJA, after 2017 both the property surrendered and the property received must constitute real property.<sup>308</sup> All personal property is now treated as “tainted property.” Real property that is held by the taxpayer as inventory remains ineligible for tax deferral under Code § 1031.<sup>309</sup>

No “Boot” may be received for total gain deferral. If “Boot” is involved in an otherwise qualifying Code § 1031 exchange, gain recognition will exist. Non-qualifying property, including tainted property and cash, which are included as part of an exchange, commonly referred to as “Boot,” may create tax consequences for the transferor and the recipient.

Deferred exchanges of both varieties are allowed, provided stringent statutory and regulatory requirements are met.<sup>310</sup> The need to “defer” an exchange often occurs because the exchanging party has found a purchaser for his/her property prior to locating replacement property (“deferred forward exchange”) or he/she has found the replacement property before locating a purchaser for his/her property (“Reverse deferred exchange”).

Related party transactions have historically been used by taxpayers to aggressively plan to circumvent legislative and IRS action. The Tax Reform Act of 1986 caused Code § 1031 to come to center stage in tax planning circles. Consequently, Congress decided to ensure that related party transactions would not be used to enhance the desirability of Code § 1031. In 1989, Congress added Code §§ 1031(f) and (g) to the Code. The 1989 legislation sought to curb several potential abuses, including basis shifting, loss acceleration, conversion of capital losses into Code § 1231 losses, shifting low basis to land and high basis to improved real estate, accelerating loss utilization and otherwise avoiding the repeal of the General Utilities Doctrine. If a taxpayer enters into an otherwise qualifying Code § 1031 exchange with a “related party”<sup>311</sup> and either the taxpayer or the related party disposes of their respective properties within two years of the exchange, then Code § 1031 does **not** apply to the initial transaction and any gain deferred is recognized at the time of the subsequent disposition.

Certain dispositions are exempted from these anti-abuse rules, namely dispositions following the death of either party involved in the exchange, dispositions occurring pursuant to an involuntary conversion provided the Code § 1031 exchange occurred prior to the threat or imminence of the conversion, or dispositions where the parties can establish to the Commissioner’s satisfaction that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax (i.e. exchanges which do not involve basis shifting).

As illustrated by the basic requirements for tax deferral under Code § 1031 above, many impediments to obtaining tax deferral exist, including but not limited to failing to meet the many statutory and regulatory requirements, having “boot” involved in an otherwise qualifying exchange, and disposition of exchange property within two (2) years following a related party exchange. This sets the stage for a potential disaster for a corporation that is subject to the built-in gains tax under Code § 1374.

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<sup>307</sup> Pre-TCJA Code § 1031(a)(2)(F).

<sup>308</sup> Code § 1031 (a)(1).

<sup>309</sup> Code § 1031(a)(2).

<sup>310</sup> See e.g., Code § 1031(a)(3) and Treas. Reg. § 1.1031(k)-1(b)(2)(iii).

<sup>311</sup> Related party is defined in Code § 1031(f).

If a corporation (that is otherwise subject to the built-in gains tax) disposes of an asset within the “recognition period” that has built-in gain at the effective date of the S election in an exchange that qualifies for tax deferral, no realized gain will be recognized.<sup>312</sup> The built-in gains tax will **not** be triggered. The corporation generally obtains a carryover basis in the replacement property and continues to be subject to the built-in gains tax throughout the remainder of the “recognition period” (with the replacement property from the exchange stepping into the same position as the relinquished property from the exchange).<sup>313</sup>

If, however, the Code § 1031 exchange is taxable, in whole or part, in addition to the regular tax, the corporation will be liable for the built-in gains tax. Consequently, before embarking upon a Code § 1031 exchange, any corporation that is vulnerable to the built-in gains tax needs to pay careful consideration to the application of Code § 1374 if any part of the exchange is found to be taxable.

The following examples illustrate potential applications of Code § 1374 arising from a Code § 1031 exchange:

**EXAMPLE 1: Corporation**, a C corporation, properly and timely elects to be treated as an S corporation, effective January 1, 2017. As of the effective date of the election, **Corporation** had two assets, namely Blackacre (raw land) which it held for investment and Office Building which is used in its trade or business. No debt existed. At that time, Blackacre had a basis of \$1,000,000 and a fair market value of \$4,000,000, and the building had an adjusted basis of \$1,500,000 and fair market value of \$5,000,000. Consequently, **Corporation** had “net unrealized built-in gain” at the time of election of \$6,500,000 ( $\$4,000,000 - \$1,000,000 + \$5,000,000 - \$1,500,000 = \$6,500,000$ ). On January 15, 2018, **Corporation** entered into an exchange, relinquishing Blackacre. Its replacement property was a large parcel of raw land – Whiteacre (which it intends to hold for investment and possibly later develop into an office building for use in its business). Blackacre had a fair market value of \$4,500,000 at the time of the exchange. The replacement property, Whiteacre, had a fair market value of \$4,000,000 at the time of the exchange. So, **Corporation** received cash of \$500,000 (which constitutes boot) in the exchange. If non-qualifying property is received in an otherwise qualifying Code § 1031 exchange, any gain realized will be recognized by the recipient to the extent of the money and the fair market value of the other Boot received.<sup>314</sup> **Corporation**, assuming all of the requirements of Code § 1031 were met, will have gain recognition of \$500,000 (the “boot” received in the exchange) and a basis in the property of \$1,500,000 ( $\$1,000,000$  plus the gain recognized of \$500,000). Unfortunately, the analysis does not stop there. **Corporation** also has built-in gains tax to pay because a built-in gains asset was disposed of during the “recognition period” in a taxable event. The net “unrealized built-in gain” at the time of the exchange, as stated above, was \$6,500,000. Assuming **Corporation’s** taxable income for the 2018 taxable year was \$500,000 or more, **Corporation** would be subject to the built-in gains tax on \$500,000 of “net recognized built-in gain.” If the highest corporate rate in effect at that time was 35%, the Federal built-in gains tax liability would be \$175,000. If, of course, **Corporation’s** taxable

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<sup>312</sup> Code § 1031(a)(1).

<sup>313</sup> In general, the basis of property received in an exchange is the basis of the property exchanged, plus any gain recognized, minus any loss recognized, plus the net liabilities assumed or taken subject to, minus the net liabilities relieved, plus cash paid, and minus cash received.

<sup>314</sup> Code § 1031(b).

income for the 2018 taxable year was less than \$500,000, the excess “net recognized built-in gain” gets carried over to future years within the recognition.

**EXAMPLE 2:** Assume same facts as Example 1, except the exchange was with a related party; no “boot” was received in the exchange; the fair market value of Whiteacre and Blackacre at the time of the exchange was \$4,500,000; and eighteen months after the exchange in the taxable year 2020, the acquirer of Blackacre (the related party) disposes of it in a sale or exchange. In accordance with Code § 1031(f), **Corporation’s** otherwise tax deferred exchange became taxable. The result of the subsequent disposition of Blackacre by the related party is that **Corporation** has to report taxable gain on the exchange of Blackacre of \$3,500,000 (\$4,500,000 value at the time of the exchange less basis of \$1,000,000). The gain gets reported on **Corporation’s** 2020 tax return (the year of the subsequent disposition by the related party). Likewise, **Corporation** would have “net recognized built-in gain” of \$3,000,000 in taxable year 2020 assuming its taxable income was \$3,000,000 or more.

**EXAMPLE 3:** Assume the same facts as Example 2, except the exchange occurred in taxable year 2021 (January 15, 2021) and the subsequent disposition occurred in taxable year 2023. The “recognition period” presumably ended for **Corporation** on December 31, 2021. In accordance with Code § 1031(f) the exchange itself did not qualify for tax deferral because of the disposition of the relinquished property by the related party within two years of the exchange, but the gain resulting therefrom is reported by the taxpayer in the year of the related party disposition. So, since the “recognition period” ended on December 31, 2021, but the taxable exchange which occurred on January 15, 2021 (inside the “recognition period”) is to be reported in the year of the subsequent disposition of the property by the related party (outside of the “recognition period”), does **Corporation** have to report a built-in gains tax under Code § 1374? **CAVEAT:** The law is not clear. Arguably, since the “recognition period” had expired at the time of the reporting obligation, no built-in gains tax is due and owing by **Corporation**. On the other hand, the Service could argue, since under Code § 1031(f) the original exchange itself failed and the original exchange occurred within the “recognition period,” the built-in gains tax is due and payable by **Corporation**, even though it is due and payable outside the “recognition period.” **Caution is advised.**

**EXAMPLE 4:** Assume same facts as Example 2, but the subsequent disposition was by **Corporation** of Whiteacre (its replacement property) rather than a disposition of Blackacre by the related party. The same result set forth in Example 2 follows.

The TCJA makes the impact of Code § 1031 exchanges potentially more problematic for taxpayers otherwise susceptible to the built-in gains tax. The possibility of concluding an exchange with taxable boot increased when President Trump, on December 22, 2017, signed the TCJA into law.

On February 21, 2014, then House Ways and Means Committee Chairman Dave Camp (R. Michigan) issued a discussion draft of the “Tax Reform Act of 2014.” The proposed legislation spanned almost 1,000 pages and contained some interesting provisions, including repealing Code § 1031, thereby prohibiting tax deferral from like-kind exchanges. Not only would taxpayers have been impacted by this proposal, but it would have turned the real estate industry upside down. Qualified intermediaries would have been put out of business. Likewise, title and escrow

companies, as well as real estate advisors specializing in exchanges, would have been adversely affected by the proposal.

Former President Barack Obama released his 2015 written budget proposals 11 days after Chairman Camp's tax reform discussion draft was made public. Many of the provisions of these proposals were similar. Both the Obama Administration and Chairman Camp wanted to significantly curtail Code § 1031. Unlike Chairman Camp, who wanted to entirely eliminate Code § 1031 exchanges, President Obama proposed placing a deferral limit of \$1 million (indexed for inflation) per taxpayer annually on Code § 1031 exchanges. The cap, however, only expressly applied to real property exchanges. Consequently, it appeared the Obama administration proposed to leave personal property exchanges under Code § 1031 intact.

Fast forward to 2016. No tax reform legislation had gained enough traction to even come close to being enacted into law. Nevertheless, President Obama's attack on Code § 1031 continued. In its 2017 budget proposal, the Obama White House further expanded its quest to limit the application of Code § 1031 by proposing that the \$1 million limitation apply to both personal and real property exchanges. In addition, the 2017 budget proposal sought to totally exclude certain personal property, collectibles and art, from the definition of "like kind."

I am not sure any real logic or significant tax policy supported President Obama's last proposal to limit the application of Code § 1031. Rather, the proposal appeared to be solely aimed at tax revenue generation. According to the Treasury, tax revenues would have increased by \$47.3 billion over 10 years if the proposal had been enacted into law.

With a new President in the White House, it was clear that things were changing. One of the many questions among real estate investors was whether Code § 1031 would be impacted by any tax law.

While tax reform has always been at the forefront of President Trump's agenda, there were no signs of repealing or curtailing Code § 1031 remaining from the prior administration. On December 22, 2017, when President Trump signed the new law, giving birth to the TCJA, the real estate industry was likely a bit surprised.

The TCJA drastically modifies Code § 1031. The changes started with § 3303 of the House proposal which, at least to our surprise, modified Code § 1031 to limit its application to real property (all real property other than real property held by the taxpayer as inventory). The legislative history tells us that this proposed change was intended to continue the eligibility for like-kind treatment any real property that was otherwise eligible for tax deferral under prior law. In other words, going forward, personal property would not be eligible for tax deferral under Code § 1031.

The Senate version of the bill retained § 3303 of the House bill without modification. The Conference Committee followed the Senate with respect to § 3303. As a result, the TCJA, as signed by President Trump, adopted the House bill's proposed limitation to Code § 1031.

The TCJA's changes apply to exchanges completed after December 31, 2017. For exchanges (forward and reverse), however, commenced on or before December 31, 2017, the old law will apply. In order to be considered commenced on or before the end of 2017, however, the

relinquished property in the case of a forward exchange must have been disposed of by the taxpayer by the end of 2017, and the replacement property, in the case of a reverse exchange, must have been received by the taxpayer by the end of 2017.

The revision to Code § 1031 comes with good and bad news. The good news includes the fact that Code § 1031 is likely simplified by this law change. The complex personal property exchange rules contained in Treasury regulations<sup>315</sup> dealing with product classes and general asset classes are no longer needed and can be eliminated. In addition, the complex rules provided in IRS guidance are no longer relevant.<sup>316</sup>

The bad news may not be crystal clear to taxpayers and their advisers. On careful examination and reflection, it is evident that this change to the Code creates several significant traps for the unwary, including unwanted results arising from: interaction with the TCJA's temporary expensing provisions; ancillary personal property will likely constitute taxable "boot" in exchanges; and timing issues.

The TCJA provides new 100% cost recovery expensing provisions. However, the TCJA's beefed-up expensing provisions have a limited shelf life. Without further change to the Code, they will expire after 2026. In contrast, the change to Code § 1031 is a so-called permanent change to the Code.

If the 100% cost recovery expensing provisions expire at the end of 2026 and personal property exchanges are not re-born for Code § 1031 purposes, taxpayers that routinely acquire and dispose of personal property used in their trade or businesses (e.g., fleets of vehicles, airplanes, ships and/or machinery), may find themselves in a world of hurt. Prior to 2018, businesses such as airlines and/or rental car companies, routinely disposed of automobiles or airplanes that they wished to retire and acquired automobiles or airplanes in tax deferred exchanges under Code § 1031. If the automobiles or airplanes can be expensed by the taxpayer under the robust cost recovery expensing rules, all is generally good even in light of the limitations put on Code § 1031. After 2026, however, if the cost recovery expensing rules go away, these taxpayers will be faced with potentially large gains from the disposition of these depreciated assets. Without further change to the Code, there will be no way to defer the gain.

Under the TCJA, taxpayers desiring to conduct a Code § 1031 exchange with real property that also includes ancillary personal property need to pause for cause. For example, consider a taxpayer who wishes to exchange a 300-unit apartment complex for a 450-unit apartment complex. While both properties constitute real property, the personal property that goes along with the real property cannot be ignored, especially under the new law. In the case of an apartment complex, lots of items of personal property likely exist (e.g., washers, dryers, dishwashers, stoves, drapes, tools, landscaping equipment, office equipment and furniture, recreation room furniture, and pool equipment). Under the new law, the personal property cannot be swept under the rug. It is, by definition, taxable "boot" in the exchange. A reasonable allocation of the transaction proceeds to the personal property is required and income must be reported from the disposition of such property.

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<sup>315</sup> Treas. Reg. § 1.1031(a)-2.

<sup>316</sup> See Rev. Proc. 87-56, 1987-2 CB674 and Chief Counsel Advice 200911006.

With personal property that may tag along in a Code § 1031 exchange, taxable boot will likely follow. If the taxpayer is already susceptible to the built-in gains tax, Code § 1374 may be triggered.

The amendment to Code § 1031 resulting from the TCJA may make the triggers of Code § 1374 broader than ever before. Some basic guidelines are warranted:

- When reviewing the viability of a Code § 1031 exchange, the possible application of Code § 1374 needs to be considered.
- While taxpayers may enjoy the current benefits of cost segregation studies when acquiring real estate, especially given the availability of the 100% cost recovery expensing provisions of the Code afforded by the TCJA for tangible personal property, they need to be aware of the tax implications segregation studies will create on the sale or exchange of the property down the road. The amounts allocated to tangible personal property from a cost segregation study would likely trigger taxable boot in a subsequent exchange since personal property is not like kind any longer. On top of that, if the taxpayer is susceptible to the built-in gains tax, Code § 1374 could be triggered, making the tax hit much more significant.
- Carefully consider the impact of the TCJA amendment to Code § 1031 and the potential trigger of Code § 1374 in the allocation of purchase price when acquiring real property that has personal property coming along in the purchase.

**EXAMPLE:** **Corporation** is a calendar year C corporation, which elects to be taxed as an S corporation effective January 1, 2018. On that date, **Corporation** has the following assets:

	<u>Tax Basis</u>	<u>Fair Market Value</u>
Apartment Complex	\$100,000	\$1,200,000
Stock	\$ 50,000	\$ 200,000
Raw Land	<u>\$150,000</u>	<u>\$ 400,000</u>
<b>TOTAL:</b>	\$300,000	\$1,800,000

**Corporation's** net unrealized built-in gain is \$1,500,000 (\$1,800,000 minus \$300,000). **Corporation** enters into a Code § 1031 exchange on March 1, 2018, exchanging its apartment complex for a newly constructed office building. The apartment complex buyer negotiated an allocation of the \$1,200,000 purchase price as follows: (1) land (\$200,000); (2) real estate improvements (\$700,000); and (3) personal property such as washers, dryers, ranges, refrigerators, pool equipment, and tools (\$300,000). **Corporation** had depreciated the personal property to zero. Since personal property no longer qualifies for tax deferral under Code § 1031, it has taxable income of \$300,000 (likely ordinary income due to depreciation recapture).

**Corporation** also has built-in gain which is likely \$300,000 (as all appreciation occurred pre-S election). While **Corporation** may have thought a Code § 1031 exchange would allow it to avoid gain, after the enactment of the TCJA, that may not be the case. **Caution is advised.** In this case, a built-in gains tax at the Federal level would equate to \$63,000 (\$300,000 x 21%).

Timing is always important in the world of tax. With this change to Code § 1031, timing is more important than ever before for taxpayers. If a taxpayer disposes of personal property in one tax year and then purchases replacement property qualifying for 100% cost recovery under the TCJA rules in the succeeding tax year, the timing could be problematic for the taxpayer. In that instance, the timing would create taxable income for the taxpayer in tax year one, some of which could be characterized as capital gain and some of which could be characterized as ordinary income resulting from depreciation recapture. Nevertheless, the taxpayer's deduction resulting from the purchase of the replacement property will not be available to it until tax year two. **Caution is advised.**

**[ii] Code § 1033.**

Under Code, if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain shall be recognized.<sup>317</sup> If, however, such property is converted into money or property not similar or related in service or use to the converted property, subject to limited exceptions, the gain (if any) shall be recognized.<sup>318</sup>

Like Code § 1031, to obtain non-recognition under Code § 1033 several requirements and formalities, including timing and reporting requirements, must be met. If these requirements are not met, gain (if any) will likely be recognized. This sets the stage for a potential disaster for a corporation that is subject to the built-in gains tax under Code § 1374.

If a corporation (that is otherwise subject to the built-in gains tax) disposes of an asset within the “recognition period” that has built-in gain at the effective date of the S election in a transaction that qualifies for tax deferral, including deferral under Code § 1033, no realized gain will be recognized.<sup>319</sup> The built-in gains tax will **not** be triggered. The corporation generally obtains a carryover basis in the replacement property and continues to be subject to the built-in gains tax throughout the remainder of the “recognition period” with respect to the replacement property.<sup>320</sup> If, however, the conversion is taxable, in whole or part, in addition to the regular tax, the corporation will be potentially liable for the built-in gains tax. Consequently, before embarking upon the acquisition of replacement property in a conversion under Code § 1033, any corporation that is vulnerable to the built-in gains tax needs to pay careful consideration to the application of Code § 1374 if any part of the conversion is found to be taxable. Meeting the

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<sup>317</sup> Code § 1033(a)(1).

<sup>318</sup> Code § 1033(a)(2).

<sup>319</sup> Code § 1033(a)(1).

<sup>320</sup> Code § 1033(b). In general, the basis of property obtained in a conversion is the basis of the old property, plus any gain recognized, minus any loss recognized, and minus cash received that is not properly applied toward the replacement property.

rigorous requirements of Code § 1033 in such cases may be more important than is normally the case (as the tax liability for non-compliance will undoubtedly be greater).

**EXAMPLE 1: Corporation**, a C corporation, properly and timely elects to be treated as an S corporation, effective January 1, 2017. As of the effective date of the election, **Corporation** had two assets, namely Blackacre (raw land) which it held for investment and Office Building which is used in its trade or business. Both assets are located in the city of Mosquitoville, Vermont. No debt existed. At that time, Blackacre had a basis of \$1,000,000 and a fair market value of \$4,000,000, and the building had an adjusted basis of \$1,500,000 and fair market value of \$5,000,000. Consequently, **Corporation** had “net unrealized built-in gain” at the time of election of \$6,500,000 ( $\$4,000,000 - \$1,000,000 + \$5,000,000 - \$1,500,000 = \$6,500,000$ ). On January 15, 2019, the Federal government, as part of its expansion and rehabilitation project of US Highway 91, condemned Blackacre. The government paid **Corporation** condemnation proceeds of \$4,100,000. In accordance with Code § 1033(g), **Corporation** has until approximately January 14, 2022 to acquire property that is similar or related in serviced or use as Blackacre. **Corporation** properly and timely made an election to defer the gain from the condemnation under Code § 1033 by attaching a statement to its 2019 IRS Form 1120S explaining that it intended to acquire property that is similar or related in use within the statutory time period. Unfortunately, **Corporation** failed to acquire replacement property as it could not find any property that met its needs or requirements. Consequently, **Corporation** had gain that was realized and recognized from the condemnation (assuming no condemnation expenses) equal to \$3,100,000 ( $\$4,100,000$  proceeds less  $\$1,000,000$  tax basis =  $\$3,100,000$ ). \$3,000,000 of the gain recognized is also subject to the built-in gains tax under Code § 1374.

**EXAMPLE 2:** Assume the same facts as Example 1, except the condemnation occurred on December 15, 2021. Since the condemnation occurred within the “recognition period,” the application of Code § 1374 should come into play, but the failure of the election to defer the gain by acquiring replacement property that is similar or related in service or use happened outside of the “recognition period.”

**QUERY:** Because the condemnation occurred within the “recognition period,” but the three-year replacement period extended beyond the “recognition period,” does Corporation escape the application of the built-in gains tax under Code § 1374 in this situation? The answer appears to be: **No.**

Here, **Corporation** realized built-in gain of \$3,000,000 within the “recognition period” (i.e., on December 15, 2021 when its property was condemned), but it had no net recognized built-in gain until December 14, 2024 (when the replacement period expired).

Code § 1374(a) expressly provides:

**“If for any taxable year beginning in the recognition period an S corporation has a net recognized built-in gain, there is hereby imposed a tax ...”**

**Corporation** did **not** have a “net recognized built-in gain” until it failed to acquire qualifying replacement property (i.e., by December 14, 2024 which was outside of the “recognition period”).

The applicable Treasury Regulations, however, provide in part:

**“If, after having made an election under § 1033(a)(2), the converted property is not replaced within the required period of time, or replacement is made at a cost lower than was anticipated at the time of the election, or a decision is made not to replace, the tax liability for the year or years for which the election was made shall be recomputed. Such re-computation should be in the form of an *amended return*.”**<sup>321</sup>

So, it appears the gain is properly recognized and reported for the year of the condemnation. In this case, **Corporation** would be required to amend its IRS Form 1120S for taxable year 2021, reporting the gain from the failed condemnation, triggering both the regular income tax and the built-in gains tax under Code § 1374. In fact, the applicable Treasury Regulations give the Service additional time to assess the tax in this circumstance:

**“If a taxpayer makes an election under § 1033(a)(2), any deficiency, for any taxable year in which any part of the gain upon the conversion is realized, which is attributable to such gain may be assessed at any time before the expiration of three years from the date the district director with whom the return for such year has been filed is notified by the taxpayer of the replacement of the converted property or of an intention not to replace, or of a failure to replace, within the required period, notwithstanding the provisions of § 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment.”**<sup>322</sup>

**Caution is advised!** It appears, under Code § 1033, a failure to acquire replacement property within the time period(s) allowed, even though the taxpayer is outside the “recognition period,” could bring the taxpayer back within harm’s way of Code § 1374.

### **[iii] Cash Basis Receivables.**

Cash basis accounts receivable create a Code § 1374 problem for the unwary. As discussed above, when a C corporation that used the cash receipts and disbursements method of accounting makes an S election, the application of the built-in gains tax under Code § 1374 may be simple and clear, but a surprise may be lurking around the corner and raise its ugly head as the C years’ accounts receivables are collected during the “recognition period.”

It is important to note that the accounts payable for these corporations that exist at the time the S election becomes effective serve as built-in losses and can reduce the net recognized built-in gain created by the cash basis receivables that exist at the time the S election becomes effective. While the taxable income limitation may save the day, at least temporarily, as discussed above, the built-in gains resulting from the receivables, like other built-in gains not recognized because of the taxable income limitation, will be carried over to future years during the “recognition period” and may be recognized during those years.

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<sup>321</sup> Treas. Reg. § 1.1033(a)-2(c)(2).

<sup>322</sup> Treas. Reg. § 1.1033(a)-2(c)(5).

**PRACTICE ALERT:** There may be opportunities for a corporation that has cash basis accounts receivable to undertake some pre-S election planning to avoid or minimize the built-in gains impact post S election. One thought is for the corporation to accelerate its recognition of income from its receivables prior to the effective date of the S election. Along the same lines, a corporation, prior to making an S election or the effective date of its S election, could change (assuming it follows the applicable formalities) its accounting method from cash to accrual, thereby accelerating its recognition of income attributable to its accounts receivable. Of course, this type of planning requires careful consideration and analysis to ensure it is appropriate. For example, this type of planning measure would likely increase C corporation earnings and profits. This could result in the application of Code § 1362(d)(3) and Code § 1375 down the road. **Caution is advised.**

**[iv] Code § 338(h)(10) and Code § 336(e) Transactions.**

Code § 338(h)(10)<sup>323</sup> potentially offers a corporate purchaser of the stock of a target corporation the ability to have a stock transaction treated as an asset purchase and sale for income tax purposes. In essence, the result of a Code § 338(h)(10) election is that the purchase and sale of the stock of a target corporation is treated as the purchase and sale of the assets of the target corporation, followed by a distribution of the proceeds of the deemed asset sale to the selling shareholders.

In a transaction in which a Code § 338(h)(10) election is made, the S corporation (“Old Target”) is treated as if it had transferred all its assets to a S corporation (“Target”) and then liquidated by distributing the proceeds to the S corporation shareholders. The assets in the hands of new Target are stepped up to fair market value. The gain on the deemed sale under Code § 338(h)(10) is reported on the Old Target’s final S corporation return and is therefore taken into account under Code §§ 1366 and 1367 to determine the Old Target shareholder’s basis in the target stock and the resulting gain or loss on the deemed distribution of proceeds in a transaction that may be characterized as a reorganization, a redemption, or a liquidation. With the exception of tax triggered by Code § 1374 (discussed below), new Target is not liable for the tax resulting from the deemed sale and exchange of Old Target’s assets.

Certain requirements for making a Code § 338(h)(10) election exist, including:

- The buyer must be a corporation.
- The target must be an S corporation or a member of an affiliated or consolidated group of corporations.
- The buyer and the Old Target (and all shareholders in the of an S corporation target) must jointly make the election.
- The transaction must constitute a qualified stock purchase. The term “qualified stock purchase” generally means any transaction or series of

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<sup>323</sup> A detailed discussion of Code § 338(h)(10) is beyond the scope of this paper. For a detailed discussion of this topic, see, Mark J. Silverman, *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings*, Practising Law Institute (2013).

transactions in which 80% of target's stock is acquired by the purchasing corporation during a 12-month period.

- If the buyer is not a corporation, Code § 336(e),<sup>324</sup> like Code § 338(h)(10), offers the purchaser of an S corporation's stock to treat the transaction as the purchase of assets. In many cases, the stock transaction is easier to accomplish than an asset purchase and sale, often avoiding interruption of contractual relationships of the target corporation, regulatory concerns, and the attendant labor of transferring assets. For income tax purposes, however, many buyers prefer to acquire assets of the target in order to obtain a fair market value basis in the target's assets. Both Code §§ 338(h)(10) and 336(e) offer a possible solution to this dilemma. The result of an election under either of these Code sections is generally as follows:
  - The transaction is treated as a taxable acquisition of the target's assets.
  - The assets of the target, including goodwill, are stepped up to fair market value.
  - The buyer gets the benefit of the asset basis step up in terms of depreciation and amortization.
  - The purchase price is allocated among the assets in accordance with Code § 1060, including goodwill which is amortized ratably over fifteen years in accordance Code § 197.
  - The seller will likely end up with an increased tax liability (that is often the subject of negotiation in the transaction) in cases where the tax basis of the stock exceeds the tax basis of the underlying assets and/or due to the recognition of gain on ordinary income type assets. The other possible trigger of additional tax occurs when Code § 1374/the built-in gains tax raises its ugly head.<sup>325</sup> This tax liability, however, remains with the new Target.<sup>326</sup> If this tax liability is unexpected, litigation between the buyer and seller may ensue after the transaction closes.

Code § 336(e) expressly delegates authority to Treasury to issue regulations, allowing taxpayers to elect to treat the sale, exchange or distribution of corporate stock as a deemed sale of the corporation's underlying assets. On May 15, 2013, Treasury finalized regulations under Code § 336(e).

A Code § 336(e) election allows certain taxpayers to treat the sale, exchange or distribution of corporate stock as an asset sale. The benefit of an asset sale is obvious—the basis of the target

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<sup>324</sup> A detailed discussion of Code § 336(e) is beyond the scope of this paper. For a detailed discussion of this topic, see, Robert Rizzi, *S Corporations and the Final § 336(e) Regulations*, Journal of Taxation (November/December 2013).

<sup>325</sup> Treas. Reg. § 1.336-2(b)(1)(i)(A).

<sup>326</sup> Treas. Reg. § 1.338(h)(10)-1(d)(2).

corporation's assets is stepped up to fair market value. The election can be especially advantageous when the target's shareholders have a basis in their stock that is lower than the target's basis in its underlying assets.

If an election is made, Old Target is treated as selling all of its assets to Target. Target is treated as purchasing those assets, resulting in a step-up in basis of the assets. Old Target recognizes the gain or loss from the deemed asset sale immediately before the close of the stock transaction.

Code § 336(e) is intended to provide taxpayers relief from multiple levels of tax on the same economic gain—economic gain attributable to the appreciation of assets held in corporate solution. Such multiple levels of tax can result from the taxable transfer of appreciated corporate stock where the assets in corporate solution do not receive a corresponding step-up in basis.

The Code § 336(e) election is available if certain requirements are met:

- First, the seller (or sellers) must be a domestic corporation, a consolidated group of corporations, or an S corporation shareholder (or shareholders). The buyer can be a partnership, limited liability company or individuals. The Old Target can be a domestic corporation or an S corporation.
- Second, the seller must own sufficient stock in the Old Target to satisfy certain “vote and value requirements.” Under the vote and value requirements, the seller must own at least 80 percent of the total voting power of the Old Target corporation's stock and 80 percent of the total value of the Old Target corporation's stock.
- Third, within a 12-month period, the seller must sell, exchange or distribute a sufficient amount of stock to satisfy the vote and value requirements—80% of the total value and 80% of the voting power of the target stock.
- Fourth, the seller and the Old Target enter into a binding, written agreement to make the election.

As stated above, a Code § 338(h)(10) election also allows certain taxpayers to treat a stock sale as an asset sale, which results in a step-up in the basis of the target corporation's assets. The final Code § 336(e) Treasury Regulations adopted many of the principals set forth in the Code § 338(h)(10) Treasury Regulations. However, there are significant differences between the Code § 338(h)(10) regulations and the final Code § 336(e) regulations, including:

- Unlike a Code § 338(h)(10) election, Code § 336(e) does not require the acquirer of the stock to be a **corporation** (or even a purchaser). This critical difference allows the corporation to be converted to a flow-through entity after the acquisition.
- While a Code § 338(h)(10) election generally requires a **single** purchasing corporation acquire the target stock, a Code § 336(e) election allows the taxpayer to aggregate all target stock sold, exchanged or distributed to

different acquirers when determining whether the vote and value requirements are met.

- Unlike a Code § 338(h)(10) election where a joint election is required by the buyer, seller and all shareholders of the target S corporation, a Code § 336(e) election is **unilaterally** made by the seller attaching a statement to its Federal tax return for the year of the acquisition.
- A Code § 336(e) election is available in certain spin-off transactions under Code § 355.

Code § 336(e) offers many planning opportunities. It allows a deemed asset sale in many situations where an election under Code § 338(h)(10) is otherwise unavailable. It is an important tool to consider when planning and negotiating a corporate acquisition. That said, like Code § 338(h)(10), it can raise ugly built-in gains tax problems under Code § 1374 if care and diligence are not used.

It is vital that the potential application of the built-in gains tax is carefully analyzed in any acquisition, especially if a Code § 338(h)(10) or Code § 336(e) election is being considered. If the target corporation is subject to Code § 1374 at the time of the transaction, both a Code § 336(e) and Code § 338(h)(10) election will trigger the built-in gains tax.<sup>327</sup>

The following examples illustrate this trap that exists for the unwary:

**EXAMPLE 1: Corporation** (Old Target) properly and timely made an S election, effective January 1, 2017. At the effective date of the S election, it had four assets, namely: (i) Blackacre (which had a fair market value of \$1,000,000 and a basis of \$200,000); (ii) inventory maintained on the FIFO method of accounting (which had a fair market value of \$3,000,000 and a basis of \$1,000,000); equipment (which had a fair market value of \$500,000 and a basis of \$100,000); and (iv) goodwill (which had a fair market value of \$5,000,000 and a basis of \$0). On January 1, 2018, buyer approaches **Corporation** and expresses interest in acquiring **Corporation**. Due to some difficulties associated with transferring many of **Corporation's** customer contracts, the parties end up settling on a stock transaction. The purchase price of \$12,000,000 is agreed upon by the parties. They agree, since buyer is an individual, that a Code § 336(e) election will be made. **Corporation** has two shareholders, namely Billy and Molly. They each have a tax basis in their stock of \$100,000. The purchase price is allocated among the assets as follows: (i) Blackacre (\$1,500,000); (ii) inventory (\$4,000,000); (iii) equipment \$500,000; and (iv) goodwill (\$6,000,000). For purposes of simplicity, assume the FIFO inventory is identical to the inventory existing at the time of the S election (i.e., no inventory has been sold and none has been produced since the S election effective date) and that **Corporation's** basis in its assets have not changed since the effective date of the S election.

If Billy and Molly sold their stock to buyer for a combined \$12,000,000 (\$6,000,000 each), they would each pay Federal income tax of approximately \$1,200,000 on the sale (assuming no AMT application). In an asset sale, the tax consequences change a bit. With the ordinary income

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<sup>327</sup> *Id.*

aspect of inventory and the recapture on the equipment, the resulting Federal income tax liability in this case would elevate by approximately \$650,000. Assuming Billy, Molly and the buyer negotiated the impact of the Code § 336(e) election in arriving at the purchase price, this result would be expected. The buyer walks away with the benefit of the increased tax basis in **Corporation's** assets. Controversy may come into play – a Code § 1374 built-in gains tax is triggered by the deemed asset sale and purchase. If the parties were not aware of it when they negotiated the transaction, a fight may ensue over the payment of the tax. As stated above, it appears that such is a liability of the new Target, but the buyer will insist, based upon the tax indemnification provisions and the representations and warranties of Molly and Billy contained in the stock purchase agreement that there are no such tax liabilities, that they pay the tax. In this case, the resulting built-in gains tax at the Federal level is almost \$3,000,000 (a total net recognized built-in gain of \$8,200,000 multiplied by 35% equals \$2,870,000). Yikes! The total Federal income tax from the transaction is approximately \$5,000,000, netting Billy and Molly a total of approximately \$7,000,000 or \$3,500,000 each. In this instance, Billy and Molly would have been better off to agree to a purchase price reduction and stick with a stock sale without a Code § 336(e) election. For example, if the combined purchase price was reduced to \$10,000,000, they would have netted, after Federal taxes, approximately \$8,000,000 or \$4,000,000 each.

**EXAMPLE 2:** Assume same facts as above, except the buyer is a subsidiary of an S corporation. Since the buyer is a corporation, Code § 338(h)(10) will apply assuming all of the requirements are otherwise met. Same result as above. Code § 1374 will raise its ugly head.

#### [v] **Installment Agreements.**

Under Code § 1374 prior to the Tax Reform Act of 1986 (“Old Code § 1374”), an installment sale could have saved the day with respect to the built-in gains tax. In other words, a newly electing S corporation could have minimized or controlled the impact of Old Code § 1374 using Code § 453. If a newly electing S corporation entered into an installment sale and received only a nominal portion of the sales price during the three-year recognition period contained in Old Code § 1374, it could limit or eliminate entirely the built-in gains tax. By limiting the gain to \$25,000 or to less than fifty percent (50%) of the taxable income of the corporation during each of the three recognition years, the tax under Old Code § 1374 could have been avoided altogether. Once the three years had expired, full payment of the remaining unpaid balance could be received with no corporate tax effect.<sup>328</sup> Like magic, the tax impact of Old Code § 1374 was either minimized or eliminated forever.

In 1986, with the passage of the Tax Reform Act of 1986 and the birth of the beefed up version of Code § 1374, practitioners and commentators alike saw the use of Code § 453 and installment agreements as a way to potentially totally skirt or curb the application of Code § 1374. For corporations that had a need to dispose of a built-in gain asset during the “recognition period,” they prescribed the use of an installment sale so that all or at least a majority of the payments were received after the “recognition period.” In 1990, the Service announced that it planned to

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<sup>328</sup> Code § 453 and PLR 8243169 (July 28, 1982).

issue regulations providing that in such circumstances the built-in gains would continue after the expiration of the “recognition period.”<sup>329</sup>

The IRS kept its word. The applicable Treasury Regulations<sup>330</sup> provide that, if a corporation sells an asset before or during the “recognition period” and reports the income from the sale using the installment method under Code § 453(a) during or after the “recognition period,” that income will be subject to tax under Code § 1374.

**“If a corporation sells an asset before or during the recognition period and reports the income from the sale using the installment method under § 453 during or after the recognition period, that income is subject to tax under § 1374.”<sup>331</sup>**

Thus, taxpayers cannot avoid the built-in gains tax by deferring all or even a portion of the payments beyond the “recognition period” through the use of an installment obligation. Treasury closed down that loophole.

**EXAMPLE 1: Corporation** is a C corporation that properly and timely elects to become an S corporation, effective January 1, 2016. On that very same date, **Corporation** sells Blackacre with a basis of \$0 and a fair market value of \$100,000, in exchange for a \$100,000 note bearing a market rate of interest, with interest and principal payable on January 1, 2022. **Corporation** does not make the election out of installment reporting under Code § 453(d) and, therefore, reports the \$100,000 gain using the installment method under Code § 453(a). In the taxable year 2022, the buyer of Blackacre pays the note in full. As a consequence, **Corporation** has capital gain of \$100,000 and interest income of \$25,000 in taxable year 2022. At that time, assume it had unexpired C year attributes of \$0, recognized built-in loss of \$0, and taxable income of \$1,000,000. Under Treasury Regulation 1.1374-4(h)(1), **Corporation** had \$100,000 of net recognized built-in gain in taxable year 2022, subject to the built-in gains tax under Code § 1374. Despite the fact that the “recognition period” ended on January 1, 2021 and the note is not paid until January 1, 2022, since the note was entered into on or before the effective date of the S election, **Corporation** must recognize the built-in gain.

**EXAMPLE 2:** Assume the same facts as above, but **Corporation** only had \$25,000 of taxable income in taxable year 2022. Under the taxable income limitation contained in Code § 1374(d)(2)(A)(ii), **Corporation** is subject to the built-in gains tax in taxable year 2022 on \$25,000, but will have \$75,000 of income subject to the built-in gains tax in succeeding taxable year(s) when its taxable income allows recognition.

## [vi] QSub Elections.

In general, when a parent S corporation elects to treat its wholly-owned subsidiary as a QSub, a liquidation of the subsidiary into the S corporation parent is deemed to occur for income tax purposes under Code § 332.<sup>332</sup> Except as provided in the applicable Treasury Regulations, assuming the requirements of Code §§ 332 and 337 are satisfied, the deemed liquidation should

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<sup>329</sup> Notice 90-27, 1990-15 IRB 1 (1990).

<sup>330</sup> Treas. Reg. § 1.1374-4(h)(1).

<sup>331</sup> *Id.*

<sup>332</sup> H.R. Rep. No. 104-188, at 89 (1996).

be tax-free. Consequently, the basis of the assets should carryover from the QSub to the parent S corporation under Code § 334(b).

Several traps for the unwary, however, may arise from the deemed liquidation. These traps may bring unintended tax consequences.<sup>333</sup>

At least two of the traps involve Code § 1374. These traps come into play when the subsidiary pre-existed the QSub election and has appreciated assets from its C corporation tax years (or appreciated assets it obtained from a C corporation in a tax-free or tax-deferred carryover-basis transaction), or has cash basis accounts receivable attributable to its C corporation years.

**Trap One: Disposition of built-in gains assets by the parent corporation that was not otherwise subject to the built-in gains tax.**

If the QSub was previously a C corporation with appreciated assets, obtained appreciated assets from a C corporation (or an S corporation subject to the built-in gains tax under Code § 1374) in a tax-free or tax-deferred transaction, and the assets are disposed of within the “recognition period” under Code § 1374(d)(7), the S corporation parent is exposed to the built-in gains taxed imposed under Code § 1374. This is a tax that the S corporation parent may have otherwise been immune from had it not made the QSub election.

**EXAMPLE 1: Corporation**, an S corporation that is not otherwise subject to the built-in gains tax under Code § 1374, acquires all of the stock of X, a C corporation with cash basis accounts receivable. **Corporation** immediately makes a valid QSub election for X. Assume the deemed liquidation is tax-free. Upon collection of the accounts receivable attributable to X prior to the QSub election within the “recognition period,” **Corporation** will be exposed to the built-in gains tax under Code § 1374. This is a tax that it was immune from prior to the acquisition of X and the making of the QSub election.

**EXAMPLE 2:** Same facts as Example 1, but X also has other assets that are highly appreciated at the effective date of the QSub election, resulting in net unrealized built-in gain of \$3,400,000. Consequently, in addition to the built-in gains tax resulting from the collection of the cash basis accounts receivable, **Corporation** will potentially be exposed to this additional tax upon the disposition during the “recognition period” of any of the built-in gain assets that it acquired for income tax purposes from the QSub election.

**PRACTICE ALERT:** In an acquisition of the stock of a corporation that may be subject to the built-in gains tax, regardless of whether a QSub election is made, the acquirer, as part of its acquisition due diligence, will want to thoroughly evaluate the built-in gains tax exposure. An appraisal of the assets is warranted.

**Trap Two: Taxable deemed liquidation resulting from QSub election.**

If the deemed liquidation of the QSub up into the S corporation parent is tax free and the carry-over basis rules apply, the story is fairly mundane. If, however, the deemed liquidation is not tax

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<sup>333</sup> For a complete discussion of the traps, see, Brant, *The Qualified Subchapter S Subsidiary Election – A Primer and Beyond*, Journal of Taxation (September 2016).

free, for any reason, the story may not end well. For one, in the instance where the deemed liquidation is not tax free and the QSub has built-in gains assets, the tax imposed under Code § 1374 will be triggered.

**EXAMPLE 1:** An individual, A, pursuant to a plan, contributes all of the stock of Y to his wholly-owned S corporation, X, and immediately causes X to make a QSub election for Y. Y has net unrealized built-in gain of \$3,400,000 at the effective date of the QSub election. It has three more years left in the “recognition period.” The transaction constitutes a Code § 368(a)(1)(D) reorganization provided the other requirements for a D reorganization (e.g. continuity of business enterprise) are met. If the liabilities of Y treated as assumed by X exceed the adjusted basis of the assets of Y, however, Code § 357(c) would apply, causing the excess liabilities to be gain from the sale or exchange of property (capital gain or ordinary income).<sup>334</sup> The Code § 357 gain trigger also triggers the application of the built-in gains tax under Code § 1374.

While taxpayers have stretched their imaginations to change the outcome of a QSub election, the stories have not all had fairy tale endings. In *Ball v. Commissioner*,<sup>335</sup> the taxpayers owned shares of an S corporation. The corporation owned one hundred percent (100%) of the shares of a subsidiary for which it caused a QSub election to be timely made.

The taxpayers took the position on their individual income tax returns that the basis in their shares was increased by the amount of built-in gain on the shares of the QSub that went unrecognized pursuant to Code § 332 as a result of the QSub election. This basis increase allowed the taxpayers to claim a loss passed through from the S corporation parent.

The Service denied the loss on the grounds the taxpayers had inadequate basis in the S corporation. The taxpayers timely filed a petition in the U.S. Tax Court.

The taxpayers, asserting an argument which did not work in *Nathel v. Commissioner*<sup>336</sup> and only temporarily worked in *Gitlitz v. Commissioner*,<sup>337</sup> argued that the unrecognized gain on the upstream liquidation into the S corporation parent was akin to tax-exempt income which results in a basis increase under the Code § 1367(a)(1)(A).

The argument sounded like magic. Unfortunately for the taxpayers, Judge Kerrigan was not too impressed with the razzle dazzle of the argument and was quick to dismiss it. The Tax Court held that unrecognized gain resulting from a QSub election does not create an item of income, nor does it create tax-exempt income under Code § 1367(a)(1)(A). The non-recognition rules do not exempt income from taxation; they merely defer recognition through the substituted basis rules.

The Service’s position was upheld. The taxpayers lost the battle. The carry-over basis rules apply in a tax-free liquidation of the QSub up into its S corporation parent.

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<sup>334</sup> Treas. Reg. § 1.1361-4(a)(2)(ii) Example 3.

<sup>335</sup> T.C.M. 2013-39 (February 6, 2013).

<sup>336</sup> 105 AFTR2d 2010-2699 (2<sup>nd</sup> Cir 2010), *aff’g* 131 TC 262 (2008), *cert. denied*, 131 S Ct 2151 (2011).

<sup>337</sup> 531 US 206 (2001).

The taxpayers in *Ball* were not the first taxpayers to put forth this magical basis increase argument. Chief Counsel of the IRS was presented with a similar argument.<sup>338</sup>

In the facts presented in a Chief Counsel Advice,<sup>339</sup> the shareholders of an S corporation contributed all their appreciated stock of a C corporation to their S corporation. They then caused the S corporation to make a QSub election for the C corporation which was now wholly-owned by the S corporation parent.

One day after the QSub election was made, the S corporation and the shareholders signed a letter of intent to sell the S corporation's stock. They proceeded and consummated the sale of stock.

Relying on *Gitlitz*,<sup>340</sup> the shareholders took the position that the QSub election increased their basis in the S corporation under Code § 1367(a)(1)(A) by the amount of the S corporation's built-in gain in the stock as a result of the QSub's deemed liquidation under Code § 332. The shareholders argued Code §§ 61(a)(3) and 331(a) applied to the QSub's deemed liquidation to produce an "item of income" within the meaning of Code § 1366(a)(1)(A), and that the income (i.e. gain) was tax-exempt by application of Code § 332. By taking this position, the shareholders were able to recognize a loss instead of a gain on the sale of their S corporation's stock. It would be a wonderful result if it works.

The Chief Counsel's office disagreed with the shareholders' position. It reasoned that Code § 332 generally results in no gain or loss recognition by a parent corporation on property distributed in complete liquidation of a wholly-owned subsidiary. When a parent corporation liquidates its subsidiary, the parent essentially switches from owning the subsidiary's stock to owning the subsidiary's assets. This mere change in form produces no accession to wealth—it does not produce an "item of income." Instead, Code § 332 generates *unrecognized* gain which is later triggered when the assets are disposed of by the parent outside the affiliated group.

The Chief Counsel's office noted the shareholders' position would allow an S corporation to create phantom basis by forming a subsidiary and later liquidating it or making a QSub election. Consequently, a QSub election and the resulting deemed Code § 332 liquidation do not give rise to an item of income under Code § 1366(a)(1)(A), and, therefore, do not increase the electing S corporation shareholders' stock bases under Code § 1367(a)(1)(A).

After *Ball* and CCA 201114017, the law seems quite clear. A QSub election, and the consequential liquidation up into the S corporation parent, in and of itself, do not create a step up in the basis of the QSub shares. Again, the carry-over basis rules apply in a tax-free liquidation of the QSub up into its S corporation parent.

The Treasury Regulations provide that the tax consequences of the deemed liquidation that arises from a QSub election are to be determined under general tax principles.<sup>341</sup> These principles specifically include the step transaction doctrine.<sup>342</sup> Consequently, if an S corporation forms a

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<sup>338</sup> *Id.*

<sup>339</sup> I.R.S. Chief Counsel Advice 201114017 (2011).

<sup>340</sup> *Id.*

<sup>341</sup> Treas. Reg. § 1.1361-4(a)(2)(i).

<sup>342</sup> *Id.*

wholly-owned subsidiary and thereafter makes a valid QSub election for its subsidiary, effective from the date the subsidiary was formed, the transfer of assets to the subsidiary and the deemed liquidation are ignored, and the subsidiary is deemed a QSub from inception.<sup>343</sup> The Treasury Regulations specifically provide that, unless a plan of liquidation is adopted on an earlier date, the making of the QSub election is the adoption of a plan of liquidation for purposes of Code § 332.<sup>344</sup>

**EXAMPLE 2:** X, a C corporation acquires all of the stock of Y, a C corporation, from an unrelated individual for cash and a note. As part of a plan, X immediately makes a valid S corporation election and a QSub election for Y. Since X acquired all of the stock of Y in a qualified purchase under Code § 338(d)(3), the deemed liquidation resulting from the QSub election is respected as an independent step separate from the stock acquisition and the liquidation under Code §§ 337 and 332.<sup>345</sup>

**EXAMPLE 3:** X, pursuant to a plan, acquires all of the stock of Y from Y's shareholders (unrelated to X) in exchange for ten percent (10%) of X's voting stock. Pursuant to the plan, X makes an S corporation election and a QSub election for Y. The transaction constitutes a reorganization under Code § 368(a)(1)(C) provided the other requirements for a C reorganization (e.g. continuity of business enterprise) are met.<sup>346</sup>

### [vii] Distributions to Shareholders.

Code § 1374 cannot be ignored or forgotten if a corporation is desiring to make distributions in kind to its shareholders. The built-in gains tax may raise its ugly head if caution is not employed.

The law is clear. A distribution by an S corporation that has no accumulated earnings and profits is taxed under a two-tier approach to the shareholders: first, the distribution is a tax-free reduction of the shareholders' basis in the corporation's stock; and second any distribution in excess of the shareholders' stock basis is treated as gain from the sale or exchange of the underlying stock.<sup>347</sup> The amount distributed in the case of property is the fair market value of the property.<sup>348</sup> When appreciated property (i.e., property that has a fair market value in excess of its adjusted basis) is distributed from an S corporation to its shareholders, gain is recognized in the same manner as if the S corporation had sold the property to the shareholders at fair market value.<sup>349</sup> The gain passes through to the shareholders and increases the basis in their stock. No loss is allowed, however, if the distributed property has a fair market value that is less than the corporation's tax basis in the property. The shareholders' basis in the distributed property is its fair market value.<sup>350</sup>

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<sup>343</sup> *Id.*

<sup>344</sup> Treas. Reg. § 1.1361-4(a)(2)(iii).

<sup>345</sup> Treas. Reg. § 1.1361-4(a)(2)(ii) Example 1.

<sup>346</sup> Treas. Reg. § 1.1361-4(a)(2)(ii) Example 2.

<sup>347</sup> Treas. Reg. § 1.13618-1(c).

<sup>348</sup> Code § 301(b)(1).

<sup>349</sup> Code §§ 311(b) and 1371(a).

<sup>350</sup> Code § 301(d).

So, if a corporation that has net unrealized built-in gain under Code § 1374 distributes a built-in gains asset to its shareholders during the “recognition period,” it will trigger the application of Code § 1374 and the built-in gains tax, as well as the normal tax consequences of a distribution of property to its shareholders as discussed above.

**EXAMPLE 1: Corporation** is a C corporation that timely and properly elects to become an S corporation, effective January 1, 2017. **Corporation**, as of the effective date of the S election had net unrealized built-in gain of \$4,200,000. It had no earnings and profits from C years. Also, it had no net operating loss carryforwards or credits from C years. Blackacre, raw land used in the operation of **Corporation’s** business for many years, had a fair market value and a tax basis at the effective date of the S election of \$1,800,000 and \$1,000,000, respectively. For many reasons, Blackacre was no any longer needed for use in **Corporation’s** business. On the other hand, **Corporation’s** sole shareholder, Barney Fife, had a significant need for the property. So, on February 5, 2019, when Blackacre had a fair market value of \$1,950,000, **Corporation** distributed it to Barney. Mr. Fife, being an astute student of tax matters, told the chief financial officer of **Corporation** to: “wait a minute!” He went on to assert that the distribution would trigger unwanted tax consequences. He was correct! Unfortunately, it was too late – the distribution had been completed. Barney, who had a basis in his stock of **Corporation** of \$2,100,000, faced a reduction in his stock basis by \$1,950,000. Additionally, he had pass-through income of \$950,000 resulting from the appreciation of Blackacre in the hands of **Corporation** (presumably capital gain). To add to his tax misery, he was faced with a Federal level built-in gains tax imposed on the distribution of \$168,000 (21% multiplied by the net recognized built-in gain (assuming the income limitation of Code § 1374(d)(2)(A)(i) did not apply). Had the taxable disposition of Blackacre occurred before 2018 when the highest corporate income tax rate under Code § 11(b) was 35%, the built-in gains tax would have been \$280,000 (35% x \$800,000). If Barney resides in a state and/or a local jurisdiction that imposes an income tax, his overall tax liability would be even greater. Barney’s accountant did provide him with some good s. The taxable income of **Corporation** which is passed through to him under Code § 1366(a) is reduced by the built-in gains tax. **Yikes!**

**EXAMPLE 2:** Assume the same facts of Example 1, except Barney is able to intervene and stop the distribution before it is completed. Nevertheless, since **Corporation** has no need for Blackacre and Barney would like to use it for a business opportunity, the growing of medical marijuana, **Corporation** simply allows Barney to occupy, improve, encumber and otherwise use the land, free of charge. No actual transfer of a fee simple interest in Blackacre is made to Barney. At the very least, however, the fair market value of the occupancy of the property will be a deemed distribution from **Corporation** to Barney. The Service could assert, because of the expansive rights that **Corporation** has granted Barney in the property that the grant itself constitutes a constructive distribution of Blackacre to Barney, triggering the normal income tax results and the built-in gains tax discussed in Example 1 above. **Caution!**

#### [viii] State Law Conversions.

Most states have adopted entity conversion statutes. These statutes allow entities to easily convert from one business form to another. The procedure, commonly referred to as “statutory conversion,” automatically transfers an entity’s assets and liabilities to a new form of entity. Unlike other methods of conversion (e.g., a merger of corporations), only one business entity is

involved – there is no need to separately form a new entity.<sup>351</sup> The most common types of conversions today are likely limited liability companies converting to corporations, and corporations converting to limited liability companies.

Unfortunately, the tax consequences of conversions are often forgotten or ignored (at least at the time of conversion).<sup>352</sup> The process is simple and it appears to be harmless. Unfortunately, from a tax perspective, it may be anything but harmless.

The conversion of a limited liability company into a corporation, for income tax purposes, is simply the liquidation of the limited liability company and the distribution of its assets and liabilities to the members, followed by the members' contribution of the assets and liabilities to the capital of a newly formed corporation. In that situation, the provisions of Code §§ 731 and 351, and other ancillary Code provisions, including, but not limited to Code §§ 357 and 743, may come into play.

The conversion of a corporation into a limited liability company, for income tax purposes, is simply the liquidation of the corporation and the distribution of its assets and liabilities to the shareholders, followed by the shareholders' contribution of the assets and liabilities to the capital of a newly formed limited liability company. In that situation, the provisions of Code §§ 721, 331 and 336, as well as other Code provisions may come into play such as Code § 1374.

While a conversion may be a simple process, if careful review and planning do not act as a precursor to the plan, unanticipated tax consequences may come to the forefront, placing a cloud over any business reasons for the entity conversion. The following example illustrates this point:

**EXAMPLE: Corporation** was formed by three college classmates. They formed the entity as a C corporation under Delaware law. The business of **Corporation** is the research, development, manufacturing and distribution of batteries for electric vehicles. Five years after Corporation was formed, it made a proper and timely election under Code § 1362 to be treated as an S corporation. At that time, its accountants had **Corporation** engage a qualified appraiser to conduct a built-in gains tax valuation of all of **Corporation's** assets, including goodwill, to determine the net unrealized built-in gain of **Corporation**. That number turned out to be \$4,000,000. Two years later, **Corporation**, which was in dire need of a capital infusion, found a potential investor, Daddy Warbucks (“DW”). DW agreed to contribute \$10,000,000 to the capital of **Corporation**, but only if Corporation becomes a limited liability company, taxed as a partnership under Subchapter K of the Code. This is the exact amount of capital that **Corporation** needs to get its product to market. So, it was clearly motivated to do whatever DW wanted in order to obtain the needed capital infusion. DW, as a non-resident alien, is not an eligible shareholder of an S corporation. DW does not, however, like to invest in closely-held C corporations. So, he insisted that **Corporation** become a limited liability company, taxed as a partnership before he invested the needed capital. **Corporation's** business attorney quickly advised the shareholders that Delaware law provides a simple process to convert a corporation to a limited liability company.<sup>353</sup> All **Corporation** has to do is file a “Certificate of Conversion”

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<sup>351</sup> For example, see Oregon Revised Statutes 60.470 et seq.

<sup>352</sup> For this discussion, I have assumed a limited liability company is being taxed as a partnership.

<sup>353</sup> DE Code § 18-214.

with the Delaware Secretary of State and pay a nominal filing fee.<sup>354</sup> The shareholders recognized that there could be a tax cost to the conversion as it would be treated as a liquidation. Given the dire need for capital, they were willing to pay that tax. They did not, however, contemplate the triggering of the built-in gains tax under Code § 1374, thereby creating two levels of tax (which they thought would be avoided as **Corporation** was an S corporation). Instead, they were under the impression that there would be a single level of tax on the liquidation of the entity. Unfortunately, they were wrong. On the deemed liquidation caused by the conversion, the built-in gains tax is triggered. **Ouch!**

Conversion statutes may create a nifty mechanism to change the form of a currently existing business entity in a fast and simple manner, but the tax consequences of the conversion cannot be forgotten. The built-in gains tax under Code § 1374 is only one of the many tax perils that loom out there in the case of a conversion.<sup>355</sup>

### [ix] **Putting the Genie Back in the Bottle.**

If a corporation makes an S election and is subject to the built-in gains tax under Code § 1374, it may be able to take action to minimize or even in some circumstances eliminate the built-in gains tax under Code § 1374. The following discussion explores some circumstances where the “genie” can possibly be put back into the bottle, in whole or in part. Sometimes triage efforts may be effective to ameliorate some or all of the harm caused by an inappropriate S election. Other times, however, they may be totally ineffective.

### [x] **Revocation of Election before Effective.**

An S election may be effective for the current year only if three conditions are met, namely:

- the election is made on or before the 15th day of the third month;
- the corporation meets all eligibility requirements for all days of the year; and
- all persons who have held stock during the year up to the date of election consent to the election.

Likewise, an S election is treated as made for the following year if:

- the eligibility requirements are not met for the entire period prior to the election date;
- the consent of all shareholders who disposed of their stock prior to the election date is not obtained; or

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<sup>354</sup> DE Code § 18-214(c).

<sup>355</sup> Conversions can create unwanted tax consequences. This is true in the conversion of a partnership to a corporation, a corporation to a partnership or a disregarded entity to a corporation. A thorough review of the tax consequences is warranted prior to embarking upon a conversion. By way of example, Code §§ 357, 336, 731, 737, and 1374 can raise their ugly heads and cause a simple conversion to be taxable.

- the election was made after the 15th day of the third month of the taxable year.<sup>356</sup>

An S election may be revoked with the consent of greater than fifty percent (50%) of the shares of stock held on the date of revocation.<sup>357</sup>

**QUERY:** Does Code § 1362(d)(1)(B) require the consent of more than fifty percent of all shares of stock (voting and nonvoting), only nonvoting shares, or only voting shares?<sup>358</sup> The Treasury Regulations that correspond with Code § 1362 indicate that more than fifty percent of total shares which includes both voting stock and nonvoting stock can effectuate a revocation. No weight is given for voting stock. Thus, theoretically the nonvoting shares alone could consent. Assume 20,000 shares of voting stock outstanding and 40,000 shares of nonvoting stock outstanding – 30,000 shares of nonvoting stock would be sufficient to revoke the corporation's S election.

**PRACTICE ALERT:** If a corporation has nonvoting stock, it could prohibit the right to revoke its S election via bylaws or shareholder agreement. Practitioners need to be aware of Code § 1362(d)(1)(B).

Revocation of an S election does not require the Secretary's consent. To revoke an S election, the corporation simply must file a statement with the Service Center where it files its Form 1120S. The statement must include:

- Intent to revoke the election pursuant to Code § 1372(a).
- Number of shares issued and outstanding, including voting and nonvoting shares at time of revocation.
- Effective date of revocation [not required but suggested].
- Signed shareholder consents and number/type of shares held by each shareholder.<sup>359</sup>

A revocation is effective for the current year (as of the first day of the year) if it is made on or before the 15th day of the third month.<sup>360</sup> Any revocation made after the 15th day of the third month is effective the first day of the next taxable year.<sup>361</sup> The corporation may designate a prospective date in the future upon which revocation becomes effective.<sup>362</sup>

A corporation may also revoke an election before it becomes effective.<sup>363</sup>

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<sup>356</sup> Code § 1362(b) and Treas. Reg. § 1.1362-6(a)(2).

<sup>357</sup> Code § 1362(d)(1)(B).

<sup>358</sup> Treas. Reg. § 1.1362-6(a)(3)(i)(b).

<sup>359</sup> Treas. Reg. § 1.1362-6(a).

<sup>360</sup> Code § 1362(d)(1)(C)(i).

<sup>361</sup> *Id.*

<sup>362</sup> Code § 1362(d)(1)(D).

<sup>363</sup> Treas. Reg. § 1.1362-2(a)(1).

A revocation may be rescinded before the revocation becomes effective. Consent of all persons who consented to the revocation and all persons who became shareholders after the revocation was filed, but prior to the filing of the rescission. If filed with the Service Center in which the corporation files its IRS Form 1120S before the revocation becomes effective, the rescission is effective on the date filed.<sup>364</sup> Mailing is arguably the filing date.

**EXAMPLE 1:** Assume **Corporation** is a calendar year S corporation. A revocation of **Corporation's** S election on February 1, 2016 will be effective January 1, 2016. A revocation of **Corporation's** S election on June 1, 2016 will become effective January 1, 2017. A revocation of **Corporation's** S election on either February 1, 2017 or June 1, 2017, designating September 1, 2017 as the effective date will become effective September 1, 2017, thereby creating two short tax years.

Two of these provisions may be key tools in a practitioner's tool box if a corporation has made an S election without knowledge of the built-in gains tax that was lurking around the corner; namely:

- the ability to revoke an S election before it becomes effective; or
- to revoke an S election for the current tax year on or before the fifteenth of the third month of the year.

In the right circumstances, these provisions could save the day (or at least the impact, in whole or part, of the built-in gains tax of Code § 1374).

**EXAMPLE 2:** **Corporation** makes an S election on November 1, 2017, effective January 1, 2018. At the beginning of December 2017, **Corporation's** astute tax practitioner, while undertaking a year-end tax review for **Corporation**, discovers that **Corporation** will likely have over \$2,000,000 of built-in gain in 2018 when it collects its cash basis accounts receivable. In this case, **Corporation** is able to put the genie back in the bottle by revoking the S election by preparing and filing a statement of revocation on or before December 31, 2017 with IRS Service Center where it files its Form 1120S. The statement clearly states that it intends to revoke the election, how many shares are issued and outstanding, including voting and nonvoting shares at time of revocation, and the effective date of revocation (January 1, 2018). It has signed shareholders consents attached, indicating the number/type of shares held by each shareholder (to reflect that the required consent was obtained). While not necessary, the revocation should be sent to the Service by US Mail, certified, return receipt requested.

**EXAMPLE 3:** Same facts as above in Example 2, but the astute tax practitioner does not discover the problem until February 16, 2018 or **Corporation** does not act on the tax practitioner's advice to revoke the election until February 16, 2018. In this case, **Corporation** is able to put the genie back in the bottle by revoking the S election by preparing and filing a statement of revocation on or before March 15, 2018 with IRS Service Center where it files its Form 1120S. The statement clearly states that it intends to revoke the election, how many shares are issued and outstanding, including voting and nonvoting shares at time of revocation, and the

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<sup>364</sup> Treas. Reg. § 1.1362-6(a)(4).

retroactive effective date of revocation (January 1, 2018). It has signed shareholders consents attached, indicating the number/type of shares held by each shareholder (to reflect that the required consent was obtained). While not necessary, the revocation should be sent to the Service by US Mail, certified, return receipt requested.

**[xi] Prospective Revocation.**

As indicated above, if a revocation of an S election is made after the fifteenth day of the third month of the taxable year, it is effective on the first day of the following taxable year.<sup>365</sup> In the instance where it is discovered that the corporation is exposed to the built-in gains tax under Code § 1374 after the effective date of the S election and after the time period allowed for a retroactive revocation, it may be possible to limit or eliminate the built-in gains tax exposure by making a prospective revocation, effective on the first day of the next taxable year. If the corporation can use the taxable income limitation for the current taxable year to eliminate the built-in gains tax under Code § 1374(d)(2), it should escape the tax altogether since its S election will be revoked as of the first day of the next taxable year. Built-in gain is only recognized during the “recognition period.” The “recognition period” only occurs during the time period in which an S election is in effect. Unlike the Treasury Regulations specifically dealing with Code § 453 installment obligations, neither the Code nor the Treasury Regulations appear to limit or prohibit this approach. There are a few obstacles, however, that need to be understood:

The first obstacle is that re-election will not likely be immediately available. Once an S election is revoked, a taxpayer cannot immediately re-elect S status. Specifically, if a corporation has made an S election and that election has been revoked or terminated, the corporation cannot re-elect for five tax years following the tax year in which the revocation or termination became effective.<sup>366</sup> The Commissioner may consent to a re-election prior to the expiration of the five years. The Service will consent to requests of taxpayers for an early re-election, but only in cases where there is evidence that no abuse or tax avoidance motive exists relative to the revocation or the re-election.<sup>367</sup> In the case of a revocation to avoid the application of the built-in gains tax under Code § 1374, the corporation will most certainly have to wait the full five (5) years for any re-election.

The second obstacle is that tax under Code § 1374 may not be able to be eliminated for the current taxable year by using the taxable income limitation. Any attempt to harvest deductions will be closely scrutinized by the Service. Code § 162 requires that expenses be ordinary and necessary, and that compensation expenses be reasonable.<sup>368</sup> The likely temptation for the shareholders of a closely-held corporation would be to increase shareholder compensation in an

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<sup>365</sup> Code § 1362(d)(1)(c)(ii).

<sup>366</sup> Code § 1362(g).

<sup>367</sup> See PLR 8842007. In that ruling, the IRS accepted a corporation’s S election on January 1, 1988 even though the same corporation had elected S corporation status effective January 1, 1987, then revoked the election in early 1987 due to adverse consequences which the election would have had on the corporation’s profit sharing plan. The IRS emphasized that the corporation had never benefited from or been subject to S corporation rules and therefore no abuse or tax avoidance was involved in the revocation or reelection. Therefore, the corporation was not forced to sit on the bench during the five-year waiting period and was allowed to rejoin the S Club.

<sup>368</sup> Code § 162 allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

attempt to zero-out taxable income during the single year that the corporation is an S corporation and avoid the built-in gains tax altogether because, as of the first day of the next taxable year, the corporation will be a C corporation.

S corporations are currently the most common choice of business entity. They represent nearly two-thirds of all corporate entities. According to recent data from the Service, 3.9 million businesses were S corporations in 2006, representing an increase of 35% from tax year 2000, and the number of S corporation shareholders is 6.7 million.<sup>369</sup> In 2006, S corporations accounted for \$413 billion in total net income and \$3.3 trillion in assets, an increase of \$166 billion in net income and \$1 trillion in net assets from tax year 2000.<sup>370</sup> Consequently, the Service has been, subject to its limited resources, focusing exam efforts on S corporations.

Usually, in the S corporation context, taxpayers are primarily concerned with making their compensation as low as possible to reduce employment and self-employment taxes, both of which include Social Security taxes and the Medicare tax. The Social Security taxes are imposed on employee compensation and self-employment income up to the Social Security Wage Base, and the Medicare tax is imposed on employee compensation and self-employment income without a ceiling. By paying low compensation, S corporations and their shareholder employees can limit their liability for Social Security and Medicare taxes.

However, the law is clear – shareholder employees of S corporations must be paid reasonable compensation for services performed for the corporation.<sup>371</sup> The cost of not paying shareholder employees adequate compensation for services actually rendered is re-characterization of distributions as wages. With such a re-characterization comes penalties, interest, and payroll taxes (Social Security and Medicare).

Despite the reasons for paying low compensation, there are countervailing incentives for some S corporations to pay high compensation. For example, a shareholder employee may wish to maximize his or her retirement income, which is based on compensation. In addition, the S corporation could be motivated to pay excessive compensation to one shareholder to avoid violating the single class of stock requirement under Code § 1361(b)(1)(D). Finally, in some cases an S corporation may want to pay excessive compensation to eliminate or reduce its taxable income, avoiding, in whole or part, paying built-in gains tax under Code § 1374. These attempts will be closely scrutinized by the Service. Success of this strategy will require the shareholder compensation (or other business expenses used to zero-out taxable income) to be ordinary, necessary and reasonable.

**EXAMPLE:** Same facts as Example 3 above. During 2018, **Corporation** increases the shareholder/employee compensation so that, as of December 31, 2018, its taxable income for the year is zero. Assuming the compensation paid by **Corporation** to the shareholder/employees is reasonable in light of actual services rendered during the taxable year by the shareholder/employees, **Corporation** will escape the built-in gains tax.

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<sup>369</sup> I.R.S. Release IR-2009-77 (Aug. 25, 2009).

<sup>370</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-1-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES (2009) (hereinafter, *GAO Report*).

<sup>371</sup> *Spicer Accounting, Inc. v. United States*, 66 AFTR2d 90-5806, 918 F.2d 90 (9th Cir. 1990).

**[xii] Termination.**

In the event the S election cannot be revoked during the current taxable year, the termination rules may be available to limit or eliminate the impact of the built-in gains tax during the current taxable year.

An election may be terminated for failure to qualify as a “small business corporation.”<sup>372</sup> The effective date of the termination is the date the corporation ceases to be a “small business corporation.”<sup>373</sup> For this purpose, a “small business corporation” means a domestic corporation that is not an “ineligible corporate”<sup>374</sup> and which does not have more than 100 shareholders, have a non-resident alien as a shareholder, have more than one class of stock, or have a shareholder that is not an individual (except for certain types of trusts, estates or tax exempt organizations).<sup>375</sup>

Terminating an S election may be a means to limit or totally avoid the impact of the built-in gains tax under Code § 1374.

The following examples are illustrative of how the termination rules could come into play:

**EXAMPLE 1:** On November 1, 2016, shareholder sells his stock (or a portion thereof) in **Corporation**, an S corporation, to a nonresident alien. As of November 1, 2016, **Corporation’s** S election was terminated.

**EXAMPLE 2:** On November 1, 2016, **Corporation**, an S corporation, amends its Articles of Incorporation, creating a new additional class of stock that provides a preferred distribution of 6% on capital contributions. On that same date, it issues shares of this new preferred stock to an otherwise qualifying person. Now, some shareholders have the old common stock while one shareholder has some of the new preferred stock, as well as some of the old common stock. As of November 1, 2016, **Corporation’s** S election was terminated.

Other possible terminating events include having more than one hundred (100) shareholders, or having an ineligible shareholder (e.g., a nonresident alien or a corporation).

So, in the event revocation is not possible for the current taxable year because the corporation is past the fifteenth day of the third month of the taxable year, a termination event would be effective on the date the corporation ceased to qualify for S status (i.e., as a “small business corporation”). In situations where the built-in gains tax is significant, termination could be a planning consideration.

**EXAMPLE 3:** **Corporation** makes an S election on November 1, 2016, effective January 1, 2017. On or about April 19, 2017, **Corporation’s** astute tax practitioner, while undertaking some tax planning for **Corporation**, discovers that **Corporation** will likely have over

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<sup>372</sup> Code § 1362(d)(2).

<sup>373</sup> *Id.*

<sup>374</sup> Ineligible corporations are generally insurance companies, banks that use the reserve method of accounting for bad debts, DISCs or former DISCs, and corporations with elections in effect under Code § 936. Code § 1362(b)(2).

<sup>375</sup> See Code § 1362(b) and (c)(6).

\$2,000,000 of built-in gain in 2017 when it collects its cash basis accounts receivable. He doubts the income limitation will come into play. In this case, **Corporation** is not able to put the genie back in the bottle by revoking the S election through preparing and filing a statement of revocation on or before March 15, 2017. It is at least a month and four days too late. Any attempt to revoke the election would be effective, at the earliest, on January 1, 2018. **Yikes!** To limit the exposure (or even eliminate it), **Corporation** could terminate the election by ceasing to be a small business corporation. A transfer of stock to an ineligible shareholder (e.g., a C corporation or a non-resident alien), or the creation and issuance of a second class of stock would, on the date of transfer, or creation and transfer, terminate the S election. If the taxable income limitation could be used (as of the end of the short S taxable year), the built-in gains tax under Code § 1374 could be avoided. If the taxable income limitation does not spare **Corporation** from enduring the built-in gains tax under Code § 1374, its exposure is limited to the period prior to the termination.

**PRACTICE ALERT:** In the case of a revocation or a termination of S status, the general rule is that the corporation will allocate income or loss for the entire year (the “S Termination Year”) between two short years – the “S Short Year” and a “C Short Year” on a pro rata basis.<sup>376</sup> Each item of income, loss, deduction and credit, and the amount of non-separately computed income for the year is allocated to each day of the S Termination Year. There is no closing of the corporation’s books on the termination date. Code § 1362(e)(3), however, gives the corporation an election to waive the pro rata allocation formula and actually attribute items to the S Short Year and the C Short Year according to when the items were incurred or realized as reflected on the corporation’s books. In such event, the corporation closes its books on the termination date – thereby carrying separate books for the S Short Year and the C Short Year. Originally, the Code required the corporation obtain the written consent of all persons who were shareholders during the S Short Year and all persons who were shareholders on the first day of the C Short Year.<sup>377</sup> After December 31, 1996, however, the corporation only needs the written consent of “affected shareholders” (shareholders whose tax liability is impacted by the termination).

**EXAMPLE 4:** **Corporation** makes an S election on December 29, 2017, effective January 1, 2018. On July 1, 2018, Corporation receives an unsolicited cash offer to purchase Blackacre for \$6,000,000 with absolutely no contingencies other than good and clear title. Closing is scheduled for August 1, 2018. It held this asset on the S election effective date. At that time, **Corporation’s** tax basis in Blackacre was \$1,000,000 and its fair market value was likely \$6,000,000. Given some zoning problems, **Corporation** cannot develop Blackacre for its intended use. So, this potential sale is a terrific development for **Corporation**. Its astute tax practitioner, however, took some of the wind out of **Corporation’s** sails when she informed **Corporation** of the built-in gains tax liability resulting from the sale of Blackacre. In this case, **Corporation** is not able to put the genie back in the bottle by revoking the S election through the preparation and filing a statement of revocation on or before March 15, 2018. It is several months too late for that approach. Any attempt to revoke the election would be effective, at the earliest, on January 1, 2019. **Yikes!** To limit the exposure (or even eliminate it), **Corporation** could terminate the election by ceasing to be a small business corporation as of July 15, 2018, and consummate the sale of Blackacre on August 1, 2018 (as a C corporation). A transfer to an

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<sup>376</sup> Code § 1362(e)(2).

<sup>377</sup> Code § 1362(e)(3)(B); Treas. Reg. § 1.1362-6(b)(2).

ineligible shareholder (e.g., a C corporation or a non-resident alien), or the creation and issuance of a second class of stock would, on the date of transfer, or creation and transfer, terminate the S election. **Corporation** and its affected shareholders could elect to close the books of the **Corporation** as of the last day of its S existence and create two tax years, and sell Blackacre during its short C year.

**[xiii] Outlasting/Surviving the Recognition Period.**

A possible, albeit difficult strategy to implement, may be to limit taxable income for each taxable year during the “recognition period” to limit or eliminate the built-in gains tax exposure under Code § 1374. Obviously, the success of that strategy depends upon the ordinary, necessary and reasonableness of the expenses that are incurred and which lower or eliminate taxable income during the “recognition period.” A corporation employing this strategy or methodology to limit or eliminate its exposure to the built-in gains tax would be, as discussed above, subject to the scrutiny of the taxing authorities. Until recently, the “recognition period” was as great as ten (10) years (where it stood for more than two decades). Today, with a “recognition period” of five (5) years, this strategy/methodology may not be too far-fetched. You can run, but hiding completely from the built-in gains tax could prove difficult to attain for most taxpayers. **Caution is advised.**

**EXAMPLE:** **Corporation** makes an S election on November 1, 2017, effective January 1, 2018. In June 2018, **Corporation’s** astute tax practitioner, while undertaking some tax planning for **Corporation**, discovers that **Corporation** will likely have over \$2,000,000 of built-in gain in 2018 when it collects its cash basis accounts receivable. In this case, because of **Corporation’s** highly appreciating technology it has been developing and for tax flexibility relative to future tax planning, it does not want to be a C corporation. It will not be able to put the genie back in the bottle by revoking or terminating the S election. Rather, it intends to manage and monitor taxable income for 2018, 2019, 2020, 2021 and 2022 to minimize or even eliminate the built-in gains tax.

**[xiv] Using C Years’ Corporate Tax Attributes.**

As discussed above, Code § 1374(b)(2) and (3) may create an additional tool for taxpayers to control or limit the exposure to the built-in gains tax under Code § 1374.

Code § 1374(b)(2) expressly permits an S corporation to use any of its net operating loss carryforwards arising from taxable years in which it was a C corporation as a deduction against the net recognized built-in gain.

**QUERY:** If an S corporation does not have any prior C year net operating losses, can it obtain such in a merger with a corporation that has a C history and unexpired net operating losses from those years?

Unfortunately, Code § 382 may prohibit or limit the ability to harvest losses from another corporation. Congress enacted Code § 382 to prevent taxpayers from “trafficking” in tax losses. Congress was concerned with certain transactions in which taxpayers had acquired target corporations, not for legitimate business purposes, but to use the target corporation’s net

operating losses and other tax attributes. The resulting rules which are contained in Code § 382 are extremely broad and complex. In fact, they clearly extend the reach of Code § 1374 to transactions far removed from situations in which taxpayers are attempting to traffic in tax losses. If a corporation acquires losses via merger from a corporation that has a C history, it will definitely have to travel the gauntlet set forth in Code § 382 to determine whether the losses can be used to reduce any built-in gains tax under Code § 1374.

**EXAMPLE 1: Corporation** makes an S election on November 1, 2017, effective January 1, 2018. As of the effective date of the S election, it had a net operating loss from C years of \$3,125,000. On or about April 19, 2018, **Corporation's** astute tax practitioner, while undertaking some tax planning for **Corporation**, discovers that **Corporation** will likely have over \$2,000,000 of built-in gain in 2018 when it collects its cash basis accounts receivable. In this case, **Corporation** will not be able to put the genie back in the bottle by revoking or terminating the S election. Instead, it will use \$2,000,000 of its lingering (carryforward) net operating loss of \$3,125,000 from prior C years, leaving it with \$1,125,000 of C years net operating loss carryforward that can be used against other built-in gains during the “recognition period” assuming the net operating losses are not lost forever because they expire. The tax practitioner correctly advises **Corporation** that, if **Corporation** remains an S corporation, aside from the limited use of C net operating losses against net recognized built-in gains, **Corporation** will lose its C net operating losses after the twenty-year carryforward period expires.<sup>378</sup> The carryforward period does not toll during S years.<sup>379</sup> Aside from the limited use of net operating losses and certain business and minimum tax credits against the built-in gains tax, a corporation's C years' tax attributes may not be used by it during subsequent S years.<sup>380</sup>

**EXAMPLE 2: Corporation** is a C corporation that has an ownership change under § 382(g)(1) on January 1, 2014. On that date, **Corporation** has a fair market value of \$500,000, NOL carryforwards of \$400,000, and a net unrealized built-in gain under § 382(h)(3)(A) of \$0. Assume **Corporation's** Code § 382 limitation under Code § 382(b)(1) is \$40,000. **Corporation** timely and properly elects to become an S corporation on January 1, 2018. On that date, it has NOL carryforwards of \$240,000 (having used \$160,000 of its pre-change net operating losses in its 4 preceding taxable years) and a Code § 1374 net unrealized built-in gain of \$250,000. In 2018, **Corporation** has net recognized built-in gain of \$100,000. It may use \$40,000 of its NOL carryforwards as a deduction against its \$100,000 net recognized built-in gain, because its Code § 382 limitation is \$40,000.<sup>381</sup>

Net operating losses are not the only tax attributes from prior C years that may be used to reduce the built-in gains tax. Some tax credits may be available to help the S corporation and its shareholders. Code § 1374(b)(3) expressly permits an S corporation to use any of its business credit carryforwards under Code § 39 and any minimum tax credit carryforwards under Code § 53 from the tax imposed by Code § 55 arising from taxable years in which it was a C corporation as a credit against the built-in gains tax imposed under Code § 1374 in the same manner as it would be applied against any tax that would have been imposed on the corporation under Code §

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<sup>378</sup> Code § 172(b)(1)(A)(ii).

<sup>379</sup> Code § 1371(b)(1).

<sup>380</sup> *Id.*

<sup>381</sup> Treas. Reg. § 1.1374-5 Example.

11 if it were a C corporation. For this purpose, the built-in gains tax imposed under Code § 1374 shall be treated as if it were imposed under § 11.<sup>382</sup>

**PRACTICE ALERT:** Prior to making an S election for an existing corporation, tax practitioners need to conduct an inventory of C corporation tax attributes that may be used during S years. This inventory should be conducted simultaneously with the pre-S election built-in gain analysis.

Treasury Regulation § 1.1374-6 pertains to credits and credit carryforwards. It provides in part:

**“The credits and credit carryforwards allowed as credits against the § 1374 tax under § 1374(b)(3) are allowed only to the extent their use is allowed under the rules applying to C corporations. Any other credits or credit carryforwards, such as foreign tax credits under § 901, are not allowed as credits against the § 1374 tax.**

**The amount of business credit carryforwards and minimum tax credit allowed against the § 1374 tax are subject to the limitations described in § 38(c) and § 53(c), respectively, as modified by this paragraph. The tentative tax determined under paragraph (a)(3) of § 1.1374-1 is treated as the regular tax liability described in §§ 38(c)(1) and 53(c)(1), and as the net income tax and net regular tax liability described in § 38(c)(1). The tentative minimum tax described in § 55(b) is determined using the rate of tax applicable to corporations and without regard to any alternative minimum tax foreign tax credit described in that § and by treating the net recognized built-in gain determined under § 1.1374-2, modified to take into account the adjustments of §§ 56 and 58 applicable to corporations and the preferences of § 57, as the alternative minimum taxable income described in § 55(b)(2).”<sup>383</sup>**

**EXAMPLE 1: Corporation** is a C corporation that timely and properly elects to become an S corporation effective January 1, 2016. On that date, **Corporation** has a \$500,000 business credit carryforward from a C year and Asset #1 with a fair market value of \$400,000, a basis for regular tax purposes of \$95,000, and a basis for alternative minimum tax purposes of \$150,000. In 2016, **Corporation** has net recognized built-in gain of \$305,000 from selling Asset #1 for \$400,000. Thus, **Corporation’s** tentative tax under paragraph (a)(3) of § 1.1374-1 and regular tax liability under paragraph (b) of Treasury Regulation § 1.1374-6(b) is \$106,750 ( $\$400,000 - \$95,000 = \$305,000 \times .35 = \$106,750$ , assuming a 35 percent tax rate). Also, **Corporation’s** tentative minimum tax determined under paragraph (b) of Treasury Regulation § 1.1374-6(b) is \$47,000 [ $\$400,000 - \$150,000 = \$250,000 - \$15,000$  (\$40,000 corporate exemption amount - \$25,000 phase-out = \$15,000) =  $\$235,000 \times .20 = \$47,000$ , assuming a 20 percent tax rate]. Thus, the business credit limitation under Code § 38(c) is \$59,750 [ $\$106,750 - \$47,000$  (the greater of \$47,000 or  $\$20,438$  ( $.25 \times \$81,750$  ( $\$106,750 - \$25,000 = \$81,750$ ))) = \$59,750]. As a result, Corporation’s Code § 1374 tax is \$47,000 ( $\$106,750 - \$59,750 = \$47,000$ ) for 2016 and it has \$440,250 ( $\$500,000 - \$59,750 = \$440,250$ ) of business credit carryforwards for succeeding taxable years.<sup>384</sup>

<sup>382</sup> Code § 1374(b)(3)(B).

<sup>383</sup> Treas. Reg. § 1.1374-6(a) and (b).

<sup>384</sup> Treas. Reg. § 1.1374-6 Example 1.

**EXAMPLE 2: Corporation** is a C corporation that timely and properly elects to become an S corporation effective January 1, 2016. On that date, Asset#1 has a fair market value of \$5,000,000, a basis for regular tax purposes of \$4,000,000, and a basis for alternative minimum tax purposes of \$4,750,000. **Corporation** also has a minimum tax credit of \$310,000 from 2015. **Corporation** has no other assets, no net operating or capital loss carryforwards, and no business credit carryforwards. In 2016, its only transaction is the sale of Asset #1 for \$5,000,000. Therefore, **Corporation** has net recognized built-in gain in 2016 of \$1,000,000 ( $\$5,000,000 - \$4,000,000 = \$1,000,000$ ) and a tentative tax under Treasury Regulation § 1.1374-1(a)(3) of \$350,000 ( $\$1,000,000 \times .35 = \$350,000$ , assuming a 35 percent tax rate). Also, it has a tentative minimum tax determined under paragraph Treasury Regulation § 1.1374-6(b) of \$47,000 [ $\$5,000,000 - \$4,750,000 = \$250,000 - \$15,000$  (\$40,000 corporate exemption amount - \$25,000 phase-out = \$15,000) =  $\$235,000 \times .20 = \$47,000$ , assuming a 20 percent tax rate]. Thus, **Corporation** may use its minimum tax credit in the amount of \$303,000 ( $\$350,000 - \$47,000 = \$303,000$ ) to offset its Code § 1374 tentative tax. As a result, **Corporation's** built-in gains tax under Code § 1374 is \$47,000 ( $\$350,000 - \$303,000 = \$47,000$ ) in 2016 and it has a minimum tax credit attributable to years for which it was a C corporation of \$7,000 ( $\$310,000 - \$303,000 = \$7,000$ ).<sup>385</sup>

**PRACTICE ALERT:** The TCJA repealed the corporate alternative minimum tax. What happens to existing minimum tax credits? Presumably, they do not disappear and can be used to offset the built-in gains tax. The Code, as amended by the TCJA, gives corporate taxpayers the ability to use unused credit carryforwards.<sup>386</sup>

#### [xv] After Acquired Assets.

Often overlooked by tax practitioners is the rule that assets acquired after the effective date of an S election are not subject to the built-in gains tax,<sup>387</sup> unless:

- The asset was acquired by the corporation after the effective date of the S election and its basis in the hands of the corporation is determined in whole or part by reference to the basis of an asset owned by the corporation at the effective date of its S election that had built-in gain or loss as of such date;<sup>388</sup> or
- The asset was acquired by the corporation after the effective date of the S election and its basis in the hands of the corporation is determined in whole or part by reference to the basis of such asset in the hands of a C corporation such as would be the case in the case of a tax free reorganization under Code § 361.<sup>389</sup>

Maintenance of adequate books and records to reflect the assets were acquired post S election is key. The burden of proof is on the taxpayer.

<sup>385</sup> Treas. Reg. § 1.1374-6 Example 2.

<sup>386</sup> Code § 53.

<sup>387</sup> Code § 1374(d)(3)(A).

<sup>388</sup> Code § 1374(d)(6).

<sup>389</sup> Code § 1374(d)(8).

[xvi] **Post-Election Appreciation.**

Often overlooked by tax practitioners is the fact that appreciation in assets that occurs after the effective date of an S election is generally not subject to the built-in gains tax under Code § 1374. In other words, the net unrealized gain is limited to the appreciation that exists at the effective date of the S election.<sup>390</sup> The burden to prove all or part of the gain on the sale of an asset after the effective date of an S election is attributable to pre-election appreciation is on the S corporation taxpayer.<sup>391</sup> Likewise, the burden is on the S corporation taxpayer to prove any recognized built-in loss existed at the effective date of the S election (i.e., did not occur post-election).<sup>392</sup> Consequently, it is imperative that corporate taxpayers contemplating an S election have each of its assets, including goodwill, properly identified and valued as of the effective date of the S election. The greatest defense to any audit or assertion by the Service that gain occurred pre-election or any loss occurred post-election is a contemporaneous written valuation at the effective date of the S election.

**PRACTICE ALERT:** Careful attention should be used to ensure the appraisal is a valid depiction and valuation of the assets owned by the corporation at the effective date of the S election. If the appraisal is well thought out and supported by objective evidence, the chance of the IRS challenging it is minimized. Taxpayers should adopt the following guidelines:

- The written appraisal report is signed and dated by the appraiser;
- The appraisal is not more than sixty days prior to the effective date of the S election (i.e., it is not stale);
- The written appraisal report clearly and unequivocally identifies all assets owned by the corporation at the time of the election (i.e., its effective date);
- The written appraisal expressly includes any intangible assets owned by the corporation, including goodwill or going concern value, at the time of the election (i.e., its effective date);
- The appraiser certifies that the written appraisal report complies with the generally accepted appraisal standards and IRS Notice 2006-96<sup>393</sup> and applicable Treasury Regulations;<sup>394</sup>
- The appraiser is qualified and experienced in valuing similar businesses, and his or her qualifications and experience are set out in the written appraisal report;

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<sup>390</sup> Code § 1374(d)(1) and (d)(3)(B).

<sup>391</sup> Code § 1373(d)(3). The statute expressly states that the S corporation must establish that the appreciation occurred post S election.

<sup>392</sup> Code § 1373(d)(4).

<sup>393</sup> Notice 2006-96, 2006-46 I.R.B. 902.

<sup>394</sup> Treas. Reg. § 1.170A-13(c).

- The appraiser has not been prohibited from practicing before the Service and has not been so disqualified or limited within three years of the appraisal date;
- The appraiser can demonstrate verifiable education and experience in valuing businesses of the same nature;
- The appraiser is unrelated to the taxpayer; and
- The appraisal does not employ discounts normally found in gifting matters such as discounts for lack of minority ownership or lack of marketability.

If a corporation has always been an S corporation, such corporation will not be subject to the built-in gains tax unless it acquires assets of a C corporation such that the basis of the assets in the hands of the C corporation carries over to the S corporation. If a corporation was a C corporation and converts to S corporation status, such corporation will normally be subject to the built-in gains tax of Code § 1374. Corporations wishing to avoid or minimize the application of Code § 1374 should keep in mind obtaining a written appraisal of assets at the time of conversion, the taxable income limitations of Code § 1374, the timing of expenses and deductions in the application of the income limitation, the carryover of built-in gain to future years within the “recognition period,” the contribution of loss property at or prior to the time of conversion (be careful not to violate the anti-stuffing rule), and the use of net operating losses and minimum tax or business credits arising from prior C corporation taxable years.

The TCJA amended Code § 11, decreasing the highest marginal corporate tax rate from 35% to 21%. It also amended Code § 1, decreasing the highest marginal individual tax rate from 39.6% to 37%. Simultaneously, the TCJA, with newly enacted Code § 199A, created a 20% deduction for qualifying business owners. The deduction, in many cases, reduces the marginal rates on business income for owners of pass-through business entities to 29.6% (i.e., 80% of 37%). With these changes, the C corporation, even with its double tax attribute, becomes a more enticing form of business entity. It ends up with a tax rate advantage of 8.6% (29.6% minus 21%). For corporations not frightened of or deterred by the accumulated earnings tax under Code § 532, the personal holding company tax under Code § 543, or deductions for unreasonably high compensation being denied under Code § 162, the C corporation may be an ideal form of business entity—that is, as long as current tax rates remain static. As a consequence, I suspect a number of S corporations are considering revoking their S elections, enabling them to avail themselves of the 21% corporate tax rate under Code § 11.

Most commentators suspect corporate tax rates, especially given the ever-increasing budget deficit, will someday be increased by lawmakers. If and when that occurs, former S corporations may want to regain their S elections. There are at least two caveats that need to be carefully considered before embarking on the revocation of an S election:

- As discussed earlier, if a corporation revokes its S election, the corporation cannot generally re-elect S status until five (5) taxable years following the tax year in which the revocation occurred have elapsed.<sup>395</sup> The Secretary may,

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<sup>395</sup> Code § 1362(g).

however, allow a re-election if there was no abuse or tax avoidance motive for the revocation. In this scenario, I suspect re-election prior to the expiration of the five (5) years would not be allowed since the revocation was motivated by the opportunity to utilize the lower tax rate available under Code § 11. So, if the 21% corporate tax rate is increased, or reasonable compensation, the accumulated earnings tax, and/or the personal holding company tax become an issue, re-electing S status may be desirable. The flexibility to re-elect S status, however, may be delayed by Code § 1362(g). **Caution is advised.**

- Following revocation, if re-election becomes a viable option, a full-blown built-in gains analysis will be necessary. All pre-election appreciation will be subject to taxation under Code § 1374. **Caution is advised.**

#### [7] **LIFO Recapture Tax.**

A shirt-tail relative of the built-in gains tax is an additional hazard commonly referred to as the LIFO recapture tax. This additional hazard requires careful consideration.

A C corporation which elects to become an S corporation and which used the LIFO method of accounting for inventory during the last taxable year before conversion may be subject to LIFO recapture under Code § 1363(d).

In order for the LIFO recapture to be triggered, two facts must exist, namely:

- The corporation must have been a C corporation; and
- The corporation must have maintained its inventory using the LIFO method of accounting during its last C corporation taxable year.

As discussed above, when a C corporation converts to an S corporation, Code § 1374 potentially imposes an entity level tax on any realized built-in gain. For a LIFO method-corporation, built-in gain is realized as inventory is sold. A LIFO method corporation can avoid the built-in gains tax to the extent it can avoid invading LIFO inventory layers during the “recognition period.” Totally avoiding the built-in gains tax under Code § 1374 for inventory through use of the LIFO method is probably rare. Nevertheless, Congress felt that this was a significant potential abuse that needed to be curbed. Code § 1363(d) provides the necessary curb.

Code § 1363(d) requires that a corporation which uses the LIFO method during its last C corporation tax year must include in that year’s income a “LIFO recapture amount.” This amount is the excess of the inventory’s FIFO value over its LIFO value at the close of the last C corporation taxable year.

In order to apply Code § 1363(d), the corporation’s inventory must be valued at the close of its last C corporation taxable year under both the FIFO and LIFO methods.

If the corporation used the retail method of valuing inventories under LIFO, that method is utilized in making the FIFO valuation.<sup>396</sup>

In other cases, the FIFO valuation should be made using the lower of cost or market values.<sup>397</sup>

The following example illustrates the application of Code § 1363(d):

**EXAMPLE: Corporation**, a C corporation, validly elects to convert S status. For its last C corporation taxable year, it used the LIFO method for valuing inventory. It had an opening inventory of 20,000 units at \$10.00 each, purchased 50,000 units at \$30.00 each, and sold 50,000 units at \$40.00 each. **Corporation** did not use the retail method of valuing inventories under LIFO. Under FIFO, its closing inventory would be \$600,000 (20,000 x \$30.00 cost) and using LIFO, its closing inventory would be \$200,000 (20,000 x \$10.00 cost). The LIFO recapture amount would be \$400,000.

The LIFO recapture amount is recognized by the corporation during its last C corporation taxable year. The tax is payable in four (4) equal installments, the first of which is payable on or before the due date of corporation's C return (without regard to extensions), and the last three (3) installments of which are due on or before the due date of corporation's return for next three (3) tax years (without regard to extensions). If the corporation, however, files a final return before all of the installments are paid, all payments are accelerated. No interest is assessed if these payments are made when due.<sup>398</sup> Otherwise, interest on the LIFO recapture amount will accrue.<sup>399</sup>

The basis of the inventory is increased by the LIFO recapture amount.<sup>400</sup>

Code § 1363(d) may still apply even though the corporation holding the inventory is a virgin S corporation. In the situation where a C corporation transfers LIFO inventory to an S corporation, the C corporation will be subject to the recapture if it: inventoried assets under LIFO during the taxable year of the transfer; and it transferred the assets to the S corporation in a non-recognition transaction in which the S corporation got a carry-over basis with respect to the inventory.<sup>401</sup> This rule only applies to transfers made after August 18, 1993.<sup>402</sup>

The application of Code § 1363(d) has no impact on the continued use of the LIFO method.

The payment of this tax, unlike the built-in gains tax, will not reduce any item of income passed through to the S corporation shareholders.

A C corporation may use its net operating losses to reduce or eliminate the LIFO recapture tax.

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<sup>396</sup> Code § 1363(d).

<sup>397</sup> Code § 1363(d)(4)(C).

<sup>398</sup> Code § 1363(d)(1); Treas. Reg. § 1.1363-2(c).

<sup>399</sup> *Id.*

<sup>400</sup> *Id.*

<sup>401</sup> Treas. Reg. § 1.1363-2(a)(2).

<sup>402</sup> *Id.*

**PRACTICE ALERT:** If NOLs are used to eliminate or reduce the tax, the basis of the inventory is still adjusted to the full extent of the LIFO recapture amount.

An announcement published by the Service in 1988 serves as a good practitioner guide with respect to the application of Code § 1363(d).<sup>403</sup>

**[8] Passive Investment Tax.**

In accordance with Code § 1375, S corporations which have C corporation earnings and profits (“E&P”) at the close of the taxable year and “passive investment income” totaling over 25% of gross receipts will be subject to a tax imposed at the highest corporate income tax rate under Code § 11.<sup>404</sup> S corporations without any C corporation E&P are excluded from the application of Code § 1375.

**[a] Purpose and Background.**

The purpose of Code § 1375 is to prevent shareholders from doing through an S corporation what they cannot do in a C corporation because of the personal holding company tax rules. Absent Code § 1375, shareholders of a C corporation could phase out the corporation’s business, sell the corporation’s assets, and continue to operate as an investment corporation. At a time like the present when the highest corporate income tax rate is less than the highest individual income tax rate, gain on the sale would be taxed at the lower (corporate) tax rate. By not liquidating the corporation, the after-tax gain on the sale would avoid individual taxation. An S election made following the sale would avoid the personal holding company tax problems applicable to C corporations and permit passive investments of corporate assets. Code § 1375 is designed to prohibit this type of planning.

The passive investment tax of an S corporation (with C corporation E&P at the close of the taxable year) for years when “passive investment income” exceeds 25% of gross receipts is based upon the lessor of:

- The “excess net passive income;”<sup>405</sup> or
- The corporation’s taxable income determined as if were a regular corporation, but without regard to the NOL deduction or the dividends received deduction.<sup>406</sup>

This amount is subject to the highest corporate tax rate in effect.

The Code § 1375 tax cannot exceed the corporation’s taxable income for the year (determined if the corporation were a C corporation and ignoring NOLs and dividend received deductions).

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<sup>403</sup> IRS Announcement 88-60, 1988-15 IRB 47.

<sup>404</sup> The 1996 Act eliminates C E&P existing before 1983 in certain circumstances.

<sup>405</sup> Code § 1375(b)(1).

<sup>406</sup> *Id.*

Corporations may not use any credits other than gasoline and special fuel credits to offset or reduce the tax.<sup>407</sup>

**[b] Passive Investment Income.**

“Passive investment income” is defined in Code § 1362(d) to include gross receipts derived from royalties, rents, dividends,<sup>408</sup> interest, annuities, and gains from sales and exchanges of stocks or securities.

- Interest derived from sales of inventory is excluded from the definition of “passive investment income.”<sup>409</sup>
- Interest income of lending and finance companies generated in the course of loan transactions is excluded from the definition of “passive investment income.”<sup>410</sup>
- Treasury takes the position that tax-exempt interest income is “passive investment income” subject to the Code § 1375 tax.<sup>411</sup> The theory is that Code § 103 only excludes tax-exempt income from “gross income,” not “passive investment income” tax imposed by Code § 1375.
- Royalty income received in the ordinary course of business from the licensing or franchising of corporate property is excluded from the definition of “passive investment income.”<sup>412</sup> Royalty income is received in the ordinary course of business if the corporation created the underlying property or performed significant services or incurred significant costs with respect to the development or marketing of the property.
- Copyrights, mineral, oil and gas royalties, and active business computer software royalties are also excluded from the definition of “passive investment income.” Provided, however, in order for copyrights, mineral, oil and gas royalties, and active business computer software royalties to be exempt, the personal holding company tax exclusions under Code §§ 543(a)(3), 543(a)(4) and 543(d) (ignoring (d)(5)) respectively must be met.

Code § 543(a)(4) applies to copyrights. It provides that income is excluded from the personal holding company tax if:

- Such income ( except royalties received for works created in whole or in part by any shareholder) constitutes at least 50% of ordinary gross income; and

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<sup>407</sup> Code § 1375(c).

<sup>408</sup> Note the exclusion for certain dividends received from C corporation subsidiaries. Code § 1362(d)(3)(F).

<sup>409</sup> Treas. Reg. § 1.1362-2(c)(5)(iii)(B).

<sup>410</sup> *Id.*

<sup>411</sup> Treas. Reg. § 1.1362-2(c)(5)(ii)(D).

<sup>412</sup> Treas. Reg. § 1.1362-2(c)(5)(A).

- The personal holding company income for the taxable year (ignoring royalties received for work created in whole or part by any shareholder owning more than 10% of the stock, and dividends received from corporations 50% or more of which the corporation owns, but including mineral, oil and gas royalties) is not more than 10% of ordinary gross income; and
- The total deductions (under Code § 162 only) which are allocable to such royalties (other than personal service compensation paid to shareholders and royalties paid to others) are 25% or more of the amount which equals ordinary gross income less royalties paid or accrued and Code § 167 depreciation deductions allowable with the respect to the copyright royalties.

Code § 543(a)(3) applies to mineral, oil and gas royalties. It provides that income is excluded from the personal holding company tax if:

- Such income constitutes at least 50% of ordinary gross income;
- The personal holding company income for the taxable year is not more than 10% of the ordinary gross income; and
- The total deductions (under Code § 162 only) which are allocable to such royalties (other than personal service compensation paid to shareholders) are at least 15% of ordinary income adjusted in accordance with Code § 543(b)(2) (subtracting depreciation, property taxes, interest, rent, etc.).

Code § 543(d) applies to active business computer software royalties. It provides that income is excluded from the personal holding company tax if:

- Such income constitutes at least 50% of ordinary gross income.
- The deductions allowable under Code §§ 162, 174 and 195 allocable to such royalties are at least 25% of ordinary gross income for the taxable year.

“Rents” mean any amounts received for the “use of, or right to use, property” of the corporation.<sup>413</sup> Specifically excluded are:

- Produced film rentals (defined in Code § 543(a)(5) as payments for use of or right to use a film, provided the interest being rented was acquired by the corporation before the film was substantially completed, and any payments to a producer for actively participating in the film production).<sup>414</sup>
- Rents derived in the active trade or business of renting property.<sup>415</sup> To qualify as a trade or business, significant services must be rendered or substantial costs must be incurred relative to the rental business. A fact and circumstance

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<sup>413</sup> Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(2).

<sup>414</sup> Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(3).

<sup>415</sup> Treas. Reg. § 1.1362-2(c)(5)(ii)(b)(2).

analysis is required – look at the number of employees in the rental business, and types of expenses (non-depreciation) incurred.

**[c] Net Passive Income.**

Net passive income is simply “passive investment income” less allowable deductions directly allocable to such production of income.<sup>416</sup>

**[d] Excess Net Passive Income.**

Excess net passive income is computed as follows:

Passive investment income for taxable year  
 less 25% of gross receipts for taxable year  
**divided by** passive investment income for taxable year  
**multiplied by** net passive investment income for taxable year

**EXAMPLE:** During a tax year, **Corporation** has gross receipts of \$5,000,000, passive investment income of \$2,000,000, Code § 162 expenses directly allocable to the passive income of \$200,000, and taxable income of \$1,500,000. **Corporation** has “excess net passive income” of \$675,000:

Passive Investment Income	\$2,000,000
Less 25% of gross receipts	<u>(1,250,000)</u>
	750,000
Passive Investment Income	\$2,000,000
Directly Allocable Expenses	<u>(200,000)</u>
Net Passive Income	1,800,000

$$\frac{\$ 750,000}{2,000,000} \times 1,800,000 \text{ equals } \$675,000$$

**Corporation** will owe Code § 1375 tax on the lesser of its “taxable income” or the “excess net passive investment income.” Since “excess net passive income” (\$675,000) is less than corporation’s taxable income (\$1,500,000), it will pay Code § 1375 tax on the “excess net passive income.” The highest corporate income tax rate will be utilized.

<sup>416</sup> Code § 1375(b)(2).

The Secretary may waive the Code § 1375 tax if:

- In good faith the corporation believed it had no C corporation E&P at the close of the taxable year; and
- During a reasonable time after it determined that it actually had C corporation E&P, such was distributed to shareholders.<sup>417</sup>

A request for waiver must be made in writing with the district director. The request, which is filed in the same format as a ruling request, must contain all relevant facts to establish the aforementioned waiver criteria; a description of how and when it determined it originally had no C corporation E&P and how and when it discovered that it actually had C corporation E&P; steps taken to distribute the E&P; and time table for distributions if not made yet. On the date the waiver is approved, all E&P must be distributed.

Recognized built-in gain or loss determined under Code § 1374 may not be used to reduce an S corporation's "passive investment income."<sup>418</sup>

**[9] S Corporation Shareholders Generally Do Not Obtain Basis as a Result of Corporate Debt.**

*Montgomery v. Commissioner*,<sup>419</sup> illustrates the rule that shareholders of S corporations, unlike partners of partnerships, do not obtain basis for debt of the corporation. The only exceptions to this general rule are:

- Shareholders obtain basis for debt of the S corporation that they actually repay; and
- Shareholders obtain basis for loans that they actually made to the S corporation.

In *Montgomery*, the taxpayers, Patrick and Patricia Montgomery, claimed a net operating loss on their 2007 joint return, which they carried back to 2005 and 2006. In the calculation of their net operating loss, they included: losses UDI Underground, LLC ("UDI") incurred in 2007 that were passed through to Patricia Montgomery as a 40% member of UDI; and losses Utility Design, Inc., an S corporation ("Utility Design"), incurred in 2007 that were passed through to Patrick and Patricia Montgomery as shareholders.

The IRS challenged the amount of the net operating loss for 2007 on two grounds. First, the IRS asserted Patricia Montgomery did not materially participate in UDI during 2007. Second, the IRS asserted portions of the losses from Utility Design were disallowed under Code § 1366(d)(1).

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<sup>417</sup> Code § 1375(d).

<sup>418</sup> Code § 1375(b)(4).

<sup>419</sup> T.C. Memo. 2013-151 (June 17, 2013).

The IRS asserted Patricia Montgomery's share of the 2007 losses from UDI Underground, LLC were losses from a passive activity. Specifically, the IRS argued Patricia Montgomery did not materially participate in UDI.

The Tax Court disagreed, holding Patricia Montgomery did materially participate in UDI. In 2007, Patricia Montgomery handled all of the office functions, managed payroll, prepared documents, met with members of the company and attended business meetings. Additionally, she continuously worked on company matters and daily discussed the company's business with Patrick Montgomery. The court ultimately concluded Patricia Montgomery participated in UDI for more than 500 hours during 2007 and her participation was regular, continuous, and substantial. Thus, Patricia Montgomery's UDI activity was a non-passive activity.

Next, the Tax Court considered whether the taxpayers' portion of their net operating loss attributable to Utility Design was limited by Code § 1366(a). It requires an S corporation shareholder, when calculating his or her taxable income for the year, to take into account his or her pro rata share of the S corporation's items of income, loss, deduction, or credit for the S corporation's tax year that ends in the tax year of the shareholder. However, the S corporation's loss taken into account by a shareholder cannot exceed the limitation amount calculated under Code § 1366(d)(1), which is equal to the shareholder's adjusted basis in the S corporation stock increased by the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

The Tax Court concluded Patrick Montgomery's basis in the Utility Design stock was zero at the beginning of 2007. It then considered basis adjustments. In 2006 and 2007, Utility Design borrowed the following amounts: \$1 million from SunTrust Bank on August 25, 2006, (which was personally guaranteed by the taxpayers); \$60,000 from Patrick Montgomery on September 26, 2007; \$30,000 from Patrick Montgomery on October 5, 2007; and \$15,000 from Patrick Montgomery on November 13, 2007.

In 2008, Utility Design defaulted on the \$1 million loan, and the taxpayers were liable for the debt under the personal guarantees. The taxpayers failed to pay the debt under the guarantees, despite demand. In November 2009, a judgment was entered in favor of the bank against them for \$425,169.54. The taxpayers took the position that their basis in the Utility Design shares was increased by the amount of the judgment (i.e. \$425,169.54).

The IRS contended the judgment amount did not increase the taxpayers' stock basis. When an S corporation shareholder guarantees a loan of the corporation, no debt has been created between the S corporation and the shareholder.<sup>420</sup> However, once the shareholder pays the bank pursuant to the guarantee, the S corporation becomes indebted to the shareholder and the shareholder obtains basis.

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<sup>420</sup> See *Underwood v. Commissioner*, 63 T.C. 468, 475-476 (1975), *aff'd*, 535 F.2d 309, 311-312 (5th Cir. 1976).

The court referenced its opinion in *Underwood v. Commissioner*:<sup>421</sup>

“It is the *payment* by the guarantor of the guaranteed obligation that gives rise to indebtedness on the part of the debtor to the guarantor. The mere fact that the debtor defaults and thereby renders the guarantor liable is not sufficient.”

Accordingly, the court in this case held that, because the taxpayers, Patrick and Patricia Montgomery, did not make any payments under the guarantee, their guarantee did not increase share basis. To add salt to the wound, the court upheld the Service’s imposition of a Code § 6651(a)(1) penalty against the taxpayers for late filing.

#### **[10] Lingering C corporation tax attributes.**

As discussed above, prior to making an S election for an existing corporation, tax practitioners need to conduct an inventory of C corporation tax attributes. Aside from the limited use of some C corporation tax attributes against the built-in gains tax (as discussed above), C corporation tax attributes are generally unavailable for use by the corporation during S corporation years. If care is not exercised, C corporation tax attributes may atrophy and in some cases lost forever. Accordingly, a review and inventory of all C corporation tax attributes, including credits and NOLs, should be conducted prior to making an S election.

#### **[11] Availability of Code § 1202 Assistance.**

Prior to making an S election, tax practitioner should determine if the shareholders of the corporation may be losing the possible benefit of Code § 1202 that could come into play if the shares of the corporation are disposed of in a taxable transaction. The benefit of this provision and its possible application should not be ignored.

Over the years, lawmakers have created incentives to encourage taxpayers to invest in small businesses. One of these incentives is contained in Code § 1202.

For taxpayers, other than corporations, Code § 1202 allows the taxpayer to exclude from gross income at least 50% of the gain recognized on the sale or exchange of qualified small business stock (“QSBS”) that has been held more than five years. For QSBS acquired after February 17, 2009, and on or before September 27, 2010, the exclusion percentage is 75%, and for QSBS acquired after September 27, 2010, and before January 1, 2014, the exclusion percentage is 100%.

In general, the gain eligible to be taken into account for purposes of this exclusion is limited to the greater of \$10 million or 10 times the taxpayer’s basis in the stock.

The issuing corporation must be a “qualified small business” as of the date of issuance and during substantially all of the period that the taxpayer holds the stock. Here is where the rub in the road occurs – a qualified small business is a subchapter C corporation (other than a C

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<sup>421</sup> 63 T.C. at 476 (*emphasis added*).

corporation that is a domestic international sales corporation (DISC) or former DISC, a corporation with respect to which an election under Sec. 936 is in effect or that has a direct or indirect subsidiary with respect to which such an election is in effect, a regulated investment company, a real estate investment trust, a real estate mortgage investment conduit or a cooperative). The corporation also generally cannot own real property that is not used in the active conduct of a qualified trade or business with a value exceeding 10% of its total assets or (2) portfolio stock or securities with a value exceeding 10% of its total assets in excess of liabilities.

To qualify as QSBS, the stock must be: issued by a domestic C corporation with no more than \$50 million of gross assets at the time of issuance; issued by a corporation that uses at least 80% of its assets (by value) in an active trade or business, other than in certain personal services and other types of businesses enumerated in the statute, issued after August 10, 1993, held by a non-corporate taxpayer, acquired by the taxpayer on original issuance (there are limited exceptions to this rule), and held by the taxpayer for more than five years to qualify for gain exclusion.

In general, an active trade or business, for Code § 1202 purposes, is any trade or business, other than those 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 the trade or business is the reputation or skill of one or more of its employees. The term also excludes any banking, insurance, leasing, financing, investing, or similar business; any farming business (including the business of raising or harvesting trees); any business involving the production or extraction of products of a character for which percentage depletion is allowable; or any business of operating a hotel, motel, restaurant, or similar business.

The potential application of Code § 1202 by the shareholders while the corporation is an S corporation.

### **1.05 TRAVELING THE ROAD FROM SUBCHAPTER S TO SUBCHAPTER C – THERE ARE MANY UGLY PROVISIONS OF THE CODE THAT SHOULD NOT BE FORGOTTEN OR IGNORED.**

The TCJA, as discussed above, adds some interesting provisions that may entice S corporations to revoke existing S elections, or cause new entities to commence life as C corporations. Before these corporations and their advisors at the wheel speed down the road, headed toward Subchapter C, they need to be aware and understand the obstacles and perils they may face on this treacherous road. The following discussion, albeit not absolutely complete, contains many of the major provisions that need to be recognized and considered in any plan to convert from S corporation status to C corporation status (or start out life as a C corporation).

#### **[1] Unreasonable Compensation.**

Closely held C corporations have historically been incentivized to distribute profits as compensation to shareholder employees. A corporation is allowed, under Code § 162(a)(1), to deduct “a reasonable allowance for salaries or other compensation for personal services actually

rendered.” There is, however, no corresponding deduction for dividend distributions, which end up being taxed twice: once at the corporate level and again at the shareholder level. Consequently, treating distributions of profits as compensation for services rendered could significantly reduce a corporation’s tax liability. On the other hand, while the corporation may get a Code § 162 deduction for the compensation payments, the shareholder employee receiving the payments ends up with a larger tax bill because the payments are taxed as ordinary income with a current top marginal rate of 37%,<sup>422</sup> plus payroll taxes (e.g., Social Security and Medicare taxes). Had the payments been characterized as dividends, the shareholder employee would have paid tax at a rate of 23.8%.<sup>423</sup>

To fully compare the two scenarios (dividend distributions vs. compensation payments), however, you must consider both the corporate and the individual income tax regimes.

Corporate profits distributed as compensation are taxed only once because the payments are deductible from the corporation’s taxable income under Code § 162. In contrast, as discussed above, distributions of corporate profits treated as dividends are taxed twice: once at the corporate level and once at the shareholder level.

For many years, the economic incentive for closely held C corporations to characterize distributions of profits to shareholders as compensation was strong. Consequently, the Internal Revenue Service (the “Service”) routinely battled taxpayers on this front, resulting in a vast amount of rulings, case law, and administrative rules.

As a result of the recent decreases to the corporate tax rate, the paradigm has significantly changed. With the corporate income tax fixed at a flat 21% under Code § 11, and the existence of the qualified dividend tax rate under Code § 1, the incentive for taking out corporate profits as compensation has dramatically decreased. Consequently, it is more likely today that the Service will raise the accumulated earnings tax (discussed below) than unreasonable compensation in the audit of C corporations.

The following examples illustrate the recent change in the unreasonable compensation paradigm:

**EXAMPLE 1:** In 2019, **Corporation** earned \$300,000. If it distributed all of its after-tax income to its sole-shareholder Mary Smith as a dividend, the tax consequences would be as follows: **Corporation** pays Federal income taxes of \$63,000 (i.e., 21% X \$300,000). In turn, on the distribution of the \$237,000 to Mary Smith, she pays Federal income tax of \$56,406 (i.e., \$237,000 X 20% qualified dividend rate and 3.8% net investment income tax rate). The net amount received by Mary is \$180,584. In the end, **Corporation** and Mary paid a combined Federal income tax of \$119,406 or 40%.

**EXAMPLE 2:** Same facts as Example 1, except **Corporation** paid all of its after-tax income to its sole-shareholder Mary Smith as compensation. Assuming the compensation was reasonable, the tax consequences would be as follows: **Corporation** has zero taxable income after it deducts

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<sup>422</sup> A marginal tax rate is the rate applying to the last dollar of the tax base. In a progressive tax system, the marginal rate usually represents a taxpayer’s highest tax bracket.

<sup>423</sup> The 23.8% rate is comprised of the 20% rate on qualified dividend income, Code § 1(h)(11), and the 3.8% net investment income tax, Code § 1411.

the compensation paid to Mary and ordinary, necessary and reasonable. **Corporation** does have to pay the employer portion of the payroll taxes on Mary's compensation. Then, Mary pays Federal income taxes (including payroll taxes) on the compensation. In the end, the **Corporation's** payroll tax obligation and Mary's Federal income tax obligation (including her share of the payroll taxes) would amount to approximately \$125,000 or 42%.

**EXAMPLE 3:** Same facts as Example 1, but the tax year at issue is 2017. The tax consequences would be as follows: **Corporation** pays Federal income taxes of \$105,000 (i.e., 35% X \$300,000). In turn, on the distribution of the \$195,000 to Mary Smith, she pays Federal income tax of \$46,410 (i.e., \$195,000 X 20% qualified dividend rate and 3.8% net investment income tax rate). The net amount received by Mary is \$148,590. In the end, **Corporation** and Mary paid a combined Federal income tax of \$151,410 or about 50%.

**EXAMPLE 4:** Same facts as Example 1, except the tax year at issue is 2017 and **Corporation** paid all of its after-tax income to its sole-shareholder Mary Smith as compensation. Assuming the compensation was reasonable, the tax consequences would be as follows: **Corporation** has zero taxable income after it deducts the compensation paid to Mary and ordinary, necessary and reasonable. **Corporation** does have to pay the employer portion of the payroll taxes on Mary's compensation. Then, Mary pays Federal income taxes (including payroll taxes) on the compensation. In the end, the **Corporation's** payroll tax obligation and Mary's Federal income tax obligation (including her share of the payroll taxes) would amount to approximately \$131,500 or 44%.

We have to keep in mind, while the incentive to pay unreasonable amounts of compensation in a C corporation setting today has greatly diminished, tax rates may change in the future. In fact, the reduced individual Federal income tax rate under Code § 1 is set to sunset at the end to 2025. The fixed corporate Federal income tax rate under Code § 11, however, has no sunset date. Of course, lawmakers could intervene and change the rate. So, a good understanding of unreasonable compensation issue is important in the C corporation setting.

**QUERY:** Today, why would a C corporation be enticed to pay unreasonable amounts of compensation? Tax rates may not be the motive. Rather, other facts could serve as motivators, including maximizing allowable retirement plan contributions, and treating equal shareholders differently from a financial perspective.

Compensation to shareholders and their families generally falls into three categories. First, most compensation payments are treated as reasonable compensation, which the corporation may properly deduct and which is taxable to the employee recipient. Second, compensation payments can also be treated as reasonable in amount, but not deductible because they are a disguised distribution of corporate profits. This reclassification usually occurs when the corporation does not pay dividends and the compensation was paid as year-end bonuses under a bonus plan designed to strip corporate earnings. Third, compensation payments can be deemed to be unreasonable in amount, not deductible by the corporation, but taxable to the employee as compensation or recharacterized as dividends.

Robert Southey's fairy tale, *Goldilocks and the Three Bears*,<sup>424</sup> which was first published in 1837, is analogous to the analysis required to determine whether compensation is reasonable. Compensation cannot be too high and compensation cannot be too low. It must be just right to be considered reasonable for tax purposes. Unfortunately, the test is not totally objective in nature and it has not been consistently applied. Further complicating matters, the Service and the courts have adopted differing tests over the years.

Historically, perhaps the strongest reason taxpayers chose to use the C corporation form of business entity was the ability to avoid double taxation through reasonable compensation payments. Compensation offers one of the easiest means of avoiding double taxation. Code § 162(a) (1) provides a deduction for reasonable compensation paid to employees for services actually rendered. Closely held C corporation shareholders usually also serve as officers or key employees. Those shareholder employees often maximized their own compensation to minimize dividend payments, allowing them to avoid two-levels of tax. At the end of a closely held C corporation's life, triggered by the sale of substantially all of its assets or upon the distribution of substantially all of its assets to its shareholders, a strong motivation existed for the corporation to maximize its compensation deductions, reducing or eliminating the corporate level of tax. Provided the compensation was reasonable and for services actually rendered, this strategy was often successful.

Professionals who provide personal services often incorporate and operate as either a C corporation or an S corporation. Personal service corporations can be further classified into two categories: (1) corporations in which client services are primarily provided by shareholder employees; and (2) corporations in which client services are provided by both shareholder and non-shareholder employees. Personal service corporations where profits are based on the services of both shareholders and non-shareholders present a unique dilemma for determining whether compensation is reasonable.

Cases in the first category generally involve S corporations and focus on whether shareholder employees can receive corporate profits generated from their own services as distributions, thereby limiting the employment tax liability. For example, in *Radtke v. United States*,<sup>425</sup> the District Court for the Eastern District of Wisconsin held S corporation distributions to a sole shareholder and sole employee, an attorney, who worked full-time but received no salary, were wages subject to employment taxes. The court explained that an employer cannot avoid employment taxes by characterizing all employee payments as non-wages.

Cases in the second category generally involve C corporations and focus on whether shareholder employees can receive compensation payments for profits generated by non-shareholders. For example, in *Richlands Medical Association v. Commissioner*,<sup>426</sup> the Tax Court allowed compensation deductions for amounts paid to owner employees—even though the total compensation was greater than the actual collections attributable to the patient services rendered by the owner employees—to reflect additional services they provided to the corporation. Eleven years later, in *Pediatric Surgical Associates, P.C. v. Commissioner*,<sup>427</sup> the Tax Court held

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<sup>424</sup> ROBERT SOUTHEY, *The Story of the Three Bears*, in *THE DOCTOR* (1837).

<sup>425</sup> 712 F. Supp. 143 (ED Wis. 1989), *aff'd per curiam*, 895 F.2d 1196 (7th Cir. 1990).

<sup>426</sup> T.C. Memo. 1990-660, *aff'd*, 953 F.2d 639 (4th Cir. 1992).

<sup>427</sup> T.C. Memo. 2001-81.

amounts paid as “compensation” to shareholder employees, but attributable to collections from the services of non-shareholder employees (after direct costs and allocated overhead), were not deductible because they were not compensation for services rendered by the shareholder employees.

Abuse is generally easier to spot in the S corporation context. In *Watson, P.C. v. United States* (discussed in more detail below),<sup>428</sup> an S corporation paid its sole shareholder a salary of only \$24,000, despite the fact that the corporation was a partner in a professional services firm that had annual revenues of \$2 to \$3 million. The *Watson* case, although it is an S corporation case focusing on unreasonably low compensation, offers judicial insight on the issue whether shareholder employees can be paid compensation in excess of their personal billings less a reasonable allocation of overhead. In *Watson*, the Eight Circuit appears to reject the taxpayer’s argument that it should limit “the amount it characterized as wages to the amount of revenue each shareholder employee personally generated, less expenses.”

When the Service audits a closely held C corporation, particularly personal service corporations, it will invariably consider whether compensation is used to strip the corporation of its earnings. If the Service concludes corporate earnings are paid out as unreasonably high compensation, it will recharacterize the compensation amount it deems to be unreasonable as a dividend.<sup>429</sup> This recharacterization usually results in the Service assessing a substantial amount of tax, penalties, and interest.

**[a] Statutes.**

**Code § 162 authorizes a deduction for reasonable compensation:**

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered[.]<sup>430</sup>

The statutory rule is expanded upon in the Regulations. The Regulations explain there is a two-part test for determining whether compensation for personal services is reasonable: first, under the “Intent Test,” compensation payments must be “purely for services”; and second, under the “Amount Test,” compensation payments must be reasonable in amount.

**[b] Regulations.**

The two-part test for deductibility of compensation is found in § 1.162-7(a) of the Regulations:

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<sup>428</sup> 109 AFTR2d 2012-1059, 668 F.3d 1008 (8th Cir. 2012).

<sup>429</sup> See, e.g., *Charles McCandless Tile Service v. United States*, 25 AFTR2d 70-870, 422 F.2d 1336 (Ct. Cl. 1970) (recharacterizing a portion compensation payments as dividends in an amount equal to 15% of net profits before salaries or Federal income tax).

<sup>430</sup> Code § 162(a)(1).

“There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for service.”

§ 1.162-7(b)(1) of the Regulations expands on the intent test, providing that payments are not deductible as compensation if they are not for the purchase of services:

Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

§ 1.162-7(b)(2) of the Regulations explains the form of the compensation payments does not decide deductibility, even if one form results in an greater total amount of compensation than another:

The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

**[i] The Amount Test.**

§ 1.162-7(b)(3) of the Regulations provides the reasonableness of compensation depends on all the circumstances existing at the time the service contract was entered into:

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

**[ii] Recharacterization of Compensation.**

§ 1.162-8 of the Regulations provides excessive compensation payments could be treated as dividend payments if the payments correspond to stockholding and “are found to be a distribution of earnings and profits”:

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient.

**[iii] Employee Bonuses.**

§ 1.162-9 of the Regulations explains that deductions for employee bonuses made in good faith for services rendered are allowable, so long as the total amount of compensation is reasonable:

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

**[c] Legislative Enactment – 1918.**

As originally enacted, the reasonable compensation provision was an expansion of the business deduction, allowing a deduction from the excise profits tax for salaries not actually paid. Once the reasonable compensation language was included in the Federal income tax laws, however,

the statutory language was read as a restriction on a taxpayer's ability to take deductions for compensation actually paid.

Code § 162(a) qualifies the taxpayer deduction for all ordinary and necessary business expenses paid with the phrase, "including a reasonable allowance for salaries or other compensation for personal services actually rendered." That qualifying phrase was first inserted into the Revenue Act of 1918, and has remained unchanged since.<sup>431</sup> Specifically, Section 234(a) of the Revenue Act of 1918 provided:

That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

(Emphasis added.)

Dean Erwin Griswold explained the legislative and regulatory origins of the reasonable allowance qualifying language in two notes published in the 1940s.<sup>432</sup> The reasonable allowance phrase was first inserted into the Revenue Act of 1918 without legislative history. The phrase was included in the original draft of the bill and went through Congress without any specific consideration.<sup>433</sup>

However, the origin of the phrase can be found in the excess profits tax, enacted in 1917.<sup>434</sup> The excess profits tax was imposed on the net income of every corporation, partnership, or individual.<sup>435</sup> It quickly became apparent the excess profits tax unfairly burdened closely held corporations, partnerships, and sole proprietors because they often did not pay salaries to their owner-officers. To fix the problem, Dean Griswold explains, Treasury quickly issued a regulation that allowed individual taxpayers, when computing the excess profits tax, to deduct a reasonable allowance for officer salaries "even though no such salaries had actually been paid."<sup>436</sup> Specifically, Article 39 of Regulations 41, issued in 1918 under the War Revenue Act of October 3, 1917, provided as follows:

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<sup>431</sup> Code §§ 214(a)(I), 234(a)(I).

<sup>432</sup> See Erwin N. Griswold, Note, *New Light on "A Reasonable Allowance for Salaries,"* 59 Harv. L. Rev. 286 (1945) [Hereinafter *New Light*]; Erwin N. Griswold, Note, *The Deduction of "A Reasonable Allowance for Salaries" – The Undefined Power of the Commissioner,* 56 Harv. L. Rev. 997 (1943) [Hereinafter *Undefined Power of the Commissioner*].

<sup>433</sup> *Undefined Power of the Commissioner,* *supra* note 10, at 997. See also H.R. 12683, 65th Cong., 2d Sess. (1918).

<sup>434</sup> *New Light,* *supra* note 5, at 287.

<sup>435</sup> *Id.*

<sup>436</sup> *Id.*

**ART. 39. Deduction allowed for salary to himself.** — An individual carrying on a trade or business having an invested capital may in computing the net income of the trade or business for purposes of the excess profits tax *deduct a reasonable amount designated by him as salary or compensation for personal service actually rendered by him in the conduct of such trade or business.* In no case shall the amount so designated be in excess of the salaries or compensation customarily paid for similar service under like responsibilities by corporations or partnerships engaged in like or similar trades or businesses.

(Boldface in original; emphasis added.) As Dean Griswold points out, the italicized language is almost identical to the words inserted in Section 234(a)(I) of the Revenue Act of 1918.

The Commissioner issued a similar rule with respect to corporations, allowing corporate taxpayers to take a deduction from the excess profits tax despite having not paid officer salaries:

51. A corporation in which most of the stock is owned by its officers has in the past voted to its officers only nominal salaries as drawing accounts. In computing net income for purposes of the excess-profits tax may the corporation deduct as items of expense amounts which would constitute reasonable compensation for the services actually rendered by its officers?

Yes, if a satisfactory explanation is given. For any period prior to March 1, 1918, reasonable salaries for services actually rendered may be deducted, even though the full amounts had not been formally voted as salaries by the corporation.

(Emphasis added.)<sup>437</sup>

In 1925, the Board of Tax Appeals extended Article 39 of Regulation 41 to partnerships. In *Appeal of Gottlieb Bros.*,<sup>438</sup> the Board considered whether a deduction should be allowed for purposes of the excess profits tax for a reasonable amount of compensation to individual partners, despite the fact compensation was not actually paid to the two partners. In 1917, the partnership had gross sales of \$240,000. However, the two partners had taken only \$40 per week for expenses. The Commissioner asserted only actual payments could be deducted when computing net income. The Board disagreed. Relying on Article 39 of Regulation 41, the Board allowed a \$20,000 deduction for “reasonable allowance for compensation of the partners.”

As originally enacted in 1917, the allowance of a deduction for reasonable compensation appears to be intended as an expansion of the law, allowing a deduction from the excise profits tax for salaries not actually paid. However, in 1918, once the language was incorporated into the Federal income tax laws, the Commissioner began applying the phrase as a limitation, rather than an expansion, of the deduction.

<sup>437</sup> Excess Profits Tax Primer ¶ 51 (1918).

<sup>438</sup> 1 B.T.A. 684 (1925).

**[d] The Intent Test.**

Although termed the “intent test” or the “compensatory purpose test,” the test is more focused on the substance of the transaction to determine whether the payments were for services rendered.<sup>439</sup>

As stated above, in order to be deductible under Code § 162(a)(1), compensation must be both reasonable in amount and intended as compensation for services. Due to the subjective nature of the “intent” test, courts often infer the existence of compensatory intent if the amounts paid are reasonable.<sup>440</sup> Once the advisor can demonstrate that compensation paid was reasonable in amount, the advisor should strongly emphasize this inference at every opportunity. Nevertheless, there are some situations where a court has found otherwise reasonable compensation is not deductible due to lack of intent.

There have been rare cases where courts have concluded compensation paid to employee shareholders was not deductible even though the amount paid was reasonable—the compensation paid nevertheless failed the intent test.<sup>441</sup> Presumably, the IRS will attempt to raise the “intent” argument after the advisor helps his or her client satisfy the “amount” test.

The intent test examines several different criteria designed to show that the payments were actually disguised dividends.<sup>442</sup> The fact a corporation has not declared any dividends will invariably attract the attention of the IRS. This inference is based on the IRS’s position in Revenue Ruling 79-8:

The failure of a closely held corporation to pay more than an insubstantial portion of its earnings as dividends on its stock is a very significant factor to be taken into account in determining the deductibility of compensation paid by the corporation to its shareholder/employees. Conversely, where after an examination of all of the facts and circumstances (including the corporation’s dividend history) compensation paid to shareholder/employees is found to be reasonable in amount and paid for services rendered, deductions for such compensation . . . will not be denied on the sole ground that the corporation has not paid more than an insubstantial portion of its earnings as dividends on its outstanding stock.<sup>443</sup>

<sup>439</sup> Michael Q. Eagan, *Reasonable Compensation and the Close Corporation: McCandless, the Automatic Dividend Rule, and the Dual Level Test*, 16 STAN L. REV. 441, 444 n.21 (1973).

<sup>440</sup> See, e.g., *Elliotts, Inc. v. Commissioner*, 52 AFTR2d 83-5976, 83-5978, 716 F.2d 1241 (9th Cir. 1983).

<sup>441</sup> See, e.g., *O.S.C. & Associates, Inc. Commissioner*, 84 AFTR2d 99-5735, 187 F.3d 1116 (9th Cir. 1999) (if “there is evidence [presented by the IRS] that the payments contain disguised dividends, the corporation must satisfy both the reasonableness and the compensatory intent prongs of the test. Reasonableness alone will not suffice.”); *David E. Watson, P.C. v. United States*, 109 AFTR2d 2012-1059, 668 F.3d 1008 (8th Cir. 2012) (explaining “*Pediatric Surgical Assocs., P.C.*, was a ‘rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend.’”); *Pediatric Surgical Associates, P.C. v. Commissioner*, T.C. Memo. 2001-81 (2001).

<sup>442</sup> See, e.g., *Elliotts*, 52 AFTR2d at 83-5978.

<sup>443</sup> Rev. Rul. 79-8, 1979-1 C.B. 92.

There is no rule requiring a profitable corporation to distribute dividends. Even the IRS concedes a corporation may refrain from paying dividends if its compensation is reasonable in amount and has a compensatory intent.<sup>444</sup>

**PRACTICE TIP:** The tax advisor should encourage his or her clients who are closely held C corporations to pay dividends every year. The decision not to declare a dividend should be documented in the corporate minutes with an explanation why no dividend was paid. A corporation may forgo paying a dividend for various reasons, but the corporation must document the decision and its supporting justification in contemporaneous minutes. The IRS will likely respect contemporaneous minutes more than documentation prepared after the audit has commenced.

The Ninth Circuit has also acknowledged, in *O.S.C. & Associates v. Commissioner*,<sup>445</sup> the failure to pay dividends can serve as evidence of a lack of compensatory intent. In *O.S.C. & Associates*, the failure to pay dividends was merely one factor used to conclude that incentive payments lacked compensatory intent. The court pointed out other circumstances indicating the lack of compensatory intent:

- The corporation failed to pay dividends despite its accountant’s advice to do so;
- In a credit memorandum, the majority shareholder explicitly stated he intended to avoid double taxation on business profits;
- The accountant manipulated corporate profits, leading to an “arbitrary increase to the incentive compensation pool;”
- The corporation’s bonus payments conformed precisely to ownership percentages;
- A high percentage (81% to 94%) of the corporation’s net income was paid to the two employee shareholders as “compensation;”
- The incentive compensation plan only applied to the two shareholder employees, not all employees;<sup>446</sup> and
- The incentive compensation formula was not based on the value of services rendered, but was structured to distribute every dollar of gross profit to the two shareholder employees.

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<sup>444</sup> *Id.* (“the United States Tax Court has repudiated any automatic dividend rule based solely on a poor dividend history”).

<sup>445</sup> 84 AFTR2d 99-5735, 99-5739, 187 F.3d 1116 (9th Cir. 1999).

<sup>446</sup> *See also Nor-Cal Adjusters v. Commissioner*, 34 AFTR2d 74-5834, 503 F.2d 359 (9th Cir. 1974) (emphasizing, “[p]erhaps the most significant factor indicating that the bonuses were essentially a dividend is that bonuses were paid only to [the corporation’s] officer-shareholders and not to any of its other employees”).

Of these facts, the most significant fact to the court was that bonus payments conformed precisely to stock ownership. That fact provides the IRS with simple and easy-to-understand mathematical “evidence” of subjective intent: Why else would bonuses conform with stock ownership unless the payments were dividends?

The IRS has occasionally invoked the attribution rules to impute stock owned by a shareholder employee’s family to that shareholder employee for purposes of determining whether the shareholder employee’s bonus was paid in proportion to stock ownership. **This is an improper use of the attribution rules.** The Code § 318 attribution rules only apply to Code sections by specific reference—the rules do not apply broadly to the entire universe of tax considerations. Absent a specific reference to Code § 318, the attribution rules do not apply. There are no Code sections specifically referencing or otherwise incorporating the Code § 318 attribution rules into a reasonable compensation inquiry.

For example, Code § 162 (deductible trade or business expenses) does not contain any reference to Sec Code § 318. Code § 301 (distributions of property by corporations) only incorporates Code § 318 for the limited purpose of determining who is a 20% shareholder for purposes of Code § 301(e)(2). Code § 301(e)(2) is not relevant to the reasonable compensation analysis. Perhaps not surprisingly, there is no case or administrative ruling concluding that, when evaluating whether compensation payments are disguised dividends, a shareholder employee is attributed ownership of stock owned by his or her family members. Without such a holding, ruling, or specific incorporation of Code § 318, the attribution rules of Code § 318 should not apply to the reasonable compensation analysis.

**PRACTICE TIP:** Due to its subjective nature, the intent test imposes a difficult burden on the advisor: How does the advisor help the corporation document subjective intent? Again, the most important step is to document the fact that the employee’s compensation is reasonable under all of the facts and circumstances. The advisor should also follow these specific steps:

- Advise the corporation to adopt formal compensation-setting procedures that do not set compensation in reference to pre-tax profits.
- Strongly advise the corporation to strictly adhere to those policies, and update them as appropriate.
- Strongly encourage the inclusion of non-shareholder employees in the bonus pool.
- Strongly encourage the avoidance of declaring bonuses in amounts that track stock ownership. (Possibly write this into the contingent compensation formula).

Following these steps should help reduce, if not eliminate, the opportunity for the Service to argue that the corporation’s compensation structure actually includes disguised dividends.

Too many closely held C corporations are caught unprepared when the Service commences a reasonable compensation audit. These taxpayers scramble to compile the necessary

documentation in response to an Information Document Request once the audit has commenced. The IRS often has a field day disposing of “evidence” prepared after the fact as self-serving “spin” of damaging facts.

The time to prepare for an audit is before the audit actually commences. Advisors must diligently work with their clients to develop and document a reasonable compensation plan that relies on objective benchmarks and awareness of the prevailing compensation standards in the marketplace. A client armed with well-documented, well-founded policies that are grounded in the applicable court’s criteria for reasonable compensation will have a great opportunity to swiftly dispose of any unreasonable compensation examination by the IRS.

[e] **Case Law.**

[i] **Paula Construction Company v. Commissioner.**<sup>447</sup>

**After-the-fact  
characterization  
distributions as  
compensation will  
not save the day**

*Paula Construction Company* is considered to be the leading case on the intent test. The taxpayer, Paula Construction Company, which had elected to be taxed as an S corporation in 1958, unknowingly lost its election in 1965 because more than 25% of its gross receipts for that year were derived from interest payments. Paula Construction, its shareholder employees, and its accountant were not aware of the automatic revocation of its S election. Because it believed its shareholder payments qualified as S corporation distributions, the company did not report its shareholder employee distributions as compensation. Instead, it reported all of its 1965 and 1966 profits as corporate distributions.

The Tax Court concluded Paula Construction was not entitled to compensation deductions for the payments it characterized and treated as S corporation distributions:

[T]he issue is limited to whether parts of the distributions in 1965 and 1966 were made purely for services rendered. It is now settled law that only if payment is made with the intent to compensate is it deductible as compensation. Whether such intent has been demonstrated is a factual question to be decided on the basis of the particular facts and circumstances of the case. On the basis of the record in this case, we conclude that the petitioner has not demonstrated the requisite intent to be entitled to the deduction.

(Citations omitted.) Accordingly, the court concluded Paula Construction had not met its burden necessary to overturn the Tax Court’s decision: “In short, the petitioner has utterly failed to produce any evidence showing that the distributions were made with the intent of compensating.”

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<sup>447</sup> 58 T.C. 1055 (1972), *aff’d*, 474 F.2d 12345 (5th Cir. 1973).

**[ii] Nor-Cal Adjusters v. Commissioner.**<sup>448</sup>

**Bonuses equal to ownership % and not paying dividends is not a good idea**

A corporation's failure to establish and document a contingent compensation formula does not mean a bonus is necessarily unreasonable. A year-end bonus based on net profits, however, will likely be subject to strict scrutiny. In *Nor Cal Adjusters*, the taxpayer was in the business of providing insurance adjuster services. It had four shareholders. All of the shareholders were officers/employees of the corporation. In 1967, each officer/employee received a salary and a year-end bonus. The corporation had never paid dividends. The Service assessed a deficiency, asserting the compensation paid to the officers/employees was unreasonable. The Tax Court upheld the assessment, but on different grounds. Specifically, the Tax Court reasoned, although the year-end bonuses were reasonable in amount, the bonuses were intended to be distributions of profits. Accordingly, the Tax Court upheld the assessment. On appeal, the Ninth Circuit agreed.

The Ninth Circuit concluded that the Tax Court properly relied on the following considerations:

- The bonuses were in exact proportion to the officers' stockholdings.
- The bonus compensation was paid in lump sums, not as the services were rendered.
- There was a complete absence of formal dividend distributions.
- The contingent compensation bonus formula was completely unstructured. That is, the shareholders determined bonuses periodically throughout the year without any established formula.
- The corporation's taxable income was consistently zeroed-out, indicating the bonus determinations were based on the corporation's available cash and not on actual services rendered by the officers.
- The president's stock was redeemed in exchange for bonus payments equal to 35% of the corporation's net profits.
- Bonus payments were made only to the officer-stockholders.

Accordingly, the Ninth Circuit concluded the Tax Court's decision was not in clear error, and the year-end bonuses were not payments for personal services, but were disguised distributions of profits.

**[iii] Elliotts, Inc. v. Commissioner.**<sup>449</sup>

The Ninth Circuit also considered the intent test in *Elliotts*. In that case, the taxpayer paid the

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<sup>448</sup> 34 AFTR2d 74-5834, 503 F.2d 359 (9th Cir. 1974).

<sup>449</sup> 52 AFTR2d 83-5976, 716 F.2d 1241 (9th Cir. 1983).

CEO, its only shareholder, a \$24,000 salary, plus a year-end bonus equal to 50% of net profits. The salary and bonus together were almost \$200,000 a year, all of which was deducted as compensation. The Service concluded the payments were unreasonably high and that only \$65,000 could be deducted as compensation. The remainder of the payments was re-characterized as dividends.

**Intent test is subjective, difficult to prove and generally inferred if amount is reasonable** On appeal, the Ninth Circuit acknowledged the two-prong test for deductibility: “(1) the amount of the compensation must be reasonable and (2) the payments must in fact be purely for services.”<sup>450</sup> The court explained the intent test is subjective, difficult to prove, and usually can be inferred if the amount is reasonable.<sup>451</sup>

The existence of a compensatory purpose can often be inferred if the amount of the compensation is determined to be reasonable under the first prong. For these reasons, courts generally concentrate on the first prong—whether the amount of the purported compensation is reasonable. Courts have generally not delved into whether a compensatory purpose exists under the second prong except in those rare cases where the commissioner has come forward with evidence that purported compensation payments, although reasonable in amount, were in fact disguised dividends.

Accordingly, the court held “where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness.”<sup>452</sup>

**[iv] O.S.C. & Associates, Inc. v. Commissioner.**<sup>453</sup>

**Overview** In *O.S.C. & Associates*, the Ninth Circuit upheld the Tax Court’s denial of the taxpayer’s Section 162 deduction for contingent compensation payments to its majority shareholder president and minority shareholder vice-president. The Ninth Circuit agreed that, under the intent test, the payments were disguised dividends and not compensation for services.

**Background** In 1970, Allen Blazick (the majority shareholder) bought a silk-screening business for \$180, which his wife operated while he went to school. The business grew, and the shareholder hired his brother-in-law, Steven Richter, to assist in the business. Due to Blazick’s and Richter’s “enthusiasm, energy and hard work,” the business became successful. In 1976, they landed Safeway Stores as a customer. Six years later, they incorporated the business. Blazick owned 90% of the stock and Richter owned the remaining 10% of the stock. By 1991, Olympic Screen Crafts (“OSC”) employed over

<sup>450</sup> *Id.* at 1243.

<sup>451</sup> *Id.*

<sup>452</sup> *Id.* at 1244.

<sup>453</sup> 84 AFTR2d 99-5735, 187 F.3d 1116 (9th Cir. 1999).

200 people and had gross annual revenues over \$13 million.

**Contingent  
compensation  
formula**

After incorporation, OSC adopted a contingent compensation plan “to recognize and compensate Blazick and Richter for their distinct and different contributions to the business.” The plan called for bonuses to be determined at the end of the tax year and taken from a pool comprised of a percentage of gross revenues equal to the difference between OSC’s actual gross margin and a hypothetical adjusted industry gross margin. Payments from the pool were made to Blazick and Richter based strictly on their respective ownership interests (90% and 10%). The formula’s effect was to distribute almost all of the corporation’s net income to Blazick and Richter (from 82% to 94%), which OSC deducted as compensation. OSC’s accountant later admitted he did not comply with GAAP and made various “miscalculations” that arbitrarily increased the bonuses. In addition, OSC never paid a dividend, despite its accountant specifically recommending it do so. The Service disallowed a significant amount of the payments, which the Tax Court upheld.

On appeal, the Ninth Circuit considered whether the evidence of disguised dividends supported the Tax Court’s conclusion that the contingent payments were not intended as compensation, regardless of whether the amounts were reasonable. The Ninth Circuit agreed, reasoning the Tax Court properly relied on the following factors indicating the payments were disguised dividends:

First, the percentage of OSC’s net income paid to its two shareholder employees was high, between 81% and 94% during the years in question. As we observed in *Elliotts*, if the bulk of corporate earnings are paid out as bonuses or the like, that is a strong indication that profits are being siphoned out of the company disguised as compensation.

Second, OSC never paid or declared a dividend. Although not a dispositive factor, it is relevant in light of the history of profitability and [the accountant’s] rejected advice to pay dividends.

Third, the shareholder employee manipulated the actual implementation of the plan to increase the allocations above what the plan itself authorized.

Fourth, the design of the plan itself was inconsistent with compensatory intent: (a) it applied only to the corporation’s shareholders and no other employees; (b) payments were calculated with reference to their proportionate stock ownership; and (c) the method of calculation was not based on the value of services rendered, but was structured to distribute every dollar of gross profit in excess of the hypothetical gross profit.<sup>454</sup>

Accordingly, the Ninth Circuit concluded the Tax Court had not erred in concluding OSC’s contingent compensation payments were not made with compensatory intent. They may have been reasonable in amount, but they were not deductible because they lacked compensatory intent.

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<sup>454</sup> *Id.* at 99-5739.

[v] **Automatic Dividend Rule.**

In *Charles McCandless Tile Service v. United States*,<sup>455</sup> the taxpayer, a closely held C corporation, deducted compensation payments to Mr. McCandless and his son, who were the taxpayer's officers and sole shareholders. The compensation payments amounted to over 50% of the corporation's net profits, before salaries and tax. Although the corporation's ceramic tile business was highly profitable, it had never paid dividends to either shareholder. The court first decided that the amount of compensation payments to the two shareholders was reasonable. It then turned to whether the payments were, in fact, intended to be compensation.

The court noted that the corporation "had neither declared nor paid dividends to its shareholders in any amount since its formation in 1960" and formulated the automatic dividend rule:

We think it clear that any return on equity capital is so conspicuous by its absence as to indicate, given all the facts, that the purported compensation payments necessarily contained a distribution of corporate earnings within.

The court then focused on what amount of dividends would have been reasonable based on the corporation's profitability. It held that 15% of net profits should be recharacterized as dividends.

Nine years after *McCandless*, the Service rejected the automatic dividend rule in Revenue Ruling 79-8.<sup>456</sup> In that ruling, the Service concluded, where the compensation amount is reasonable and is paid for services actually rendered, a deduction will not automatically be denied due to the fact the corporation has not paid dividends. The automatic dividend rule appears to have finally died.

The reasonable amount test is the more important of the two tests. As the Ninth Circuit Court of Appeals explained:

Proof of the second prong, which requires a 'compensatory purpose,' can be difficult to establish because of its subjective nature. The existence of a compensatory purpose can often be inferred if the amount of the compensation is determined to be reasonable under the first prong. For these reasons, courts generally concentrate on the first prong – whether the amount of the purported compensation is reasonable.<sup>457</sup>

Generally, courts only expand the inquiry to include compensatory intent where "there is evidence that an otherwise reasonable compensation payment contains a disguised dividend."<sup>458</sup>

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<sup>455</sup> 25 AFTR2d 70-870, 422 F.2d 1336 (Ct. Cl. 1970).

<sup>456</sup> 1979-1 C.B. 92.

<sup>457</sup> *Elliotts, Inc. v. Commissioner*, 52 AFTR2d 83-5976, 716 F.2d 1241 (9th Cir. 1983) (citing *Pacific Grains, Inc. v. Commissioner*, 22 AFTR2d 5413, 399 F.2d 603 (9th Cir. 1968); Note, "Reasonable Compensation," 26 STAN. L. REV. at 447; Coggin, "The Status of the McCandless Doctrine," 55 TAXES 720, 720 (Nov. 1977).

<sup>458</sup> *O.S.C. & Associates, Inc. v. Commissioner*, 84 AFTR2d 99-5735, at 99-5739. Such evidence includes (1) a high percentage (between 81% and 94%) of corporate net income paid to employee-shareholders as compensation; (2) no history of declaring dividends; (3) disregarding an established compensation plan to manipulate distributions; and (4) making distributions according to stock ownership percentages. *Id.*

The United States Supreme Court has not adopted a single set of guiding criteria for all courts to follow when making the determination of whether compensation is reasonable in amount. To date, the Federal Circuits have been left to their own devices to develop tests for application in reasonable compensation cases. Circuit Courts have considered as few as 1 and as many as 21 different factors in determining whether compensation is reasonable in amount.

**[f] Additional Tests.**

The courts have utilized two separate conceptual methods to determine whether compensation is reasonable—the multi-factor test and the independent investor test. The IRS, however, generally applies the multi-factor test to determine whether compensation is reasonable.

**[i] Multi-factor Test.**

The multi-factor test is the predominant test adopted by the Federal Circuits. The multi-factor test has been developed based on two cases, *Mayson Manufacturing Co. v. Commissioner*,<sup>459</sup> a Sixth Circuit opinion from 1949, and *Elliotts, Inc. v. Commissioner*,<sup>460</sup> a Ninth Circuit opinion decided in 1983. The independent investor test was adopted by the Seventh Circuit in *Exacto Spring Corp. v. Commissioner*.<sup>461</sup> The Tax Court will follow decisions of the Court of Appeals for cases arising in the Circuit to which appeal of its decision would lie.<sup>462</sup>

*Mayson Manufacturing v. Commissioner* is the foundational case establishing the multi-factor test. In *Mayson Manufacturing*, the taxpayer paid three key officers significant salary and bonus compensation. The officers and their families were the taxpayer's only stockholders. The Service assessed a deficiency, asserting a portion of the officers' compensation was unreasonable in amount. The Tax Court agreed and sustained the deficiency assessment. The Sixth Circuit reversed, applying what has become known as the “*Mayson* factors.”

In determining the compensation was reasonable, the court considered the following nine factors:

- employee qualifications;
- nature, extent, and scope of the employee's work;
- size and complexity of the employer's business;
- employee compensation as compared with the employer's gross and net income;
- prevailing general economic conditions;
- employee compensation and stockholder distributions;

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<sup>459</sup> 38 AFTR 1028, 178 F.2d 115 (6th Cir. 1949).

<sup>460</sup> 52 AFTR2d 83-5976, 716 F.2d 1241 (9th Cir. 1983), *rev'g* T.C. Memo. 1980-282.

<sup>461</sup> 84 AFTR2d 99-6977, 196 F.3d 833 (7th Cir. 1999), *rev'g* T.C. Memo. 1998-220.

<sup>462</sup> *Golsen*, 54 T.C. 742 (1970), *aff'd*, 27 AFTR2d 71-1583, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

- compensation paid by comparable businesses for comparable positions;
- employer’s salary policy for all employees; and
- prior employee compensation.

The multi-factor test established under *Mayson Manufacturing* has evolved over time, most significantly in response to the *Elliotts* and *Exacto Spring* decisions.

The first factor is the employee’s qualifications, which may justify high compensation. Courts frequently look to the employee’s education, training, experience, dedication, specialized skills, and understanding of the corporation’s business operations.<sup>463</sup> Also relevant, when profitability depends on sales, are the employee’s motivation, ambition, and energy.<sup>464</sup>

The second *Mayson* factor is the nature, extent, and scope of the employee’s work. This factor focuses on the employee’s responsibilities and activities, and the role the employee’s activities played in the corporation’s success. Courts frequently look to whether the success is due to the employee’s personal efforts – such as hours worked by the employee; the employee’s skill, dedication and creativity; and whether the corporation could function without the employee.<sup>465</sup> For example, in *Home Interiors & Gifts, Inc. v. Commissioner*,<sup>466</sup> although the founding shareholder and her son received very high compensation, their individual efforts produced extraordinary results for the corporation and everyone connected to it. Because of their “rare talents,” the corporation’s gross sales increased over a seven-year period from \$4,284,456 to \$97,583,835. Accordingly, the Tax Court concluded the compensation was reasonable in amount and allowed the corporation’s compensation deduction.

In addition, where the shareholder employee performs job duties normally associated with multiple employees, some courts may allow the corporation to aggregate salaries, resulting in higher compensation.<sup>467</sup>

The third *Mayson* factor considers the business size and complexity. This is a fact-intensive inquiry, usually based on sales, net income, gross receipts, or capital value.<sup>468</sup> Other considerations include: number of employees; number of independent contractors; amount of supervision required; complexity of billing and collections; number of customers; difficulty in obtaining or retaining customers; and level of business specialization.<sup>469</sup>

The fourth *Mayson* factor compares employee compensation with gross and net income of the business. The comparison can indicate whether a corporation is using employee compensation to

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<sup>463</sup> *Mad Auto Wrecking, Inc. v. Commissioner*, T.C. Memo. 1995-153.

<sup>464</sup> 73 T.C. 1142, 1158 (1980).

<sup>465</sup> *Mad Auto Wrecking*, T.C. Memo. 1995-153; *Home interiors*, 73 T.C. at 1158; *Kennedy v. Commissioner*, 49 AFTR2d 82-628, 82-635, 671 F.2d 167 (6th Cir. 1982).

<sup>466</sup> 73 T.C. 1142 (1980).

<sup>467</sup> *Elliotts, Inc. v. Commissioner*, 52 AFTR2d 83-5976, 716 F.2d 1241 (9th Cir. 1983).

<sup>468</sup> *Eberl’s Claim Service, Inc. v. Commissioner*, T.C. Memo. 1999-211, *aff’d*, 87 AFTR2d 2001-2075, 249 F.3d 994 (10th Cir. 2001).

<sup>469</sup> *Id.*

strip out earnings. The fact compensation represents a high percentage of net income strongly indicates the compensation is unreasonable in amount. (If the compensation is paid at the end of the year to strip down net profit, however, the compensation may be deemed to violate the intent test.) For example, in *Eberl's Claim Service*, the taxpayer paid Eberl 99.5% of its net income in one year and 98% of net income in another year.<sup>470</sup> The Tax Court relied on this factor to conclude a portion of the compensation was a disguised dividend.

The fourth *Mayson* factor also looks to whether there was an established contingent compensation formula. It is important that a corporation establish its contingent compensation plan according to set criteria. If the corporation instead determines its compensation amounts at the end of the year, a court may infer the bonuses were distributions of profits.<sup>471</sup>

The fifth *Mayson* factor looks to the general economic conditions to determine the extent of the employee's effect on the corporation. Where general conditions are exceptionally favorable to a particular business, it tends to indicate the business success is due to factors outside of the employee's control.<sup>472</sup>

An interesting early example of the importance of economic conditions is *Hoffman Radio Corp. v. Commissioner*.<sup>473</sup> In that case, the Ninth Circuit disallowed an employer's compensation deduction despite the fact the shareholder employee's employment contract was reasonable when made. The employment agreement was entered into prior to the start of World War II when the taxpayer was in a very poor financial condition. The three-year employment agreement provided the employee would be paid 3% of gross sales each month. The Ninth Circuit specifically stated the employment agreement was reasonable when made. However, after the start of the war, the taxpayer's business exploded, and in 1943, the employee earned around \$63,000, due in large part to the contingent compensation formula. In concluding the salary amount was unreasonable, the court explained the business's success was not due to the employee's efforts: "[T]he unusually large amount of business done that year was attributable in the main, not to services rendered by Hoffman, but to war conditions making for abnormal earnings." Although this case illustrates the importance of general economic conditions, it is unlikely the same result would be reached today. As explained in *Elliotts, Inc.*, the key question in evaluating a contingent compensation formula is whether the formula is reasonable, **not the amount that results from the formula**.<sup>474</sup>

The sixth *Mayson* factor compares employee compensation and stockholder distributions. The failure to pay more than a nominal dividend indicates amounts paid as compensation to controlling shareholders may be unreasonable.<sup>475</sup> However, the failure to pay dividends, in and of itself, does not conclusively establish unreasonable compensation.<sup>476</sup> Instead, a shareholder could be satisfied with appreciation in the value of their stock due to the corporation's retained

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<sup>470</sup> *Id.*

<sup>471</sup> *Builder's Steel Co. v. Commissioner*, 42 AFTR 23, 197 F.2d 263, 264 (8th Cir. 1952).

<sup>472</sup> See *Eberl's Claim Service*, T.C. Memo. 1999-211.

<sup>473</sup> 38 AFTR 775, 177 F.2d 264 (9th Cir. 1949).

<sup>474</sup> *Elliotts*, 52 AFTR2d at 83-5982.

<sup>475</sup> See *Charles Schneider & Co. v. Commissioner*, 34 AFTR2d 74-5422, 500 F.2d 148, (8th Cir. 1974), *aff'g* T.C. Memo. 1973-130.

<sup>476</sup> See *Elliotts*, 52 AFTR2d 83-5976 (rejecting the automatic dividend rule).

earnings.<sup>477</sup> Nevertheless, a corporation's failure to pay dividends in conjunction with paying contingent compensation to controlling shareholders strongly indicates the compensation is unreasonable in amount.<sup>478</sup> In addition, it is under this factor a court considers the corporation's return on equity. See the return on equity discussion under the *Elliotts* factor test, independent investor, below.

The seventh *Mayson* factor compares employee compensation to compensation paid to persons holding comparable positions in comparable companies. It is very important to have evidence of compensation paid to comparable employees in similar companies. A court will disregard this factor unless expert testimony establishes compensation from sufficiently comparable positions in comparable companies. This factor is often disregarded due to the failure to find sufficiently comparable data.<sup>479</sup>

The eighth *Mason* factor looks to the employer's salary policy for all employees. Disguised dividends are indicated where salaries paid to controlling shareholders are large compared to salaries paid to nonowner employees who have similar responsibilities.<sup>480</sup> This factor considers whether an entity pays top dollars to shareholder employees and non-shareholder employees.<sup>481</sup>

For example, in *Builder's Steel Co. v. Commissioner*, the Eighth Circuit explained, "[a]s [the minority shareholder's] capabilities were comparable to the other named employees, the corporation could not consistently avoid paying him a similar bonus as such omission would be a glaring admission that these bonuses were simply distributions of profits."<sup>482</sup>

The final *Mayson* factor focuses on prior employee compensation. In general, an employer may pay (and deduct) compensation in one year for services rendered in prior years.<sup>483</sup> The taxpayer bears the burden of showing the "catch-up" compensation was warranted.<sup>484</sup> Specifically, to compensate for past under-compensation, the taxpayer must establish: (1) the amount of the past under-compensation; and (2) the catch-up payments were contemporaneously intended to compensate employees for past services.<sup>485</sup>

In addition to the nine *Mayson* factors, some courts have considered additional factors such as the employer's financial condition, whether the employer and employee dealt at arm's length, and whether the employee personally guaranteed the employer's debt.<sup>486</sup> Personally

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<sup>477</sup> *Owensby & Kritikos, Inc. v. Commissioner*, 60 AFTR2d 87- 5224, 819 F.2d 1315 (5th Cir. 1987), *aff'g* T.C. Memo. 1985-267.

<sup>478</sup> *Eberl's Claim Service, Inc. v. Commissioner*, T.C. Memo. 1999-211, *aff'd*, 87 AFTR2d 2001-2075, 249 F.3d 994 (10th Cir. 2001).

<sup>479</sup> *Id.*; *Mad Auto Wrecking, Inc. v. Commissioner*, T.C. Memo. 1995-153.

<sup>480</sup> *Eberl's Claim Service*, T.C. Memo. 1999-211.

<sup>481</sup> *Owensby & Kritikos, Inc. v. Commissioner*, 60 AFTR2d 87-5224, 87-5234, 819 F.2d 1315, 1322-1323 (5th Cir. 1987), *aff'g* T.C. Memo. 1985- 267.

<sup>482</sup> 42 AFTR 23, 197 F.2d 263 (8th Cir. 1952).

<sup>483</sup> *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930).

<sup>484</sup> *Standard Asbestos Mfg. & Insulating Co. v. Commissioner*, 5 AFTR2d 1164, 276 F.2d 289 (8th Cir. 1960).

<sup>485</sup> *Pacific Grains, Inc. v. Commissioner*, 22 AFTR2d 5413, 5415, 399 F.2d 603, 606 (9th Cir. 1968), *aff'g* T.C. Memo. 1967-7.

<sup>486</sup> *Eberl's Claim Service*, T.C. Memo. 1999-211; *Boca Construction Inc. v. Commissioner*, T.C. Memo. 1995-5.

guaranteeing the corporation's debt may support a high salary under the employee's role in the corporation factor.<sup>487</sup>

For example, in *Boca Construction Inc. v. Commissioner*,<sup>488</sup> the Tax Court considered whether a closely held construction company was allowed to deduct the full amount of salaries and bonuses paid to the company's two shareholders. Despite the large compensation amounts (the company paid each shareholder \$350,000 in 1989 and \$400,000 in 1990), the Tax Court allowed the full amount of the deduction, concluding the payments were reasonable under the circumstances. In reaching its conclusion, the tax court considered 12 separate factors:

- The employee's qualifications;
- The nature, extent, and scope of employee's work;
- The size and complexity of a taxpayer's business;
- Comparison of salaries paid with gross and net income;
- General economic conditions;
- Comparison of salaries with shareholder distributions and retained earnings;
- The taxpayer's salary policy to all employees;
- The taxpayer's financial condition;
- Prevailing rates of compensation for comparable positions in comparable companies;
- Compensation paid in previous years;
- Whether the employee guaranteed the taxpayer's debt; and
- Whether the employee and employer dealt at arm's length.

In considering the last factor—whether the employee and the employer dealt at arm's length—the court explained that, where there is a conflict of interest such as if the employee is also the controlling shareholder, it will closely scrutinize the transaction to determine “whether an independent investor would approve the compensation in view of the nature and quality of the services performed and the effect of those services on the investor's return on his or her investment.”

The Ninth Circuit case of *Elliotts, Inc. v. Commissioner*<sup>489</sup> is considered particularly important for: (1) rejecting the *McCandless* automatic dividend rule; (2) inserting an equity-based

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<sup>487</sup> *Leonard Pipeline Contractors, Ltd. v. Commissioner*, T.C. Memo. 1998-315, *aff'd*, 210 F.3d 384 (9th Cir. 2000).

<sup>488</sup> T.C. Memo. 1995-5.

<sup>489</sup> *Elliotts, Inc. v. Commissioner*, 52 AFTR2d 83-5976, 716 F.2d 1241 (9th Cir. 1983).

independent investor factor into the analysis; and (3) reducing the nine *Mayson* factors down to five. The *Elliotts* test has been adopted by a minority of circuits.<sup>490</sup>

- First Circuit;
- Second Circuit;
- Ninth Circuit; and
- Eleventh Circuit.

Specifically, in determining whether the compensation was reasonable, the court considered the following factors, considered in light of the independent investor test:

- The employee’s role in the company;
- External comparison with other companies;
- The character and condition of the company;
- Conflict of interest (from the perspective of a hypothetical independent investor and
- Internal consistency (from the perspective of a hypothetical independent investor).

The *Elliotts* court explained the five reasonable compensation factors are to be considered from an independent investor’s perspective. Recently, however, courts have applied the independent investor test as a sixth factor rather than using it as the lens through which to analyze the five factors.

### Factual Background

The taxpayer in *Elliotts* was an Idaho corporation that sold and serviced John Deere equipment, and serviced equipment from other manufacturers. It was one of only three John Deere retailers handling both agricultural and industrial equipment in the western United States. The taxpayer was formed in 1952. In its first year, the taxpayer had gross sales of \$500,000 and employed 8 people. By 1975, the first tax year at issue, the taxpayer employed 40 people and had gross sales in excess of \$5 million. Edward Elliott was the taxpayer’s CEO and had been its sole shareholder since 1954. He had “total managerial responsibility” for the business. He worked approximately 80 hours per week and participated in every aspect of the business.

For the tax years at issue, 1975 and 1976, taxpayer paid Elliott a monthly salary of \$2,000 and a year-end bonus. Elliott’s year-end bonus was set at 50% of taxpayer’s net profits. In total, the taxpayer paid Elliott \$181,074 for 1975 and \$191,663 for 1976. The Service concluded the compensation paid to Elliott was unreasonable. It limited the deduction each year to \$65,000.

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<sup>490</sup> MCCOSKEY, *Reasonable Compensation: Do You Know Where Your Circuit Stands?* 109 J. Tax’n 228 (2008).

The Tax Court reviewed the testimony and statistical evidence, and concluded the salary payments were not reasonable in amount. Instead, it determined that \$120,000 was reasonable compensation for Elliott in 1975 and that \$125,000 was reasonable compensation for Elliott in 1976. The taxpayer appealed to the Ninth Circuit. After concluding the automatic dividend rule was based on an incorrect premise, the Ninth Circuit turned to whether the amounts paid to Elliott were reasonable.

The Ninth Circuit has adopted five factors to be considered when evaluating whether compensation is reasonable under specific circumstances. In general, “no single factor [is] decisive of the question.”<sup>491</sup> The Ninth Circuit’s factors were analyzed and applied succinctly in the *Elliotts* decision, but have been subsequently applied in several other cases. The five factors are: the employee’s role in the company; external consistency; character and condition of the company; conflict of interest; and internal consistency.

The “role in the company” factor looks to the overall significance of the employee to the company.<sup>492</sup> A court will examine a number of relevant considerations, including:

- the position held by the employee;
- the hours worked by the employee;
- the duties performed by the employee;
- the general importance of the employee to the success of the company;
- if the employee has received a large salary increase, a comparison of past duties and salary with current duties and salary;<sup>493</sup> and
- whether the employee personally guaranteed the company’s debt.<sup>494</sup>

In the *Elliotts* decision, the court noted that, in addition to the factors listed above, the Tax Court should have considered the taxpayer’s “extreme personal dedication and devotion to his work . . . [t]o the extent that this benefited the corporation, it is surely something for which an independent shareholder would have been willing to compensate” the employee.<sup>495</sup> It is relevant for the courts to consider the employee’s “pivotal position in the corporation.”<sup>496</sup> Another circumstance supporting higher compensation is where an employee assumes multiple roles (such as CEO and CFO).<sup>497</sup>

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<sup>491</sup> *Elliotts*, 52 AFTR2d at 83-5980 (citations omitted).

<sup>492</sup> *Id.*

<sup>493</sup> See *American Foundry v. Commissioner*, 37 AFTR2d 76-1373, 536 F.2d 289 (9th Cir. 1976).

<sup>494</sup> See *Aries Communications, Inc. v. Commissioner*, T.C. Memo. 2013-97; *Leonard Pipeline Contractors, Ltd. v. Commissioner*, T.C. Memo. 1998-315, *aff’d*, 210 F.3d 384 (9th Cir. 2000).

<sup>495</sup> *Elliotts*, 52 AFTR2d at 83-5980.

<sup>496</sup> *Labelgraphics, Inc. v. Commissioner*, 86 AFTR2d 2000-5541, at 2000-5546, 221 F.3d 109 (9th Cir. 2000).

<sup>497</sup> *Aries Communications*, T.C. Memo. 2013-97.

Finally, it appears the Tax Court will treat an owner-employee as acting in his scope of employment (and thus entitled to compensation) and not in his passive investment capacity when proper formalities are followed.<sup>498</sup> In *Aries Communications, Inc.*, the Service argued the sole owner-president was acting as an investor when he negotiated the sale of business assets (FCC Licenses) and not as an employee. The Tax Court rejected the argument, asserting that the owner-president's choices should be treated as the decisions of the chief executive and he should be compensated "for his successful investment choices."<sup>499</sup>

**PRACTICE TIP:** Tax Advisors should evaluate each relevant employee's role in the company and prepare a separate summary for each such employee emphasizing the employee's special qualifications or other attributes that support the employee's compensation. Such qualifications or other attributes may include, but are not limited to, the following:

- Is the employee an officer of the company?
- Does the employee serve in a management role?
- Did the employee found the company?
- Is the reputation of the company closely tied to the reputation of the employee?
- Does the employee play a vital role generating sales?
- Is the company managed by a small, tightly-knit management group?
- Would there be a material adverse effect to the company if the employee left?

Advisors should recommend to clients that they include language in relevant corporate documents supporting compensation decisions. The language should include the basis for a raise or bonus, and the specific contributions made by the employee to the company's success. Contemporaneous documentation provides much stronger evidence than documentation generated upon audit.

The next relevant factor involves a comparison of the employee's salary with those paid by "similar companies for similar services."<sup>500</sup> The comparisons are to be based on the services actually performed.<sup>501</sup> This test is also found in the Regulations:

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<sup>498</sup> *Id.*

<sup>499</sup> *Id.*

<sup>500</sup> *Elliotts*, 52 AFTR2d at 83-5980 (citing *Hoffman Radio Corp. v. Commissioner*, 38 AFTR 775 (9th Cir. 1949)); *E. Wagner & Son v. Commissioner*, 20 AFTR 593 (9th Cir. 1937).

<sup>501</sup> *Id.*

“It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.”<sup>502</sup>

The stronger the similarities of the companies and the services provided by the employees, the stronger the impact of the comparison on the ultimate outcome.<sup>503</sup> It is critical to document the similarities between the companies and the employee services. A careful advisor can provide substantial value to his or her clients. Documenting the comparables at the time of compensation decisions is preferred. Waiting until the IRS begins an examination is not recommended. For example, the advisor could draft corporate resolutions setting compensation to refer to compensation paid by similarly-situated companies. The comparisons do not necessarily need to be provided through an expensive compensation study – anecdotal evidence or information available in the public domain (e.g., through Internet searches or industry surveys) may provide reliable contemporaneous evidence.

**PRACTICE TIP:** Tax advisors should carefully review the information to ensure that the companies and employees are in fact comparable. One recommended benchmark to consider when evaluating whether a corporation is comparable to another is to identify whether the two companies are in direct competition in the same markets. The advisor should also consider the companies’ comparative size, revenues and ownership structure. Other factors to be considered are: whether one corporation has substantially higher overhead; whether one corporation is located in a higher-price city; and whether employees have the same educational background and credentials, etc.

Courts focus on a variety of factors when examining the “character and condition of the company,” including the following:

- company size;
- sales;
- net income;
- capital value;
- complexities of the business; and
- the general economic conditions.<sup>504</sup>

**Company Size.** It is clear that, despite the inclusion of “company size” in the list of factors to be considered by the courts in this test, it is not axiomatic that larger companies can pay higher

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<sup>502</sup> Treas. Reg. § 1.162-7(b)(3).

<sup>503</sup> See, e.g., *Labelgraphics*, 86 AFTR2d at 2000-5546 (Ninth Circuit Court of Appeals upheld Tax Court’s rejection of taxpayer’s experts where “these experts offered no details on which to base a comparison and failed to show a meaningful connection” between the companies).

<sup>504</sup> *Elliotts*, 52 AFTR2d at 83-5980 (citations omitted).

salaries than smaller companies. In *Wechsler & Co, Inc. v. Commissioner*, the Tax Court examined this factor in the context of a small investment and trading company.<sup>505</sup> The taxpayer was a small corporation (from 1992 to 1999, the tax years at issue, the number of employees decreased from 20 to 12) that was engaged in the sophisticated business of functioning “primarily as a market maker, or ‘specialist’ in convertible bonds, as a broker dealer in convertible bonds, and as an investor for its own account in convertible bonds, with a portion of its portfolio in hedged positions.”<sup>506</sup> The IRS challenged the compensation deductions claimed by the taxpayer with regard to several employees, including the controlling shareholder and president.

Despite the taxpayer’s small size, the Tax Court found it “enjoyed an excellent . . . reputation for its expertise as a market maker in convertible securities.”<sup>507</sup> In addition, the court noted there was a logical explanation for the taxpayer’s small size—it had outsourced a substantial portion of its operations. Accordingly, the Tax Court concluded the taxpayer was “a successful, well-managed, but relatively small, investment and trading company with a very lean management team. This factor supports [the taxpayer].”<sup>508</sup>

Net Income vs. Capital Value. A recent case, *Aries Communications, Inc. v. Commissioner*,<sup>509</sup> is particularly interesting. During the tax year at issue, the corporation sold off its major assets—two radio stations. During the years immediately before and after the sales, the corporation operated at a net loss. Had the sales not occurred, it was questionable whether the corporation could have continued to be a going concern. Nevertheless, the corporation was able to sell the radio stations for a total of \$53 million. Despite the significant sale proceeds, the court concluded the “character and condition” factor favored the IRS:

“Because Aries was a large asset-laden complex business with a negative net income and a bleak financial picture despite the favorable fact that it enjoyed a successful asset sale during the years at issue, we find this factor favors respondent.”<sup>510</sup>

This holding seems to indicate a consistent pattern of business performance will outweigh a successful asset sale at the end of the corporation’s life.

**PRACTICE TIP:** The “character and condition” factor is one of the more amorphous tests adopted by the Ninth Circuit. The character and condition factor provides an opportunity for the company to put its “best foot forward” when documenting employee compensation:

- Has the shareholder employee been directly responsible for increased sales or profits?

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<sup>505</sup> T.C. Memo. 2006-173.

<sup>506</sup> *Id.*

<sup>507</sup> *Id.*

<sup>508</sup> *Id.* (emphasis added).

<sup>509</sup> T.C. Memo. 2013-97.

<sup>510</sup> *Id.*

- Can any of the company’s financial success be attributed to the shareholder employee’s management of the company or reputation in the community?
- If the company had significant revenues from the sale of its business assets, was the shareholder employee’s role pivotal in locating a buyer, negotiating and closing the sale?
- Has the company placed special reliance on the shareholder employee in recent years?

The advisor should document these facts and include them in its written compensation analysis.

When evaluating the conflict of interest factor, the courts will consider whether a relationship exists between the company and its shareholder employee “which might permit the company to disguise nondeductible corporate distributions of income as [deductible salary].”<sup>511</sup> Such a relationship may occur where:

- The employee is the company’s sole or controlling shareholder;
- The company has a history of bonuses that distribute all or nearly all of the company’s pre-tax earnings; and
- The company has a bonus system that provides large bonuses to owner-executives but none or nominal bonuses to non-owner management employees.<sup>512</sup>

The shareholder employee relationship invites close scrutiny, but such a relationship, even where there is no dividend history, does not necessarily, in and of itself, establish unreasonably high compensation.<sup>513</sup>

Where a closely held C corporation has a history of paying little or no dividends to its shareholder employees, the Ninth Circuit will closely scrutinize employee compensation from the perspective of a hypothetical independent investor.<sup>514</sup> As discussed previously, if the company’s earnings on equity would satisfy an independent investor, “there is a strong indication that management is providing compensable services and those profits are not being siphoned out of the company disguised as salary.”<sup>515</sup> The reverse can also true. The Ninth Circuit observed in a footnote that “there are situations in which the compensation paid to employees is reasonable and yet the corporation may suffer a loss or an inadequate return on equity.”<sup>516</sup>

In the *Elliotts* decision, the Ninth Circuit concluded that a hypothetical independent investor would be satisfied with a 20% return on equity and would indicate that the shareholder employee

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<sup>511</sup> *Elliotts*, 52 AFTR2d at 83-5980.

<sup>512</sup> *Id.* at 83-8981 (citations omitted).

<sup>513</sup> *Id.*

<sup>514</sup> *Id.*

<sup>515</sup> *Id.*

<sup>516</sup> *Id.* at 83-5981 n.5.

and the corporation “were not exploiting their relationship.”<sup>517</sup> The court also specifically noted that the Tax Court had inappropriately limited its analysis to the facts that the shareholder employee was the corporation’s sole shareholder and the corporation no dividend history. The Ninth Circuit reasoned that, although a company’s failure to pay dividends is a relevant factor, it cannot be viewed in isolation. Accordingly, the court rejected the automatic dividend rule. The taxpayer’s no-dividend policy does not conclusively establish the relationship between the shareholder employee and the corporation was exploited.<sup>518</sup>

**PRACTICE TIP:** Because of the appearance of impropriety, the Service aggressively pursues the conflict of interest factor when auditing closely held C corporations. Accordingly, the advisor must be prepared to refute the appearance of a conflict of interest with evidence that, despite appearances, the shareholder employees have not paid themselves unreasonable salaries.

- Return on Equity. As indicated by the Ninth Circuit, a return on equity of 20% or greater may provide the strongest evidence that no conflict of interest resulted in improper compensation.
- Bonus Program. A closely held C corporation should also establish and document a bonus program based on objective benchmarks. If possible, the compensation plan should benefit both shareholder employees and non-shareholder employees alike. Such a system can be used to show the company did not set compensation to strip out pre-tax earnings for the benefit of shareholder employees.

It is strongly recommended that these procedures in effect before pre-tax earnings are determined. The Service will seize upon year-end bonuses paid out only to shareholder employees (absent a formal bonus program) as clear evidence of a conflict of interest, and such evidence may be difficult to refute.

The final consideration adopted by the Ninth Circuit is the internal consistency factor. The internal consistency factor examines bonuses paid to shareholder employees and to non-shareholder employees. Specifically, if bonuses are not awarded pursuant to a structured, formal, consistently applied plan, or if they are consistently awarded in relation to the recipient’s stockholdings or in relation to a tax benefit, then the bonuses may be considered to be unreasonable. Conversely, “evidence of a reasonable, longstanding, consistently applied compensation plan is evidence that the compensation paid in the years in question was reasonable.”<sup>519</sup> Where the formula would not allow an independent investor to ever obtain a reasonable return on equity, it is unlikely the compensation is reasonable.<sup>520</sup>

Another facet of the internal consistency factor is a comparison of shareholder employees’ compensation and compensation paid to unrelated non-shareholder employees.<sup>521</sup> To be relevant, however, the services provided by the non-shareholder employees must be comparable

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<sup>517</sup> *Id.* at 83-5981.

<sup>518</sup> *Id.*

<sup>519</sup> *Id.* at 83-5982.

<sup>520</sup> *Id.*

<sup>521</sup> *Id.* at 83-5981.

in scope to those services provided by the shareholder employees.<sup>522</sup> In some circumstances, however, the Tax Court has based its comparisons on a market rate benchmark. That is, it will look to whether the compensation paid to shareholder employees is at or above market rates and whether the compensation paid to non-shareholder employees is below market rates.<sup>523</sup>

Employers often pay bonus compensation in one year for services rendered in prior years. It is a long-standing rule that compensation paid in a current year for services provided in a prior year is deductible in the year paid.<sup>524</sup> However, the taxpayer bears the burden of establishing the “catch-up” compensation was warranted.<sup>525</sup> Specifically, to compensate for past under-compensation, the taxpayer must establish two things: First, the employer must establish the amount of the past under-compensation, and second, the employer must show the catch-up payments were contemporaneously intended to compensate employees for past services.<sup>526</sup>

When establishing under-compensation, courts have accepted evidence that the employees had previously and knowingly accepted low salaries. For example, in *Alpha Medical, Inc. v. Commissioner*,<sup>527</sup> the shareholder employee had received, but rejected an offer from the taxpayer of more than \$1 million annual salary. And, in *Comtec Systems, Inc. v. Commissioner*,<sup>528</sup> the company’s vice president had received no pay for 6 years until the corporation was successful. In contrast, the Ninth Circuit in *Pacific Grains, Inc. v. Commissioner*<sup>529</sup> rejected the taxpayer’s argument that its shareholder employee’s high salary operated to compensate him for prior services. The court pointed out that: (1) the board of directors did not “ earmark the funds as being in part for prior services” and (2) the company did not show a percentage or amount of the compensation was intended to make up for prior under-compensation.<sup>530</sup>

When advising a corporate client, it is particularly important to contemporaneously document the reasons for any catch-up compensation—particularly where there is a substantial increase in pay from the prior year. Specifically, the board of directors should document the catch-up payments in minutes approving officer compensation:

- State the officer compensation is payment, in part, for services performed in prior years;
- Identify the percentage or amount of compensation intended to compensate for prior services; and

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<sup>522</sup> *Clymer*, T.C. Memo. 1984-203.

<sup>523</sup> *Normandie Metal Fabricators, Inc. v. Commissioner*, T.C. Memo. 2000-102, *aff’d*, 87 AFTR2d 2001-2485 (2d Cir. 2001).

<sup>524</sup> *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, 119 (1930); *see also Aries Communications*, T.C. Memo. 2013-97.

<sup>525</sup> *Standard Asbestos Mfg. & Insulating Co. v. Commissioner*, 5 AFTR2d 1164, 276 F.2d 289 (8th Cir. 1960).

<sup>526</sup> *Pacific Grains, Inc. v. Commissioner*, 22 AFTR2d 5413, 5415, 399 F.2d 603 (9th Cir. 1968), *aff’g* T.C. Memo. 1967-7.

<sup>527</sup> *Alpha Medical, Inc. v. Commissioner*, 83 AFTR2d 1922, 172 F.3d 942 (6th Cir. 1999), *rev’g* T.C. Memo. 1997-464.

<sup>528</sup> T.C. Memo. 1995-4.

<sup>529</sup> 22 AFTR2d 5413, 399 F.2d 603 (9th Cir. 1968).

<sup>530</sup> *Id.* at 5415.

- Identify the prior years of under-compensation, the reasons for and the amount of such under-compensation, and the prior services performed.

The tax advisor should have the corporation document any under-compensation and the intent to make pay catch-up compensation as early as possible, even if it intends to pay the catch-up compensation in a future year. This is particularly true where there is an established bonus plan in place. Otherwise, the corporation's compensation deduction could be attacked on two fronts: The Service could assert the "catch-up" payment explanation was only an afterthought developed at a time when the reasonableness of the compensation was already under attack; and the Service could argue the additional "catch-up" payments were a bonus outside the company's bonus formula.

Contingent compensation plans, typically connected to gross revenues, profits, or sales, are often adopted to incentivize key employees. The pivotal question in evaluating a bonus formula is whether the formula itself is reasonable, not the amount that results from the formula.<sup>531</sup> An incentive compensation agreement is to be judged under the circumstances existing at the time the agreement was made; not at the time it is questioned. In general, a formula will be respected if it was established when the business started or at a time when the amount of future earnings was undeterminable and if the formula has been consistently followed.<sup>532</sup> With respect to closely held C corporations, a contingent compensation formula need not be in writing and may be informal.<sup>533</sup> For obvious reasons, however, memorializing the plan in writing is strongly recommended.

In determining whether a contingent compensation formula is reasonable, a court will likely consider the return on equity an independent investor should have achieved: "A formula which would **not** allow a reasonable return on equity is likely to be unreasonable."<sup>534</sup>

In general, an incentive plan that pays bonuses to shareholder employees is not unreasonable merely because the shareholder employee would have received the benefit anyway through the distribution of dividends. "If an outside investor would approve such a compensation plan, that plan is probably reasonable. The fact that the recipient is a shareholder employee does not make the plan unreasonable."<sup>535</sup> Nevertheless, the Tenth Circuit stated in *Pepsi-Cola Bottling Co. v. Commissioner*:

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<sup>531</sup> *Elliotts*, 52 AFTR2d at 83-5982. *But see Hoffman Radio Corp. v. Commissioner*, 38 AFTR 775, 177 F.2d 264 (9th Cir. 1949) (Ninth Circuit agreed that the employment contract was reasonable when made, but ultimately concluded the amount paid under the formula was unreasonably high because the company's success was due to general economic conditions and not the employee's efforts.).

<sup>532</sup> *Dexsil Corp. v. Commissioner*, 81 AFTR2d 98-2312, 98-2316, 147 F.3d 96 (2nd Cir. 1998).

<sup>533</sup> *Id.*; *Mad Auto Wrecking, Inc. v. Commissioner*, T.C. Memo. 1995-153.

<sup>534</sup> *Elliotts*, 52 AFTR2d at 83-5982.

<sup>535</sup> *Id.*

[D]ue to the identity between the predominant shareholder and the employee in our case we cannot accept the applicability of the “incentive compensation” reasoning. [The shareholder employee] did not have a lack of such incentive. As owner of 248 of 250 shares she would profit from her hard work even without salary compensation. A bonus contract that might be reasonable if executed with an executive who is not a controlling shareholder may be viewed as unreasonable if made with a controlling shareholder, since incentive to the stockholder to call forth his best effort would not be needed.<sup>536</sup>

Judge Posner rejected this argument in *Menard, Inc. v. Commissioner*,<sup>537</sup> but also pointed out *Pepsi-Cola Bottling Co.* was ultimately decided based on the external consistency factor (comparison with similar positions in similar companies) and not the reasoning above.

It looks particularly bad where bonuses are determined at the end of the year when the company can predict its potential income tax liability absent a Code § 162 compensation deduction for compensation paid to its shareholder employee.<sup>538</sup> Even if the court determines the amount of the compensation is reasonable, it may conclude the year-end bonuses are disguised dividends (particularly where the company has no dividend history and where the bonuses correspond to stockholdings).

**PRACTICE TIP:** Adopting a formal compensation plan and following it consistently will go a long way toward satisfying this test. It is vital that the company memorialize in writing anytime it under-compensates its shareholder employees (e.g., during start-up years, during lean economic times, etc.). The company should reference such documentation in current corporate minutes if it decides to pay a shareholder employee a bonus to compensate for past services. The advisor should help with the documentation.

Furthermore, the “internal consistency” factor provides yet another opportunity for the taxpayer to invoke the reasonable investor standard. A long-standing compensation formula can still generate unreasonable compensation. The taxpayer must demonstrate that an independent investor would still invest in the company even though the company uses the compensation formula (i.e., demonstrate that the return on equity meets or exceeds 20% for the year at issue even after the formulaic compensation is paid).

The *Elliotts* court explained the five reasonable compensation factors are to be considered from an independent investor’s perspective. Nevertheless, the court recently moved away from this position and applied the independent investor test as a sixth factor.<sup>539</sup> The “independent investor” test examines whether a hypothetical, independent investor would be willing to compensate the employee as he was actually compensated.<sup>540</sup> It is particularly important in considering whether compensation paid to a sole shareholder is reasonable.<sup>541</sup>

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<sup>536</sup> 37 AFTR2d 76-369, 76-373, 528 F.2d 176 (10th Cir.1975).

<sup>537</sup> 103 AFTR2d 2009-1280 2009-1286, 560 F.3d 620 (7th Cir. 2009).

<sup>538</sup> *Aries Communications, Inc. v. Commissioner*, T.C. Memo. 2013-97.

<sup>539</sup> *Id.*

<sup>540</sup> *Metro Leasing and Dev. Corp. v. Commissioner*, 94 AFTR2d 2004-5251, 376 F.3d 1015 (9th Cir. 2004).

<sup>541</sup> *Elliotts*, 52 AFTR2d at 83-5981.

There are two basic criteria for this test:

- First, to determine whether “an inactive, independent investor would be willing to compensate the employee as he was compensated,” the court looks to the nature and the quality of the shareholder employee’s services; and
- Second, the court considers the effect of those services on the rate of return that the hypothetical investor would see on his investment. “The corporation’s return on equity would be relevant to the independent investor in assessing the reasonableness of compensation in a small corporation where excessive compensation would noticeably decrease the rate of return.”

The *Elliotts* court reviewed the conflict of interest factor and the internal consistency factor from an independent investor perspective. As discussed previously, the conflict of interest factor is implicated where a closely held corporation has a history of paying little or no dividends.<sup>542</sup> In that case, the Ninth Circuit will closely scrutinize employee compensation from the perspective of an independent investor. If the company’s return on equity would satisfy an independent investor, “there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary.”<sup>543</sup> However, in some situations, compensation can be reasonable despite the corporation suffering inadequate return on equity.<sup>544</sup>

The internal consistency factor is reviewed from an independent investor perspective to determine whether a contingent compensation formula is reasonable.<sup>545</sup> The reasonableness of payments under a contingent compensation formula turn on the formula itself – not the amount paid in any particular year.<sup>546</sup> The reasonableness of a formula depends, in part, on whether the formula would allow an independent investor a reasonable return on equity.<sup>547</sup> A formula that pays all of the profits out as a year-end bonus would result in a very small return on equity, which an independent investor would not accept. However, as in *Elliotts*, a formula that allows a 20% return on equity is likely reasonable.<sup>548</sup>

Return on equity is commonly understood as the measure of a corporation’s profitability that measures how much profit a corporation generates with the money the shareholders have invested. Generally, return on equity is calculated by dividing the corporation’s net profit by its shareholders’ average equity for the year at issue.<sup>549</sup> Courts have consistently resisted taxpayer efforts to calculate return on equity based on the present value of the shareholder’s initial

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<sup>542</sup> *Id.* at 83-5981 (citations omitted).

<sup>543</sup> *Id.*

<sup>544</sup> *Id.* at 83-5981 n.5.

<sup>545</sup> *Id.* at 83-5982.

<sup>546</sup> *Id.*

<sup>547</sup> *Id.*

<sup>548</sup> *See id.*

<sup>549</sup> *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo. 2005-114.

investment.<sup>550</sup> Instead, the Ninth Circuit calculates return on equity by dividing the taxpayer's net income for a year by: (1) its equity at the beginning of the year;<sup>551</sup> (2) its equity at the end of the year;<sup>552</sup> or (3) the year's average equity.<sup>553</sup> In addition, some courts have considered the cumulative average return on equity.<sup>554</sup> This consideration, however, is generally not as significant as the return on equity for the tax year at issue.<sup>555</sup>

An adequate return on equity, depending on the fact and circumstances, can range from 10% or greater to 20% or greater.<sup>556</sup> In *Elliotts*, the Ninth Circuit concluded that a hypothetical independent investor would be satisfied by a 20% or greater return on equity. In contrast, the Tax Court concluded in *Aries Communications* that an independent investor would be willing to accept a 10% return on equity where a highly-leveraged taxpayer possessed assets likely to appreciate.

**PRACTICE TIP:** As shown above, the Ninth Circuit invokes the independent investor test in the context of several other criteria. Accordingly, advisors must determine their clients' return on equity for the years at issue at the outset of any excessive compensation examination.

The *Elliotts* criteria provide advisors with a solid set of rules and guidelines for establishing a compensation plan for clients. While there are countless different methods of establishing compensation levels for shareholder employees, the advisor's primary duty is to help the client:

- design a plan based on relevant, objective benchmarks rather than merely distributing pre-tax company earnings to shareholder employees;
- include (if possible) non-shareholder employees in the plan;
- document the plan's existence and criteria accurately and thoroughly; and
- strive to develop the compensation plan so that it satisfies the independent investor test whenever possible.

An advisor who accomplishes these four goals will do much of the work necessary to defeat an IRS compensation attack even before the audit occurs.

The Second Circuit applies the five *Elliotts* factors when considering whether compensation is reasonable, but it applies a unique twist. The crucial difference is, in the Second Circuit, the

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<sup>550</sup> See *Ebrel's Claim Service v. Commissioner*, T.C. Memo. 1999-221; *B & D Foundations, Inc. v. Commissioner*, T.C. Memo. 2001-262.

<sup>551</sup> *Alpha Medical, Inc. v. Commissioner*, T.C. Memo. 1997-464.

<sup>552</sup> *Labelgraphics, Inc. v. Commissioner*, T.C. Memo. 1998-343, *aff'd*, 86 AFTR2d 2000-5541, 221 F.3d 1091 (9th Cir. 2000).

<sup>553</sup> *Dexsil Corp. v. Commissioner*, 81 AFTR2d 98-2312, 98-2314, 147 F.3d 96 (2nd Cir. 1998).

<sup>554</sup> *Labelgraphics, Inc. v. Commissioner*, 86 AFTR2d 2000-5541, 2000-5548, 221 F.3d 1091 (9th Cir. 2000).

<sup>555</sup> *B & D Foundations, Inc. v. Commissioner*, T.C. Memo. 2001-262.

<sup>556</sup> *Thousand Oaks Residential Care Home I, Inc. v. Commissioner*, T.C. Memo. 2005-114.

independent investor test is not a separate factor. In *RAPCO, Inc. v. Commissioner*,<sup>557</sup> where the court adopted the five *Elliotts* factors, the court explained “the court should assess the entire tableau from the perspective of an independent investor – that is, given the dividends and return on equity enjoyed by a disinterested stockholder, would that stockholder approve the compensation paid to the employee?”<sup>558</sup> In *Dexsil Corp. v. Commissioner*, the court emphasized it specifically adheres to this requirement, explaining that “the independent investor test is not a separate autonomous factor; rather, it provides a lens through which the entire analysis should be viewed.”<sup>559</sup> In that case, the court vacated and remanded the opinion below because “the Tax Court made no mention of either the independent investor test or the specific considerations that courts have held to comprise the independent investor inquiry.”<sup>560</sup>

The first factor focuses on the employee’s role in the company. When considering the employee’s role in the company, a court, from the perspective of an independent investor, looks to whether compensation paid to an employee is justified by the employee’s position, hours worked, and duties performed, plus any special duties or role (such as personally guaranteeing corporate loans).<sup>561</sup>

It is a significant consideration that an employee performs multiple roles in a company when conducting a comparison to similar companies. In *Dexsil Corp.*, the Second Circuit explained, “multiple roles are relevant in conducting a meaningful comparison to similar companies. After all, the inquiry at hand is whether the compensation paid was reasonable in light of the services performed.”<sup>562</sup>

The relationship between an employee’s salary and the employee’s duties are particularly relevant. A red flag is raised when an employee’s salary is increased in the same year his responsibilities are decreased. For example, in *Normandie Metal Fabricators*, a case appealable to the Second Circuit, the Tax Court noted an independent investor would object to an increase in an employee’s salary in a year in which that employee’s day-to-day responsibilities were shifted to another employee.<sup>563</sup> In *Normandie*, the majority shareholder had shifted his day-to-day responsibilities to his son, but increased his salary from 8% of gross sales to 10% of gross sales. The taxpayer argued the increase in salary was catch-up compensation for prior under-compensation. However, no prior documentation existed that memorialized any under-compensation had occurred and no current corporate records existed that indicated the company intended the compensation increase to include a catch-up component. Accordingly, the Tax Court held that compensation does not qualify as catch-up compensation if contemporaneous corporate records do not show the taxpayer intended the compensation to be for past services.

**PRACTICE TIP:** When advising closely held C corporations, advisors should recommend having the company contemporaneously document in the corporate minutes the purpose for a

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<sup>557</sup> 77 AFTR2d 96-2405, 85 F.3d 950 (2d Cir. 1996).

<sup>558</sup> *Dexsil Corp. v. Commissioner*, 81 AFTR2d 98-2312, 98-2317, 147 F.3d 96 (2d Cir. 1998).

<sup>559</sup> *Id.*

<sup>560</sup> *Id.*

<sup>561</sup> *RAPCO*, 77 AFTR2d at 96-2409.

<sup>562</sup> *Dexsil Corp.*, 81 AFTR2d at 98-2317.

<sup>563</sup> *Normandie Metal Fabricators, Inc. v. Commissioner*, T.C. Memo. 2000-102, *aff’d*, 87 AFTR2d 2001-2485 (2d Cir. 2001).

change in salary or a compensation formula. The reasons should satisfy an independent investor. This is particularly important during family succession periods where a child assumes the responsibilities of the parent. Also, to rely on the *Ox Fibre* catch-up compensation rationale, the closely held corporation should document the catch-up amount, and the years of and reasons for under-compensation.

Under the external consistency factor, the court will compare employee compensation to the compensation paid to persons holding comparable positions in similar companies.<sup>564</sup> As explained above, this factor generally comes down to a battle of the experts, particularly in closely held corporations. However, because of the lack of available data in the closely held corporation world, this factor is often disregarded.<sup>565</sup>

The character and condition of the company—based on its sales, net income, capital value, and general economic fitness—is particularly important in determining officer compensation.<sup>566</sup> This factor looks to whether the condition of the company would give an investor doubts about the performance of company management. For example, in *Normandie Metal Fabricators*,<sup>567</sup> the Tax Court pointed out that, despite a significant increase in sales, the company's retained earnings dropped each year at issue, as did its net income before taxes. Accordingly, the Tax Court concluded an independent investor would have doubts about the company management's performance.

A conflict of interest is indicated where a company has the ability to disguise dividends as salary, particularly where the compensated employee is the majority shareholder, or if a large percentage of the compensation is paid as a bonus.<sup>568</sup> An independent investor would most likely not be satisfied with the return on equity where it appears employees are siphoning off company profits disguised as salary.<sup>569</sup>

A conflict exists where the majority shareholder sets his or her own salary.<sup>570</sup> In addition, where the majority shareholder sets the salary of a family member, the Second Circuit will closely scrutinize the compensation payments.<sup>571</sup> For example, in *Normandie Metal Fabricators*, the Tax Court found a conflict of interest between a company and the sole-shareholder's son where the son's "impressive salary in 1993 and 1994 despite [the company's] unimpressive performance suggests that his compensation did not result from arm's-length negotiations and was not handled as an independent investor would have handled it."

In addition, the Tax Court has noted that a conflict of interest between a company and its sole shareholder is indicated where large year-end bonuses result in a company paying out most of its taxable income as compensation to its officers.<sup>572</sup> In that situation, an independent investor would not be satisfied because large bonus payments made in the last week of the year indicate

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<sup>564</sup> See *RAPCO*, 77 AFTR2d at 96-2409.

<sup>565</sup> See *Wechsler & Co., Inc. v. Commissioner*, T.C. Memo. 2006-173 (appealable to the Second Circuit).

<sup>566</sup> See *RAPCO*, 77 AFTR2d at 96-2409.

<sup>567</sup> *Normandie Metal Fabricators*, T.C. Memo. 2000-102.

<sup>568</sup> See *RAPCO*, 77 AFTR2d at 96-2409.

<sup>569</sup> *Normandie Metal Fabricators*, T.C. Memo. 2000-102.

<sup>570</sup> *Id.*

<sup>571</sup> *Id.* (citing *Seven Canal Place Corp. v. Commissioner*, 13 AFTR2d 1568, 332 F.2d 899 (2d Cir. 1964)).

<sup>572</sup> *Id.*

profits were “siphoned out of the company disguised as salary.”<sup>573</sup> Timing and characteristics of a bonus plan are closely scrutinized under this factor as well as the internal consistency factor (discussed below).

The Second Circuit has explained a company’s inconsistent compensation system suggests employee compensation may not reasonable.<sup>574</sup> The Second Circuit follows the Ninth Circuit on this issue and generally looks to a company’s bonus plan (or lack thereof) and how shareholder employees are treated in comparison to other employees.<sup>575</sup>

For example, in *Normandie Metal Fabricators*,<sup>576</sup> a case appealable to the Second Circuit, the Tax Court used market rates as a benchmark in determining whether the company was internally consistent with its compensation policy. In that case, the taxpayer paid its majority-shareholder, his son and another key employee above market compensation. However, the Tax Court found other employees were not paid at or above market rates. The Tax Court also noted that, although the taxpayer paid its majority shareholder and his son large bonuses at the end of the year, the company did not have a bonus plan in place and did not pay bonuses to other employees. Accordingly, the Tax Court concluded the internal consistency factor indicated compensation paid to the shareholder and his son was unreasonable in amount.

The internal consistency factor appears to be one of the most significant factors applied by the Second Circuit in its analysis of compensation disputes. In *Dexsil Corp. v. Commissioner*, the Second Circuit remanded the case to the Tax Court to specifically consider the taxpayer’s argument that it had adopted a consistent contingent compensation formula of approximately 11% of gross sales. The Tax Court had relied on its finding that, with respect to bonuses paid to non-shareholder employees, there was no evidence of a set bonus formula. The Second Circuit Court explained that the determination of whether a bonus plan was consistently applied to non-shareholder employees was “separate from whether a contingent compensation formula used to determine a shareholder-officer’s compensation was reasonable.” Accordingly, the court remanded the case to the Tax Court with instructions to consider whether a contingent compensation formula existed with respect to the shareholder employee, whether the formula was reasonable, and whether the formula was consistently applied. Unsurprisingly, on remand, the Tax Court found the testimony about the bonus plan unreliable and concluded the contingent compensation formula had not existed.<sup>577</sup>

In the Second Circuit, the independent investor test is not a separate factor.<sup>578</sup> Instead, it provides a lens through which the entire reasonable compensation analysis is viewed.<sup>579</sup> Thus, if the company’s earnings on equity, when viewed in relation to such factors as the company’s overall performance and levels of compensation, “remain at a level that would satisfy an

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<sup>573</sup> *Id.* (citing *Dexsil Corp. v. Commissioner*, 81 AFTR2d 98-2312, 98-2317, 147 F.3d 96 (2nd Cir. 1998)).

<sup>574</sup> See *RAPCO*, 77 AFTR2d at 96-2409.

<sup>575</sup> See *Normandie Metal Fabricators*, T.C. Memo. 2000-102.

<sup>576</sup> *Id.*

<sup>577</sup> *Dexsil Corp. v. Commissioner*, T.C. Memo. 1999-155.

<sup>578</sup> See *RAPCO*, 77 AFTR2d at 96-2409 to 10.

<sup>579</sup> *Id.*

independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary.”<sup>580</sup>

**[ii] IRS Factors.**

The old Internal Revenue Service Manual recommends examiners consider several criteria when considering whether the amount of compensation is reasonable under all of the circumstances. Those factors include the following:

- nature of employee duties;
- employee’s background and experience;
- employee’s knowledge of the business;
- employee’s contribution to profit;
- employee’s time devoted to the business;
- the general and local economic conditions;
- the character and amount of the employee’s responsibility;
- the time of the year when compensation is determined;
- the relationship of employee compensation to shareholdings;
- whether the employee’s compensation is, in fact, payment for assets; and
- amount paid by similar size businesses in the same area to equally qualified employees for similar services.

As illustrated above, the IRS factors are restatements of the criteria used by the circuits in determining whether compensation is reasonable in amount. When compared to the *Elliotts* test:

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<sup>580</sup> *Dexsil Corp.*, 81 AFTR2d at 98-2316.

<u><i>Elliotts Test</i></u>	<u><i>Analogous Factor from IRS Manual</i></u>
1. Role in company.	Nature of employee's duties; employee's background and experience; employee's knowledge of business; employee's contribution to profit-making; time devoted by employee; and character and amount of employee's responsibility.
2. External comparison.	Amount paid by similar size businesses in the same area to equally qualified employees for similar services.
3. Character and condition of company.	Size of business; and economic conditions in general and locally.
4. Conflict of interest.	Whether alleged compensation is in reality, in whole or in part, payment for a business or assets acquired.
5. Internal consistency.	Time of year compensation is determined.

When compared to the *Mayson* factors:

<u><i>Mayson Factors</i></u>	<u><i>Analogous Factor from IRS Manual</i></u>
1. Employee qualifications.	Employee's background and experience; employee's knowledge of business.
2. Nature, extent, and scope of the employee's work.	Nature of employee's duties; Time devoted by employee; and character and amount of employee's responsibility.
3. Size and complexity of the employer's business.	Size of business.
4. Employee compensation as compared with the employer's gross and net income.	Employee's contribution to profit-making.
5. Prevailing general economic conditions.	Economic conditions in general and locally.

6.	Employee compensation and stockholder distributions.	The relationship of employee compensation to shareholdings.
7.	Compensation paid by comparable businesses for comparable positions.	Amount paid by similar size businesses in the same area to equally qualified employees for similar services.
8.	Employer’s salary policy for all employees.	Time of year compensation is determined.
9.	Prior employee compensation.	Whether alleged compensation is in reality, in whole or in part, payment for a business or assets acquired.

Due to the fact that the factors listed in the Internal Revenue Service Manual are essentially restatements of the *Mayson* and *Elliotts* factors, the analysis discussed above to apply each of the Ninth Circuit’s criteria should likewise be applied to the IRS’s factors.

The Seventh Circuit is unique in that it applies the independent investor test (also known as the hypothetical investor test) as the only criterion in determining the amount of reasonable compensation. In *Exacto Spring Corp. v. Commissioner*,<sup>581</sup> the court reviewed the various multi-factor tests utilized by the other circuits and rejected them for being too vague and too difficult to apply. In *Menard, Inc. v. Commissioner*<sup>582</sup> the court further explained its reason for departing from the multi-factor tests applied by other circuits:

Multifactor tests with no weight assigned to any factor are bad enough from the standpoint of providing an objective basis for a judicial decision . . . multifactor tests when none of the factors is concrete are worse, and that is the character of most of the multifactor tests of excessive compensation. They include such semantic vapors as “the type and extent of the services rendered,” “the scarcity of qualified employees,” “the qualifications ... of the employee,” his “contributions to the business venture,” and “the peculiar characteristics of the employer’s business.”

The independent investor test establishes a rebuttable presumption that a shareholder employee’s salary is reasonable if a hypothetical independent investor would obtain a “far higher return than they had any reason to expect.”<sup>583</sup> The independent investor test is based on the policy rationale that investors pay compensation to incentivize managers to increase the value of the managed assets.<sup>584</sup> A high return on equity indicates the manager provided valuable services to the company, which an independent investor would appreciate.<sup>585</sup> Thus, a court will generally

<sup>581</sup> *Exacto Spring Corporation v. Commissioner*, 84 AFTR2d 99-6977, 196 F.3d 833 (7th Cir. 1999), *rev’g*, T.C. Memo. 1998- 220.

<sup>582</sup> 103 AFTR2d 2009-1280, 2009-1282 (7th Cir. 2009) (internal citations omitted).

<sup>583</sup> *Exacto Spring*, 84 AFTR2d at 99-6982.

<sup>584</sup> *Id.* at 99-6981 to 82.

<sup>585</sup> *Id.*

presume a manager’s compensation is reasonable if a high return on equity allows hypothetical investors to obtain returns greater than what they would reasonably expect.<sup>586</sup>

The presumption is rebutted, however, if the high rate of return is not attributable to the manager’s efforts.<sup>587</sup> The presumption is easily rebutted where the shareholder employee performs no actual services for the corporation.<sup>588</sup> Other circumstances that can rebut the presumption include a conflict of interest and a comparison of the shareholder employee’s compensation and the compensation of other company executives.<sup>589</sup>

In *Exacto Spring*,<sup>590</sup> Judge Posner discarded the multi-factor test in favor of a single factor independent investor test. Exacto Spring Corporation (“Exacto”) is a closely held corporation that manufactures precision springs.<sup>591</sup> Exacto’s majority shareholder, William Heitz, who is also its cofounder and chief executive, was paid \$1.3 million in 1993 and \$1 million in 1994.<sup>592</sup> The Service denied Exacto’s compensation deduction, allowing a compensation deduction of only \$381,000 in 1993 or \$400,000 in 1994.<sup>593</sup> Exacto challenged the Service’s assessment in Tax Court. The Tax Court, after applying a seven factor test, concluded Heitz’s maximum reasonable compensation should have been \$900,000 in 1993 and \$700,000 in 1994.<sup>594</sup> Exacto appealed to the Seventh Circuit Court of Appeals.<sup>595</sup>

On appeal, Judge Posner rejected the multi-factor test for the following reasons:

- First, the multi-factor test is “like many other multi-factor tests, ‘redundant, incomplete, and unclear.’”<sup>596</sup> He criticized the test for not indicating how the factors are to be weighed in comparison to each other (such as when some factors support the Service and some support the taxpayer).
- Second, many of the factors—such as “the peculiar characteristics of the employer’s business”—are vague. The factors do not clearly relate to each other or the purpose of Section 162(a)(1)—which is to prevent nondeductible distributions from being disguised as compensation payments.<sup>597</sup>
- Third, the multi-factor test “invites the Tax Court to set itself up as a super-personnel department for closely held corporations, a role unsuitable for

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<sup>586</sup> *Id.*

<sup>587</sup> *Id.* at 99-6982; see also *Menard*, 103 AFTR2d 2009-1280, 560 F.3d 620 (7th Cir. 2009), *rev’g* T.C. Memo. 2004-207 (giving examples).

<sup>588</sup> *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 109 AFTR2d 2012-2140, 680 F.3d 867 (7th Cir. 2012).

<sup>589</sup> *Id.*

<sup>590</sup> 196 F.3d 833, 84 AFTR2d 99-6977 (1999).

<sup>591</sup> *Id.* at 99-6977.

<sup>592</sup> *Id.*

<sup>593</sup> *Id.*

<sup>594</sup> *Id.*

<sup>595</sup> *Id.*

<sup>596</sup> *Id.* at 99-6978.

<sup>597</sup> *Id.*

courts.” No judges are equipped to determine the salaries of corporate officers.<sup>598</sup>

- Fourth, due to the test’s nondirective character, it results in arbitrary decisions based on “unanalyzed discretion or unprincipled rules of thumb.”<sup>599</sup>
- Fifth, the test is unpredictable and imposes risk on a corporation’s compensation decisions, which may be indispensable to the businesses success.<sup>600</sup>

Judge Posner criticized the Tax Court’s opinion, explaining that, despite all the factors either being neutral or in the taxpayer’s favor, the Tax Court concluded the compensation unreasonably high:

Having run through the seven factors, all of which either favored the taxpayer or were neutral, the court reached a stunning conclusion: “We have considered the factors relevant in deciding reasonable compensation for Mr. Heitz. On the basis of all the evidence, we hold that reasonable compensation for Mr. Heitz” was much less than Exacto paid him.

The failure of the Tax Court’s reasoning to support its result would alone require a remand. But the problem with the court’s opinion goes deeper. The test it applied does not provide adequate guidance to a rational decision.<sup>601</sup>

Accordingly, the court abandoned the multi-factor test and adopted the independent investor test. Under the independent investor test, there is a rebuttable presumption a shareholder employee’s salary is reasonable if a hypothetical independent investor would obtain a “far higher return than they had any reason to expect.”<sup>602</sup> The presumption can be rebutted however, if it can be shown the return was not due to the employee’s efforts.<sup>603</sup>

Judge Posner found that Exacto was entitled to the presumption because it obtained a 20% return on equity, more than 50% greater than the 13% return an independent investor would have expected. In addition, the Service failed to rebut the presumption, because there was no indication the return was not due to Heitz’s efforts. Accordingly, the court concluded Heitz’s compensation was reasonable in amount and reversed the Tax Court.<sup>604</sup> In *Menard, Inc. v. Commissioner*,<sup>605</sup> Judge Posner again reversed the Tax Court, holding the taxpayer’s compensation payments to its majority shareholder were reasonable in amount where the corporation obtained an 18% return on equity. Menard, Inc. sold hardware and building supplies

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<sup>598</sup> *Id.*

<sup>599</sup> *Id.* at 99-6978 to 79.

<sup>600</sup> *Id.* at 99-6979.

<sup>601</sup> *Id.* at 99-6980 to 81.

<sup>602</sup> *Id.* at 99-6982.

<sup>603</sup> *Id.*

<sup>604</sup> *Id.*

<sup>605</sup> 103 AFTR2d 2009-1280, 560 F.3d 620 (7th Cir. 2009).

under the name “Menards” through its 138 Midwest retail stores. It was the third largest home improvement chain, behind Home Depot and Lowe’s.

John Menard founded Menards in 1962 and was the chief executive officer through the tax period at issue—1998. He owned 100% of the corporation’s voting shares and 56% of its nonvoting shares. Mr. Menard’s family members owned the remaining nonvoting shares. The record reflected the following evidence:

- Hours Worked. Mr. Menard worked six or seven days a week, twelve to sixteen hours per day. He took only seven vacation days a year, and he worked even while spending time with his family.
- Company Involvement. Mr. Menard was involved “in every detail of his company’s operations.” For example, he fixed all employee compensation.
- Company Growth. Under Mr. Menard’s direction, company revenue grew by over \$3 billion dollars from 1991 to 1998. Specifically, during that time revenue grew from \$788 million to \$3.8 billion and taxable income grew from \$59 million to \$315 million.
- Return on Equity. According to the Service’s expert, the company’s 1998 return on equity was 18.8%—which was higher than either Lowe’s or Home Depot.
- Compensation. Mr. Menard’s 1998 compensation was comprised of three components. The first portion was his relatively low base salary of \$157,000. The second portion was his \$3 million profit-sharing bonus (all Menards’ executives participated in the profit sharing bonus program). The largest portion of his 1998 compensation package was his “5% bonus” of \$17,467,800.
- 5% Bonus Program. The corporation’s board of directors adopted the 5% bonus program in 1973 at the prompting of the company’s accounting firm. Under the 5% bonus program, Mr. Menard was paid a bonus equal to 5% of net profits before taxes. The plan also called for Mr. Menard to reimburse the company if the Service or state taxing authorities disallowed his compensation deduction for being a disguised dividend.

The Tax Court found the taxpayer established the presumption of reasonableness with respect to the 5% bonus. However, it concluded the presumption was rebutted by evidence comparable firms paid their CEOs much less than Mr. Menard was paid. Home Depot’s CEO was paid \$2.8 million in 1998, and Lowe’s CEO was paid \$6.1 million.

Judge Posner disagreed with the Tax Court. He first explained a meaningful comparison looks at more than just salary; it also looks at compensation risk. For example, had taxpayer lost money in 1998, Mr. Menard’s salary would have been limited to his base salary of \$157,500. Thus, it is improper to focus on the amount of salary without context: “The 5 percent bonus plan was in

effect for a quarter of a century before the IRS pounced; was it just waiting for Menard to have such a great year that the IRS would have a great-looking case?”<sup>606</sup>

Next, Judge Posner criticized the Service and the Tax Court for making a salary comparison without taking into account the other CEOs’ compensation packages:

Just two years after Mr. Menard received his questioned \$20 million, Robert Nardelli became CEO of Home Depot. In his slightly more than six years in that post he was paid \$124 million in salary, exclusive of stock options; and when fired in 2007 (he was unpopular, and during his tenure the market capitalization of Home Depot increased negligibly-only to jump when his firing was announced), he received a much-criticized severance payment of \$210 million (including the value of his stock options). He went on to become the CEO of Chrysler, where he is being paid \$1 a year, thought by some observers to be generous. We wonder whether the IRS plans to challenge Menard’s compensation for the years 2001 to 2006, using Nardelli’s compensation package as a basis for comparison.<sup>607</sup>

Judge Posner also was not impressed with the Tax Court’s “arbitrary” method of determining Mr. Menard’s maximum reasonable compensation. The Tax Court ruled \$7.1 million was reasonable through a complicated mathematical comparison with Home Depot’s rate of return and CEO salary, and Lowe’s CEO salary. The method did not consider, among other things, the full compensation packages of the Home Depot and Lowe’s CEOs. Further, it did not even consider Lowe’s rate of return.

In addition, the Tax Court also reasoned the 5% bonus was intended as a dividend, based on Mr. Menard’s reimbursement obligation. In response, the Judge Posner cited the Fifth Circuit:

This argument, however, misses the economic realities of the corporate form as taxed under the internal revenue code. For compensation purposes, the shareholder-employee should be treated like all other employees. If an incentive bonus would be appropriate for a nonshareholder-employee, there is no reason why a shareholder-employee should not be allowed to participate in the same manner. In essence, the shareholder-employee is treated as two distinct individuals for tax purposes: an independent investor and an employee.<sup>608</sup>

Accordingly, Judge Posner concluded the Tax Court improperly disallowed the taxpayer’s compensation deduction.

*Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*,<sup>609</sup> discussed in more detail below, is the Seventh Circuit’s discussion of the independent investor test. In that case, the Seventh Circuit affirmed the Tax Court’s denial of a professional corporation’s deduction for “consulting fee”

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<sup>606</sup> *Id.* at 2009-1284.

<sup>607</sup> *Id.* at 2009-1284 to 85.

<sup>608</sup> *Id.* at 2009-1285 (citing *Owensby & Kritikos, Inc. v. Commissioner*, 60 AFTR2d 87-5224, 819 F.2d 1315 (5th Cir. 1987)).

<sup>609</sup> 680 F.3d 867, 109 AFTR2d 2012-2140 (7th Cir. 2012).

payments to three related entities, because the payments failed both the intent and amount tests. Those entities were solely owned by the taxpayer’s majority shareholders.

Judge Posner explained that the independent investor test is premised on the concept that a non-employee shareholder will not begrudge a shareholder employee his or her high salary if the return on equity is sufficient. With respect to small personal service corporations, however, this premise does not hold up because such firm’s operate with a “pane of glass” between billings and salaries. In *Mulcahy*, however, the taxpayer did not operate with a mere “pane of glass” between billings and salaries because it had sufficient capital to support 40 employees in multiple offices. Therefore, the court applied the independent investor test, concluding the taxpayer’s return on equity did not justify the payments:

The Tax Court was correct to reject the firm’s argument that the consulting fees were salary expenses. Treating them as salary reduced the firm’s income, and thus the return to the equity investors, to zero or below in two of the three tax years at issue, even though, judging by the salaries received by the founding shareholders, the firm was doing fine. So, the firm flunked the independent-investor test.<sup>610</sup>

Accordingly, the Seventh Circuit affirmed the Tax Court.

**[g] Case Law Historical Overview.**

**[i] Lucas v. Ox Fibre Brush Co.<sup>611</sup>**

**Reasonable compensation can include amounts paid for services performed in prior years**

*Ox Fibre* is an early example of the Service applying the “reasonable allowance” qualifying phrase as a limitation on—not an expansion of—the deduction for ordinary and necessary business expenses. In *Ox Fibre*, the U.S. Supreme Court held compensation paid in one year to compensate employees for work performed in an earlier year was reasonable in amount. In 1920, the Ox Fibre Brush Company paid \$24,000 of extra compensation to both its president and its treasurer to compensate them for services performed in prior years. It was agreed the additional compensation was for services performed in prior years and that the payments were reasonable for such services. The issue on audit was whether payments for services performed in prior years are properly deductible in the year actually paid.

The Service disallowed the deduction, asserting compensation paid for services performed in prior years was not deductible in the year paid. The Board of Tax Appeals agreed, holding additional compensation paid for services performed in prior years is not reasonable in amount and therefore not deductible. The Fourth Circuit reversed the Board, holding the compensation was paid for past services, was reasonable in amount, and was deductible. The Service appealed.

The sole issue before the Supreme Court was whether payments for past services were properly deductible in 1920, the year actually paid. The Supreme Court pointed out the Ox Fibre Brush

<sup>610</sup> *Id.* at 2012-2143.

<sup>611</sup> 281 U.S. 115, 119 (1930).

Company was leading the brush trade and its 1920 net income, after deducting all expenses including salaries, represented a 21.13% return on equity. The Supreme Court reasoned Section 234(a) did not require the services be actually rendered during the taxable year, rather that payments for services be proper expenses paid or incurred during the taxable year.

**[ii] E. Wagner & Son v. Commissioner.**<sup>612</sup>

**External consistency**

*E. Wagner & Son* is an early case applying the external comparison factor. The taxpayer's two equal shareholders, a father and son, decided in 1929 they should each receive an annual salary of \$10,000 for that year and for years going forward. In September 1929, they issued themselves a \$3,000 bonus. The taxpayer then claimed a \$26,000 deduction for officer compensation on its 1929 income tax return. The Service disallowed \$20,000 of the deduction, and the taxpayer petitioned the Board of Tax Appeals. The Board concluded a reasonable allowance for salaries was \$4,000 to the father and \$10,000 to the son. The taxpayer then appealed the Ninth Circuit Court of Appeals.

On appeal, the taxpayer argued that the Board erred in disregarding the son's testimony that the \$13,000 of total compensation paid to each of the shareholders was reasonable. The court rejected this argument, pointing out the taxpayer had not introduced any evidence showing the salaries paid by other businesses in similar circumstances. Accordingly, the Ninth Circuit affirmed the Board's decision.

**[iii] Hoffman Radio Corp. v. Commissioner.**<sup>613</sup>

**Success was primarily due to general economic conditions – not shareholder-officer efforts**

In *Hoffman Radio Corp.*, the Ninth Circuit partially disallowed a deduction for compensation paid to the taxpayer's president, its majority shareholder. When the president acquired the corporation's stock in 1941 (and was hired), the taxpayer was in a poor condition—its plant and equipment were obsolete and its financial condition was poor. That year, the corporation and the president entered into a 3-year employment contract that provided for a fixed salary, plus contingent compensation equal to 3% of the monthly gross sales. The corporation's conditions improved drastically due to World War II, and in 1943 the president earned around \$63,000. After the Tax Court limited the taxpayer's deduction for compensation to \$40,000, the taxpayer appealed to the Ninth Circuit Court of Appeals.

On appeal, the Ninth Circuit agreed that the employment contract was reasonable when made, considering the taxpayer's poor condition. However, the court ultimately agreed with the Tax Court that the compensation paid in 1943 was unreasonable, despite language in the Regulations that “[t]he circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.” The court rationalized its departure from the Regulations based on the fact that “the unusually large amount of business done that year was attributable in the main, not to services rendered by

<sup>612</sup> 20 AFTR 593, 93 F.2d 816 (9th Cir. 1937).

<sup>613</sup> 38 AFTR 775, 177 F.2d 264 (9th Cir. 1949).

Hoffman, but to war conditions making for abnormal earnings.” The court then explained that the allowed deduction compared favorable to salaries from “kindred industrial concerns.” Accordingly, the Ninth Circuit affirmed the Tax Court.

**[iv] Builder’s Steel Co. v. Commissioner.**<sup>614</sup>

**External consistency trumps internal consistency**

In *Builder’s Steel*, the Eighth Circuit considered whether salaries and year-end bonuses paid by the taxpayer to its president, vice-president, secretary-treasurer and one other employee (all of whom were shareholders) for services rendered were unreasonable in amount. The court considered it significant that the four employees were very efficient and industrious, and that the bonuses paid to these four employees were not in proportion to their stock holdings (the sixth *Mayson* factor). Nevertheless, the court held the total compensation paid to these shareholders employers was unreasonable in amount. The court based its decision on a comparison of seven similarly situated companies and the compensation such companies paid for similar services (the seventh *Mayson* factor), finding the salaries paid by the taxpayer were “far in excess” of those paid by the comparable companies.

**[v] Golden Construction Co. v. Commissioner.**<sup>615</sup>

**The Tenth Circuit adopts the *Mayson* factors**

**The key factor was compensation paid for comparable positions**

In *Golden Construction*, the Tax Court, in a case affirmed by the Tenth Circuit, applied the *Mayson* multi-factor test to determine whether the salary paid to the taxpayer’s president in 1950 was reasonable. The taxpayer constructed residential houses for sale. Mr. Golden was the president, sole executive, and majority shareholder of the taxpayer. The taxpayer had not paid any dividends since incorporation, despite having significant net income. Mr. Golden fixed his own salary, usually as a percentage of profits. For 1947 through 1949, Mr. Golden fixed his salary at 40% of profits (computed on an accrual basis). But in 1950, he increased his salary to 60% of profits (computed on an accrual basis), which resulted in a salary of \$44,438. The Service concluded \$20,000 was reasonable in amount, and disallowed \$24,438.

The Tax Court agreed the amount paid in 1950 was unreasonable. It concluded, however, \$31,000 was a reasonable amount. The court considered the following *Mayson* factors: the employee’s qualifications; the extent and scope of his work; prevailing rates of compensation for comparable positions in comparable concerns; size and complexity of the business; ratio of salaries to gross income and net income; salaries paid in prior years; and comparison of salaries with distributions to stockholders. In concluding that \$31,000 (or 40% of income) was a reasonable amount, the Tax Court placed the most emphasis on the rates of compensation for comparable positions.

<sup>614</sup> 42 AFTR 23, 197 F.2d 263 (8th Cir. 1952).

<sup>615</sup> T.C. Memo. 1954-221, *aff’d*, 228 F.2d 637 (10th Cir. 1955).

[vi] **Harolds Club v. Commissioner.**<sup>616</sup>**A conflict of interest can trump a clearly established and followed contingent compensation plan**

In *Harolds Club*, the Ninth Circuit denied the taxpayer's deduction for a portion of compensation payments made to its general manager, Raymond Smith, who was also the father of the two shareholders. The taxpayer operated a legal gambling organization in Nevada. Smith became the general manager in 1941, when the taxpayer was not financially sound. His employment contract provided for a set salary, plus 20% of net profits. Under Smith's direction, the taxpayer prospered, becoming one of the largest gaming organizations in Nevada. From 1952 to 1956, the taxpayer paid Smith compensation ranging from around \$350,000 to around \$550,000.

The Service disallowed the portion of the taxpayer's compensation deductions that exceeded \$100,000 for tax years 1952 to 1956. The taxpayer petitioned the Tax Court. The court allowed deductions for each tax year at issue equal to \$10,000 plus 15% of net income—a significant increase from the Service's position. The Tax Court's decision was based in part on testimony of the taxpayer's competitors that the amount paid to Smith was reasonable and that he was worth every penny of what he was paid. The taxpayer appealed to the Ninth Circuit Court of Appeals.

On appeal, the taxpayer asserted the entire amount paid to Smith was reasonable because it was contingent compensation paid pursuant to a "free bargain." It based its argument on Treasury Regulation 111, § 29.23(a)-6 and Treasury Regulation 118, § 39.23(a)(6) for the years 1952 and 1953, and Treasury Regulations § 1.162-7(b) for the remaining years. Regulation § 1.162-7(b)(2), which is substantially the same as the earlier regulations, provides in part:

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

Accordingly, the taxpayer asserted that Smith's exceptionally high salary was reasonable because it was contingent compensation paid pursuant to a "free bargain." The Ninth Circuit disagreed, reasoning that the record showed the general manager "dominated" his sons, notwithstanding the fact the sons were competent adults. The court ruled that, where such domination exists, there can be no "free bargain" even between competent adults. Accordingly, the Ninth Circuit affirmed the Tax Court.

This case illustrates that even where there is a clearly established and followed contingent compensation agreement, a conflict of interest can override the analysis and result in a finding of unreasonably high compensation.

<sup>616</sup> 15 AFTR2d 241, 340 F.2d 861 (9th Cir. 1965).

[vii] **Pacific Grains, Inc. v. Commissioner.**<sup>617</sup>

**Another attempt to strip profits through a bogus bonus system**

In *Pacific Grains*, the Ninth Circuit disallowed a deduction for compensation paid to the company’s sole shareholder who was also its president, treasurer, and in charge of grass seed trading. The shareholder was paid a \$25,200 salary, and a bonus of approximately \$16,000 for 1963 and \$30,000 for 1964. The bonuses were authorized by the shareholder and his wife.

The taxpayer first argued the rate of return on equity enjoyed by the company justified the high salaries. The court rejected this precursor to the independent investor test by pointing to the company’s failure to pay dividends. (Note that more recent opinions have held that dividends are not necessary, an independent investor could be satisfied with the appreciation in stock value due to retained earnings.) The taxpayer also argued that, under *Ox Fibre Brush Co.*, the shareholder’s early salaries were low and his current high salary operated to compensate him for prior services rendered. The court rejected this argument, pointing out the board of directors did not “ earmark the funds as being in part for prior services” and the company did not show the percentage of catch-up compensation was intended to make up for prior under-compensation.

After rejecting the taxpayer’s arguments, the court concluded the taxpayer was attempting to strip company profits through a bonus system that paid the shareholder employee a disproportionately large percentage of gross income when combined with salary. In addition, the court pointed to prior years in which the shareholder employee was paid much less while doing substantially the same work. Accordingly, the court affirmed the Tax Court.

**This case could easily have gone the other way had the taxpayer properly documented its compensation payments by: (1) establishing a consistent bonus formula; and (2) contemporaneously documenting the need for catch-up compensation in board minutes.**

[viii] **Nor-Cal Adjusters v. Commissioner.**<sup>618</sup>

**Switching from the amount test to the intent test is not a “new matter”**

A corporation’s failure to establish and document a contingent compensation formula does not mean a bonus is necessarily unreasonable, but a year-end bonus based on net profits will be subject to close scrutiny. In *Nor-Cal Adjusters*, the taxpayer was in the business of insurance adjusting. It had four shareholders who were all officers/employees. In 1967, each officer received a salary and a year-end bonus. The taxpayer had never paid dividends. The Service issued a notice of deficiency, asserting the officer compensation was unreasonable in amount under Section 162 (the Amount Test). In Tax Court, however, the Service changed its argument – it argued the bonuses were distributions of profits, not payments for services (the Intent Test). So, the payments violated the Intent Test.

On appeal to the Ninth Circuit, the taxpayer argued the Service interjected a new position into the proceeding when it asserted the deduction failed the Intent Test. Generally, the taxpayer

<sup>617</sup> 22 AFTR2d 5413, 399 F.2d 603 (9th Cir. 1968).

<sup>618</sup> 34 AFTR2d 74-5834, 503 F.2d 359 (9th Cir. 1974).

bears the burden to establish to the Tax Court its entitlement to a deduction. However, under Rule 142 of the Rules of Practice, where the Service interjects a new position, the burden shifts to the Service. The Service’s notice of deficiency appears to assert the deduction was denied because the compensation was unreasonable in amount:

“[I]t is determined that compensation paid your officers during the taxable year 1967 is excessive in the amount of \$13,000.00. Such amount exceeds a reasonable allowance for salaries or other compensation for personal services actually rendered within the ambit of Paragraph 162 of the Internal Revenue Code.”

The Ninth Circuit disagreed, concluding the Service had not interjected a new position: “While such a notice does not specifically detail the theory upon which the Commissioner intends to defend his position in disallowing the deduction, it is sufficient to inform the taxpayer that the deductions are to be disallowed and the reasons therefor.” Accordingly, the Ninth Circuit concluded the burden remained with taxpayer to establish its entitlement to the deduction.

[ix] **American Foundry v. Commissioner.**<sup>619</sup>

**Employee’s role in the company justifies compensation** In *American Foundry*, the Ninth Circuit concluded that compensation payments to the majority shareholder’s daughter, who was also a minority shareholder, were deductible by the taxpayer. The court looked primarily at the daughter’s role in the company, including the following:

- Positions held;
- Hours worked;
- Duties performed; and
- The general importance to the success of the company.

Specifically, the court pointed out that the daughter played a key role in the company, which she joined after obtaining a college degree in business administration. She served as the taxpayer’s secretary-treasurer and eventually replaced her father as general manager. After finding that there was no evidence contradicting the testimony that the daughter was a key contributor to the success of the business, the court reversed the Tax Court’s determination limiting her compensation to \$7,000.

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<sup>619</sup> 37 AFTR2d 76-1373, 536 F.2d 289 (9th Cir. 1976).

[x] **Home Interiors & Gifts, Inc. v. Commissioner.**<sup>620</sup>

**An employee’s superior qualifications, skill, experience, enthusiasm, and contribution to the taxpayer’s business may justify high compensation**

In *Home Interiors*, the only issue before the Tax Court was whether amounts paid by the taxpayer to the majority shareholder, her son, and an unrelated officer, were reasonable. The Tax Court, applying the *Mayson* factors, ultimately concluded the salary, contingent compensation and bonuses were reasonable in amount. The court noted, although the officer’s salaries were very large, their individual efforts produced extraordinary results for the company and everyone connected to it: its gross sales increased from \$4,284,456 in 1968 to \$97,583,835 in 1975. The court found that: the majority shareholder “possesses rare talent;” that her son “made immense contributions to the success of Home Interiors;” and that the other officer’s “responsibilities were more limited, but his compensation was also considerably less.”

In addition, the taxpayer regularly paid dividend distributions. Although the dividend distributions declined over the years, it resulted from a decision to retain additional earnings and not from paying excessive salaries. The court also noted that, although the shareholder and her son received high compensation, Section 162 does not necessarily deny deductions for compensation that exceeds the normal compensation paid to officers of similar companies. Finally, the court noted, where the country is experiencing inflation, the “concept of reasonable compensation must take into consideration such inflation.”

[xi] **Ray Clymer, Jr.**<sup>621</sup>

In *Clymer*, the Tax Court held compensation paid to the company’s sole shareholder and CEO was excessive. The Service argued the fact the shareholder-CEO received payments considerably higher than other employees indicates the payments were distributions of earnings. The internal consistency factor compares shareholder employee compensation and compensation paid to other unrelated non-owner employees. The court explained that, for this factor to be relevant, the services provided by the other employees must be comparable in scope to those provided by the shareholder employee. Nevertheless, the Tax Court found the company’s success (and the CEO’s corresponding increase in salary) was due largely to general economic conditions, and it denied a portion of the compensation deduction as excessive.

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<sup>620</sup> 73 T.C. 1142 (1980).

<sup>621</sup> T.C. Memo. 1984-203.

[xii] **Leonard Pipeline Contractors, Ltd. v. Commissioner.**<sup>622</sup>

**Personally guaranteeing the company's debts supports a high salary under the employee's role in the company factor**

In *Leonard Pipeline Contractors*, the Tax Court, on remand from the Ninth Circuit, applied the *Elliotts* factors to support its conclusion that the amount of compensation paid to the taxpayer's president (and sole shareholder) was unreasonably high. The court found the first factor favored the taxpayer because the president was essential to the taxpayer's success and personally guaranteed a significant debt of the taxpayer. With respect to the second factor—the external consistency—the court found the experts at times acted as advocates for their clients, and rejected their testimony as unreliable.

Finally, the court noted the taxpayer did not determine employee bonuses under any consistent plan or formula. In addition, the taxpayer did not pay any dividends during the years at issue and the bonuses were paid two days before the end of the tax years. Accordingly, the court concluded the taxpayer deliberately attempted to distribute its profits as compensation.

[xiii] **Eberl's Claim Service, Inc. v. Commissioner.**<sup>623</sup>

In *Eberl's Claim Service, Inc. v. Commissioner*, the Tenth Circuit rejected the single factor *Exacto Spring* independent investor test and affirmed the Tax Court. The Tax Court disallowed a portion of the taxpayer's compensation deduction based on an analysis of the following factors:

- Employee qualifications;
- The nature, extent, and scope of employee's work;
- The size and complexity of a taxpayer's business;
- Comparison of salaries paid with gross and net income;
- General economic conditions;
- Comparison of salaries with shareholder distributions and retained earnings;
- The taxpayer's salary policy to all employees;
- The taxpayer's financial condition;
- Prevailing rates of compensation for comparable positions in comparable companies;
- Compensation paid in previous years;

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<sup>622</sup> T.C. Memo. 1998-315, *aff'd*, 210 F.3d 384 (9th Cir. 2000).

<sup>623</sup> 87 AFTR2d 2001-2075, 249 F.3d 994 (10th Cir. 2001), *aff'g* T.C. Memo. 1999-211.

- Whether the employee and employer dealt at arm's length; and
- Whether the employee guaranteed the taxpayer's debt.

The sixth factor, which compares salaries with shareholder distributions and retained earnings, specifically considers whether an independent investor would be satisfied with employee salaries in light of the corporation's return on equity.

**[xiv] B & D Foundations, Inc. v. Commissioner.**<sup>624</sup>

In *B & D Foundations*, the Tax Court applied the *Mayson* factors and separately discussed the independent investor test in denying a portion of the taxpayer's compensation deduction. With respect to the independent investor analysis, the Tax Court explained that courts have consistently resisted taxpayer efforts to calculate return on equity based on the present value of the shareholder's initial investment. Instead, return on equity is usually calculated by dividing the taxpayer's net income for a year by: (1) its equity at the beginning of the year; (2) its equity at the end of the year; or (3) the year's average equity. In addition, some reasonable compensation cases have also considered the cumulative average return on equity; however, the cumulative average return on equity is generally not considered as significant as the net income method discussed above.

**[xv] Thousand Oaks Residential Care Home I, Inc. v. Commissioner.**<sup>625</sup>

**You can save the failing nursing home, but don't pay yourself too much**

In *Thousand Oaks*, a case appealable to the Ninth Circuit, the Tax Court applied the five factor *Elliotts* test to conclude compensation payments to a husband and wife were not deductible by the corporate taxpayer. In 1973, Dr. Robert Fletcher purchased a struggling business, Thousand Oaks Residential Care Home I, Inc. Dr. Fletcher was the sole shareholder. Dr. Fletcher, Ms. Pearl Fletcher (Dr. Fletcher's wife), and Ms. Fletcher's brother comprised the board of directors. Dr. Fletcher was the general manager, and was responsible for general operations, finances, and supervising maintenance. Ms. Fletcher, a nurse, managed the personnel and resident relations for the corporation.

In 2002, the corporation sold substantially all of its assets in a \$3.4 million installment sale. After the sale, the corporation created a defined benefit plan. From 2003 to 2005, the corporation paid the Fletchers each \$200,000, \$200,000, and \$30,000, respectively. In addition, in 2003 and 2004, the corporation contributed \$191,433 and \$259,506 to the plan for Dr. Fletcher and \$191,433 and \$198,915 for Ms. Fletcher. Accordingly, Dr. Fletcher's total compensation for this three-year period was \$880,939 and Ms. Fletcher's total compensation for this three-year period was \$820,348. The corporate minutes for 2003 and 2004 expressly stated the compensation was catch-up compensation for inadequate compensation during prior years.

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<sup>624</sup> T.C. Memo. 2001-262.

<sup>625</sup> T.C. Memo. 2013-10.

In concluding the Fletcher’s compensation was unreasonable in amount, the Tax Court applied the five *Elliotts* factors:

- Role in Company. The Tax Court found the first factor favored the taxpayer because the Fletchers bought the corporation when it was failing and turned it around within a year and a half. In addition, Dr. Fletcher was president and overall manager, and Ms. Fletcher was head nurse and was in charge of personnel and resident relations.
- External Comparison. The corporation did not present expert testimony. The Service’s expert agreed the Fletchers were underpaid, but that the proper catch-up amount should have been much less than the total compensation package actually given to the Fletchers. The Tax Court found the Service’s expert reliable and concluded the second factor favored the Service’s position.
- Character and Condition of the Company. The Tax Court found this factor slightly favored the taxpayer because, although the corporation was not sufficiently profitable to pay the Fletchers in some years, they managed to make it sufficiently successful to pay its own bills, pay down its long-term debt, and command a substantial price when sold.
- Conflicts of Interest. The Tax Court concluded the fourth factor “undoubtedly” weighed against the taxpayer because the Fletchers were the owner-operators; they never received a dividend; and they used all of the profits from the asset sale to pay themselves.
- Internal Consistency. The Tax Court found the fifth factor favored the taxpayer, because the high compensation payments for the years at issue were adequately documented as catch-up payments.
- Independent Investor. Finally, the Tax Court concluded that, although “the Fletchers did intend the compensation as catch-up compensation for prior services rendered, paying out compensation packages that deplete the rest of the corporation’s assets denies the corporation’s equity owners a fair return on their capital investment.” The court explained that, because the corporation was a small highly leveraged business, a hypothetical investor would be satisfied with a 10% return on equity. Because the corporation did not have \$503,300 of profit (the 10% return) after payment of compensation, the court concluded the final factor weighs against finding the compensation was reasonable.

Accordingly, the Tax Court concluded the Fletchers were paid unreasonably high compensation. To determine the amount that would be reasonable, the court took \$503,300 (an amount that represents a 10% return on equity) and subtracted from that amount the taxpayer’s actual retained earnings for the year, to conclude the Fletchers were overpaid by \$282,615.

[xvi] **K & K Veterinary Supply, Inc. v. Commissioner.**<sup>626</sup>

In *K & K Veterinary Supply*, the Tax Court denied the taxpayer's compensation deduction, concluding it was unreasonably high. The sole shareholder incorporated the business in 1988 to operate as a wholesale distributor of veterinary supplies and other animal health products for large animals. The taxpayer also distributed lawn and garden supplies, pet products, and other farm items. It had four key employees.

The sole shareholder, John Lipsmeyer, was the taxpayer's president, co-chief executive officer, and co-chief operating officer. John's duties included negotiating with vendors, pricing products, managing personnel (including all hiring and determining salary and bonus amounts), and sales calls to 34 important customers. He and his wife, Melissa Lipsmeyer, were co-guarantors of the corporation's \$3.3 million line of credit. Before forming the business, John worked for a veterinary supply company for almost 17 years. The taxpayer paid John \$981,728 in 2006 and \$746,229 in 2007.

The shareholder's wife, Melissa, was the taxpayer's vice president, secretary and assistant chief financial officer. She was hired by the taxpayer in 1999. Melissa had previously worked in accounts payable and receivable, customer service and inventory control for another animal health company. She generally worked 30 to 35 hours a week for the taxpayer, but would work more when needed. Melissa was not a shareholder of the taxpayer. She was paid \$215,000 in 2006 and \$198,000 in 2007.

The shareholder's brother, David Lipsmeyer, was the taxpayer's senior vice president of sales, co-chief executive officer, and co-chief operating officer. David had worked for the taxpayer since its 1988 incorporation, although he was not a shareholder. He had previously worked for a veterinary supply company. David regularly worked from 60 to 65 hours a week. He was responsible for approximately 50 client accounts. David was on the road, traveling to customers about three weeks of each month. His duties also involved training the taxpayer's sales force and advising John on pricing and hiring decisions. Finally, he was responsible for two trade shows the taxpayer organized and produced each year. David was paid \$922,853 in 2006 and \$735,029 in 2007.

The shareholder's daughter, Jennifer Stewart, was the taxpayer's chief financial officer. After Jennifer attained this position in 2002, her duties involved supervising accounts payable and receivable staff, meeting with the taxpayer's accountant and bankers, and serving as co-trustee of the 401(k) plan. She had 90 college credit hours toward a business finance degree. Jennifer had worked full time in the business for 19 years (including pre-incorporation). Jennifer was paid \$287,528 in 2006 and \$287,429 in 2007.

The Tax Court applied the nine *Mayson* factors, plus an additional "debt guaranty" factor to conclude the corporation paid unreasonably high compensation to its sole shareholder and three family members. Although the shareholder, the brother, and the daughter had relevant experience, were qualified for their positions, and were important to the taxpayer's success, compensation to them was unreasonable for two primary reasons: first, the total compensation

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<sup>626</sup> T.C. Memo. 2013-84.

was more than 100% of the taxpayer's reported income before taxes; and second, the compensation was greater than compensation paid by similar companies for similar positions.

Employee Qualifications. The court concluded John and David were highly experienced and qualified; that Jennifer was sufficiently experienced and qualified due to the duration of employment and her education; but that Melissa's experience was not sufficient to qualify her as vice president, secretary, and assistant chief financial officer.

Nature, Extent, and Scope of Employee's Work. The court found John, David and Jennifer were important to the corporation's success. However, the court found Melissa's work responsibilities did not justify her salary, considering she worked only 30-35 hours per week and her vague testimony about job duties: "It's very hard for me to say what exactly I was doing other than the obvious, which was helping with, you know, like the financial decisions. . . . Well, just have conversations naturally with my husband about, you know, what was going on with the business as far as were there any—you know, where monies were going or anything that was upcoming as far as needs of the company, just in general finances."

Debt Guaranty. The court found John's and Melissa's personal guarantee to be a factor in favor of finding the compensation was reasonable in amount.

Comparison of Salaries Paid with Gross and Net Income. The court found this factor to be particularly damning to the taxpayer. On its 2006 Form 1120, the corporation reported gross receipts of almost \$60 million, but net income before taxes of only \$128,454. Similarly, on its 2007 Form 1120, the corporation reported \$65 million gross receipts, but net income of only \$41,948. For both years, compensation was more than 100% of net income.

Prevailing Rates of Compensation. Both the Service and the taxpayer presented expert reports on the prevailing rates of compensation for similar positions. However, the Tax Court dismissed the taxpayer's expert because he failed to base his opinion on comparable companies. Specifically, he first did not identify companies within the industry and he did not establish the sample companies were a comparable size to the taxpayer. In contrast, the Services' expert identified 12 companies engaged in wholesale distributing of nondurable goods, comprising of chemical, and farming equipment and supplies.

Having lost the battle, the taxpayer argued that, under the doctrine of equitable recoupment, it can offset the amount of excess income tax John and Melissa had paid on the unreasonably high compensation they received against its resulting corporate tax liability. That is, had the disallowed compensation been distributed as dividends, John and Melissa would have paid less individual income tax. Unfortunately for the taxpayer, the party claiming equitable recoupment has the burden to establish it applies.<sup>627</sup> To prevail on equitable recoupment, the taxpayer had to prove the four requisites exist:

- The period of limitation has expired on the overpayment or deficiency for which recoupment is sought;

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<sup>627</sup> See *Menard, Inc. v. Commissioner*, 130 T.C. 54 (2008).

- The overpayment or deficiency arose out of the same transaction, item, or taxable event as the issue before the court;
- That transaction, item, or taxable event was inconsistently subjected to two taxes; and
- “[I]f the transaction, item, or taxable event involves two or more taxpayers, there is sufficient identity of interest between the taxpayers subject to the two taxes that the taxpayers should be treated as one.”<sup>628</sup>

Ultimately, the court concluded the corporation had not met its burden of establishing equitable recoupment, because it could not establish the fourth requisites—sufficient identity of interest. The court explained, “[a] corporation formed for legitimate business purposes and its shareholders are separate entities.” Thus, the Tax Court concluded, there was not sufficient identity of interest to treat the taxpayer, and John and Melissa as one taxpayer. The taxpayer lost on all counts.

[xvii] **Aries Communications, Inc. v. Commissioner.**<sup>629</sup>

**A sole shareholder that pays himself year-end dividends ends up in hot water**

In *Aries Communications*, the Tax Court granted in part and denied in part the taxpayer’s compensation deduction for payments to its sole owner, Arthur Astor, during its 2004 tax year. The taxpayer was a communications corporation that, through two subsidiaries, owned and operated a number of radio stations, including 92.1 FM, and 94.3 FM. Mr. Astor, in addition to being the sole shareholder, was also Aries’s president and chief financial officer. Mr. Astor worked in radio broadcasting for over 60 years. During that time, Mr. Astor acquired a number of radio stations, which he bought and sold through Aries Communications and its subsidiaries. Mr. Astor acted as the general manager for each of the radio stations.

In May 2003, the taxpayer sold 94.3 FM. Although the taxpayer had retained a business broker, Mr. Astor’s efforts were primarily responsible for negotiating a sales price of \$35 million. In April 2004, the taxpayer sold 92.1 FM. Again, the taxpayer retained the same business broker. However, Mr. Astor’s efforts were primarily responsible for raising the initial offer of \$12 million to a final sales price of \$18 million.

On its 2004 tax return, the taxpayer claimed a compensation deduction of almost \$6.9 million for payments to Mr. Astor. The Service denied the majority of the deductions and issued the taxpayer a \$6.08 million deficiency. The taxpayer filed a petition with the Tax Court. The primary issue for review was whether Mr. Astor’s 2004 compensation was reasonable.

The taxpayer asserted that all of Mr. Astor’s compensation was reasonable. His compensation included catch-up payments for prior years, and it properly included a bonus for his performance in selling the radio stations. The court agreed Mr. Astor could take compensation as catch-up payments and that he could take a bonus for his performance in selling the radio stations, but,

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<sup>628</sup> *United States v. Dalm*, 494 U.S. 596 (1990).

<sup>629</sup> T.C. Memo. 2013-10 (1/14/13).

after applying the following *Elliotts* factors, it ultimately concluded the total amount of compensation was unreasonable:

- Role in Company. The Tax Court found the first factor favored the taxpayer because Mr. Astor served as the president, CFO, and general manager. He played a pivotal role in the profitable sale of the radio stations.
- External Comparison. The court had difficulty accepting the evidence offered by both sides' experts. Neither expert was credible. It ultimately rejected the testimony of both experts. Rather, it concluded that, given Mr. Astor's participation in the sales, he could reasonably be paid a bonus equal to one-third of the \$6 million increase in sales price of the second radio station, or \$2 million. The court did not mention the sale of the first radio station.
- Character and Condition of the Company. The Tax Court found the third factor weighed against taxpayer: "Because Aries was a large asset-laden complex business with a negative net income and a bleak financial picture despite the favorable fact that it enjoyed a successful asset sale during the year at issue, we find this factor favors respondent."
- Conflicts of Interest. The Tax Court found the fourth factor weighed against the taxpayer. The court noted there was no clear evidence the taxpayer ever paid (or Mr. Astor received) a dividend. This fact, combined with the fact Mr. Astor was the sole shareholder of the taxpayer, resulted in the court concluding a conflict of interest existed.
- Internal Consistency. The Tax Court concluded the fifth factor weighed against the taxpayer because the bonuses were not paid under a formal plan and because the "bonuses were determined at the end of the year when Mr. Astor and petitioner could reasonably predict Aries' profits and potential Federal income tax liability absent a section 162 deduction for Mr. Astor's compensation."
- Independent Investor. The court noted the independent investor return on equity analysis was a weak factor in the case, because determining the return on equity was skewed by interparty loans and the sale of the two major assets. Nevertheless, the court explained that, although the taxpayer was highly leveraged, it possessed assets likely to appreciate and an independent investor might be satisfied with a 10% return. In fact, the taxpayer had sufficient retained earnings to satisfy a 20% return on equity, compounded annually. Thus, the court concluded the independent investor test favored the taxpayer.

The Tax Court eventually concluded Mr. Astor was entitled to \$460,000 of catch-up payments for prior years when he was under-compensated, and a bonus equal to one-third of the \$6 million increase in the sales price (\$2 million) of one of the radio stations.

**[h] Reasonable Compensation in the Context of the Personal Service Corporation.**

Personal service corporations or “PSCs” are corporations that primarily perform personal services. For this discussion, PSCs include “qualified personal service corporations,” professional corporations, service corporations taxed under Subchapter C, and service corporations that are taxed under Subchapter S. Personal service providers form PSCs as C corporations to take advantage of two tax avoidance strategies: first, PSCs attempt to avoid the corporate level tax by paying their earnings as deductible compensation; and second, PSCs attempt to avoid the double tax on asset sales by allocating the sales proceeds to personal goodwill.

The first technique continues to be a viable option so long as it is not taken to the extreme, such as in *Pediatric Surgical Associates, P.C. v. Commissioner*,<sup>630</sup> where the taxpayer deducted compensation payments to its shareholder employees that included amounts attributable to net profits generated by non-shareholder employees. In the S corporation context, abuse is generally easier to spot, such as in *Watson, P.C. v. United States*,<sup>631</sup> where the corporation paid its sole shareholder employee a salary of only \$24,000, despite the fact that the corporation was a partner in a personal services firm that had \$2 to \$3 million in gross revenues. Nevertheless, the *Watson* case has added fuel to the debate whether shareholder employees can be paid compensation in excess of personal billings less a reasonable allocation of overhead.<sup>632</sup> In *Watson*, the Eighth Circuit appears to reject the taxpayer’s argument that it should limit “the amount it characterized as wages to the amount of revenue each shareholder employee personally generated, less expenses.”<sup>633</sup> Accordingly, the Eight Circuit affirmed the Tax Court:

“Nevertheless, although we think evidence of shareholder-employee billings and collections may be probative on the issue of compensation, in view of all the evidence presented to the district court in this case, we see no error. Therefore, as noted earlier, because the district court applied the correct legal standard, we affirm its determination on *Watson*’s FICA wages.”<sup>634</sup>

The second technique has to do with the sale of personal goodwill, which is a capital asset.<sup>635</sup> Personal goodwill is “the personal relationships and customer contacts which the owner of the business has been able to develop.”<sup>636</sup> The issues involving sales of personal goodwill are generally twofold: whether the gain on the sale is ordinary income or capital gain, and whether the goodwill is the asset of the shareholder, allowing him or her to personally sell the asset and

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<sup>630</sup> T.C. Memo. 2001-81.

<sup>631</sup> 109 AFTR2d 2012-1059, 668 F.3d 100 (8th Cir. 2012).

<sup>632</sup> *Id.* at 2012-1064.

<sup>633</sup> *See, e.g.,* Stephen R. Looney, *Eighth Circuit Recharacterizes S Corporation Dividend Distributions as Wages*, 14 BUS. ENTITIES 16 (2012).

<sup>634</sup> *Watson*, 109 AFTR2d at 2012-1064.

<sup>635</sup> *Butler v. Commissioner*, 46 T.C. 280, 287 (1966); *Kennedy v. Commissioner*, T.C. Memo. 2010.

<sup>636</sup> *McCubbin v. McCubbin*, 465 N.E.2d 672, 674 (Ill. App. Ct. 1984).

avoid double taxation. In a number of recent cases, the taxpayers were unable to meet these hurdles.<sup>637</sup>

Finally, certain PSCs are subject to a flat tax. Specifically, “qualified personal service corporations” do not obtain the benefit of graduated rates and are taxed at a flat 35% tax rate (for tax years beginning before 1993, PSCs were taxed at a flat 34% rate).<sup>638</sup> A corporation is a qualified PSC if it meets two tests under Section 448(d)(2). First, the corporation meets the “function test” if substantially all its activities involve performing services in health, law, engineering, architecture, accounting, actuarial science, or consulting. Second, the corporation meets the “ownership test” if substantially all the value of its stock is held by the employees providing the services, retired employees, or their estates.

**Compensation payments to shareholder-service providers in excess of each provider’s billings constitutes a distribution of profits** In *Klamath Medical Service Bureau v. Commissioner*,<sup>639</sup> an early case out of the Ninth Circuit Court of Appeals, the court considered whether a professional corporation owned by its physician-employees could “deduct as compensation, payments to its stockholder-member-physicians in excess of 100 per cent of base fee billings by its members[.]”

The taxpayer was an Oregon corporation, organized to sell prepaid health plans and to provide medical services under the plans. The physicians who provided the services were also shareholders. The physician employment agreements with the corporation included a complex compensation formula. The court summarized the complex formula as follows: “In short, the petitioner determines what its net profit will be, deducts amounts necessary for retiring bonds, etc., and then pays out a percentage of its profits to the doctors, regardless of what the fee schedule amount would be, since the latter is only a base fee.” Under the formula, each physician was paid compensation in excess of their total billings.

Although the Tax Court thought the payments to the shareholder-physicians were reasonable in amount, it ultimately concluded the payments in excess of billings were “a guise for distributing corporate profits.” The Ninth Circuit agreed the compensation paid to shareholder-physicians was deductible to the extent of billings under the hospital’s fee schedule; however, compensation in excess of billings was held to be intended as distributions of earnings. Accordingly, the court concluded the taxpayer, on appeal, had not met its burden of showing the compensation in excess of billings was indeed compensation and not a distribution of profits.

In dicta, the court opined there was another reason for affirming the Tax Court’s opinion:

<sup>637</sup> See *Muskat v. Commissioner*, 103 AFTR2d 2009-666, 554 F.3d 183 (1st Cir. 2009); *Kennedy v. Commissioner*, T.C. Memo. 2010; *Howard v. United States*, 106 AFTR2d 2010-5533 (E.D. Wash. 2010), *aff’d*, 106 AFTR2d 2010-5533 (2011).

<sup>638</sup> Code § 11(b)(2).

<sup>639</sup> *Klamath Medical Service Bureau v. Commissioner*, 29 T.C. 339 (1957), *aff’d*, 3 AFTR2d 322, 261 F.2d 842 (9th Cir. 1958), *cert. denied*, 359 U.S. 966 (1959).

There is another reason why we believe the judgment of the Tax Court was correct. As the Tax Court interpreted a contract it found to be ambiguous, the petitioner’s members had signed contracts with it whereby the petitioner was obligated to pay them 100 per cent of the base fee (however and at whatever figure it was set), but no more! Any amount over and beyond the 100 per cent base fee could, or could not, be paid to the doctor-members, as the management saw fit. The petitioner could use it for the buying of office equipment or equipment for the hospital, or new hospitals, or even a hotel. This voluntary payment to the doctors of more than the 100 per cent of base pay the doctors had agreed to accept as compensation in full for their services, might be an ordinary, but could not be a necessary, expense and hence, not an *ordinary* and *necessary* expense.

(Emphasis in original.) **Fortunately, this view has not been adopted by later decisions. Otherwise, all discretionary bonuses to shareholder employees would automatically be considered a distribution of profits.**

In *Radtke v. United States*,<sup>640</sup> the District Court for the Eastern District of

**If your sole shareholder is the only employee, you’ve got to pay him some salary**

Wisconsin held an S corporation PSC’s distributions to its sole shareholder and only employee, an attorney who worked full-time, were wages subject to employment taxes. The PSC paid the attorney no salary, but declared dividends whenever it had money in the bank. It paid no employment taxes on the dividends. The court explained that an employer cannot evade FICA and FUTA taxes by characterizing all employee payments as non-wages, and that the situation “is simply the flip side of those instances in which corporations attempt to disguise profit distributions as salaries for whatever tax benefits that may produce.” Accordingly, the court held the “dividends” functioned as “remuneration for employment” and thus were subject to employment taxes. The Seventh Circuit agreed.<sup>641</sup>

**Shareholder-physicians could receive 100% of the collections attributable to their services**

In *Richlands Medical Association v. Commissioner*,<sup>642</sup> the taxpayer provided physician services and owned a hospital that provided ancillary medical services. The taxpayer paid compensation under a formula by which, after paying expenses and certain reserves, all profits were distributed to its owner-physicians. The taxpayer’s expert witness could not explain how, under the compensation formula, the taxpayer could ever earn a profit. Nevertheless, the court allowed the taxpayer to deduct compensation payments to owner-employees—even though those payments were greater than the receipts attributable to owner-physician services to patients—to reflect additional services the physicians provided to the association. However, the Tax Court held a portion of the compensation was a nondeductible dividend

<sup>640</sup> 63 AFTR2d 89-1469, 712 F.Supp. 143 (1989), *aff’d per curiam*, 65 AFTR2d 90-1155, 895 F.2d 1196 (7th Cir. 1990).

<sup>641</sup> *Radtke v. United States*, 65 AFTR2d 90-1155, 90-1156, 895 F.2d 1196 (7th Cir. 1990).

<sup>642</sup> T.C. Memo. 1990-660, *aff’d*, 953 F.2d 639 (4th Cir. 1992).

distribution, because a portion of the profits were attributable to ancillary hospital service charges that were not from owner-physician services.

Eleven years after it decided *Richlands Medical Association*, the Tax Court clarified that the case “does not establish a rule of law that, in all circumstances, an employer may deduct as compensation paid to an employee amounts collected for services performed by such employee.”<sup>643</sup>

**Compensation paid to shareholder employees derived from earnings resulting from the efforts of non-shareholder professionals is not deductible by the taxpayer**

In *Pediatric Surgical Associates*,<sup>644</sup> the Tax Court held a professional corporation that employed both shareholder-surgeons non-shareholder-surgeons could not deduct the payments to shareholder employees attributable to services performed by the non-shareholder surgeons. The taxpayer was a Texas personal service corporation specializing in providing surgical services to infants and children. In 1994 and 1995, the corporation employed six pediatric surgeons, four of whom were shareholders.

The Service argued to the Tax Court that amounts paid as compensation to the shareholder surgeons was in fact profit attributable to services of the non-shareholder surgeons, and should be treated as a nondeductible distribution of profits. Thus, the question before the Tax Court was whether those amounts were paid to the shareholder surgeons purely for their services. The Tax Court concluded a portion of the compensation the taxpayer paid to the shareholder-surgeons was not reasonable because such amounts were not attributable to their personal services. The disallowed portion was profit from the services of non-shareholder surgeons after reduction for costs and allocable overhead. Accordingly, the Tax Court held the compensation attributable to the non-shareholder-surgeons paid to its shareholders as compensation was in fact a distribution of profits and not deductible by the corporation.

*Pediatric Surgical Associates* has been criticized for ignoring the fact that the business of a professional practice includes activities other than personal production that result in greater profit for the practice as a whole, such as extensive business development, recruiting, training, practice management and regulatory compliance.<sup>645</sup>

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<sup>643</sup> *Pediatric Surgical Associates, P.C. v. Commissioner*, T.C. Memo. 2001-81.

<sup>644</sup> T.C. Memo. 2001-81.

<sup>645</sup> See Alson R. Martin & Morton A. Harris, *Unreasonable Compensation: Pediatric Surgical Poses a Major New Threat for PCs*, 97 J. TAX’N 41 (2002).

**Distributions of corporate net income to sole shareholder employee were wages**

In *Veterinary Surgical Consultants*,<sup>646</sup> a veterinarian, Sadanaga, organized the taxpayer as an S corporation to provide consulting and surgical services to veterinarians. Sadanaga, who was the taxpayer’s president and only officer, generated all of the taxpayer’s income by providing consulting and surgical services to the Veterinary Orthopedic Services, Ltd. (“Orthopedic”).

The taxpayer made “distributions other than dividend distributions paid from accumulated earnings and profits” to Sadanaga of around \$125,000 in 1994, \$225,000 in 1995, and \$212,000 in 1996. The taxpayer did not issue a Form W-2 to Sadanaga for any of the tax years at issue. On his Forms 1040, Sadanaga reported his share of pass-through income as nonpassive income from an S corporation.

Sadanaga was also an employee of Bristol-Myers Squibb Co., from which he reported wages of around \$91,000 in 1994, \$95,000 in 1995, and \$102,000 in 1996.

On audit, Sadanaga’s accountant asserted Sadanaga was not an employee of the taxpayer and that all of the distributions were actually his share of the corporation’s net income. The Service disagreed. In Tax Court, the taxpayer asserted Sadanaga was its sole shareholder but not its employee, and it had, therefore, correctly distributed its net income to Sadanaga.

**Employment Tax Overview**

Sections 3111 and 3301 impose FICA (Social Security) and FUTA (unemployment) taxes on employers for employee wages. The two key terms are “employee” and “wages.” A corporate officer is considered an employee and his or her wages are subject to employment taxes if the officer:

- performs substantial services; and
- receives remuneration for those services in any form.

The Tax Court first concluded Sadanaga was an employee. It found Sadanaga, who was an officer of the taxpayer, performed substantial services for the taxpayer because: (1) he worked around 33 hours a week; (2) he was the only individual working for the taxpayer; and (3) his surgical and consulting services generated all of the taxpayer’s income.

Next, the court concluded Sadanaga received remuneration for the services he provided to the taxpayer. The court said the taxpayer’s characterization of the payments as distributions was “a subterfuge for reality.” Citing *Spicer Accounting* and *Radtke*,<sup>647</sup> the court explained that, regardless of an employer’s characterization, “the true analysis is whether the payments represent remuneration for services rendered.”

<sup>646</sup> 117 T.C. 141 (2001), *aff’d sub nom, Yeagle Drywall Co. v. Commissioner*, 90 AFTR2d 2002-7744, 54 Fed. Appx. 100 (3d Cir. 2002).

<sup>647</sup> *Spicer Accounting, Inc. v. United States*, 66 AFTR2d 90-5806, 918 F.2d 90 (9th Cir. 1990); *Joseph Radtke, S.C. v. United States*, 65 AFTR2d 90-1155, 895 F.2d 1196 (7th Cir. 1990).

The Tax Court also established what appears to be a bright-line rule for small, closely-owned and operated S corporations:

Dr. Sadanaga’s reporting the distributions as nonpassive income from an S corporation has no bearing on the Federal employment tax treatment of those wages. He was petitioner’s sole source of income. And as petitioner’s sole full-time worker, he must be treated as an employee. Accordingly, we hold that Dr. Sadanaga is an employee of petitioner for the period at issue and, as such, the payments to him from petitioner constitute wages subject to Federal employment taxes.

Accordingly, the Tax Court ruled the test of employment status is whether payments to the taxpayer represent remuneration for services, and held the payments to Sadanaga constituted wages.

Finally, the taxpayer argued that, because Sadanaga paid the maximum FICA tax required on his wages from Bristol-Myers Squibb Co., it was not required to withhold FICA tax. The Tax Court soundly rejected the argument, explaining the FICA wage base applies separately to each employer:

This argument is simply a “red herring.” For Federal employment tax purposes, the taxable wage base applies separately to each employer. Thus, if an employee receives wages from more than one employer, the annual wage limitation does not apply to the aggregate compensation received. The employee however may be eligible for a credit or refund of the excess employee portion of the FICA tax that applies with respect to wages in excess of the applicable wage base.

Thus, the Tax Court held Sadanaga was an employee of the taxpayer for the tax period at issue.

**Strike out!  
Paying nearly  
all your profits  
as consulting  
fees fails the  
independent  
investor test  
and the intent  
test**

In *Mulcahy, Pauritsch, Salvador & Co.*,<sup>648</sup> the Tax Court denied a professional corporation’s deduction for “consulting fee” payments to three related entities (which passed the “fees” on to the taxpayer’s shareholders) because the payments failed both the Intent Test and Amount Test: The payments were not reasonable in amount and were not intended to be payments for services. The related entities were owned by the corporation’s three controlling shareholders and did not perform any services for the corporation. The corporation was an accounting and consulting firm. The corporation argued the fee payments were really compensation for the founders’ services.

The court first concluded that, even if the payments were treated as compensation, the compensation was not deductible because it was unreasonable in amount. Specifically, the court pointed out that, after calculating the corporation’s return on equity under the annual net income method (net profit/annual equity),<sup>649</sup> the taxpayer’s rate of return was around or below zero; thus,

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<sup>648</sup> T.C. Memo. 2011-74.

<sup>649</sup> See discussion above at 1.05[3][f][iii].

the presumption of reasonableness under independent investor test didn't apply. In addition, the corporation could not establish the consulting fee payments involved would ordinarily be paid for like services by like companies.

In addition, the court also concluded that the payments failed the Intent Test:

We find that the firm intended for the payments to the related entities to distribute profits, not to compensate for services. We find that the firm intended for the payments to the related entities to distribute profits, not to compensate for services. As discussed above, Salvador chose the amount to pay each year so that the payments distributed all (or nearly all) accumulated profit for the year. He did this for tax planning purposes. Each founder's percentage of the payments to the related entities was tied to hours worked, but the firm's intent in making the payments was to eliminate all taxable income. The firm did not intend to compensate for services.

Finally, the court held the corporation was liable for the 20% substantial understatement of income penalty under Section 6662 because it had not acted in reasonable cause and good faith. The Tax Court noted the corporation, which specialized in accounting, could not provide evidence of efforts to determine its tax liability.

**Personal service corporation shareholders can strip earnings from capital as compensation for services** On appeal to the Seventh Circuit,<sup>650</sup> Judge Posner in *Mulcahy* (Round Two) affirmed the Tax Court's denial of the corporation's Section 162(a)(1) deduction for payments to the three related entities described above. Apparently, the accounting and consulting firm structured the payments this way to disguise the amount of profits deflected to its three majority shareholders. Judge Posner was not impressed with this planning method: "A corporation cannot avoid tax by using a cockeyed method of distributing profits to its owners."

On audit, the firm argued the consulting fees were compensation payments to its majority shareholders. The Service did not agree. It recharacterized the consulting fee payments as nondeductible disguised dividends and assessed a deficiency. The Tax Court similarly concluded the fees were disguised dividends and the taxpayer appealed. On appeal, the Seventh Circuit also rejected the argument that the consulting fees were deductible compensation because it failed the independent investor test.

**Independent Investor Analysis** Judge Posner explained that, the independent investor test's "premise is that an investor who is not an employee will not begrudge the owner-employee his high salary if the equity return is satisfactory; the investor will consider the salary reasonable compensation for the owner-employee's contribution to the company's success." However, this premise does not hold up in small professional services firms, which operate with a "pane of glass" between billings and salaries:

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<sup>650</sup> 109 AFTR2d 2012-2140, 680 F.3d 867 (7th Cir. 2012).

It is thus no surprise that most professional-services firms (including firms much larger than in our example) are organized as limited liability companies (LLCs), limited liability partnerships (LLPs), limited partnerships (LPs), small business corporations (S-corps), or other pass-through entities. In those entities as in a general partnership (which differs from the pass-throughs we listed mainly in not limiting partners' personal liability for the entity's debts, and for that reason has largely given way to those other pass-throughs), the company's receipt of income is not a taxable event; instead the income is deemed to pass directly to the owners and is taxed as personal income to them.

However, the court explained, Mulcahy, Pauritsch, Salvador & Co. was not a small firm operating as a mere "pane of glass," because the firm had sufficient capital to generate earnings: it had physical capital to support 40 employees in multiple offices; and it had intangible capital in the form of "client lists and brand equity." Accordingly, the court concluded the payments failed the independent investor analysis:

The Tax Court was correct to reject the firm's argument that the consulting fees were salary expenses. Treating them as salary reduced the firm's income, and thus the return to the equity investors, to zero or below in two of the three tax years at issue, even though, judging by the salaries received by the founding shareholders, the firm was doing fine. So, the firm flunked the independent-investor test.

**The Intent Test – Return of capital not compensation** The most interesting discussion in the opinion, however, is whether a personal service corporation with profits derived from capital can zero out its taxable income through compensation payments to shareholder employees. As an initial matter, Judge Posner explained that even professional service corporations in which ownership is limited can be required to show a return of capital:

We are mindful that Illinois limits equity investments in an accounting firm to the firm's "active participants," (presumably its accountants), just as only a law firm's lawyers can own equity in the law firm. But the fact that only members of a firm (and hence employees) can contribute capital to it doesn't mean that there is no return on that capital. We know the firm had significant capital, both tangible and intangible, and we are given no reason to think that its capital didn't generate a return that a non-conflicted investor would be entitled to a portion of.

The court then reasoned that the consulting fees represented a return of capital:

Remarkably, the firm’s lawyers (an *accounting* firm’s lawyers) appear not to understand the difference between compensation for services and compensation for capital, as when their reply brief states that the founding shareholders, because they “left funds in the taxpayer over the years to fund working capital,” “deserved more in compensation to take that fact into account.” True—but the “more” they “deserved” was not compensation “for personal services actually rendered.” Contributing capital is not a personal service. Had the founding shareholders lent capital to the company, as it appears they did, they could charge interest and the interest would be deductible by the corporation. They charged no interest.

Thus, the court concluded, the firm failed the Intent Test: “There is no evidence that the ‘consulting fees’ were compensation for the founding shareholders’ accounting and consulting services.”

Finally, after affirming the 20% penalty, Judge Posner pulled out the hammer when he stated: “That an *accounting* firm should so screw up its taxes is the most remarkable feature of the case.”

**Compensation can exceed sole shareholder’s billings reduced by overhead** In *Watson, P.C. v. United States*,<sup>651</sup> the Eight Circuit considered whether S corporation distributions to its sole-shareholder employee were, in fact, compensation payments for services. This case (discussed in further detail below) is notable because it explicitly stands for the proposition that compensation payments to a majority shareholder service provider can reasonably exceed his or her personal billings.

David E. Watson became a CPA in 1983 and in 1996 incorporated DEWPC, a professional corporation which elected to be treated as an S corporation. Watson is the sole officer, shareholder and director of DEWPC. In 2003 and 2004, the tax years at issue, DEWPC paid him a yearly \$24,000 salary and distributions totaling roughly \$320,000.

For each tax year, the Service reclassified around \$67,000 of the distributions as wages, stating DEWPC structured Watson’s salary and distribution payments to avoid Federal employment taxes, and issued an assessment of around \$48,000. After making a few payments toward the \$48,000 tax assessment, DEWPC filed a claim for refund in district court. The district court held in favor of the Service. It reasoned that DEWPC structured Watson’s salary and dividend payments in an effort to avoid Federal employment taxes, with full knowledge that the distributions to Watson were actually “remuneration for services performed.”

Watson appealed the district court decision to the Eighth Circuit Court of Appeals, where he asserted at least two alternative positions:

- The government’s expert on the issue of reasonable compensation should not be relied upon; and

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<sup>651</sup> 109 AFTR2d 2012-1059, 668 F.3d 1008 (8th Cir. 2012).

- The focus should be on the corporation’s intent with respect to compensation rather than on the reasonableness of compensation.

After much discussion, the Eighth Circuit found both of the taxpayer’s arguments meritless.

The court quickly set aside the taxpayer’s arguments. It stated a deduction for compensation is allowed if it is reasonable and the payments are for actual services rendered. Citing the Ninth Circuit Court of Appeals in *Elliotts, Inc. v. Commissioner*,<sup>652</sup> the court concluded the reasonableness inquiry is so broad, it most often subsumes the intent inquiry. The lower court correctly analyzed the matter with its focus on reasonableness.

Most importantly for our discussion, DEWPC argued the lower court should have applied the principles of *Pediatric Surgical Associates*<sup>653</sup> to limit Watson’s reasonable compensation to his personal billing receipts less expenses attributable to those receipts. The Eighth Circuit quickly pointed out that Watson was not the only person generating revenue. **Non-shareholder employees were also generating revenue.** So, merely focusing on Watson’s personal time-keeper receipts and expenses attributable thereto was not appropriate in this case. Other evidence is relevant to the inquiry of reasonableness, including but not limited to: (1) business generated by the shareholder employee; (2) the employee’s experience, expertise, hours worked, and education; (3) lack of arms-length negotiation; (4) compensation history; and (5) the financial ability of the corporation.

In *Brinks Gilson & Lione, a Professional Corporation, v. Commissioner*,<sup>654</sup> the Tax Court applied the independent investor test to characterize compensation paid by a law firm operated as a C corporation to its shareholder-employees as nondeductible dividend distributions and subject the taxpayer to accuracy-related penalties for mischaracterizing the dividends as deductible compensation.

Starting with the recognition of professional corporations as corporations in the late 1960s, many small and mid-sized professional service practices, starting in the medical and dental field and followed by law firms and other professionals, converted from sole proprietorships and partnerships to professional corporations and professional associations. The driving consideration was access to higher deductions to qualified retirement plans available to shareholder-employees as opposed to partners and self-employed professionals under “H.R. 10” retirement plans, then limited to \$2,500 per year. Similar limitations on contributions and benefits applied to S corporations. Parity in benefits and contributions allowed under corporate and partnership or self-employed retirement plans was legislated over time. S corporation eligibility rules were relaxed. Many professional practices have been restructured as partnerships and professional limited liability companies, or converted to S status. However, some professional service firms continue to be operated as C corporations.

In *Brinks*, the law firm taxpayer (the “Taxpayer”) was operated as a C corporation on the cash method of accounting. The Taxpayer treated the corporation as a partnership for operational purposes, and treated its 65 shareholders as partners. Perhaps very little thought had been given

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<sup>652</sup> 52 AFTR2d 83-5976, 716 F.2d 1241 (1983).

<sup>653</sup> *Pediatric Surgical Associates, P.C. v. Commissioner*, T.C. Memo. 2001-81 (2001).

<sup>654</sup> T.C. Memo. 2016-20 (filed Feb. 16, 2016).

to the choice of entity, as one might wonder why it was operated as a C corporation. With fewer than 100 shareholders, an S election could have been made long ago, as would have been recommended by most professional tax advisors. But it was not, and the facts are the facts. This article summarizes the *Brinks* case, the Court's rationale based on other recent constructive dividend cases, and the steps that similar professional practice firms can take to avoid the same fate.

During the years in issue, the Taxpayer employed about 150 attorneys, including the 65 shareholders, and also employed a non-attorney staff of about 270. Each shareholder-attorney of the Taxpayer acquired shares at a price equal to book value and was required by the shareholder agreement to sell the shares back to the Taxpayer at book value upon termination of employment, retirement, or death. Subject to minor exceptions for the Taxpayer's "name partners," each shareholder-attorney's proportionate ownership of the Taxpayer's shares equaled the proportionate share of compensation paid by the Taxpayer to each of the shareholder-attorneys. For the years in issue, the board of directors of the Taxpayer set the yearly compensation to be paid to shareholder-attorneys and then determined the adjustments in the shareholder-attorneys' share-ownership percentages necessary to reflect changes in proportionate compensation. These adjustments in share ownership were affected by share redemptions and reissuances. Sounds like a professional partnership, right? But it was a C corporation.

For at least 10 years prior to and including the years in issue, the Taxpayer did not pay any dividends to its shareholders. In late November or early December of the year preceding the compensation year, the Taxpayer's board met to set the amount available for all shareholder-attorney compensation for that year, and set compensation and share-ownership percentages. Because the board's estimate of the amount available for compensation-year payments to shareholder-attorneys was only an estimate, each shareholder-attorney received during the course of the compensation year only a percentage of his or her expected compensation (draw), with the expectation of receiving an additional amount (year-end bonus) at the end of the year. The board intended the sum of the shareholder-attorneys' year-end bonuses to reduce the Taxpayer's book income to zero. With limited exceptions for certain older, less active attorneys, shareholder-attorneys shared in the bonus pool in proportion to their draws (and, likewise, in proportion to their share-ownership percentages). Thus, the Taxpayer conducted its business as if it were a partnership for tax purposes.

The Taxpayer calculated the year-end bonus pool for 2007 equal to \$8,986,608 and for 2008 equal to \$13,736,331, which equaled its book income for each year after subtracting all expenses other than the bonuses. These bonuses averaged \$125,000 to \$175,000, not unreasonable in today's dollars.

The Taxpayer treated as employee compensation the total amounts paid to its shareholder-attorneys, including the year-end bonuses. The Taxpayer used an independent payroll processing firm to prepare Forms W-2 for 2007 and 2008 to its shareholder-employees. The Forms W-2 were then forwarded to its accountant to prepare the corporate returns. Apparently, this was the way that it had always been done. The Taxpayer had invested capital, measured by the book value of its shareholders' equity, of approximately \$8 million at the end of 2007 and approximately \$9.3 million at the end of 2008. No dividends had been paid. The stage was set.

The Taxpayer's corporate tax return had been audited for 2006, and resulted in a "no change" letter. However, when the IRS audited the Taxpayer for 2007 and 2008, the year-end bonuses that the Taxpayer paid to its shareholder-attorneys were disallowed as nondeductible constructive dividend distributions. After negotiations, the parties entered into a closing agreement providing that portions of the Taxpayer's compensation deductions to its shareholder-employees for the years in issue, \$1,627,000 in 2007 and \$1,859,000 in 2008, should be disallowed and characterized as nondeductible dividends (a return on invested capital of approximately 20-23 percent). The issue before the Tax Court was whether the Taxpayer was liable for accuracy-related penalties on underpayments of tax relating to amounts deducted as compensation that it conceded were nondeductible dividends.

Code § 6662(a) and (b) of the Internal Revenue Code (the "Code") provide for an accuracy-related penalty of 20 percent of the portion of an underpayment of tax attributable to negligence or disregard of rules and regulations, or "any substantial understatement of income tax." Code § 6662(d)(2)(A) defines the term "understatement" as the excess of the tax required to be shown on the return over the amount shown on the return as filed. In the case of a corporation, an understatement is substantial if it exceeds the lesser of (i) 10 percent of the tax required to be shown on the return for the tax year, or (ii) \$10 million. An understatement is reduced, however, by the portion attributable to the treatment of an item for which the taxpayer has "substantial authority."<sup>655</sup> Code § 6664(c)(1) provides an exception to the imposition of the Code § 6662(a) accuracy-related penalty if it is shown there was "reasonable cause" for the underpayment and the taxpayer acted in good faith.

Although the Taxpayer did not dispute that the deficiency to which it had agreed for the years in issue exceeded 10 percent of the agreed income tax it was required to show on its returns for such years, it argued that it had substantial authority for deducting in full the year-end bonuses paid to its shareholder-attorneys. Although the Taxpayer's expert witness, a national authority on law firm management, gave testimony at trial that law firm clients base hiring decisions on the reputations of individual lawyers rather than the firms at which they practice, the expert admitted that a firm's reputation and customer list could be very valuable entity-level assets.

The Taxpayer further argued that because it relied on the services of a reputable accounting firm to prepare its returns for the years in issue, it had reasonable cause to deduct those amounts and acted in good faith in doing so.

**IRS Position Based on the "Independent Investor Test."** The IRS claimed that the amounts paid to the shareholder-employees of the Taxpayer were not deductible as compensation to the extent the payments were funded by earnings attributable to the services of non-shareholder employees or to the use of the Taxpayer's intangible assets or other capital, and should be characterized as nondeductible dividends. In support of its position, the IRS relied primarily on the Tax Court decision in *Pediatric Surgical Associates*,<sup>656</sup> and the recent decision by the Seventh Circuit Court of Appeals affirming the Tax Court in *Mulcahy, Pauritsch, Salvador & Co.*<sup>657</sup>

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<sup>655</sup> Code Sec. 6662(d)(2)(B)(i).

<sup>656</sup> *Pediatric Surgical Associates, P.C. v. Commissioner*, T.C. Memo. 2001-81.

<sup>657</sup> *Mulcahy, Pauritsch, Salvador & Co. v. Commissioner*, 680 F.3d 867 (CA-7 2012), *aff'g* T.C. Memo. 2011-74.

In *Pediatric Surgical Associates*, the Tax Court recharacterized a portion of the amounts paid as wages to the shareholder-employees of a C corporation operating a medical practice as nondeductible dividend distributions. The Court rejected the argument advanced by the taxpayer that *Richlands Medical Association*<sup>658</sup> established a rule of law that an employer may deduct as compensation paid to an employee an amount equal to the collections received by the corporation for services performed by such employee.

In *Mulcahy*, the Seventh Circuit Court of Appeals, affirming the Tax Court, held that over \$850,000 paid in each of the three years in issue to entities controlled by the founding shareholders of an accounting firm operated as a C corporation should be recharacterized as nondeductible dividend distributions. The *Mulcahy* case represents the first case in which a court applied the so-called “independent investor test” in determining reasonable compensation in the professional service corporation setting.

The IRS had not challenged the salary deductions, but disallowed the consulting fees paid to entities controlled by common shareholders as nondeductible dividends, resulting in a deficiency in corporate income tax of more than \$300,000 for each of the three years in issue. The Court stated that whatever the method of allocation of the firm’s income (in accordance with stock ownership or otherwise), if the fees were paid out of corporate income, the firm owed corporate income tax on the net income represented by those fees and specifically stated that “a corporation cannot avoid tax by using a cockeyed method of distributing profits to its owners.”

The *Mulcahy* Court went on to state that “remarkably, the firm’s lawyers (*an accounting firm’s lawyers*) appear not to understand the difference between compensation for services and compensation for capital ...” The Court also noted its puzzlement that the firm chose to organize as a conventional business corporation in the first place, and scathingly concluded by stating “(t)hat an *accounting firm* should so screw up its taxes is the most remarkable feature of the case.”

Under the independent investor test, the courts consider whether payments made as salary to shareholder-employees meet the standards for deductibility by taking the perspective of a hypothetical “independent investor” who is not an employee. In essence, the test provides that if the corporation’s return on equity remains at a level that would satisfy an independent investor, there is a strong indication that management is providing compensable services and that profits are not being siphoned out of the corporation as disguised salary.

**The Tax Court’s Independent Investor Analysis.** In *Brinks*, the Tax Court found that the Taxpayer had substantial investment capital even without regard to any intangible assets based on the shareholders’ equity of \$8 million at the end of 2007 and \$9.3 million at the end of 2008. The Court found that investor capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder-employees is really a distribution of earnings. Consequently, the Court concluded that the Taxpayer’s practice of paying out year-end bonuses to its shareholder-employees that eliminated its book income failed the independent investor test.

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<sup>658</sup> T.C. Memo. 1990-660, *aff’d without published opinion* 953 F.2d 639 (CA-4 1992).

The Taxpayer argued that Code § 83 and the regulations dealing with transfers of property in connection with the performances of services, as well as the fact that the shareholder-employees acquired their stock at a price equal to its cash book value and must sell their stock back to the corporation for a price determined under the same formula upon terminating their employment, suggested that its shareholder-attorneys lack the normal rights of equity owners, and as such, that the independent investor test should not apply in their case. The Tax Court rejected both of these arguments:

If petitioner's shareholder-attorneys are not its owners, who are? If the shareholder-attorneys do not bear the risk of loss from declines in the value of the assets, who does? The use of book value as proxy for fair market value deprives the shareholder-attorneys of the right to share in the unrealized appreciation upon selling their stock - although they are correspondingly not required to pay for unrealized appreciation upon *buying* the stock. Acceptance of these concessions to avoid difficult valuation issues does not compel the shareholder-attorneys to forego, in addition, any current return on their investments based on the corporation's profitable use of its assets in conducting its business. Petitioner's arrangement effectively provides its shareholder-attorneys with a return on their capital through amounts designated as compensation. Were this not the case, we do not believe the shareholder-attorneys would be willing to forego any return on their investments.<sup>659</sup>

Concluding that the Taxpayer's authority for its position was not "substantial when weighed against the contrary authority," the Tax Court found that the independent investor test authority outweighed the authority for deducting amounts which effectively zeroed out the corporate income.

The *Brinks* Tax Court addressed the Taxpayer's argument that it had reasonable cause for its position and acted in good faith. Specifically, the Taxpayer alleged that its reliance on its accounting firm to prepare its returns for the years in issue constituted reasonable cause and demonstrated good faith. The Tax Court concluded that the Taxpayer consistently followed a system of computing year-end bonuses that disregarded the value of its shareholder-attorneys' interest in the capital of the firm and inappropriately treated such amounts as compensation in order to eliminate the firm's book income. Specifically, the Tax Court stated that "(a)lthough petitioner offered no evidence as to why it adopted its practice of paying year-end bonuses, it is difficult to imagine reasons that are not tax related."

As demonstrated by *Brinks* and *Mulcahy*, it may be difficult for professional corporations to satisfy the independent investor test where the professional corporation distributes all or substantially all of its income in the form of compensation to its shareholder-employees, leaving no return for the shareholders for their investment. The IRS can also attack compensation paid to the shareholders of a professional services corporation based on the compensatory intent

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<sup>659</sup> T.C. Memo. 2016-20 at p. 26.

prong of Treasury Regulation § 1.162-7(a), as demonstrated by *Richlands Medical Association*<sup>660</sup> and *Pediatric Surgical Associates*.<sup>661</sup>

The *Brinks* case should send a strong signal to mid-size to large personal service corporations operating as C corporations that the IRS can and will recharacterize wages as nondeductible dividends where the professional corporation's normal practice is to zero out all income by payment of compensation to its shareholder-employees.

**[i] S Corporation's – Unreasonable Compensation.**

While things may be changing after the enactment of the TCJA, S corporations currently dominate the corporate landscape. They represent nearly two-thirds of all corporate entities. According to the Service, 3.9 million businesses were S corporations in 2006, representing an increase of 35% from tax year 2000, and the number of S corporation shareholders is 6.7 million.<sup>662</sup> In 2006, S corporations accounted for \$413 billion in total net income and \$3.3 trillion in assets, an increase of \$166 billion in net income and \$1 trillion in net assets from tax year 2000.<sup>663</sup> Consequently, S corporations have been a focus of IRS exam efforts.

Usually, in the S corporation context, taxpayers are primarily concerned with making their compensation as low as possible to reduce employment and self-employment taxes, both of which include Social Security taxes and the Medicare tax. The Social Security taxes are imposed on employee compensation and self-employment income up to the Social Security Wage Base (currently \$132,900), and the Medicare tax is imposed on employee compensation and self-employment income without a ceiling. By paying low compensation, S corporations and their shareholder employees can limit their liability for Social Security and Medicare taxes.

However, the law is clear – shareholder employees of S corporations must be paid reasonable compensation for services performed for the corporation.<sup>664</sup> The cost of not paying shareholder employees adequate compensation for services actually rendered is recharacterization of distributions as wages. With such a recharacterization comes:

- Penalties;
- Interest; and
- Payroll taxes (Social Security and Medicare).

Despite the reasons for paying low compensation, there are countervailing incentives for some S corporations to pay high compensation. For example, a shareholder employee may wish to maximize his or her retirement income, which is based on compensation. In addition, the S corporation could be motivated to pay excessive compensation to one shareholder to avoid

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<sup>660</sup> *Richlands Medical Association v. Commissioner*, T.C. Memo. 1990-66, *aff'd without published opinion*, 953 F.2d 639 (CA-4 1992).

<sup>661</sup> T.C. Memo. 2001-81.

<sup>662</sup> I.R.S. News Release IR-2009-77 (Aug. 25, 2009).

<sup>663</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-1-195, TAX GAP: ACTIONS NEEDED TO ADDRESS NONCOMPLIANCE WITH S CORPORATION TAX RULES (2009) (hereinafter, *GAO Report*).

<sup>664</sup> *Spicer Accounting, Inc. v. United States*, 66 AFTR2d 90-5806, 918 F.2d 90 (9th Cir. 1990).

violating the single class of stock requirement under Code § 1361(b)(1)(D). Finally, in some cases an S corporation may want to pay excessive compensation to eliminate its income, avoiding paying built-in gains tax under Code § 1374.

The self-employment tax is comprised of two components, namely Social Security and Medicare (or hospital insurance). Under Code § 1401, it is imposed on net earnings from self-employment. The term “net earnings from self-employment” is defined under Code § 1402(a) as the gross income derived by an individual from any trade or business less any allowable deductions attributable to such trade or business. To be engaged in a trade or business, an individual must be involved in an activity with continuity and regularity, and his primary purpose for engaging in the activity must be for income or profit.<sup>665</sup>

In Revenue Ruling 59-221,<sup>666</sup> the Service ruled income passing through from an S corporation to its shareholders is not “net earnings from self-employment” and thus is not subject to self-employment tax. The 1982 Subchapter S Revision Act,<sup>667</sup> specifically excludes “dividends on any share of stock.”<sup>668</sup> Thus, S corporation distributions are excluded from self-employment tax treatment.<sup>669</sup>

The ability to limit the employment tax liability is one of the most popular reasons small business corporations make S elections. Employers are required to withhold employment taxes (also known as payroll taxes) under Federal law. Code §§ 3111 and 3301 impose the Federal Insurance Contribution Act (“FICA”) and Federal Unemployment Tax Act (“FUTA”) taxes on employers for wages paid to employees “with respect to employment.”<sup>670</sup> The FICA tax has two components: the Old-Age, Survivor, and Disability Insurance (“OASDI”) component (i.e., Social Security component); and the Hospital Insurance (“HI”) component (i.e., Medicare component).

- FUTA is usually not relevant in reasonable compensation cases because its tax base is limited to the first \$7,000 paid to an employee. FUTA is only paid by the employer. Although the Federal FUTA rate is 6%, most employers received a maximum credit of 5.4% for state unemployment contributions. Thus, in most cases the FUTA tax rate is effectively .6%.
- FICA’s OASDI component imposes a 6.2% tax on both the employer and the employee, for a combined 12.4% rate.<sup>671</sup> The OASDI tax base is wages paid “with respect to employment” up to a specified ceiling.<sup>672</sup> For 2019, the ceiling is \$132,900; so the maximum combined tax on the OASDI component

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<sup>665</sup> *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

<sup>666</sup> 1959-1 C.B. 225.

<sup>667</sup> Pub. L. No. 97-354, 96 Stat. 1669 (1982).

<sup>668</sup> Code § 1402(a)(2).

<sup>669</sup> In *Ding v. Commissioner*, 84 AFTR2d 99-7517, 200 F.3d 587 (9th Cir. 1999), the Ninth Circuit held that the taxpayer must compute net earnings from self-employment and Code § 1401 self-employment tax liabilities without taking into account S corporation passthrough items and that net earnings from self-employment must be computed without taking into account any net operating carryover loss.

<sup>670</sup> Code § 3111(a), (b).

<sup>671</sup> Code §§ 3101(a) (6.2% imposed on the employee), 3111(a) (6.2% imposed on the employer).

<sup>672</sup> Code § 3111(a), (b).

is \$16,479.60 (the employer pays its \$8,239.80 portion and withholds the employee's \$8,239.80 portion).<sup>673</sup>

- FICA's HI component imposes a 1.45% on both the employer and the employee, for a combined rate of 2.9%. The HI component is not subject to a ceiling. In fact, there is an additional .9% tax imposed on the employee only on wages in excess of a threshold amount.<sup>674</sup> The threshold amount is \$250,000 for joint returns, \$125,000 for married taxpayers filing separately, and \$200,000 in all other cases. Thus, an unmarried taxpayer making \$300,000 of wages would pay 1.45% on the first \$200,000 and 2.35% on the \$100,000 in excess of the threshold amount.

In determining whether employment taxes apply, the two key terms are “employee” and “wages.” The first key term—employee—is defined for employment tax purposes to include any officer of a corporation.<sup>675</sup> There is, however, a limited exception: An officer who performs no services (or only minor services) and who is not entitled to receive remuneration is not considered an “employee” for employment tax purposes.<sup>676</sup> The second key term—wages—is defined for employment tax purposes as “all remuneration for employment.”<sup>677</sup> In considering whether a payment is “wages,” the payment form is immaterial; rather, the only relevant consideration is whether payment was received as remuneration for employment.<sup>678</sup>

Therefore, as the Tax Court explained in *Veterinary Surgical Consultants v. Commissioner*,<sup>679</sup> a corporate officer is considered an employee and his wages are subject to Federal employment taxes if the officer:

- performs substantial services, and
- receives remuneration for those services in any form.

In that case, the Tax Court held the distributions of the taxpayer (an S corporation) to its sole shareholder were subject to employment tax; the shareholder, who was an officer of the taxpayer, performed substantial services for the taxpayer where: (1) he worked around 33 hours a week for the taxpayer; (2) he was the only individual working for the taxpayer; and (3) his surgical and consulting services generated all of the taxpayer's income.

While the reasonable compensation analysis is usually considered in the context of the Section 162 income tax deduction, the Service applies same concept to FICA tax cases. In Revenue Ruling 74-44,<sup>680</sup> an S corporation distributed dividends to its two sole shareholder employees, but did not pay any wages for their services. The Service ruled it could recharacterize dividend

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<sup>673</sup>  $6.2\% \times \$132,900 = \$8,239.80$ .

<sup>674</sup> Code § 3101(b)(2).

<sup>675</sup> Code § 3121(d).

<sup>676</sup> Treas. Reg. § 31.3121(d)-(1)(b).

<sup>677</sup> Code §§ 3121(a), 3306(b).

<sup>678</sup> Treas. Reg. §§ 31.3121(a)-1(b), 31.3306(b)-1(b).

<sup>679</sup> 117 T.C. 141 (2001), *aff'd sub nom, Yeagle Drywall Co. v. Commissioner*, 90 AFTR2d 2002-7744, 54 Fed. Appx. 100 (3d Cir. 2002).

<sup>680</sup> 1974-1 C.B. 287,

payments as wages for FICA tax purposes because “the ‘dividends’ paid to the shareholders . . . were in lieu of reasonable compensation for their services.” Similarly, many circuits apply the reasonable compensation tests to S corporation FICA cases.<sup>681</sup>

The Federal Insurance Contribution Act (FICA)<sup>682</sup> imposes “on every employer an excise tax, with respect to having individuals in [its] employ,” calculated as a certain percentage of wages the employer pays “with respect to employment.”<sup>683</sup> Wages means “all remuneration for employment,” subject to some exceptions.<sup>684</sup> However, an employer is not required to pay FICA taxes on dividends and other types of employee income.<sup>685</sup> In determining whether employee payments constitute “wages,” it is immaterial what the employee payments are called and what medium the payments are made.<sup>686</sup>

Treasury Inspector General for the Tax Administration Report No. 2002-30-125 was issued on July 5, 2002. The report was the result of a study on compensation paid by S corporations to its shareholders employees. The report reveals that 5% of 2,600,000 IRS Forms 1120S filed in 1998 reported S corporation shareholder employee compensation under \$10,000. In fact, in eighty four S corporation cases under examination by the Service, the study revealed that the average wages for S corporation shareholders employees was approximately \$5,300, while the average distribution to these same shareholders employees was approximately \$350,000. The report recommended that the Service aggressively review S corporation shareholder employee compensation to ensure reasonable compensation is reported and appropriate FICA taxes are collected. The result of this study is currently being felt by tax practitioners in that shareholder compensation is being carefully scrutinized by the Service in its audits of S corporations.

In 2005, the Service launched a study to assess the reporting compliance of S corporations. The study, carried out under the National Research Program (“NRP”), examined roughly 4,800 randomly selected S corporation returns from tax years 2003-2004. While the Service has not revealed the full, detailed results of the study, it appears likely there will be a significant increase in S corporation audits in the future and they will focus on at least six areas:

- Unreasonably low compensation;
- Insufficient S corporation stock basis to deduct losses passed through from S corporations;
- Noncompliance with qualification rules;
- Failure of shareholders to report income passed through from S corporations;

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<sup>681</sup> See, e.g., *Joseph Radtke, S.C. v. United States*, 65 AFTR2d 90-1155, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. United States*, 66 AFTR2d 90-5806, 918 F.2d 90 (9th Cir. 1990).

<sup>682</sup> Code §§ 3101 to 3128.

<sup>683</sup> Code § 3111(a), (b).

<sup>684</sup> Code § 3121(a).

<sup>685</sup> *Watson, P.C. v. United States*, 109 AFTR2d 2012-1059, 668 F.3d 1008 (8th Cir. 2012) (citing *HB & R, Inc. v. United States*, 86 AFTR2d 2000-6426, 229 F.3d 688 (8th Cir. 2000)).

<sup>686</sup> Treas. Reg. §§ 31.3121(a)-1(c) & -1(e).

- Improper tax-free treatment of fringe benefits provided to S corporation shareholder employees and their families; and
- Conversion of nondeductible personal expenses into deductible business expenses.

Unreasonably low compensation is likely at the top of the Service's S corporation audit list. It is low-hanging fruit. Tax practitioners need to take action to prevent the Service from asserting that S corporation distributions should be treated as shareholder employee compensation.

**PRACTICE TIP:** Advise S corporation clients to consider developing a compensation methodology for shareholder employees which establishes compensation based upon:

- Personal qualifications;
- Nature, extent and scope of work actually performed;
- Compensation required to be deferred in prior years due to lack of cash;
- Compensation paid for similar work by the corporation to its non-shareholder employees; and
- Compensation paid for similar work in comparable businesses.

Application of the above factors, and the actual compensation derived therefrom, should be documented in written corporate minutes each year.

A report of the United States Government Accountability Office (“GAO”) was submitted to the Senate Finance Committee in December 2009.<sup>687</sup> The report was the result of a study on long-standing S corporation income and employment tax noncompliance issues. The Senate Finance Committee asked the GAO to analyze the types of S corporation noncompliance, what the IRS has done to address the noncompliance and to identify options to improve compliance. It also asked the GAO to analyze the extent of shareholder compensation noncompliance and to identify options to improve compliance. Although the report was based primarily on the data from the NRP, it also reflects the GAO's interviews of CPAs, legal professionals, small business representatives, and IRS officials and examiners, as well as representatives of several of the companies selected for audit during the NRP.

According to the GAO Report,<sup>688</sup> an estimated 68 percent of all S corporation returns filed for tax years 2003 and 2004 misreported at least one item affecting net income. The aggregate misreported amount (taking into consideration both underreported and over reported amounts) for those years was estimated at \$85 billion. Assuming a 10% tax rate, that is \$8.5 billion in lost tax revenues for tax years 2003 and 2004. The major items misreported were:

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<sup>687</sup> *Supra* note 247.

<sup>688</sup> *Supra* note 370.

- Distributions;
- Gross Sales;
- “Other” Deductions (e.g., amortization, professional fees, insurance premiums, certain business costs, supplies, travel, meal, entertainment and utilities);
- Shareholder Compensation;
- Cost of Goods Sold; and
- Depreciation.

Misreporting of net income was more prevalent with S corporations having three or fewer shareholders. It was also more prevalent with S corporations having fewer than \$250,000 of net assets. In some cases, S corporations had deducted personal expenses of the shareholder(s) (e.g., payments for personal taxes, personal tax return preparation, personal insurance or personal vehicles). In other cases, the S corporations were unable to substantiate the expenses they had deducted. Interestingly, the misreporting statistics were generally the same among S corporations which used a paid tax return preparer and those which did not use a paid tax return preparer.

The GAO made a number of recommendations to the Senate Finance Committee to improve S corporation compliance, but it heavily stressed the importance of stricter regulation on tax return preparers. For instance, Federal tax returns filed by taxpayers in Oregon (a state with rigorous preparer licensing requirements) for tax year 2008 were shown to be more accurate compared to those filed by taxpayers in the rest of the country. Alternatively, the GAO recommended the possibility of levying penalties on tax return preparers who understate a taxpayer’s tax liability. Statistics, however, do not show penalties will necessarily improve tax compliance.

Another major issue the GAO addressed was avoidance of employment taxes (Social Security and Medicare) vis-à-vis large distributions to shareholders.<sup>689</sup> Because distributions to S corporation shareholders are not subject to employment taxes, S corporations sometimes improperly pay their shareholders low wages while making large distributions to them during the year. According to NRP data, about 13% of S corporations paid inadequate wages, resulting in just over \$23.6 billion in net underpaid wages. Nearly all underpayments of wages occurred in S corporations with one to three shareholders.

Determining what a shareholder’s wages should have been during a year is based on the facts and circumstances. Consequently, the IRS often has difficulty determining when too few wages have been reported and/or arriving at justifiable conclusions on the appropriate amount of wages a shareholder should have received. IRS examiners reported they typically only pursue the issue in cases in which a shareholder reported little to no wages, but had large distributions from an S corporation during the year.

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<sup>689</sup> *Supra* note 370.

The GAO recommended disposing of the facts and circumstances test in determining an employment tax liability. Instead, the GAO proposed the following options:

- Make net business income reported by S corporations subject to employment taxes;
- Make net business income for service sector businesses subject to employment taxes;
- Make net business income for majority shareholders subject to employment taxes;
- Make payments to active shareholders subject to employment tax;
- Make payments to active shareholders up to a dollar tolerance subject to employment tax; or
- Retain character of income between entities.

The first three options would eliminate the need to determine an adequate wage payment for each shareholder. Instead, the basis for an employment tax liability would be shifted to the S corporation's net business income, similar to sole proprietors and partnerships. Under the fourth and fifth options, an employment tax liability would be shifted to all payments made to active shareholders, including wages, personal payments, distributions or loans. Under the final option, the current facts and circumstances test would not change. However, it would eliminate the ability of taxpayers to use an S corporation to shelter business income from a partnership—(i.e., the shareholder could not insert an S corporation between the partnership and individual and shelter the partnership income from employment taxes). Any income flowing from the partnership to the S corporation would retain its self-employment tax character to the individual shareholder.

As discussed above, businesses choose to operate as S corporations to, among other reasons, limit FICA tax liability paid on employee wages. This attribute of S corporation status is viewed by many to be a loophole that gives S corporations and their shareholders an unfair tax advantage. Accordingly, there have been numerous attempts to limit the ability of service providers to avoid employment taxes by routing income through an S corporation and paying themselves nominal salaries.

One of the provisions of the American Jobs and Closing Tax Loopholes Act of 2010,<sup>690</sup> passed by the House, (the “tax extenders bill”) would have required shareholders of a professional service S corporation to take into account for self-employment tax purposes all of their pro rata share of S corporation income attributable to the service business. This change would make it more difficult for the shareholders to avoid employment taxes by paying themselves nominal salaries for services rendered to the corporation. The proposed employment tax rules would have applied to: (i) any S corporation which is a partner in a professional service business, if

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<sup>690</sup> H.R. 4213, 111th Cong. § 413 (2010).

substantially all the S corporations' activities are performed in connection with such partnership; or (ii) any other S corporation engaged in a professional service business if the principal asset of such business is the reputation and skill of three or fewer employees. The term "professional service business" was defined as any trade or business, substantially all of the activities of which involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, investment advice, or brokerage services. These changes were set to go into effect for all taxable years beginning after December 31, 2010.

The proposed employment tax changes were not received particularly well in the Senate. Initially, the Senate Finance Committee Chairman, Max Baucus, indicated the language of the rules would need to be modified. He proposed to change the bill to target S corporations engaged in a professional service business if 80% or more of the gross income of such business is attributable to the service of three or fewer shareholders, thereby removing the concepts of principal asset, reputation and skill, and employees.

On September 17, 2010, however, Baucus completely removed the new employment tax rules from the tax extenders bill, much to the jubilation of S corporation allies. Although the new rules have been removed for the time being, most people expect them to return in the future, whether in a similar or modified form.

In 2012, another legislative attempt was made to limit personal service providers' ability to avoid employment taxes by routing income through an S corporation. Senator Harry Reid introduced the Stop Student Loan Interest Rate Hike Act of 2012,<sup>691</sup> on April 25, 2012. The bill would have treated S corporation pass-through items as income or loss from self-employment.<sup>692</sup> Specifically, "the net earnings from self-employment" of a shareholder "who provides substantial services with respect to a professional service business" would have included the shareholder's pro rata share of S corporation income or loss.<sup>693</sup> Again, fortunately for S corporation allies, this legislative attempt to curb S corporation avoidance of employment taxes failed.

It is important to note that if an S corporation shareholder earns income directly, he cannot have the S corporation report the income in order to avoid the self-employment tax. In *Ruckman v. Commissioner*,<sup>694</sup> the Tax Court held amounts paid to an S corporation shareholder for dispatch services provided to another corporation were income to the shareholder and, therefore, subject to self-employment tax. The court explained, in determining the true earner of income, a court will look to the person who controls the earning of the income:

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<sup>691</sup> S. 2343, 112th Cong. § 3 (2012).

<sup>692</sup> *Id.*

<sup>693</sup> *Id.*

<sup>694</sup> T.C. Memo. 1998-83.

A two-part test must be satisfied before the corporation, rather than its service-performing agent or shareholder, will be considered to control the earning of the income. First, the service provider must be the employee of the corporation, whom the corporation has the right to direct and control in some meaningful sense. Second, there must exist between the corporation and the service recipient a contract or similar indicium recognizing the corporation's controlling position.<sup>695</sup>

The court rejected the shareholder's argument that income was properly reportable by the S corporation and, therefore, not subject to self-employment tax.

S corporation employee shareholders could seemingly take earnings without paying employment or self-employment taxes. However, the IRS and the courts have ruled S corporations must at least pay reasonable salaries to employee shareholders, which would be subject to FICA tax.

Regardless of how an employer characterizes employee payments, the true analysis is whether the payments represent remuneration for services rendered. As discussed above, in *Radtke v. United States*,<sup>696</sup> the District Court for the Eastern District of Wisconsin held an S corporation PSC's distributions to its sole shareholder and only employee, an attorney who worked full-time, were wages subject to employment taxes.

The Seventh Circuit agreed that where compensation is paid as dividends, and no salary is paid, the dividends are reclassified as compensation for services subject to employment tax.<sup>697</sup>

**An S corporation must pay its shareholder employees reasonable compensation for services performed for the corporation**

In *Spicer Accounting v. United States*,<sup>698</sup> the Ninth Circuit denied the taxpayer's claim for a refund of employment taxes paid on amounts the corporation distributed to its shareholder employee, Spicer. Spicer was the president, treasurer, and director of the taxpayer, Spicer Accounting, Inc.

Spicer and his wife were shareholders in the taxpayer, each owning a 50% interest. Spicer never signed an employment agreement and was never paid wages from the taxpayer. He reported the taxpayer's distributions as dividend income. Spicer worked for the taxpayer around thirty-six hours a week. He was the taxpayer's only accountant, although his wife and another employee worked as bookkeepers and prepared tax returns. Spicer testified he thought paying compensation as dividends was a correct way to avoid paying employment taxes.

The Service assessed FICA and FUTA taxes, penalties, and interest for 1981 and 1982. After paying the assessed amounts, the taxpayer filed a refund claim with the Service. Upon denial, he filed suit in the district court. The district court held Spicer was an employee and his wages were subject to employment taxes. The taxpayer then appealed to the Ninth Circuit.

<sup>695</sup> *Id.* at 98-466.

<sup>696</sup> *Joseph Radtke, S.C. v. United States*, 63 AFTR2d 89-1469, 712 F.Supp. 143 (E.D. Wis. 1989), *aff'd*, 65 AFTR2d 90-1155, 895 F.2d 1196 (7th Cir. 1990).

<sup>697</sup> *Id.* at 90-1156.

<sup>698</sup> 66 AFTR2d 90-5806, 918 F.2d 90 (9th Cir. 1990).

On appeal, The Ninth Circuit concluded Spicer was an employee and the dividends were wages subject to employment taxes. It explained that, under Treasury Regulation §§ 31.3121(a)1(b), 31.3306(b)-1(b), “an officer who performs substantial services for the corporation is considered an employee, whose wages are subject to FICA and FUTA.”<sup>699</sup> It then found Spicer performed substantial services for the taxpayer:

In the present case, Mr. Spicer clearly performed substantial services for the taxpayer corporation. He was the only accountant working for taxpayer, an accounting concern. During the years in question, he performed accounting services for the taxpayer approximately 36 hours a week. He was the only one who signed customers’ returns as the preparer, performed financial planning for Taxpayer, audited clients’ books, prepared opinion letters for clients, and represented clients before the Internal Revenue Service. He also reviewed and paid Taxpayer’s bills, and set Taxpayer’s billing rate.<sup>700</sup>

Thus, the Ninth Circuit affirmed the district court and held, “because Mr. Spicer performed substantial services that were essential to Taxpayer, Mr. Spicer should be deemed an employee, and payments to him should be deemed “wages” subject to FICA and FUTA.”<sup>701</sup>

As discussed above, in *Veterinary Surgical Consultants*,<sup>702</sup> the taxpayer, an S corporation, provided consulting and surgical services to veterinarians. Its sole shareholder, officer and employee, rendered all of the services which generated taxpayer’s revenues. Accordingly, the Tax Court concluded he was an employee of the taxpayer.

As discussed above, in *Watson, P.C. v. United States*,<sup>703</sup> the taxpayer, David E. Watson, graduated from the University of Iowa with a bachelor’s degree in business administration and a specialization in accounting. He became a CPA in 1983. In 1996, Watson incorporated DEWPC, a professional corporation which elected to be treated as an S corporation. Watson is the sole officer, shareholder and director of DEWPC. The corporation was a partner in a small accounting firm. In 2003 and 2004, the tax years at issue, he was the only person to whom DEWPC distributed money. His salary in both years was \$24,000. In arriving at his \$24,000 annual salary figure, Watson had only considered what he thought he could pay an employee on a regular and continuous basis, regardless of the “seasonability” of the business or whether it was a good economy or bad economy. He did not consider what comparable businesses paid for similar services. During 2003 and 2004, Watson received distributions totaling roughly \$320,000.

For each tax year, the Service reclassified \$67,044 of the distributions as wages, stating DEWPC structured Watson’s salary and distribution payments to avoid Federal employment taxes. The Service’s recharacterization resulted in a \$48,519 employment tax assessment against DEWPC. After making a few payments toward the assessment, DEWPC filed a claim for refund. The IRS denied the claim and DEWPC sued in district court.

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<sup>699</sup> *Id.* at 90-5808.

<sup>700</sup> *Id.*

<sup>701</sup> *Id.* at 90-5809.

<sup>702</sup> 117 T.C. 141 (2001).

<sup>703</sup> 109 AFTR2d 2012-1059, 668 F.3d 1008 (8th Cir. 2012).

The district court held in favor of the Service. It reasoned that Watson was an exceedingly qualified accountant. He has both a bachelor's degree and an advanced degree, and approximately 20 years of experience in accounting and taxation. During 2002 and 2003, Watson worked approximately 35 to 45 hours per week for his reputable and well-established firm which had over \$2 million and nearly \$3 million in gross revenue, respectively, during those years. The court further reasoned that any reasonable person in Watson's role as DEWPC's sole shareholder, officer, and employee would have earned more than \$24,000, particularly in light of the large distributions he received. Based on these facts and circumstances, the court was convinced that DEWPC structured Watson's salary and dividend payments in an effort to avoid Federal employment taxes, with full knowledge that the distributions to Watson were actually "remuneration for services performed."

Watson appealed the district court decision to the Eighth Circuit Court of Appeals, where he asserted at least two alternative positions:

- The government's expert on the issue of reasonable compensation should not be relied upon; and
- The focus should be on the corporation's intent with respect to compensation rather than on the reasonableness of compensation.

After much discussion, the Eighth Circuit found both of the taxpayer's arguments meritless.

DEWPC asserted the government's expert, among other things, was not qualified to render a reliable opinion on reasonable compensation. He was a certified business valuation analyst, but had no credentials specifically relating to compensation. The court concluded the taxpayer's argument was not convincing. The expert was an experienced "general engineer" for the IRS; he spent 40% of his time dealing with compensation issues. In fact, he had worked on 20 to 30 reasonable compensation cases. In accordance with Rule 702 of the Federal Rules of Evidence, a witness may qualify as an expert by "knowledge, skill, experience, training or education."

DEWPC also argued the government's expert witness should not be relied upon because he changed his opinions during the lower court proceeding, failed to consider important facts in rendering his opinion, and he adopted flawed methods to arrive at his conclusions. Unfortunately, DEWPC never raised these objections in the lower court, nor did it introduce evidence through its own expert witness to contradict the government's position.

To address DEWPC's second argument, the Eighth Circuit surveyed the cases on reasonable compensation. "[A] business may deduct a 'reasonable allowance for salaries or other compensation for services actually rendered' as ordinary and necessary business expenses." The determination of reasonableness requires an analysis of all of the facts and circumstances. The lower court considered the relevant facts and circumstances. Nevertheless, DEWPC asserted, rather than focus on reasonableness, the court should have focused on the taxpayer's intent; that is – did the taxpayer have compensatory intent in making the distributions to Watson.

The court quickly set aside the taxpayer's argument. It stated a deduction for compensation is allowed if it is reasonable and the payments are for actual services rendered. Citing the Ninth

Circuit Court of Appeals in *Elliotts, Inc. v. Commissioner*,<sup>704</sup> the court concluded the reasonableness inquiry is so broad, it most often subsumes the intent inquiry. The lower court correctly analyzed the matter with its focus on reasonableness.

Last, DEWPC argued the lower court should have applied the principles of *Pediatric Surgical Associates*.<sup>705</sup> Specifically, DEWPC asserted Watson's reasonable compensation should have been limited to his personal billing receipts less expenses attributable to those receipts. The Eighth Circuit quickly pointed out that Watson was not the only person generating revenue. Non-shareholder employees were also generating revenue. So, merely focusing on Watson's personal time-keeper receipts and expenses attributable thereto was not appropriate in this case. Other evidence is relevant to the inquiry of reasonableness, including but not limited to: (1) business generated by the shareholder employee; (2) the employee's experience, expertise, hours worked, and education; (3) lack of arms-length negotiation; (4) compensation history; and (5) the financial ability of the corporation.

The Eighth Circuit, after concluding the lower court's decision was based upon the proper legal standards, affirmed.

There are significant economic incentives for certain S corporations to pay unreasonably high compensation. First, an S corporation would want to pay excessive contribution to avoid paying built-in gains tax under Code § 1374 (discussed above). Second, a shareholder employee may wish to maximize his or her retirement income, which is based on compensation. Finally, the S corporation could be motivated to pay excessive compensation to one shareholder to avoid violating the single class of stock requirement under Code § 1361(b)(1)(D).

Maximizing retirement contributions is a common reason for S corporations to pay unreasonably compensation to its shareholders.<sup>706</sup> An illustrative case is *LaMastro v. Commissioner*.<sup>707</sup> Anthony LaMastro, formed a professional service corporation taxed under Subchapter S in 1970 to operate a dental practice.<sup>708</sup> The corporation's first fiscal tax year—1970—was a short 14 days.<sup>709</sup> During that first fiscal year, the corporation adopted a pension plan, borrowed funds from LaMastro, and contributed the borrowed funds to the plan.<sup>710</sup> The corporation's pension plan contribution deduction resulted in a \$25,796 net operating loss, which passed through to LaMastro.<sup>711</sup> LaMastro and his wife, Helen LaMastro (the petitioners), reported the net operating loss on their 1970 joint return.<sup>712</sup>

The Service issued a notice of deficiency to Anthony and Helen LaMastro that disallowed the corporation's entire \$24,000 retirement plan contribution, thereby increasing LaMastro's distributive share of taxable income. Anthony and Helen LaMastro petitioned the Tax Court. In

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<sup>704</sup> 716 F.2d 1241, 52 AFTR2d 83-5976 (1983).

<sup>705</sup> T.C. Memo. 2001-81 (2001).

<sup>706</sup> See, e.g., *Bianchi v. Commissioner*, 66 T.C. 324 (1976), *aff'd per curiam*, 39 AFTR2d 77-894, 553 F.2d 93 (2d Cir. 1977).

<sup>707</sup> 72 T.C. 377, 378 (1970).

<sup>708</sup> *Id.* at 378-79.

<sup>709</sup> *Id.* at 379.

<sup>710</sup> *Id.*

<sup>711</sup> *Id.*

<sup>712</sup> *Id.* at 379-80.

its amended answer, the Service reduced its disallowance, and later stipulated that only \$19,207 of the \$24,000 pension plan contribution should have been disallowed.

The Tax Court explained that Section 404(a) limits allowable deductions to compensation that would otherwise be deductible under Section 162.<sup>713</sup> It concluded the pension plan contribution was an unreasonably high compensation allowance for services rendered by LaMastro during the corporation's 14-day taxable year. Accordingly, the Tax Court upheld the Service's disallowance of the petitioners' net operating loss deduction.

Finally, an S corporation may be incentivized to pay unreasonably high compensation to avoid having disproportionate distributions, thereby losing its S election. Under Sections 1361 (b)(1)(D), S corporations may only have one class of stock. Accordingly, they are required to make shareholder distributions pro rata based on share ownership. If the corporation wants to treat one shareholder differently than another, because it needs to maintain one class of stock, it may attempt to differentiate the shareholders through compensation.

## **[2] Accumulated Earning Tax.**

The accumulated earnings tax ("AET") is a corporate-level tax intended "to deter use of a corporate entity to avoid personal income taxes."<sup>714</sup> The purpose of the tax is to prevent corporations from retaining earnings and profits in excess of the corporation's business needs so that shareholders will become liable for taxes on the dividends received.<sup>715</sup> In the past, prior to the enactment of the Internal Revenue Code of 1986, Federal income tax rates imposed on individuals were much higher than rates imposed on corporations. Because of this disparity, closely held C corporations were strongly motivated to accumulate corporate earnings and profits. Once again, after the enactment of the TCJA, the Federal income tax rates of individuals are much higher than C corporations (37% versus 21%). So, closely-held C corporations find themselves motivated to retain earnings and profits.

Shareholders of closely held business are motivated to retain earnings and profits at the corporate level for a number of reasons, including:

- First, the income accumulated could then compound at the lower corporate rate instead of at the higher individual rates. The deferral of the tax on distributions allows closely held corporations to obtain returns on cash that, if distributed, would have been used to pay tax.
- Second, the shareholder could dispose of the stock in a tax deferred merger.
- Third, if earnings are retained until the shareholder's death, the shareholder's beneficiaries will then obtain a step up in basis of the stock under Code § 1014.

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<sup>713</sup> *Id.* at 381.

<sup>714</sup> *United States v. Donruss Co.*, 393 U.S. 297, 303 (1969).

<sup>715</sup> *Id.*

Today, with the top income tax rate for individual taxpayers at 37% and a flat corporate income tax rate of 21%, the incentive to retain corporate earnings and profits in the C corporation form of business exists.

For each taxable year, Code § 531 imposes a 20% tax on the “accumulated taxable income” of a corporation described in Code § 532.<sup>716</sup> A corporation described in Code § 532 is a corporation “formed or availed of for the purpose of avoiding the income tax” by allowing “earnings and profits to accumulate instead of being divided or distributed.” Thus, two factors must be presented before the tax can be imposed:

- the proscribed purpose of avoiding the income tax for its shareholders; and
- the proscribed conduct of permitting earnings and profits to accumulate instead of being divided or distributed.<sup>717</sup>

The first factor is presumed to have been established if a corporation allows earnings and profits to accumulate beyond its reasonable business needs, unless the corporation can prove otherwise by a preponderance of the evidence.<sup>718</sup>

The term “accumulated taxable income” means the corporation’s taxable income, adjusted for taxes and other items in Code § 535(b), minus the sum of the dividends paid deduction defined in Code § 561 and the accumulated earnings credit defined in Code § 535(c). The accumulated earnings credit is equal to the earnings and profits retained (in excess of the dividends paid deduction) for the reasonable needs of the business.<sup>719</sup> Code § 537 defines the reasonable needs of the business as “the reasonably anticipated needs of the business.” Code § 535(c)(2) also provides for a minimum accumulated earnings credit, which “shall in no case be less than the amount by which \$250,000 [\$150,000 in the case of a PSC] exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.”

The American Taxpayer Relief Act of 2012<sup>720</sup> increased the tax rate on the accumulated earnings tax (and the undistributed personal holding company tax discussed in the next section) from 15% to 20%.<sup>721</sup> The Act also removed the prior sunset provisions, making the accumulated earnings tax permanent.<sup>722</sup>

Accumulated taxable income is defined as the corporation’s taxable income, which is adjusted to reflect more accurately economic income, and from which the dividends paid deduction<sup>723</sup> and

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<sup>716</sup> For further information, see CAROLINE H. NGO & JAMES C. WARNER, ACCUMULATED EARNINGS TAX, 796-3rd TAX MGMT. PORTFOLIO (BNA) (2013).

<sup>717</sup> *GPD Inc. v. Commissioner*, 35 AFTR2d 75-348, 508 F.2d 1076 (6th Cir. 1974).

<sup>718</sup> Code § 533(a).

<sup>719</sup> Code § 535(c).

<sup>720</sup> Pub. L. No. 112-240, 126 Stat. 2313 (2013) (hereinafter *Taxpayer Relief Act*).

<sup>721</sup> *Id.* at § 102(c)(1)(A).

<sup>722</sup> *Id.* at § 102(a).

<sup>723</sup> The dividends paid deduction is defined by Code § 561 to consist of dividends paid during the taxable year and consent dividends allowed by Code § 565.

accumulated earnings credit<sup>724</sup> are subtracted. While the tax is imposed only on the accumulated taxable income of the specific year(s), the accumulations from earlier years have a bearing on the questions of tax avoidance and reasonable business needs. As noted above, the AET is imposed in addition to the regular corporate income taxes and is assessable as an additional tax rather than as a penalty. The prohibited avoidance of income tax at the shareholder level may be accomplished with one corporation or a chain of corporations. The AET may be imposed on a lower tier corporation if it accumulates earnings for the purpose of sheltering the shareholders of its parent corporation from income tax that would have been payable if all corporations in the chain had distributed their earnings.

In view of the requirement that the corporation be formed or availed of to avoid tax at the shareholder level, the Internal Revenue Service in practice generally applies the AET only to those corporations, the ownership and control of which is concentrated in a small group of shareholders. Liability for the tax depends on the state of mind or intent to avoid tax by those persons in control of the corporation. Tax avoidance need not be the primary or dominant purpose for accumulation. The Supreme Court, in *United States v. Donruss Co.*,<sup>725</sup> held that tax avoidance need be only one of the purposes; it is sufficient if it merely contributes to the decision to accumulate.

As to evidence of a purpose to avoid tax, the statute provides that “the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.” Moreover, “[t]he fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.”<sup>726</sup> In determining whether the accumulation was for a tax avoidance purpose, the regulations set forth the following factors which are to be considered, along with the specific circumstances of each case: (1) dealings between the corporation and its shareholders, such as loans to shareholders or corporate expenditures for the personal benefit of shareholders; (2) investments of undistributed earnings in assets having reasonable connection with the corporation’s business; and (3) the extent to which the corporation has distributed its earnings and profits. The first two factors tend to show liquidity and dividend capacity of the corporation, from which the prohibited tax avoidance purpose can be inferred. Similarly, a poor dividend history coupled with a favorable earnings history is evidence of a bad motive.

Although liability for the AET theoretically turns on the state of mind or intent, the Supreme Court’s holding in *Donruss* has caused a shift in emphasis from motivation for the accumulation to an analysis of the reasonable needs of the business. Indeed, while the ultimate question technically may be whether the corporation was formed or availed of for tax avoidance at the shareholder level, in practice, the question is whether the corporation had business needs for the accumulation.

Most AET cases have been decided on the reasonable business needs question, apparently based on the statutory rule that an accumulation beyond the reasonable business needs shall be

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<sup>724</sup> The accumulated earnings credit is defined by Code § 535(c).

<sup>725</sup> 393 U.S.297, 69-1 U.S.T.C. P. 9167 (1969).

<sup>726</sup> Code § 533(b).

determinative. After *Donruss*, once an accumulation is found to be unreasonable, it is virtually impossible to bear the burden of proof that tax avoidance was not a purpose for the accumulation.<sup>727</sup>

**[a] Reasonable Needs of the Business.**

The determination of reasonable business needs is a uniquely factual issue. The character of a corporation's accumulated surplus is crucial;<sup>728</sup> earnings translated into plant, equipment and/or inventories cannot be easily distributed to shareholders regardless of the amount of the accumulated earnings.

For the determination of reasonable business needs, the Regulations adopt a “reasonable businessman” standard, which is the tax law equivalent of the hypothetical “reasonable man” tort standard. Generally, the courts are reluctant to substitute their business judgment for that of the corporate officers and directors, but will do so if warranted by the facts and circumstances of the case.<sup>729</sup>

Although the particular circumstances of each case ultimately govern, the AET Regulations set forth certain common grounds or categories of reasonable needs: (1) to provide for bona fide expansion of business or replacement of plant; (2) to acquire a business enterprise through purchasing stock or assets; (3) to provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue; (4) to provide necessary working capital for the business, such as, for the procurement of inventories; or (5) to provide for investment or loans to suppliers or customers if necessary in order to maintain the business of the corporation.<sup>730</sup>

Conversely, the Regulations also set forth a non-exclusive list of grounds or categories reflecting unreasonable accumulations: (1) loans to shareholders, or the expenditure of funds of the corporation for the personal benefit of the shareholders; (2) loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons; (3) loans to another corporation, the business of which is not that of the taxpayer corporation, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer corporation and such shareholder or shareholders are in control of both corporations; (4) investments in properties, or securities which are unrelated to the activities of the business of the taxpayer corporation; or (5) retention of earnings and profits to provide against unrealistic hazards.<sup>731</sup>

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<sup>727</sup> A post-*Donruss* case in which the taxpayer successfully defended against the AET in spite of an unreasonable accumulation is *Simons-Eastern Co. v. United States*, 354 F. Supp. 1003 (N.D.Ga., 1972).

<sup>728</sup> See, e.g., *Smoot Sand & Gravel Corporation v. Commissioner*, 274 F.2d 495, 60-1 U.S.T.C.9241, 5 A.F.T.R.2d 626 (4th Cir.), affirming 17 T.C.M. 1086, 1958 T.C. Memo. P. 58,022, cert. denied, 362 U.S. 976, rehearing denied, 363 U.S. 832 (1960); *John P. Scripps Newspapers*, 44 T.C. 453 (1965).

<sup>729</sup> See, e.g., *Electric Regulator Corp. v. Commissioner*, 336 F.2d 339 (2d Cir. 1964); *Crawford County Printing & Publishing Co.*, 17 T.C. 1404 (1952).0

<sup>730</sup> Treas. Reg. § 1.537-2(b).

<sup>731</sup> Treas. Reg. § 1.537-2(c).

**[b] What is “The Business” - Expansion and Diversification of Existing Businesses.**

Before it is possible to ascertain what the reasonable needs of the business are and what investments are related to the activities of the business, it is necessary to identify the business of the corporation. The Regulations provide that “[t]he business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.”<sup>732</sup> Clearly, accumulations to finance the natural growth of an existing business vertically and horizontally are allowable. In some cases, however, accumulations for expansion in the corporation’s existing business have been penalized. These cases inevitably seem to fail on the ground of vagueness or lack of reality of so-called “expansion plans.”

This pattern is illustrated by *Raymond I. Smith, Inc.*,<sup>733</sup> which involved expansion plans that were determined to be disproportionate to the taxpayer’s capitalization, income and financial position. The taxpayer’s earned surplus exceeding \$600,000 was used for the purchase of 348 contiguous acres of farmlands near Reno. The purchase price of the land was approximately \$1 million, an amount roughly twice the book value of the taxpayer’s business assets. While the land was leased to crop farmers at a loss, it was not used by the taxpayer to carry on a separate business. The taxpayer contended that the land was acquired to protect the taxpayer’s bar concession, in the event rival gambling operations should try to develop strip operations in Reno. In the Tax Court’s view, any profits to be derived from the operation of additional bars would be long deferred and a doubtful return on the taxpayer’s large investment. The Court thus found the investment in the farmland beyond the reasonable business needs. The Ninth Circuit also thought that the taxpayer’s investment in the land was grossly disproportionate to its financial resources and position and that the prospect of its making use of the farmlands in its business was questionable and, in any event, remote and vague.<sup>734</sup>

Unbridled expansion to new lines of business or diversification into unrelated businesses has been a source of confusion in the law. The Regulations permit the acquisition of a business enterprise and simultaneously proscribe the investment in unrelated properties or securities. This conflict, however, is readily resolved by the distinction between active business and passive investment, as discussed further below. The Service’s Tax Audit Guidelines in effect prior to being withdrawn in 2005 provided as follows:

The regulations indicate that the business of a corporation is any business which it wishes to enter. Although this would indicate that a corporation is free to diversify into any business, some court cases tend to limit diversification by corporations into products or businesses similar or related to their principal field or product.<sup>735</sup>

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<sup>732</sup> Treas. Reg. § 1.537-3(a).

<sup>733</sup> 33 T.C. 141 (1959), *acq.*, *aff’d*, 292 F.2d 470, 61-2 U.S.T.C. 9562, 8 A.F.T.R.2d 5119 (9th Cir.), *cert. denied*, 368 U.S. 948 (1961).

<sup>734</sup> What if Mr. Smith had put a few cows on the place or entered into sharecropping arrangements with local operators rather than leasing the farmland to the third-party operators? This may have been viewed as a separate business and carried the day before the Tax Court.

<sup>735</sup> Former I.R.M. 776.2(1)

The subsequently withdrawn AET Audit Guidelines may have misinterpreted the thrust of the case law. In apparently no case does a court limit expansion, change in business or diversification per se to similar or related products or businesses. The Service's victories generally are based on passive investment grounds, the vagueness of the taxpayers' expansion or diversification plans and the taxpayers' failure as to the burden of proof, or on a combination of all these grounds.

Along similar lines, in *Electric Regulator Corp. v. Commissioner*,<sup>736</sup> the Court of Appeals for the Second Circuit stated the following broad dictum going beyond the situation presented in a case involving diversification into related products:

In answering the question: what are the reasonable needs of the business?, the corollary question arises, namely, what "business"? If the Treasury decides that the manufacture of [a particular electromechanical voltage regulator] is the "business," then it would forever consign petitioner to the manufacture of that product and view its needs accordingly. Courts, however, must not blind themselves to the realities in this age of rapid technological change. The product of today is frequently outmoded tomorrow. The results of research in the electronics, pharmaceutical and chemical fields alone justify this statement ....

If the Tax Court's views here were to be accepted, they would give to the Treasury virtually absolute power to stifle or encourage economic growth as it – not the corporate directors – decided how each company should handle its corporate and financial affairs. The Courts are not unmindful of the efforts of the Department of Justice through its Anti-Trust Division to encourage competition by attacking monopolistic practices which might be harmful to smaller units of industry, and of Congress' decided interest in small business and its development. It would be anomalous indeed were the Treasury to have the power to thwart these praiseworthy objectives. But equally praiseworthy is (and should be) the Treasury's vigilance lest a corporation, particularly a private or family-owned corporation with only a few stockholders, be used to prevent the imposition of high taxes on such stockholders.<sup>737</sup>

Clearly, a corporation is not required to be static; technological change may force entry into a new line of business. Even in the absence of technological changes, a corporation whose business is generally declining may accumulate its earnings to enter a new business. In *New England Wooden Ware v. United States*,<sup>738</sup> the taxpayer, having suffered a near-disaster from the decline of the wooden pail and tub manufacturing industry, survived by changing its business to the manufacture of corrugated boxes. Almost two decades later, however, it found itself in the "cellar position" in that industry due to competition from several widely known, national concerns. Accordingly, it decided to diversify. Accumulating its earnings, it began a bona fide

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<sup>736</sup> 336 F.2d 339 (2d Cir. 1964), reversing 40 T.C. 757 (1953)

<sup>737</sup> 336 F.2d at 345-346.

<sup>738</sup> 289 F. Supp. 111, 68-2 U.S.T.C. 9568, 22 A.F.T.R.2d 5465 (D. Mass. 1968).

search for a new business. It explored various diversification possibilities in businesses quite different from its then existing business. In each instance, it reached the stage of a clear definition of the product (sometimes including the making and testing of prototypes) and a detailed study of market potential and production feasibility and it engaged the services of a noted consulting firm. Finding the taxpayer “prudently expansionist” and citing its prior business history and serious search efforts, the district court allowed the accumulations. Moreover, even though the taxpayer at the time of trial had not yet diversified, the court thought consummation of its intent was reasonably foreseeable.

Similarly, the acquisition of an entirely new and unrelated business is unquestionably warranted if the corporation’s existing business ceases due to a casualty or unanticipated sale. The corporation, however, must enter the new business promptly, or at least begin an earnest search for a new business immediately. In *Alex Brown, Inc.*,<sup>739</sup> the taxpayer received an unsolicited offer for its business and sold the entire business the following month. The proceeds from the sale were invested passively in government obligations. During the five months from the date of the sale to the close of the taxable year, there were no apparent efforts to develop any plans to engage in any type of business activity. Although the AET was imposed for the year of the sale, the Tax Court’s opinion nevertheless authorizes the acquisition of a new business by its finding that “there was no judgment by management, even of an embryonic nature. [The taxpayer] was not required to be an instant Horatio Alger, but neither was [it] entitled to be a financial Rip Van Winkle.”<sup>740</sup>

A corporation should be permitted to diversify into an entirely new business if it has demonstrable managerial capacity to operate the new business. This appears to be the position of the court in *Atlantic Commerce & Shipping Co., Inc. v. Commissioner*,<sup>741</sup> despite the court’s finding that the taxpayer’s accumulation for diversification into an unrelated real estate venture was unreasonable. During the taxable years in issue, the taxpayer was engaged in the business of furnishing brokerage and management services to shippers. Having decided to invest its surplus earnings in real estate, it investigated various possible investments including a hospital, shopping centers, a post office and office buildings. The following year, it joined with a related company in the purchase of a factory building. The Tax Court held and the Second Circuit affirmed that the acquisition of the factory was a passive investment in real estate unrelated to the taxpayer’s business. Although it was implied that an acquisition of waterfront terminal facilities might be sufficiently related to the taxpayer’s ship brokerage business, the courts found that the real estate investigated by the taxpayer was unrelated to shipping. The Second Circuit noted, moreover, that “[t]here is no indication in the record that [the taxpayer] would have been capable of managing [the properties investigated] as a new line of business.”

In determining whether property acquired constitutes a business or an investment, the key element is the degree of activity involved in operation and management, as illustrated by *Sandy Estate Co.*<sup>742</sup> There, the taxpayer, an apartment house owner and manager, accumulated its earnings and profits from real estate in order to provide funds for its dealings in mortgage loans.

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<sup>739</sup> 60 T.C. 364 (1973), *aff’d per curiam*, 496 F.2d 621, 74-1 U.S.T.C. I 9405, 33 A.F.T.R.2d 1226 (6th Cir. 1974).

<sup>740</sup> 60 T.C. at 368.

<sup>741</sup> 32 T.C.M. 473, 1973 T.C. Memo. T 73,106, *aff’d*, 500 F.2d 937, 74-2 U.S.T.C. 9624, 34 A.F.T.R.2d 5667 (2d Cir. 1974).

<sup>742</sup> 43 T.C.361 (1964) *acq.*

The court found that its mortgage loan activities constituted a business that was “healthy and vigorous, with a strong expansion policy.” The mortgages were not simply liquid investments, they were, in view of the “extensive and continuous activities in relation to them... of such magnitude and character as to constitute a business in and of themselves.”<sup>743</sup>

**[c] Active Real Estate Trade or Business vs. Passive Investment in Real Estate.**

In the context of the AET, real estate investments may be divided into two categories: (1) situations in which the real estate activities purportedly constitute a separate trade or business of the corporation, and (2) real estate investments which are incident to the corporation’s business, as where a corporation acquires an office building to be used as its headquarters, with excess space, if any, to be rented out. Unless the acquisition of interests in real estate can be shown to be part of a separate trade or business, the acquisition of real estate unrelated to the existing business may render the corporation vulnerable to the AET.<sup>744</sup>

The question of whether an activity rises to the level of a trade or business arises in many contexts under the Code. The United States Supreme Court has stated that the existence of a trade or business “requires an examination of the facts in each case.”<sup>745</sup> In *Commissioner v. Groetzing*, dealing with the question of whether a full-time gambler was involved in a trade or business, the Court stated:

This (the facts and circumstances approach) may be thought by some to be a less-than-satisfactory solution, for facts vary. But the difficulty rests in the Code’s wide utilization in various contexts of the term “trade or business,” in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we feel, at this late date, the ultimate responsibility rests.

Several cases have dealt with the question of whether owning and operating real estate rental properties amounts to engaging in a trade or business. In *Pinchot v. Commissioner*,<sup>746</sup> the question before the Board of Tax Appeals and the Second Circuit Court of Appeals was whether a non-resident alien was engaged in business in the United States at the time of her death. If so,

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<sup>743</sup> 43 T.C.at 375-376.

<sup>744</sup> See, e.g., *Automotive Rebuilding Co., Inc.*, 17 T.C.M. 968, 1958 T.C. Memo. P 58,197, citing *Higgins v. Commissioner*, 312 U.S. 212, 41-1 U.S.T.C. 9233, 25 A.F.T.R. 1160 (1941), for the proposition that the law spawned by Code § 162(a) (relating to ordinary and necessary expenses incurred in a trade or business) is relevant for differentiating between an active business and a passive investment for purposes of the AET.

<sup>745</sup> *Higgins, supra*, 312 U.S. at 217, *Commissioner v. Groetzing* 480 U.S. 23 (1987). See Boyle, What is a Trade or Business? 39 Tax Lawyer 737, 767 (1986); Note, The Business of Betting: Proposals for Reforming the Taxation of Business Gamblers, 38 Tax Lawyer 759 (1985); Lopez, Defining “Trade or Business” Under the Internal Revenue Code: A Survey of Relevant Cases, 11 Fla. St. U. L. Rev. 949 (1984). Cf. Comment, Continuing Vitality of the “Goods or Services” Test, 15 U. Balt. L. Rev. 108 (1985).

<sup>746</sup> 113 F. 2d 718 (2d Cir., 1940).

her bank deposits and other assets in the United States would be subject to federal estate taxation.

The stipulated facts reflected that the decedent's property in the United States consisted of improved real estate in the City of New York owned in common by her and her two brothers, one of whom was the executor and petitioner in the case. The real estate was made up of eleven parcels, of which the decedent's share had a gross value of about \$1 million. The petitioner managed the properties for the decedent and the other brother under broad powers of attorney. This management "consisted of the leasing and renting of the properties when they become idle, collection of rents and payment of operating expenses, taxes, mortgage interest and other necessary obligations." Over a period of 18 years, five parcels of real estate had been sold and five parcels purchased. There were no sales or purchases during the three years preceding the decedent's death.

The Second Circuit Court of Appeals found that the real estate management activities of decedent, through her agent, was sufficient to be considered "engaging in business" in the United States:

Though the stipulation does not show the number and the amount of the transactions of the petitioner in managing these eleven buildings in New York, it is certain that they must have been considerable in both respects as well as continuous and regular. Their maintenance required the care and attention of the owners and the decedent supplied her part of that by means of her agent and attorney and fact... What was done was more than the investment and re-investment of funds in real estate. It was the management of the real estate itself for profit. Whether or not that was engaging in business within the meaning of the federal tax statutes is a federal question which cannot be controlled by state decisions..... It necessarily involved alterations and repairs commensurate with the value and number of buildings cared for and such transactions as were necessary constitute a recognized form of business. The management of real estate on such a scale for income producing purposes required regular and continuous activity of the kind which is commonly concerned with the employment of labor; the purchase of materials; the making of contracts and many other things which come within the definition of business in [*Flint v. Stone Tracy Co*, 220 U.S.107 (1911)]....and within the commonly accepted meaning of that word. We think that the Board [of Tax Appeals] was right in deciding that this decedent was engaged in business in this country at the time of her death.<sup>747</sup>

In the context of the accumulated earnings tax, the crucial factor in determining the existence of a trade or business is the corporation's degree of active involvement in the operation and management of the real estate. In *Dahlern Foundation, Inc.*,<sup>748</sup> the taxpayer located

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<sup>747</sup> 113 F2d at 719 (citations omitted).

<sup>748</sup> 54 T.C. 1566 (1970).

undeveloped real estate suitable for use as a shopping center site, negotiated and paid the purchase price for it, secured leases from businesses to occupy the center, arranged for a loan for the construction of a shopping center, handled various management functions with respect to the center and maintained and repaired various portions of the center. In addition, it owned and actively managed another shopping center, an apartment house, a restaurant and the ground lease to a service station. It was generally responsible for repairs and maintenance of the leased properties and was otherwise involved in its tenants' businesses. Emphasizing the managerial functions and extensiveness of the taxpayer's activities, the Tax Court held that the taxpayer was engaged in sufficient activities to take it out of the mere holding or investment company category.<sup>749</sup> Accordingly, the court held that the business of the taxpayer did not include the business of the subsidiary. Thus, the taxpayer was not permitted to accumulate its earnings for the needs of its real estate subsidiary. Moreover, the court noted even if the real estate company were characterized as the business of the taxpayer, the accumulations could not have been justified in any event because the taxpayer had no specific plans that would qualify as business needs regarding the real estate. On the other hand, the real estate might be acquired and held directly by the corporation itself in addition to its regular business. While the corporation would not have status as a mere holding or an investment company, the real estate would not be treated as a second business in the absence of the corporation's involvement in substantial activities relating to operation and management.

The definition of a "trade or business" for tax purposes further brings into relevance the line of cases under Code § 162 that distinguish between activities that constitute "trade or business" activities from those that are merely investment activities.<sup>750</sup> In the preamble to the recently finalized regulations under Code § 1411 dealing with the new net investment income tax, the Treasury Department and the Service stated the following with respect to a change from the previously issued proposed regulations with respect to whether the management of real estate may constitute a trade or business:

Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in *Higgins v. Commissioner*, 312 U.S. 212 (1941), the Supreme Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case." 312 U.S. at 217. Except for certain clarifications made in response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.

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<sup>749</sup> By contrast, in *Henry Van Hummell, Inc.*, 30 T.C.M. 1765, 1964 T.C. Memo. 64290, *aff'd*, 364 F.2d. 746, 66-2 U.S.T.C. 9610, 18 A.F.T.R. 2d 5500 (10<sup>th</sup> Cir. 1966), *cert. denied*, 386 U.S. 956 (1967), the taxpayer, an insurance company, acquired and held a 92 percent stock interest in a real estate company. The latter simply held the real estate, collected its income, and had no employees; its operational activities and management requirements were contracted out to others. The court found that the subsidiary "was not engaged in the active conduct of a trade or business."

<sup>750</sup> See, e.g., *Whipple v. Commissioner*, 373 U.S. 193 (1963) (certain investment activities not a trade or business); *McCullen v. Commissioner*, T.C. Memo. 1997-280 (certain real estate activities not a trade or business); *Moller v. United States*, 553 F. Supp 1071 (Fed. Cl. 1982) (investment activities qualified as a trade or business); *Higgins v. Commissioner*, 312 U.S. 212 (1941) (certain real estate activities qualified as a trade or business, while investment activities did not).

In response to these commentators, § 1.1411-1(d) of the final regulations provides that the term trade or business, when used in section 1411 and the final regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162. One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed § 1.1411-4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that § 1.183-1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.

The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of “activity” within the meaning of § 1.183-1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183-1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within § 1.183-1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of “activity” can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining whether a trade or business exists using the activity determinations of Code provisions unrelated to section 162 is appropriate.

The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically, commentators stated that Example 1 of proposed § 1.1411-5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as *Fackler v. Commissioner*, 45 BTA 708 (1941), *aff’d*, 133 F.2d 509 (6th Cir. 1943); *Hazard v. Commissioner*, 7 T.C. 372 (1946); and *Lagreide v. Commissioner*, 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.

The concession by the Treasury Department and the Service that the management of a single property can rise to the level of a trade or business in the context of the net investment income tax, which applies to “passive” investment income, supports the conclusion that such activities should constitute an active trade or business in the context of Code § 531. While the net

investment income tax and the AET are separate taxes, the application of each tax turns on the distinction between trade or business and non-trade or business activities, and the authorities developed under each tax follow the principles developed under Code § 162.

The level of involvement in the activity by the taxpayer, either directly or through agents or employees, is usually controlling, as opposed to passive activities that do not rise to the level of a trade or business. Where real estate is involved, a trade or business will be found to exist only where the taxpayer is involved in substantial activities relating to the operation and management of the real estate.<sup>751</sup> Such involvement may be direct or indirect through agents or employees.

Section 1.01 of the Restatement of the Law of Agency (Third) defines agency as follows:

Agency is the fiduciary relationship that arises when one person (a “principal”) manifests assent to another person (an “agent”) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.

The common law of agency is described by the cannon law maxim, *qui facit per alium facit per se*, i.e. “whoever acts through another does the act himself.” This is a parallel concept to vicarious liability and strict liability in which one person is held liable for the acts or omissions of another. A corporation cannot act for itself – it can only act through its authorized agents.

In general, activities carried on by an agent of a corporation are no different from activities carried on by officers, directors, and employees of a corporation. The acts are performed by the agent for and on behalf of the principal, regardless of the title or position held by the agent (independent contractor, officer, director, or employee) with respect to the principal.

In the context of Code § 6166(a), dealing with the deferral of estate taxes with respect to an interest in a closely-held business, the Service ruled in Rev. Rul. 2006-34<sup>752</sup> that “the fact that some of the activities are conducted by third parties such as independent contractors who are neither agents nor employees of the decedent, partnership, LLC or corporation, will not prevent the business from qualifying as an active trade or business so long as these third-party activities are not of such a nature that the activities of the [corporation] (and their respective agents and employees) are reduced to the level of merely holding investment property.” While Rev. Rul. 2006-34 dealt with whether the activities of the business were sufficient to constitute the carrying on of an active trade or business for purposes of Code § 6166(a)(1), the conclusions of the Service should be relevant for purposes of Code § 531.

Rev. Rul. 2006-34 dealt with fact situations similar to two rulings issued in 1975. In Rev. Rul. 75-365,<sup>753</sup> the Service considered a situation in which the decedent individually maintained a fully equipped business office to collect rental payments on commercial and farm rental properties, receive payments on notes receivable, negotiate leases, make occasional loans, and direct by contract the maintenance of the properties. The ruling held that the decedent was

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<sup>751</sup> *Raymond I. Smith, Inc., supra* (farmlands passively leased to crop farmers).

<sup>752</sup> I.R.B 2006-26.

<sup>753</sup> 1975-2 C.B. 471.

merely an owner managing investment assets to obtain the income ordinarily expected from them, and was not conducting a trade or business. Therefore, the commercial and farm rental properties and notes receivable included in the decedent's gross estate did not constitute an interest in a closely held business for purposes of Code § 6166. Similarly, Rev. Rul. 75-367<sup>754</sup> held that a decedent's ownership of 100 percent of the stock of an electing small business corporation that built homes on land owned and developed by the decedent, together with a business office and warehouse used both by the corporation and by the decedent in the land development activities, constituted an interest in a closely held business. Rev. Rul. 75-367 held, however, that the eight homes that were owned by the decedent and rented to tenants and for which the decedent collected rents, made the mortgage payments, and performed necessary repairs and maintenance, did not constitute an interest in a closely held business because the decedent's interest in those homes merely represented an investment.

Rev. Rul. 2006-34 revoked Rev. Rul. 75-365 and the portion of Rev. Rul. 75-367 dealing with the eight rental homes. The facts of Situation 1 of Rev. Rul. 2006-34 involved taxpayer A, who owned a strip mall, provided significant services to the strip mall tenants, and personally handled the day-to-day operation, management and maintenance of the strip mall, hiring independent contractors to perform repairs and other tasks. The Service concluded in its analysis that:

A's activities went beyond those of a mere investor collecting profits from a passive asset. Moreover, even in situations in which A hired independent contractors to perform repairs that A could not perform personally, A was involved in the selection of the contractors and reviewed and approved the work performed. Under these circumstances, the use of independent contractors on occasions when A could not personally perform the work does not prevent A's activities from rising to the level of the conduct of an active trade or business. Thus, A's ownership of the strip mall qualifies as an interest in a closely held business for purposes of Code § 6166.

Situation 4 of Rev. Rul. 2006-34 involved a closely held business which owned three strip malls for which it performed "substantial management functions, including collecting rental payments and negotiating leases, performing daily maintenance and repairs (or hiring, reviewing and approving the work of third party independent contractors for such work), and making decisions regarding periodic renovations of the three strip malls." Under these facts, the Service determined that the activities of the business were sufficient to constitute the carrying on of an active trade or business, and that the strip malls would not be considered to be passive assets under Code § 6166(a)(1) because they were used in carrying on an active trade or business.

In summary, under the authorities described above, the operation, management, and leasing of real estate, directly or through agents and employees, should constitute a business for purposes of the AET if the taxpayer is involved in substantial activities, either directly or through agents and employees, relating to the operation and management of the real estate.

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<sup>754</sup> 1975-2 C.B. 472.

**[3] Personal Holding Company Tax Implications.**

Code § 541 *et seq.* imposes a 20 percent tax (“PHC Tax”) on the undistributed personal holding company income (“PHCI”) of a corporation that is a personal holding company (“PHC”). The framework of the PHC Tax is rather complex and does not generally apply to S corporations.<sup>755</sup> The PHC Tax typically impacts C corporations with substantial passive income, such as dividends, rents and royalties. As long as the earnings are distributed to the shareholders, the PHC Tax does not apply. Like the AET, the PHC Tax is designed to prevent taxpayers from taking advantage of lower corporate tax rates and avoiding tax at the shareholder level.

The PHC Tax could potentially apply to an S corporation in the event its S election is terminated to take advantage of lower corporate tax rates. Consequently, an S corporation considering a termination of the S election to take advantage of the flat 21% corporate income tax rate under the TCJA should consider the potential PHC Tax exposure. While the PHC Tax is easy to plan around, once an S corporation election is revoked or terminated, the PHC Tax could raise its ugly head.

**[a] The PHC Tax and Key Definitions.**

Under Code § 542, a corporation is a PHC in any tax year in which it meets the following two tests:

- At least 60% of its adjusted ordinary gross income (“AGOI”) for a tax year is PHCI (the “60% Test”); and
- At any time during the last half of the tax year, more than 50% of the value of its outstanding stock is owned, directly or indirectly, by five or fewer individuals (the “5 or Fewer Ownership Test”).

Code § 543 contains the key definitions for the PHC regime:

- “Ordinary Gross Income” (“OGI”) means gross income determined by excluding capital gains and Code § 1231 gains.<sup>756</sup>
- “Adjusted OGI” (“AOGI”) is defined by taking into account certain adjustments, including, in the case of rents, subtracting the amount allowable as deductions for: (i) depreciation and amortization of property other than tangible personal property that is not customarily retained by any one lessee for more than 3 years; (ii) property taxes; (iii) interest; and (iv) rent (in the case of subleases).<sup>757</sup>
- “Adjusted Income from Rents” (“AIR”) means the gross income from rents, reduced by the same four categories of items (described above) that reduce the amount of AOGI in the case of rents.

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<sup>755</sup> Code § 1363(a).

<sup>756</sup> Code § 543(b)(1).

<sup>757</sup> Code § 543(b)(2)(A).

- “Personal Holding Company Income” (“PHCI”) is defined as the portion of AOGI that consists of dividends, rents and royalties. With respect to rents, the focus is on the definition of AIR.<sup>758</sup> There is a key exception to the definition of “PHCI” that excludes AIR from being deemed “PHCI” if:
  - The AIR constitutes 50% or more of the AOGI (the “50% Test”); and
  - The sum of dividends paid<sup>759</sup> or deemed paid during the tax year equals or exceeds the amount, if any, by which other (i.e., non-rental) PHCI exceeds 10% of OGI (the “10% Test”).<sup>760</sup>

The impact of this key exception to the definition of PHCI is that AIR is treated as PHCI only if either: (1) AIR constitutes less than 50% of the C corporation’s AOGI; or (2) the corporation’s non-rental PHCI constitutes more than 10% of OGI (assuming no dividends are distributed or deemed to have been distributed).<sup>761</sup> The 10% Test can also be satisfied if the amount of non-rental PHCI in excess of 10% of OGI is distributed as a dividend.<sup>762</sup>

As a consequence of this key exception to the definition of PHCI, certain C corporations may be able to avoid PHC status entirely if virtually all of their gross income is rental income (such that rents exceed the threshold of the 50% Test) and they have minimal other, non-rental income or dividends sufficient to meet the 10% Test. An example would be a corporation operating an equipment leasing business, an apartment complex, an office building, or a shopping center where substantially all of the income consists of rentals of either tangible personal property or real estate.

The 50% Test and the 10% Test may also be used to avoid PHC status when a corporation’s S election is terminated or revoked and it becomes a C corporation. By increasing its rental income and either generating non-rental income or paying dividends, it can potentially avoid PHC status by meeting the 50% Test and 10% Test of the exception under Code § 543(a)(2). If the corporation qualifies for this exception in any tax year, its rental income would not be considered PHCI.

### **[b] Effect of Corporate Rate Cuts on Use of PHCs.**

Until the Tax Reform Act of 1986 (1986 TRA), the highest marginal corporate income tax rate was lower than the highest marginal individual income tax rate. The 1986 TRA temporarily inverted the corporate and individual income tax rates. Individual income tax rates were raised above corporate income tax rates again in 1993.<sup>763</sup> In 2003, however, the maximum marginal

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<sup>758</sup> Code § 543(a)(2).

<sup>759</sup> As determined under the dividends-paid deduction rules of Code § 562.

<sup>760</sup> *Id.*

<sup>761</sup> *Id.*

<sup>762</sup> *Id.*

<sup>763</sup> See Pub. L. No. 103-66, § 11101, § 13201, § 13202. From 1993 through 2000, the maximum individual rate was 39.6%, while the maximum corporate rate was 35%. See Code § 1, § 11(b)(1)(D).

individual rate was lowered to 35%, which was also the maximum corporate rate.<sup>764</sup> However, for tax years beginning after 2012, the maximum individual income tax rate was 39.6%.<sup>765</sup> For tax years beginning after 2017, the corporate tax rate is significantly reduced to a flat 21%,<sup>766</sup> while the maximum individual tax rate is only slightly reduced to 37%. Corporate distributions that meet the definition of “qualified dividend income” are taxed to noncorporate shareholder-recipients not at ordinary individual income tax rates but rather at capital gain rates, which generally are lower.<sup>767</sup>

The corporate dividends-received deduction of Code § 243 provides another explanation for the continued use of PHCs. Code § 243 provides a deduction to corporations for a percentage of dividends received from other corporations. In years in which the highest corporate tax rate is lower than the highest individual rate, taxpayers may be tempted to use PHCs as “incorporated pocketbooks” and then try to avoid the PHC tax. For instance, one author concluded that under 1994 tax rates, but without the PHC tax, use of a PHC would be profitable if assets were held and income compounded within the corporation for at least 15 years. Assets held in corporate solution for at least that period of time would compound (before being taxed at the shareholder level) with total growth that exceeded the shareholder-level tax on the eventual corporate distribution.<sup>768</sup>

Assuming, again, that the taxpayer can avoid the PHC tax, graduated income tax rates provide a secondary rate-based benefit to continued use of PHCs for years in which the lower-bracket corporate rates are less than the rates at which the shareholders would be taxed.

If it applies, the PHC tax should eliminate the difference between the tax consequences of holding assets in a corporation and distributing them to the shareholders. The PHC tax directly affects a small number of taxpayers and yields a small amount of direct tax to the Department of the Treasury (Treasury). In 2000, the PHC tax was self-assessed by an estimated 3,728 active C corporations with net income. The aggregate self-assessed PHC tax for such corporations was estimated at \$14,055,000, for a yield of less than \$3,800 per return. According to the Paperwork Reduction Act notice by the IRS in the instructions to the Form 1120, the record keeping, analysis, and return preparation for Schedule PH (the schedule that calculates PHC tax for a Form 1120) should take approximately 30.62 hours of a taxpayer’s time. The aggregate of total taxpayers’ hours spent preparing and filing Schedules PH yields self-assessed PHC tax to Treasury at approximately \$123.00 per hour of taxpayer’s preparation time. The PHC tax is,

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<sup>764</sup> See the Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 JGTRRA), Pub. L. No. 108-27, § 105. See also Code § 11(b)(1).

<sup>765</sup> Code § 1(i)(3), as amended by the American Taxpayer Relief Act of 2012 (2012 ATRA), Pub. L. No. 112-240, § 102.

<sup>766</sup> See Code § 11(b), as amended by the 2017 Tax Act, Pub. L. No. 115-97, § 13001(a), applicable for tax years beginning after December 31, 2017.

<sup>767</sup> Code § 1(h)(11), effective generally for taxable years beginning after 2002. “Qualified dividend income” generally means dividends received from domestic corporations and dividends received from certain foreign corporations. The 2012 ATRA, Pub. L. No. 112-240, § 102, made permanent the capital-gain treatment of “qualified dividend income” and set the top capital gains rate at 20%.

<sup>768</sup> Goodman, *Employing a Corporation and Other Strategies to Reduce Taxes*, 72 TAXES 174 (Apr. 1994). In reaching this conclusion, the author of the article assumed that the business’s pre-tax annual rate of return on invested assets was 10%, and that neither the PHC tax nor the accumulated earnings tax applied.

thus, a low-yield, high-cost method of compelling corporate distribution of passive corporate income.

On the other hand, the self-assessed PHC tax understates the consequences of the tax because the tax applies only if a corporation fails to distribute sufficient amounts of personal holding company income (PHCI). The favorable tax and policy consequences of distributions to avoid imposition of the PHC tax probably are material.<sup>769</sup>

**EXAMPLE:** PH Corporation, which historically was a C corporation, is currently an S corporation. In reviewing PH Corporation’s 2019 Form 1120S Federal income tax return, you learn the following: it has \$590,190 of accumulated E&P as of year-end; it received \$206,913 in gross rents and had no other income for the tax year; it incurred depreciation expenses of \$29,581 for the tax year; it incurred tax expenses of \$18,875 for the tax year; it incurred interest expenses of \$15,390 for the tax year; it incurred rent expenses of \$1,996 for the tax year; and it distributed \$33,368 to its shareholders on a pro-rata basis during the tax year. Based on these figures, PH Corporation would have approximately \$141,071<sup>770</sup> of AOGI and AIR for 2019. In this scenario, both the 50% Test and the 10% Test would be met, such that none of PH Corporation’s rental income would be considered PHCI. The 50% Test would be met because its AIR is 100% of AOGI, thus exceeding the 50% threshold. The 10% Test would be met because PH Corporation’s non-rental PHCI would be zero<sup>771</sup> and therefore less than 10% of its OGI. Consequently, in the event PH Corporation’s S corporation election is terminated or revoked and it again becomes a C corporation, it would likely avoid PHC status under the exception in Code § 543(a)(2) that excludes rental income in certain circumstances. As noted above, PHC status is determined on a year-by-year basis, so PH Corporation would have to meet this exception in each future year in which it is a C corporation. However, that is likely to be the case, if the revenue and operations in future years are consistent with the figures reported on the draft of PH Corporation’s 2019 Form 1120S Federal income tax return. Moreover, to the extent there is other, non-rental PHCI in any tax year, PH Corporation could ensure the 10% Test is met by distributing dividends necessary to meet the 10% Test.

#### [4] Net Investment Income Tax and Increased Medicare Tax.

Effective January 1, 2013, the Patient Protection and Affordable Care Act, as modified by the Health Care and Education Reconciliation Act of 2010,<sup>772</sup> imposes a 3.8% Medicare tax on the lesser of:

- the individual’s “net investment income;” or

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<sup>769</sup> Proposed regulations on PHC matters were issued in 1968, but were withdrawn in 1983<sup>11</sup> because of their “extreme age” and because some provisions of the underlying statute had changed. No other proposed regulations were issued in their place

<sup>770</sup> Because gross receipts consist entirely of rent, AIR and AOGI would be equal, both determined by subtracting the sum of depreciation, property taxes, interest, and rent deductions from gross rental receipts.

<sup>771</sup> Based on the draft 2016 Form 1120S Federal income tax return, Baltic has no other income to constitute non-rental PHCI, so this figure would be zero.

<sup>772</sup> Pub. L. No. 111-152, § 1402(a)(1), 124 Stat. 1029, 1061 (2010).

- the excess of modified adjusted gross income over a “threshold amount” (generally \$250,000 for taxpayers filing a joint return, \$125,000 for married taxpayers filing a separate return, and \$200,000 in all other cases).

Net investment income means the excess of: (i) interest, dividends, capital gains, annuities, royalties, rents, income from passive activities, and income from trading financial instruments; over (ii) allowable deductions properly allocable to such income.<sup>773</sup> Some types of income are exempt from the tax, including income from the disposition of the shares of an S corporation.

In addition, non-passive income from a taxpayer’s **active participation** in an S corporation is not subject to the tax. (The tax would apply to passive income and income from a trade or business of trading financial instruments or commodities.) By contrast, investment income from C corporations will be subject to the tax, and self-employment income on wages and distributions from entities taxed as a partnership will be subject to a 0.9% Medicare tax increase. This slight tax advantage will be a potential planning opportunity for taxpayers considering making an S corporation election. For those corporations traveling the road from Subchapter S to Subchapter C, the net investment income tax and the increased Medicare tax need to be considered.

Importantly, if the self-employment tax applies, the Medicare contribution tax won’t apply, because net investment income does not include any item taken into account in determining self-employment income and subject to the self-employment Medicare tax under Code § 1401(b).<sup>774</sup>

## [5] Tax Rates.

For taxpayers traveling on the road between Subchapter C and Subchapter S, especially those heading in the direction toward Subchapter C, potential future changes by lawmakers in the Federal income tax rates of individuals and C corporations cannot be ignored. As already discussed, the current Federal income tax rate for C corporations is set at a low flat rate of 21%.<sup>775</sup> The top individual taxpayer Federal income tax rate is currently 37%.<sup>776</sup> Even though the current Federal income tax rate for C corporations is a so-called “permanent” provision of the Code, lawmakers will likely revisit the matter down the road, possibly increasing the flat rate and/or removing the flat rate concept and reverting the law back to a graduated-tier system with higher rates. The current highest Federal income tax rates for individual taxpayers is set to sunset at the end of 2015. Unless Congressional action is taken, the rates existing prior to the TCJA (with a top rate of 39.6%)<sup>777</sup> will again apply. Taxpayers traveling on this road need to keep a keen lookout for changing tax rates. The motivation to remain at Subchapter C may no longer exist as a permanent location after traveling down the long and winding road to get there if Congress acts in this regard. Getting back to Subchapter S may not be a short or uneventful trip. A careful eye at the eligibility requirements, elections rules, the built-in gains tax, the passive activity implications, LIFO recapture, and C corporation tax attributes is necessary.

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<sup>773</sup> Code § 1411(c).

<sup>774</sup> Code § 1411(c)(6).

<sup>775</sup> Code § 11(b).

<sup>776</sup> Code § 1(j).

<sup>777</sup> *Id.*

**[6] Bailing Out AAA.**

As discussed above, once a corporation coming from Subchapter S reaches Subchapter C, the ability to utilize AAA may be limited.

Prior to the passage of the TCJA, in the instance of an S corporation that converted to a C corporation, distributions of cash (as opposed to in kind distributions) by the C corporation to its shareholders during the “post-termination period” to the extent of the amount of the AAA were tax free to the shareholders. Such distributions served to reduce the adjusted basis of the shareholders’ stock. Distributions in excess of the AAA account were treated as coming from C earnings and profits.

For this purpose, the “post-termination period” was generally the one-year period immediately following the effective date of the S election termination. Under the pre-TCJA law, after the “post-termination period,” all distributions from the former S corporation were charged to C earnings and profits.

In essence, the old law gave former S corporations a period of one year to distribute its AAA to shareholders free of tax. In cases where it took a while for the corporation to compute its AAA, the post-termination period was quite helpful. Once the post-termination period expired, the AAA was lost forever. So, even if the corporation re-elected S status down the road, its former AAA was gone in the ether, never to be resurrected. As stated above, the IRS in Chief Counsel Advice recently confirmed this conclusion.<sup>778</sup> It concludes that AAA is forever gone once the post-termination period expires; it does not reappear if a subsequent S election is made.

The TCJA changes the rules for distributions of money following the “post-termination period” for “eligible terminated S corporations” (discussed above). It provides that such distributions made after the “post-termination period” (but only for “eligible terminated S corporations”) will be chargeable to the AAA account in the same ratio as the amount of AAA bears to the amount of accumulated earnings and profits. Thus, part of a distribution made following the “post-termination period” can still be bailed out on a tax-free basis. It may be mixed, however, with taxable distributions of earnings and profits. Careful planning and consideration is needed for those corporations heading on the road from Subchapter S to Subchapter C.

## **1.06 CONCLUSION**

The road between Subchapter S and Subchapter C, albeit scenic, is long, meandering, somewhat congested, and at some locations along the way can be hazardous. Caution is advised!

If you find yourself traveling on the road from Subchapter S heading toward Subchapter C, do not forget to cautiously review and analyze the impact of double taxation, loss of the pass-through deduction under Code § 199A, unreasonable compensation, the accumulated earnings tax, the personal holding company tax, the net investment tax, and the existence of undistributed AAA.

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<sup>778</sup> *Supra* at note [141].

In the event you are driving on the road from Subchapter C to Subchapter S, it is necessary that you perform a review and analysis of the numerous S corporation eligibility requirements, the election rules, the re-election limitations, the impact and potential application of the built-in gains tax, potential LIFO recapture, the impact of the passive investment income, and the existence of lingering C corporation attributes.

No matter what direction you are driving on this road, taxpayers and their advisors need to keep a close eye on client circumstances as well as the obvious and not so obvious current and changing tax laws. What has been historically good for a particular taxpayer may not be so good for that taxpayer in the future if circumstances change and/or Congress amends the Code. Without a keen eye on the road, a perilous accident is bound to occur. Proper review and analysis will certainly help avoid unwanted and unexpected disasters.

## AUTHOR BIOS

**Larry J. Brant** is a Shareholder at Foster Garvey P.C. in Portland, Oregon. His practice focuses on tax planning and advice, tax controversy, and business transactions. Larry regularly advises clients on tax matters and in structuring mergers and acquisitions, joint ventures, and other business transactions.

Larry publishes articles on numerous income tax issues, including Tax Reform, Corporate Tax, § 1031 Exchanges, Taxation of S Corporations, Reasonable Compensation, Circular 230, Worker Classification, Choice of Entity, Entity Tax Classification, and State and Local Taxation. He is an Expert Contributor to Thomson Reuters Checkpoint Catalyst. In addition, Larry regularly speaks at national, regional and local tax institutes, including the NYU Federal Tax Institute, the Florida Tax Institute, the NYU Tax Conferences in July, the Portland Tax Forum, the Portland State Tax Institute, the IRS Tax Practitioners Forum, the OSCPFA Forest Products Conference, the OSCPFA Real Estate Conference, the OSCPFA Northwest Federal Tax Conference, and the Oregon Tax Institute. Larry is a Fellow in the American College of Tax Counsel. He was the 2015 Recipient of the Oregon State Bar Tax Section Award of Merit. Larry was named a “Top Author” for Tax by JD Supra in its 2019 Readers’ Choice Awards for his nationally recognized tax blog ([www.larrystaxlaw.com](http://www.larrystaxlaw.com)).

Larry obtained his LL.M. in Taxation from the University of Florida College of Law; his J.D., *cum laude*, from Willamette University College of Law; and his B.S. in Business Administration, *cum laude*, from Portland State University.

**C. Wells Hall, III** is a partner in Nelson Mullins Riley & Scarborough’s Charleston and Charlotte offices where he advises clients on the federal, state, and multi-state tax aspects of mergers, acquisitions, reorganizations, structuring of business entities, private equity transactions, real estate investment trusts (REITs), and estate and gift tax planning in connection with such transactions.

Wells recently participated in preparation of comments by the ABA Section of Taxation regarding the need for published guidance with respect to the scope of a specified service trade or business within the meaning of new section 199A; he also participated in the preparation of comments by the ABA Section of Taxation on the originally proposed Treasury Regulations under section 1411 of the Internal Revenue Code (net investment income tax). He is one of the original drafters of the North Carolina S Corporation Income Tax Act, and the Model S Corporation Income Tax Act endorsed by the American Bar Association and the Multi-State Tax Commission. He was a member of the drafting committee for the original enactment and subsequent revision of the North Carolina Limited Liability Company Act.

He is an active member of the ABA Section of Taxation, immediate past Vice Chair - Pro Bono and Outreach, a former Member of Council, and Past Chair of the S Corporation Committee of the Section. He is a former Chair of the North Carolina Bar Association Section of Taxation. Wells is currently President and a former Regent of the American College of Tax Counsel, and a

former Regent and North Carolina State Chair of the American College of Trust & Estate Counsel.

Wells is a frequent speaker at the NYU Institute on Federal Taxation and the NYU Summer Institute on Wealth Taxation, the Southern Federal Tax Institute, the UNC J. Nelson Young Tax Institute, and other national and regional tax programs. He is a columnist for the S Corporation Corner of the *Journal of Passthrough Entities* and has been a contributor to numerous other tax periodicals.

Wells received his B.S. from North Carolina State University and his J.D. from Duke University School of Law.

OREGON TAX INSTITUTE

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The Road Between Subchapter C and Subchapter S – It May Be a Well-Traveled Two-Way Thoroughfare, But It Isn't Free of Potholes and Obstacles

Revisiting Choice of Entity In Light of Tax Changes on the Horizon

Larry J. Brant, Esq.

Foster  
Garvey

SEATTLE

PORTLAND

WASHINGTON, D.C.

NEW YORK

SPOKANE

BEIJING

## Agenda



- 1. C to S conversions, including the reasons why travelers may soon be motivated to drive down the road from Subchapter C heading toward Subchapter S, and the perils they may encounter along the way;**



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## **Agenda (continued)**

- 2. S to C conversions, including the reasons why travelers may soon be motivated to drive down the road from Subchapter S heading toward Subchapter C, and the perils they may encounter along the way; and**



## **Agenda (continued)**

- 3. Possible Exits from Corporate Solution and the Tax Implications.**



## **Setting The Stage**

**Tax Law Changes are on the Horizon**



## **Setting The Stage Possible Bad News**

- 1. Corporate Income Tax Rates;**
- 2. International Tax Law Changes;**
- 3. Individual Tax Rate Increases;**
- 4. Changes to the Capital Gains Taxes;**
- 5. Changes to the Net Investment Income Tax;**

## **Setting The Stage Possible Bad News (continued)**

- 6. Changes to Self-Employment Tax;**
- 7. Reduction of the Code Section 199A deduction;  
and**

## **Setting The Stage Possible Bad News (continued)**

- 8. An Assault on Carried Interest.**



## **Setting The Stage Possible Good News**

**Code Section 1031 may remain unscathed (aside from the damage done by the TCJA).**



## **Possible Bad News**

**No Clear Path To Restore or Revive Life Into the  
SALT deduction**

**[The Administration's proposal is silent/light on  
the SALT deduction]**



**Statistics Regarding Choice of Entity**

	2017 (Actual)	2018 (Actual)	2019 (Actual)	2020 (Actual)	2026 (Projected)
Form 1065	4,046,325	4,239,198	3,946,342	4,470,095	5,551,400
Form 1120S	4,842,706	5,128,058	5,186,557	5,044,303	5,603,900
Form 1120	1,649,386	1,720,920	1,734,396	1,595,515	1,667,100

Publication 6292

**Possible Reasons Enticing Travelers to Plan a Trip Along the Thoroughfare from Subchapter C toward Subchapter S**



## **Possible Reasons Enticing Some Travelers to Plan a Drive Along the Thoroughfare from Subchapter C toward Subchapter S (continued)**

1. **No Double Tax on Earnings;**
2. **Avoiding Unreasonable Compensation Challenges;**
3. **Avoid Double Tax on Sale or Liquidation;**
4. **Increases in the Corporate Tax Rates under Code Section 11(b);**
5. **Obtaining the Code Section 199A Deduction;**
6. **Limitation of Social Security Taxes;**

## **Possible Reasons Enticing Some Travelers to Plan a Drive Along the Thoroughfare from Subchapter C toward Subchapter S (continued)**

7. **NIIT Avoidance (may not be available if HR 5376 is passed) ;**
8. **Avoiding An AET Attack;**
9. **Potential Avoidance of the PHC Tax under Code Section 541;**
10. **Avoidance of Investment Interest Limitations; and**
11. **Use of Cash Method of Accounting.**

## **The Road from Subchapter C toward Subchapter S – The Ugly (or Scary) Provisions**

### **The Potential Road Bumps/Perils**

1. Entity Eligibility;
2. May Not Have Greater Than One Class of Stock;
3. Shareholder Eligibility;
4. Election;
5. Re-Election;



## **The Road from Subchapter C toward Subchapter S – The Ugly (or Scary) Provisions (continued)**

6. Inability to Utilize Section 1202;
7. Built-In Gains Tax;
8. LIFO Recapture Tax;
9. Passive Investment Tax; and
10. Lingering C Corporation Attributes.



## **Possible Reasons Enticing Travelers to Plan a Trip Along the Thoroughfare from Subchapter S toward Subchapter C**



## **Possible Reasons Enticing Travelers to Plan a Trip Along the Thoroughfare from Subchapter S toward Subchapter C (continued)**

- 1. Tax Rate Changes and Code Section 199A;**
- 2. The TCJA Repeal of the Corporate AMT;**
- 3. The Strict S Eligibility Rules;**
- 4. S Shareholder Limitations; and**
- 5. The S Corporation Prohibition Against Having More than One Class of Stock.**

## The Road from Subchapter S toward Subchapter C – The Ugly (Scary) Provisions To Keep An Eye On

1. Double Taxation;
2. Unreasonable Compensation;
3. Accumulated Earnings Tax;
4. Personal Holding Company Tax;
5. Bailing out AAA from S Corporation Years; and
6. Possible Change in Accounting Method.



## Leaving Corporate Solution In Search of Partnership Taxation



## Conclusions/Take-Aways



## Travel Alerts

When traveling the road between Subchapter S and Subchapter C, regardless of the direction we are traveling, we have to keep our eye on the road. Before you start the journey, you need to see what lawmakers do to the Tax Code.



## The Ugly Aspects of Subchapter C



We Should Never Forget The Ugly Aspects of Subchapter C –  
Maybe Some Things Will Change,  
But We Are Left With:

1. Double Taxation;
2. Unreasonable Compensation Attacks;
3. Accumulated Earnings Tax; and
4. Personal Holding Company Tax.

## Shortcomings of Subchapter S

We Should Never Forget The Shortcomings of Subchapter S –

1. Timely and Proper Election Required;
2. Domestic Corporation;
3. Subject to Limited Exceptions, the Corporation Cannot be a Bank or Insurance Company;
4. The Corporation Cannot be a Disc or Former Disc;
5. The Shareholders Must be Eligible;



## Shortcomings of Subchapter S (continued)

6. No Shareholder can be a Nonresident Alien;
7. Cannot have more than One (1) Class of Stock;
8. No Basis for the Corporation's Debt;
9. Five Years before Re-election Once Terminated;



## Shortcomings of Subchapter S (continued)

10. Possible Application of the Built-In Gains Tax;
11. Possible Application of the LIFO Recapture Tax; and
12. Passive Investment Tax Implications.

## The End



## Presenter



Larry J. Brant  
[Larry.Brant@foster.com](mailto:Larry.Brant@foster.com)  
(503) 228-3939

## Chapter 3

# Presentation Slides: Partnership Book/Tax Disparities: Recognize, Create, Exploit

**PROFESSOR HOWARD ABRAMS**

Harvard Law School  
Cambridge, Massachusetts



# Partnership Book/Tax Disparities: Recognize, Create, Exploit

Howard E. Abrams  
William K. Jacobs Visiting Professor  
Harvard Law School

## Subchapter K Rules We Will Use

- Debt Rules –
  - On the sale of a partnership interest; and
  - On the partial sale of a partnership interest.
- Inside Basis Adjustment Rules –
  - Section 734(b): Distributions of Cash and Property; and
  - Section 743(b): Dispositions of a Partnership Interest.

## Debt and the Sale of a Partnership Interest

- When a partnership interest is sold, the seller's share of the partnership's debt is added to amount realized on the sale. §752(d).
  - This rule makes sense because the debt was added to the seller's outside basis under §752(a).
  - Remember that debt share increase does not increase a partner's capital account and debt share decrease does not affect reduce a partner's capital account.
- Throughout this presentation, we will assume that all assets are either capital assets or assets described in §1231(a).

## Debt and the Partial Sale of a Partnership Interest: The Problem

- X and Y each own half of the XY partnership. XY owns Blackacre with inside basis of \$400, fair market value of \$500, and subject to a debt of \$380. Each partner has an outside basis \$200 (including one-half of the partnership's debt). Y sells one-half of her interest (that is, one-quarter of the partnership) to Z for its fair market value of \$30. None of the debt shifts to Z as a result of the sale.
- If we simply compute Y's gain or loss from the sale in the usual way, then Y's amount realized equals \$30 and Y's adjusted basis in the interest sold equals \$100, so Y realizes a loss of \$70 on the sale. That cannot be right because the property has appreciated: there is no loss property.
- If a taxpayer sells encumbered property, the amount of the encumbrance adds to the amount realized even if the seller remains liable on the debt. But technically the sale of a partnership interest having inside debt is not the sale of encumbered property and the recourse debt rules of section 752 turn on economic risk of payment, and that has not changed as a result of the sale.

## Revenue Ruling 84-53

- Under Rev. Rul. 84-53, a portion of the selling partner's debt share is removed from the selling partner's outside basis in computing gain or loss from the partial sale. In addition, amount realized includes debt to the extent it shifts as part of the partial sale.
- *One implication of this rule is that if the selling partner has a zero outside basis and no debt shifts as a result of the partial sale, then the debt is ignored.*
- I have written on Rev. Rul. 84-53 at Abrams, Partnership Inequalities: The Consequences of Book/Tax Disparities, 92 Taxes: The Tax Magazine 111 (March 2014).

## Part I: How Subchapter K Is Supposed to Work

- Example 1

- X and Y each contribute \$100 to the XY Partnership in exchange for a 50% interest in capital, profits and losses. The partnership purchases two nondepreciable assets, Blackacre and Whiteacre, for \$100 each. Over time, Blackacre increases in value to \$190 and Whiteacre increases in value to \$200. The assets are then sold for cash. The books of the venture become - -

X		Y		
Book	Tax	Book	Tax	Explanation
100	100	100	100	Formation
45	45	45	45	Sale of Blackacre
50	50	50	50	Sale of Whiteacre
195	195	195	195	Total

Asset	Book Value	Inside Basis
Blackacre	100	100
Whiteacre	100	100
Cash	390	390

Note that each partner has been taxed on \$95, one-half of the partnership's total gain of \$190. Each partner was taxed as the partnership engaged in a taxable sale. If the partnership now distributes its cash of \$390 in liquidation of the venture, each partner will receive \$195 without additional gain or loss because there are no book/tax disparities in the t-accounts.

• Example 2

- X and Y form the XY Partnership, with X contributing \$100 of cash and Y contributing Whiteacre having an adjusted basis of \$60 and a fair market value of \$100. Each partner receives an equal share of profits and losses except as required by §704(c)(1)(A). The partnership purchases Blackacre for \$100. Over time, Blackacre increases in value to \$190 and Whiteacre increases in value to \$200. The assets are then sold for cash. The books of the venture become --

X		Y		
Book	Tax	Book	Tax	Explanation
100	100	100	60	Formation
45	45	45	45	Sale of Blackacre
50	50	50	50	Sale of Whiteacre: §704(b)
			40	Sale of Whiteacre: §704(c)(1)(A)
195	195	195	195	Totals

Asset	Book Value	Inside Basis
Blackacre	100	100
Whiteacre	100	60
Cash	390	390

There is a book/tax disparity in the t-account of Y at the time of formation and in the partnership's books for Whiteacre because of the deferral given to Y by §§721 and 722. When Whiteacre is sold for \$200, there is book gain of \$100 but tax gain of \$140, and §704(c)(1)(A) demands that the tax gain without matching book gain in the current year correspond to the prior book increase without matching tax increase.

• Example 3

- X and Y each contribute \$100 to the XY Partnership in exchange for a 50% interest in capital, profits and losses. The partnership purchases two nondepreciable assets, Blackacre and Whiteacre for \$100 each. Over time, Blackacre increases in value to \$190 and Whiteacre increases in value to \$200. Whiteacre is then sold for cash and Blackacre is distributed to X in a nonliquidating distribution. The books of the venture become - -

X		Y		Explanation
Book	Tax	Book	Tax	
100	100	100	100	Formation
50	50	50	50	Sale of Whiteacre
45		45		Book-up of Blackacre (mandatory!)
-190	-100			Distribution of Blackacre
5	50	195	150	Totals

Asset	Book	Tax
Blackacre	<del>100</del> +90 = 190	<del>100</del>
Whiteacre	100	100
Cash	200	200

If the partnership now liquidates, distributing \$5 of its cash to X and \$195 of its cash to Y, X will recognize a loss of \$45 and Y will recognize a gain of \$45. If X also sells Blackacre for cash of \$190, X will recognize a gain of \$90. The net result for X is recognition of \$50 (sale of Whiteacre) - \$45 (liquidating distribution) + \$90 (sale of Blackacre), or \$95. For Y, there is recognition of \$50 (sale of Whiteacre) + 45 (liquidating distribution), or \$95.

## Park II: How Subchapter K Works for You

- We will now apply these familiar rules, recognizing that the partners can choose when and if to sell assets or their partnership interest.
- Note that the order in which transactions are done can be crucial!

- Example 3 (strategic)

- X and Y each contribute \$100 to the XY Partnership in exchange for a 50% interest in capital, profits and losses. The partnership purchases two nondepreciable assets, Blackacre and Whiteacre for \$100 each. Over time, Blackacre increases in value to \$190 and Whiteacre increases in value to \$200. Whiteacre is then sold for cash and Blackacre is distributed to X in a nonliquidating distribution. The books of the venture become - -

X		Y		
Book	Tax	Book	Tax	Explanation
100	100	100	100	Formation
50	50	50	50	Sale of Whiteacre
45		45		Book-up of Blackacre (mandatory!)
-190	-100			Distribution of Blackacre
5	50	195	150	Totals

Asset	Book	Tax
Blackacre	<del>100</del> + 90 = 190	<del>100</del>
Whiteacre	<del>100</del>	<del>100</del>
Cash	200	200

**But now do not assume the partnership liquidates or that X sells Blackacre.** Note that we have a book/tax disparity in each partner's t-account but no book/tax disparity in the partnership's assets. The partnership now owns \$200 in cash, and Y's indirect share is \$195, a profit of \$95. But Y has as yet been taxed on only \$50. So long as the partnership remains in place, Y has \$45 of positive deferral.

X		Y		Explanation
Book	Tax	Book	Tax	
100	100	100	100	Formation
50	50	50	50	Sale of Whiteacre
45		45		Book-up of Blackacre (mandatory!)
-190	-100			Distribution of Blackacre
5	50	195	150	Totals

Asset	Book	Tax
Blackacre	<del>100</del> +90 = 190	<del>100</del>
Whiteacre		<del>100</del>
Cash	200	200

And it's just as good for X! If X sells her partnership interest for its fair market value of \$5, X recognizes a loss of \$45, for net recognition of \$50 - \$45, or \$5. To be sure, if X sells Blackacre for its fair market value of \$190, X will recognize a gain of \$90. But until X chooses to sell Blackacre, X has converted an investment of \$100 into an asset worth \$190 by recognizing only \$5 of income. Whiteacre was sold at a \$100 of gain, but the government's net collection has been inclusion to X of \$5 and inclusion to Y of \$50.

## Example 4

- The ABCD Limited Partnership owns a capital asset with inside basis of \$40 and fair market value of \$100. A, B, and C want to change their investment. Each partner has an adjusted basis of \$10.
  - The partnership borrows \$75 dollars, guaranteed only by D. This increases D's outside basis from \$10 to \$85.
  - The partnership distributes the asset, encumbered by the debt, to D in a liquidating distribution.
- Result:
  - D takes the property with an asset basis of \$85. §732(b).
  - The partnership owns unencumbered cash of \$75.

## Example 4 Analysis

- For D: Sale of the property will trigger a gain of \$15, D's share of the appreciation.
- For A, B and C, the asset has been converted into cash without recognition of gain.
  - When a replacement asset is purchased by the partnership for \$75, its basis will be reduced by \$45 to \$30 under §734(b)(2)(B), thereby preserving a \$15 gain for A, B and C. As a result, aggregate inside basis will equal aggregate outside basis of \$30.
  - Each continuing partner's capital account remains at \$10, hiding the deferral the transaction provided.

## Example 4: Why Does it Work?

- This transaction should be taxable to A, B and C as a “reverse” disguised sale; that is, as a sale of the asset from the partnership to D. From the perspective of the continuing partners, the transaction is no different than a sale to a third party.
- But the drafters of the reverse disguised sale regulation, Reg. §1.707-6, either didn't understand the issues or were lazy, writing that there is a disguised sale only to the extent the debt shifts to D as a result of the distribution, Reg. §1.707-6(b)(1), -6(d) (ex. 2).

## Example 5

- X and Y each contribute \$100 to the XY Limited Liability Company.
- XY purchases a capital asset for \$200, and it increases in value to \$1,000.
- XY borrows \$490, guaranteed by X.
- The loan proceeds are distributed to Y.
- Y sells her partnership interest to Z for its fair market value of \$10.
- **The partnership has an election under section 754 in effect.**

## Example 5: t-Accounts

X		Y		Z		
Book	Tax	Book	Tax	Book	Tax	
100	100	100	100			Formation
0	490	0	0			Borrowing
400	0	400	0			Book-Up of Partnership Asset
0	0	-490	-490			Dist. of Proceeds: Y Gain of \$390
					10 [+ 205]	Sale of Interest: Y Gain of \$10

Asset	Book Value	Inside Basis
Capital Asset	1,000	200 + 390 = 590
Cash	490	490

## Example 5: t-Accounts

X		Y		Z		
Book	Tax	Book	Tax	Book	Tax	
100	100	100	100			Formation
0	490	0	0			Borrowing
400	0	400	0			Book-Up of Partnership Asset
0	0	-490	-490			Dist. of Proceeds: Y Gain of \$390
0	0			10	10 [+ 205]	Sale of Interest: Y Gain of \$10
0	205			0	205 - 205	Sale of Property for \$1,000
0	-490			0	0	Repayment of Debt
500	305			10	10	Totals

## Example 5: Analysis

- On the distribution of \$490 to Y –
  - Y recognizes a gain of \$390.
  - The inside basis of the property is increased under section 734(b) by \$390, reducing the taxable gain when the property is sold from \$800 to \$410.
- On the sale by Y of her partnership interest for \$10 –
  - Y recognizes a gain of \$10.
  - Z gets a basis increase under section 743(b) to eliminate Z's share of any sale unrealized tax gain in the partnership's asset; i.e., one-half of \$410, or \$205.
- When the property is sold for \$1,000, there is a gain of \$410 –
  - X recognizes \$205.
  - Z recognizes \$205 less the 743(b) basis adjustment, or \$205 - \$205, = \$0.

## Example 5: No Sale Analysis

X		Y		Z		
Book	Tax	Book	Tax	Book	Tax	
100	100	100	100			Formation
0	490	0	0			Borrowing
400	0	400	0			Book-Up of Partnership Asset
0	0	-490	-490			Dist. of Proceeds: Y Gain of \$390
<u>0</u>	<u>205</u>	<u>0</u>	<u>205</u>			Sale of Property
500	795	10	205			Totals
<u>0</u>	<u>-490</u>	<u>0</u>	<u>0</u>			Repayment of the Debt
500	305	10	205			Totals

## Example 6

- X is a 60% partner and Y is a 40% partner. The partnership owns an asset with inside basis of \$0, book value of \$0, and fair market value of \$2,000. Each partner has a capital account and outside basis of \$0.
  - The partnership borrows \$500, allocated 60% to X and 40% to Y. The loan proceeds are distributed \$300 to X and \$200 to Y.
  - Y sells one-half of her partnership interest for \$300.
  - The partnership sells the asset for \$2,000, and the debt is repaid.

## Example 6: t-Accounts

X		Y		Z		
Book	Tax	Book	Tax	Book	Tax	
0	0	0	0			Starting values
0	300	0	200			Borrowing
1,200	0	800	0			Book-Up (?)
-300	-300	-200	-200			Distribution of debt proceeds
0	0	-300	0	300	300	Sale by Y; recognition of \$300
0	1,200	0	400	0	400-400	Sale of asset; 743(b) for Z
<u>0</u>	<u>-300</u>	<u>0</u>	<u>-200</u>	<u>0</u>	<u>0</u>	Repayment of debt
900	900	300	200	300	300	Totals

## Example 6: t-Accounts (book/tax disparity)

X		Y		Z		
Book	Tax	Book	Tax	Book	Tax	
0	0	0	0			Starting values
0	300	0	200			Borrowing
1,200	0	800	0			Book-Up (?)
-300	-300	-200	-200			Distribution of debt proceeds
0	0	-300	0	300	300	Sale by Y; recognition of \$300
0	1,200	0	400	0	400-400	Sale of asset; 743 for Z
<u>0</u>	<u>-300</u>	<u>0</u>	<u>-200</u>	<u>0</u>	<u>0</u>	Repayment of debt
900	900	300	200	300	300	Totals



## Example 6: t-Accounts (743 adjustment)

X		Y		Z		
Book	Tax	Book	Tax	Book	Tax	
0	0	0	0			Starting values
0	300	0	200			Borrowing
1,200	0	800	0			Book-Up (?)
-300	-300	-200	-200			Distribution of debt proceeds
0	0	-300	0	300	300	Sale by Y; recognition of \$300
0	1,200	0	400	0	400-400	Sale of asset; 743 for Z
<u>0</u>	<u>-300</u>	<u>0</u>	<u>-200</u>	<u>0</u>	<u>0</u>	Repayment of debt
900	900	300	200	300	300	Totals



## Notes to Example 6

- Z's outside basis equals cost of \$10 under sections 742 and 1012(a).
- Z's capital account is a proportionate share (i.e., one-half) of Y's pre-sale capital account under Regulation section 1.704-1(b)(2)(iv)(I).
- Z's share of the built-in gain in the partnership's asset is "proportionate to the interest transferred" (i.e., one-half) under Regulation section 1.704-3(a)(3)(7).
- Z's share of "previously taxed capital" under Regulation section 1.743-1(d) equals \$10 - \$400, or negative \$390. Accordingly, the adjustment equals \$10 [cost] - (-390) [previously taxed capital], or \$400.

## Book/Tax Disparities

- Temporary book/tax disparities can arise when –
  - Property is contributed; and
  - Debt is incurred.
- Permanent book/tax disparities can arise when –
  - Property is distributed;
  - An adjustment under section 734(b) is made; or
  - A partnership incurs syndication expenses.

## Partnership Book/Tax Disparities: Recognize, Create, Exploit

Howard E. Abrams  
William K. Jacobs Visiting Professor  
Harvard Law School



## Chapter 4

# Presentation Slides: Hot Real Estate Topics

**RICHARD LIPTON**  
Baker & McKenzie LLP  
Chicago, Illinois



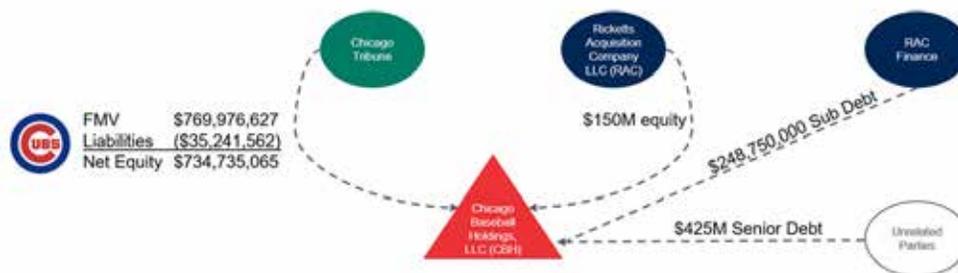
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## Hot Real Estate Topics

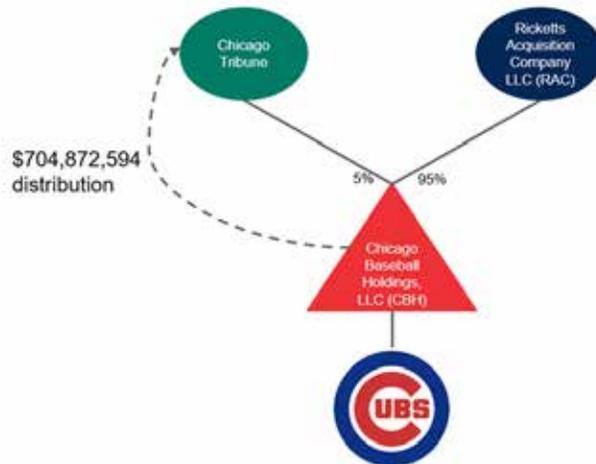
Richard M. Lipton | June 3, 2022



### 2009 Cubs Transaction



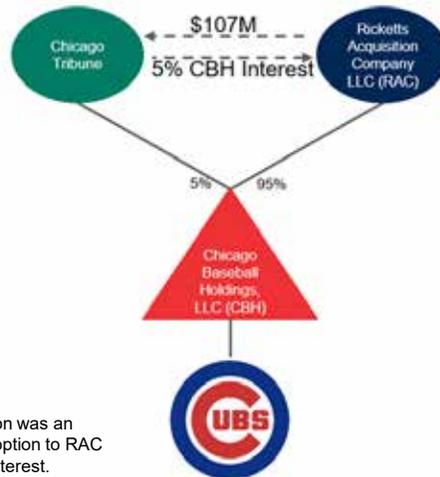
## 2009 Cubs Transaction



### § 1.707-5(b)(1) Debt-Financed Distribution Rule

“[I]f a partner transfers property to a partnership and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable \* \* \* to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money \* \* \* transferred exceeds that partner’s allocable share of the partnership liability.”

## 2028 Purchase of Tribune's 5% Interest



Embedded in the Cubs transaction was an option to Tribune to sell, and an option to RAC to buy, Tribune's remaining 5% interest. In 2018, RAC exercised its call option and paid Tribune \$107 million for its 5% interest.

## Dixie Dairies Debt/Equity Factors – Subordinated Debt

### Factors Indicating Equity

- Intent of the parties – 95/5 and PPM noted “ability to pay” and “complete loss of investment”
- Right to enforce payments – Focus on subordination limited practical rights
- Risk involved in making advances– Odds of forcing a liquidation “beyond unlikely”
- Identity of interest between creditor and stockholder
- Use to which advances were put – Not used to fund operations
- Fixed maturity date - 15 years but not before Senior Debt is paid
- Ability of corporation to obtain credit from outside sources – Marketed but never sold

### Factors Indicating Debt

- “Thinness” of capital structure in relation to debt – 4:1 ratio similar to other teams
- Names given to the certificates – Low probative Value
- Failure of debtor to repay – All amounts paid when due

### Neutral Factors

- Status of the advances in relation to regular creditors
- Participation in management – No terms but already had management
- Source of payments – Debt not restricted, but interest restricted to waterfall

## **Recourse Debt – General Rule**

A partner bears the risk of economic loss for a partnership liability if the partner would be obligated to make payment to the creditor if the partnership were constructively liquidated.

In a constructive liquidation, all of the following events are deemed to occur simultaneously:

- all of the partnership's liabilities become payable in full;
- all of the partnership's assets (except property contributed to secure a partnership liability), including cash, become worthless;
- the partnership disposes of all of its property in a fully taxable transaction for no consideration;
- all items of income, gain, loss, or deduction are allocated among the partners as of the date of the constructive liquidation; and
- the partnership liquidates

## **Senior Debt Guaranty – Was Guarantee Invalid?**

- IRS claim – Guarantee invalid because it required lender to exhaust all legal claims
- Court disagreed.
  - “The test here is whether Tribune must repay the senior debt creditors in a worst-case scenario. No other party was liable for the debt, no partnership assets secured the loans, and if the debt were due in full in the world of a constructive liquidation, the senior debt creditors would seek repayment from Tribune and no other party.”

### **Senior Debt Guaranty – Was Guarantee Contingent?**

- IRS claim – Guarantee invalid because it was a contingent obligation “unlikely that it would ever be discharged” again focusing on the need to exhaust all legal claims.
- Court disagreed.
  - “The fact that the senior debt guaranty is a collection guaranty does not negate Tribune’s ultimate obligation. And the requirements in the senior debt guaranty that lenders exhaust their remedies is not a contingency under [the regulations]. If it were, most if not all collection guaranties would be disregarded as conferring an obligation under the constructive liquidation test, when the regulations clearly intend to treat guaranties -- including collection guaranties -- as obligations.”

### **Senior Debt Guaranty – Recourse Debt Anti-Abuse Rule**

- Obligation may be disregarded if “facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.”
- Court concluded anti-abuse rule does not apply.
  - “...the probability of Tribune’s fulfillment of its promise in the senior debt guaranty is irrelevant. It is clear that if CBH could not pay its senior debt, Tribune would have to do so.”

### **Senior Debt Guaranty – Canal Distinguished**

- Court distinguished Canal
  - Despite having declared bankruptcy, Tribune had sufficient assets to satisfy the guaranty.
  - In Canal, the party with the guaranty would have gotten additional equity in the event the guaranty was exercised.

### **Senior Debt Guaranty – Partnership Anti-Abuse Rule**

- Court concluded the partnership anti-abuse rule did not apply.
  - Partnership needed business purpose, but every component (i.e. the guaranty) did not.
  - In any event, guaranty provided an ultimate payor and that is a purpose by itself.
  - The guaranty was taken into account by S&P in its credit rating.

## **Senior Debt Guaranty – Substance Over Form**

- Court concluded the substance over form doctrine did not apply.
  - In this case both the form and substance were of a disguised sale.

## **Background on Administrative Procedure Act**

- Section 553 of the Administrative Procedure Act (APA), 5 U.S.C. 553, generally requires a federal agency to provide public notice and an opportunity for comment on any proposed rule
  - The concept of “rule” is broad enough to encompass virtually any agency statement about what regulated parties must or should do
  - Exception for “interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice”
  - Legislative rules, however, are subject to notice and comment procedure

## Chevron Deference

- *Chevron USA Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984): considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer; 2-step analysis:
  - Whether Congress has directly spoken to the precise question at issue by employing precise, unambiguous statutory language
  - If not, whether EPA's interpretation was "based on a permissible construction of the statute"
- *Mayo Foundation for Medical Education and Research v. U.S.*, 562 U.S. 44 (2011): applied Chevron 2-step analysis in upholding the validity of regulations that disqualified medical residents from the FICA student exception
  - In *Mayo*, the Supreme Court rejected the longstanding view that the APA did not apply to IRS rulemaking
- Concept of notice and comment procedures recently addressed in *Mann Construction Inc. v. U.S.*, No. 21-1500 (6th Cir. 2022):
  - IRS has authority to identify shelters and impose penalties for failure to report them, but identification of reportable deals must be preceded by notice and comment procedures, unless the good cause exception applies
  - IRS' issuance of Notice 2007-83 including certain employee-benefit plans featuring cash-value life insurance policies as listed transactions was invalid because the IRS issued it without providing notice or the opportunity for comment

## Hewitt v. Commissioner

- Facts
  - The taxpayers owned 1325 acres of land used as a cattle ranch
  - The taxpayers created an easement on 247 acres and in 2012 donated the easement to a conservatory and claimed a \$2.8 million charitable deduction; carried forward to 2013 and 2014
  - The terms of the easement provided that if the taxpayers had to extinguish the easement, the taxpayers would return to the charity the profits from the sale, except that the taxpayers could keep the increase in value of the easement due to any improvements that the taxpayers made to it
  - IRS disallowed carryforward deductions in 2013 and 2014
  - IRS argued that the division of the proceeds violated Reg. Section 1.170A-14(g)(6)(ii); objection to allowing donor to keep value of any improvements made after donation
- Tax Court (TC Memo 2020-89): upheld IRS position
  - Reg. section 1.170A-14(g)(6)(ii) does not permit value of post easement improvements to be subtracted from the proceeds before determining the donee's share
    - Section 170(h)(5)(A): a conservation easement must be protected in perpetuity

## Hewitt v. Commissioner (cont'd)

- Reg. Section 1.170A-14(g)(6)(ii) (the “proceeds regulation”): when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction, the donee must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction
- For purposes of the extinguishment provisions, the subject property may change, but donee’s property right to the extinguishment proceeds may not
- 11th Circuit (128 AFTR 2d 2021-7033) :
  - Reversed the Tax Court; regulation invalid
  - Taxpayers argued their extinguishment clause met requirements of Reg. Section 1.170A-14(g)(6)(ii) and reg was procedurally invalid under the APA and substantively invalid under Chevron
  - Court rejected first argument
  - Court explained APA review; three-step procedure for notice and comment rulemaking:
    - Agency must issue a general notice of proposed rulemaking
    - If notice is required, the agency must give interested persons an opportunity to participate in the rulemaking
    - In promulgating the final rule, the agency must include in the rule’s text a concise general statement of its basis and purpose

## Oakbrook Land Holdings, LLC v. Commissioner

- Facts
  - Taxpayer LLC purchased a 143-acre parcel of land near Chattanooga for \$1,700,000 in 2007
  - Taxpayer donated conservation easement on 106 acres of the land to Southeast Regional Land Conservancy (SRLC) in 2008
    - The terms of the easement provided that if the taxpayers had to extinguish the easement, the taxpayers would return to the charity the profits from the sale, except that the taxpayers could keep the increase in value of the easement due to any improvements that the taxpayers made to it
  - Oakbrook claimed charitable deduction for 2008 tax year of \$9,545,000
    - Amount of deduction was a re-appraised amount
    - Original appraised value of easement was \$19,500,000
    - IRS denied the deduction in full

## Oakbrook Land Holdings, LLC v. Commissioner (cont'd)

- Tax Court (TC Memo 2020-40)
  - Taxpayer: deed satisfied regulation; alternatively, the regulation was invalid
  - IRS: Oakbrook's deed violated the regulation in two ways
    - Failed to define a fraction to be multiplied by amount of future proceeds
    - Failed because regulation prohibits any scenario in which donor gets to recover compensation for improvements in excess of a share of proceeds defined by before and after easement value of unimproved land at time of donation
  - Tax Court: regulation is valid and Oakbrook's deed violated the proceeds regulation in two ways
    - By ascribing a fixed, rather than a proportionate, value that would go to SRLC upon judicial extinguishment
    - By subtracting from this amount any post-donation improvements that Oakbrook made to the land

## Oakbrook Land Holdings, LLC v. Commissioner (cont'd)

- 6th Circuit (129 AFTR 2d 2022-1031 (6th Cir. 2022): regulation is valid; affirm judgment of Tax Court
  - Declined to address new argument IRS raised on appeal (that Oakbrook's deed would fail to compensate SRLC at FMV should easement be extinguished)
  - Regarding the validity of the regulation:
    - Adequacy of Treasury Concise Statement of Basis and Purpose—court found the concise statement of basis and purpose Treasury issued after comment period closed to be sufficient, after weighing competing considerations
    - Failure to respond to comments regarding Reg. Section 1.170A-14(g)(6)(ii)—court recognized significance is difficult to measure in the abstract and is context dependent, but upon review of certain comments on the proposed regulations, court concluded that they do not qualify as significant
  - *Chevron* deference—taxpayers also argued that deference to Treasury's statutory interpretation is warranted
    - Whether Congress has directly spoken to the precise question at issue by employing precise unambiguous statutory language: no, section 170(h)(5)(A) does not speak to the question at issue (how judicial extinguishment affects the perpetuity requirement)
    - Was Treasury's interpretation based on a permissible construction of the statute: 30+ years of congressional acquiescence to the proceeds regulation "leaves us confident that the regulation is owed our deference under *Chevron*"

## Oakbrook Land Holdings, LLC v. Commissioner (cont'd)

- 6th Circuit (cont'd)
  - Arbitrary or Capricious Review issue—court said scope of review is “an extremely narrow one” and a court may not “substitute its judgment for that of the agency”
  - Judge Ralph’s concurring opinion--concurrence in the judgment only: agreed with IRS’ statutory argument but concluded that regulation is procedurally invalid
    - Comment provided by NYLC regarding the proposed regulations was significant because it showed that the regulation “would thwart” one of the purposes of the statute by deterring prospective donors; thus it required a response but Treasury ignored their significant comment and every other comment about the proceeds regulation
    - Rulemaking process was “procedurally defective” so the proceeds regulation does not survive *Chevron*
    - Treasury’s rationale for the proceeds regulation contains only post hoc explanations, which are not sufficient to explain agency action

## What’s Next? Implications?

- Conflict in circuits about validity of the proceeds regulation: what is the likelihood that the Supreme Court will hear the conservation easement issue?
- Do recent cases signal greater need for IRS publication items to be subject to the comment process? For example, notices concerning tax shelter reporting?

## Implications – FIRPTA Withholding

- A Form W-8 (e.g., Form W-8EXP) submitted by a partner that is a foreign government, foreign tax-exempt organization, or other foreign person for purposes of withholding under §§1441 through 1443 will also operate to establish the foreign status of such partner under this section. However, except as set forth in § 1.1446-3(c)(3) (regarding certain tax-exempt organizations described in section 501(c)), the submission of Form W-8EXP will have no effect on whether there is a 1446 tax due with respect to such partner's allocable share of partnership ECTI. For example, a partnership must still pay 1446 tax with respect to a foreign government partner's allocable share of ECTI because such partner is treated as a foreign corporation under section 892(a)(3). Treas. Reg. § 1.1446-1(c)(2)(ii)(G).

## Implications – Carried Interest Lookthrough Rule

- The API would have a holding period of three years or less if the holding period of such API were determined by not including any period before the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates. ... Solely for the purpose of this paragraph (b)(9)(i)(A), a substantial legal obligation to contribute money or property is an obligation to contribute a value that is at least 5 percent of the partnership's total capital contributions as of the time of the API disposition.

## Implications – Carried Interest ATB Test

- 1062(c)(2) – “applicable trade or business” means any activity...which...consists, in whole or in part, of-
  - raising or returning capital, and
  - Either-
    - Investing in (or disposing of) specified assets..., or
    - Developing specified assets.



**Questions**

## Speaker



Richard M. Lipton  
Baker McKenzie  
richard.lipton@bakermckenzie.com

Richard Lipton is senior counsel in Baker McKenzie, Dallas. He advises on tax planning for corporations, partnerships and limited liability companies, and has handled numerous engagements in structuring partnership and real estate transactions. Richard served on the Internal Revenue Service Advisory Council, and is an adjunct professor at the University of Chicago Law School, where he teaches partnership taxation. Richard is past Chair of the ABA section of Taxation.

Richard advises US and multinational clients on federal tax issues. He also has extensive experience in a number of other areas relating to tax law, including tax-exempt organizations and the rules involving unrelated business income tax, the tax consequences of bankruptcies and workouts, and various tax accounting issues. He also provides tax advice to several professional sports franchises. Richard has represented large corporations in complex partnership transactions, and has served as an expert witness on matters concerning partnerships and partnership taxation. He also has considerable experience in the areas of real estate investment trusts, real estate funds and investment in real estate by tax-exempt organizations and foreign investors.

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## Chapter 5

# Hot Topics in Estate Planning (Finding Gems in the Ashes of the Dumpster Fire)

PAUL LEE  
Northern Trust  
New York, New York

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**HOT TOPICS IN ESTATE PLANNING  
(FINDING GEMS IN THE ASHES  
OF THE DUMPSTER FIRE)<sup>1</sup>**

Paul S. Lee, J.D., LL.M.  
Chief Tax Strategist  
The Northern Trust Company  
New York, NY  
Email: [PSL6@ntrs.com](mailto:PSL6@ntrs.com)

I. INTRODUCTION

A. COVID-19, Congress, and the Biden Administration

1. These materials (the ubiquitous “top planning techniques today” outline) have been written and updated over a number of years, and much of this outline predates 2022. However, it is necessary to recognize the unprecedented period that we, as advisors, and our clients have been and are currently living as COVID-19 Omicron variant spreads rapidly around the world. In the wake of the U.S. government’s relief programs which include the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”)<sup>2</sup> (including the Paycheck Protection Program and Economic Injury Disaster Loans), the American Rescue Plan Act of 2021,<sup>3</sup> and other legislation,<sup>4</sup> will cost over \$5 trillion. In order to offset the resulting budget deficit, it is speculated that income tax rates (and perhaps transfer tax rates) will need to be increased in the future.

2. H.R. 5376, the Build Back Better Act, passed by the House of Representatives on November 19, 2021, has been pared down significantly from the original version released by the House Ways & Means Committee on September 13, 2021. The House-passed version of the Build Back Better Act does not have any changes to the current ordinary income and long-term capital gain tax rates, but it retains the use of surcharges on very high amounts of income for individual taxpayers (with a significantly lower threshold for non-grantor trusts). It also omits the transfer (proposed § 2901) and income (proposed § 1062) tax provisions dealing with grantor trust transfers and transactions (discussed below). Surprisingly, the bill does not contain any transfer tax provisions at all. Given that the Senate has not yet considered or voted on the

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<sup>1</sup> Portions of these materials were initially prepared for the 52<sup>nd</sup> Annual Heckerling Institute on Estate Planning (2018), published by LexisNexis Matthew Bender, and are reprinted with the permission of the Heckerling Institute and the University of Miami. Portions of this material have been previously presented by Turney P. Berry & Paul S. Lee. *See also* Turney P. Berry and Paul S. Lee, *Retaining, Obtaining, and Sustaining Basis*, 7 Est. Plan. & Community Prop. L. J. 1 (Fall 2014).

<sup>2</sup> P.L. 116-136 (Mar. 27, 2020).

<sup>3</sup> P.L. 117-2 (Mar. 11, 2021).

<sup>4</sup> Families First Coronavirus Response Act, P.L. 116-127 (Mar. 18, 2020), Coronavirus Preparedness and Response Supplemental Appropriations Act, P.L. 116-123 (Mar. 6, 2020). Consolidated Appropriations Act, 2021, P.L. 116-260 (Dec. 21, 2020), and Coronavirus Preparedness and Response Supplemental Appropriations Act, P.L. 116-123 (Mar. 6, 2021).

bill or a reconciliation version, a complete discussion of the act is premature. While there is some speculation that the Build Back Better Act has little or no chance of passing this year, there is indirect evidence that the Biden Administration believes it will pass, along with a number of additional provisions that are complementary to its provisions.

3. Earlier this year the Treasury Department issued its “General Explanations of the Administration’s Fiscal Year 2023 Revenue Proposals” (the Biden Administration’s “Green Book”).<sup>5</sup> The Green Book calls for increasing the top individual income tax rate and capital gains tax rate (for those taxpayers with more than \$1 million in taxable income), repealing like-kind exchanges for gains of more than \$500,000, eliminating the “step-up” in basis for certain inherited assets, replacing the foregoing with a capital gain realization on certain transfers of appreciated property by gift and at death, and various other tax increases focused on upper-income taxpayers. Some of these proposals seem far reaching and it's difficult to predict what may be enacted into law given political and economic consideration. A side-by-side summary of the salient Green Book and Build Back Better Act income tax proposals is set forth in the table below (unless noted otherwise, the effective date of the provisions is 1/1/2023:

 <b>Build It Up... Back Down... Better? Income Tax, Pt. 1</b>		
	BBB (H.R. 5376)	2023 Greenbook
<b>Rates for Individuals, Trusts &amp; Estates</b>	<ul style="list-style-type: none"> <li>• 5% surcharge on MAGI &gt;\$10 Mil./\$200K T&amp;E</li> <li>• § 642(c) deduction allowed in MAGI</li> <li>• 3% on MAGI &gt;\$25 Mil./\$500K T&amp;E</li> <li>• SALT cap of \$80,000</li> </ul>	<ul style="list-style-type: none"> <li>• 39.6% (\$400K Single/\$450K Joint)</li> </ul>
<b>Long-Term Capital Gains Rates</b>		<ul style="list-style-type: none"> <li>• 37%/39.6% &gt; \$1 million taxable income</li> <li>• Includes qualified dividends</li> <li>• <b>Eff. date of enactment</b></li> </ul>
<b>Recognition Events</b>		<ul style="list-style-type: none"> <li>• Gift or transfer on death is a recognition event (deductible for estate tax purposes)</li> <li>• Trust, partnership, or other non-corporate entity every 90 years (since 12/31/1998 = first recognition would occur 12/31/2030)</li> <li>• Includes transfer to or from trusts and partnerships (if gift)</li> <li>• Exceptions for transfers to U.S. spouses and charity (partially for split-interest trusts), tangible personal property (excluding collectibles)</li> <li>• \$5 mil. exclusion (portable &amp; indexed after 2022) + Base Exclusion Amount</li> <li>• \$250K exclusion on personal residences would be applicable</li> <li>• QSBS exclusion would be applicable</li> <li>• Election to defer recognition on family-owned and –operated businesses until sold or no longer family-owned and –operated</li> <li>• 15-year fixed rate payment plan on transfers at death (other than liquid assets)</li> </ul>
<b>“Billionaire” Tax</b>		<ul style="list-style-type: none"> <li>• Minimum 20% tax on total income, including unrealized capital gain, for taxpayers with wealth greater than \$100 Mil.</li> <li>• Minimum 20% tax would be fully phased-in for taxpayers with wealth greater than \$200 Mil.</li> <li>• Elect to pay first year in 9 equal, annual installments, 5 annual installments in subsequent years</li> <li>• Taxpayers above \$100 Mil. required to report to IRS on annual basis</li> <li>• Non-tradable assets would be valued at the greater of adjusted cost basis, last valuation event, or other methods approved by IRS with adjustments at conservative floating return in between valuations</li> <li>• “liquid” taxpayers (tradeable assets less than 20% of wealth) may elect to include unrealized gain of only tradeable assets (subject to deferral charge not to exceed 10% of unrealized gains)</li> </ul>

<sup>5</sup> *General Explanations of the Administration’s Fiscal Year 2023 Revenue Proposals*, Department of Treasury, March 2023. Available online at: <https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf>

 <b>Build It Up... Back Down... Better? Income Tax, Pt. 2</b>		
	BBB (H.R. 5376)	2023 Greenbook
<b>IRAs &amp; Qualified Plans</b>	<ul style="list-style-type: none"> <li>• Prohibition on Roth conversions with \$400/\$450K AGI—<b>Eff. 1/1/32</b></li> <li>• Prohibition on Roth conversion from qualified plans, unless taxable</li> <li>• Prohibition of contributions to large qualified accounts (\$10 Mil)-\$400K/\$450K AGI</li> <li>• Mandatory distributions (50%) from mega-IRAs (\$10-\$20 Mil) then 100% (\$20+)-\$400K/\$450K ATI</li> </ul>	
<b>Corporate Taxes</b>	<ul style="list-style-type: none"> <li>• 15% (alternative minimum tax) on corporations with adjusted financial income &gt; \$1 billion</li> <li>• 1% tax on share repurchase of publicly-traded companies</li> </ul>	• 28%
<b>Net Investment Income Tax</b>	<ul style="list-style-type: none"> <li>• NIT on all passthrough business income of trusts, estates, and individuals with MAGI &gt;\$400K</li> </ul>	
<b>QSBS</b>	<ul style="list-style-type: none"> <li>• 100% &amp; 75% exclusion disallowed for individuals with AGI of \$400K or more and trusts &amp; estates—<b>Eff. sales after 9/13/21</b></li> </ul>	
<b>Carried Interest</b>		<ul style="list-style-type: none"> <li>• Income from "Investment Services Partnership Interest" is treated as ordinary income if taxable income &gt; \$400K (§ 1051 still applicable for partners &lt; \$400K in taxable income)</li> </ul>
<b>Basis Shifting</b>		<ul style="list-style-type: none"> <li>• Prohibit any partner in the partnership that is related to the distributee partner from benefiting from a basis increase until distributee partner has a taxable sale of the property</li> </ul>
<b>Like-Kind Exchanges</b>		<ul style="list-style-type: none"> <li>• Gains from like-kind exchanges in excess of \$500K (\$1 Mil. joint) would be recognized</li> </ul>
<b>Recapture</b>		<ul style="list-style-type: none"> <li>• § 1250 recapture treated as ordinary income to the extent of depreciation deductions taken after effective date for taxpayers with AGI of \$400K or above</li> </ul>

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4. Unlike last year, this year’s Green Book contains significant transfer tax proposals, as outlined in the following table:

 <b>Build It Up... Back Down... Better? Transfer Tax</b>		
	BBB (H.R. 5376)	2023 Greenbook
<b>GRATs</b>		<ul style="list-style-type: none"> <li>• Term of at least 10 years and not more than life expectancy of the grantor plus 10 years</li> <li>• No decreasing annuities</li> <li>• Taxable gift equal to the greater of 25% or \$500K</li> <li>• <b>Eff. trusts created on or after enactment</b></li> </ul>
<b>Grantor Trusts</b>		<ul style="list-style-type: none"> <li>• Transfer of an asset for consideration between grantor trust and its deemed owner as one that is regarded for income tax purposes (recognizing gain), including sales as well as the satisfaction of an obligation (i.e., annuity or unitrust payment)—<b>Eff. all transactions on or after enactment</b></li> <li>• Payment of income tax on grantor trust income is a gift on 12/31 of that year, immediately before death, or owner's renunciation of reimbursement right—<b>Eff. all trusts created on or after enactment</b></li> </ul>
<b>Promissory Notes</b>		<ul style="list-style-type: none"> <li>• Promissory notes with sufficient interest to avoid income and gift tax consequences must be valued for transfer tax purposes by limiting the discount rate to the greater of the actual rate of interest, or the applicable minimum interest rate for the remaining term of the note on date of death—<b>Eff. valuation dates or after introduction</b></li> </ul>
<b>GST Tax</b>		<ul style="list-style-type: none"> <li>• GST Exemption applies only to: (1) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the time of the creation of the trust; and (2) taxable terminations while any person described above is a beneficiary of the trust</li> <li>• No "reset" of generation assignment</li> <li>• <b>Eff. on or after enactment, but pre-enactment trust treated as created on date of enactment</b></li> </ul>
<b>Conservation Easements</b>		<ul style="list-style-type: none"> <li>• Qualified conservation deduction by a partnership is limited to 250% of each relevant partner's basis in the partnership, unless a 3-year holding requirement is satisfied</li> <li>• Limitation does not apply to pass-through entities where substantially all of the interests are held, directly or indirectly, by an individual and family members</li> <li>• <b>Eff. contributions after 12/23/16 (12/31/18 for certified historic structures)</b></li> </ul>
<b>Special Use Valuation</b>		<ul style="list-style-type: none"> <li>• Increase maximum reduction on "qualified real property" to \$11.7 MIL (from \$1.23 MIL in 2022)</li> <li>• <b>Eff. decedents dying on or after enactment</b></li> </ul>
<b>Trust Reporting</b>		<ul style="list-style-type: none"> <li>• Trusts administered in the U.S. will be required to report annually with information including name, address, and TIN of each trustee and grantor, and general information regarding the nature and estimated total value of trust's assets</li> <li>• Each trust with total value &gt; \$300K or gross income &gt; \$10K</li> </ul>

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5. The combined international tax provisions of the Build Back Better Act and the Green Book are outlined below:

 <b>Build It Up... Back Down... Better? International Planning</b>		
	BBB (H.R. 5376)	2023 Greenbook
<b>Section 250 Deduction</b>	<ul style="list-style-type: none"> <li>Deduction for global intangible low-tax income (GILTI) reduced from 50% to 28.5% and foreign-derived intangible income (FDII) reduced to from 37.5% to 24.8%</li> </ul>	<ul style="list-style-type: none"> <li>Increase C corporation rate to 28% with GILTI deduction constant under a BBB Act baseline (effective 20% applied on country-by-country basis)</li> </ul>
<b>CFCs</b>	<ul style="list-style-type: none"> <li>Repeal of 1-month deferral of taxable year of CFCs (majority U.S. shareholder); <b>Eff. taxable years after 11/20/22</b></li> <li>Deduction under § 245A (deduction for foreign-source dividend) limited to CFCs (not 10-percent owned foreign corporations)</li> <li>Restore § 958(b)(4) (stock owned by foreign person not attributed downward to U.S. person)</li> <li>New § 951B added applying subpart F to foreign controlled U.S. shareholder (U.S. shareholder owning more than 50% of foreign corporation and downward attribution from foreign persons apply)</li> </ul>	
<b>Foreign Tax Credit</b>	<ul style="list-style-type: none"> <li>Any amount paid by a dual capacity taxpayer to a foreign country for any period is not considered a tax (a) if such foreign country does not impose a generally applicable income tax, or (b) to the extent such amount exceeds the amount which would be paid by the taxpayer under generally applicable income tax imposed by such country if the taxpayer were not a dual capacity taxpayer</li> <li>Foreign tax credit limitations applied on a country-by-country basis (on a taxable unit basis)</li> </ul>	
<b>GILTI</b>	<ul style="list-style-type: none"> <li>Country-by-country application of GILTI on a CFC taxable unit basis</li> <li>Reduction of net deemed tangible income return from 10% to 5% (except property located in a U.S. possession)</li> <li>Elimination of exception for foreign oil and gas extraction income from CFC tested income</li> <li>Increases deemed foreign taxes paid from 80% to 95% (100% for foreign income taxes paid to a U.S. possession)</li> </ul>	
<b>Other Provisions</b>	<ul style="list-style-type: none"> <li>Base erosion and anti-abuse tax (BEAT) applicable to all taxpayers with gross receipts greater than \$500 million making payments to foreign related parties (no longer limited to corporations with a 3% base erosion percentage or higher); <b>Eff. taxable years after 12/31/23</b></li> </ul>	<ul style="list-style-type: none"> <li>Repeal BEAT. Replace with undertaxed profit rule (UTPR). Reporting groups that have global revenue of \$850+ million, UTPR domestic corporations and branches would be disallowed U.S. tax deductions by reference to low-taxed income of foreign entities. Effective rate of at least 15% in the foreign entities; <b>Eff. taxable years after 12/31/23</b></li> <li>Expand retroactive QEF election for PFIC shareholders</li> </ul>

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6. At a time like this, estate planners can provide sage and practical advice that can give their clients the confidence to take action without jeopardizing their future well-being. The planning techniques that will resonate the most with clients are the ones that can transfer wealth at depressed values and leverage the very low interest rates, but also allow these clients to retain access to the transferred assets (e.g., spousal lifetime access trusts) or cash flow for life (e.g., long-term GRATs, private annuities, and preferred partnerships). In addition, with volatility in the financial markets likely to be high in the near future (perhaps even for years), these techniques should be structured to defer, as long as possible any required distributions (e.g., deferred private annuity sales or back-loaded charitable lead annuity trusts<sup>6</sup>). Sadly, estate planners must acknowledge that for the time being, until COVID vaccines are widely distributed, we must prepare our clients for unexpected and premature deaths, so in addition to carefully reviewing testamentary documents, tax basis planning that can benefit from the most from the “step-up” or “step-down” in basis at death will be critical.

7. Given all of the foregoing variables and uncertainty, some consideration should be given to making taxable gifts that can be “undone” after the fact, if it turns out that it

<sup>6</sup> For a comprehensive discussion of back-loaded annuity CLATs, see Paul S. Lee, Turney P. Berry, and Martin Hall, *Innovative CLAT Structures: Providing Economic Efficiencies to a Wealth Transfer Workhouse*, 37 ACTECL. J. 93 (Summer 2011).

would be more beneficial to have not made the gift. There are many potential situations where making the gift in 2022 could increase a client's potential income or transfer tax liability. Some of these situations include: (i) the "doubled" Basic Exclusion Amount becomes permanent in 2022, which, as discussed later, generally means taxpayers should try to preserve as much exclusion as possible to benefit from a "free step-up" in basis; (ii) the gifted asset declines in value; (iii) the donor passes away, and the estate would prefer to benefit from a "step-up" in basis on the gifted assets; and (iv) in some states, like New York, if a donor dies within 3 years of making a gift, the value of the gift is included in the state estate tax calculation, but the additional state estate tax is not deductible for federal estate tax purposes, which increases the combined tax rate on the gifted assets from a maximum of 49.6% to 56%. Some strategies to consider include making a gift to a trust that provides that if a beneficiary disclaims his or her interest in the trust, the gifted property returns to the donor. If the beneficiary claims the property within 9 months of the gift (and all other conditions are met under section 2518 of the Code), then the gift is treated for gift tax purposes as if it had never been made. Another strategy to consider is making a gift to an inter-vivos trust that satisfies all of the requirements to be considered a QTIP trust under section 2523 of the Code. If, before the due date for the donor's gift tax return (April 15 or October 15 of the year after the gift is made), if the donor determines that making an adjusted taxable gift in 2022 is not desirable, the donor can make a QTIP election to treat the gift as a marital deduction transfer.

B. Tax Cuts and Jobs Act

1. Permanence and Expiration

a. On December 22, 2017, the "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018"<sup>7</sup> act, more commonly known as the "Tax Cuts and Jobs Act" ("TCJA") became law. TCJA makes significant changes to the U.S. income tax system including reducing the top income tax rate while eliminating most itemized deductions of individual taxpayers, limiting the deductibility of business interest expense, reducing the corporate tax rate to 21%, adding a special deduction for business income of "pass-thru" entities, and changing the taxation of foreign earnings.

b. A complete discussion of the TCJA is beyond the scope of this outline, but a number of significant changes were made to the income and transfer taxation of individuals and partnerships, disregarded entities, and other non-corporate entities. These are discussed in detail in these materials.

c. Unless otherwise indicated, all changes are effective for tax years beginning after December 31, 2017, and most of the provisions will expire after December 31, 2025, due to the "Byrd rule,"<sup>8</sup> as adopted by the U.S. Senate, which require the affirmative vote of three-fifths of the members (60 Senators if no seats are vacant), which did not occur with TCJA. Thus, most of the provisions of TCJA will "sunset," reverting back to the law that was in place when the provisions were enacted (as discussed later in these materials).

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<sup>7</sup> P.L. 115-97. The Senate parliamentarian removed the short title "Tax Cuts and Jobs Act" as extraneous. Hereinafter, P.L. 115-97 will nonetheless be referred to as the "Tax Cuts and Jobs Act" or "TCJA."

<sup>8</sup> Section 313 of the Congressional Budget Act of 1974, as amended (2 U.S.C. § 644).

2. Pertinent Changes to the Income Taxation of Individuals and Trusts

a. TCJA adds subsection 1(j) to the Code, which temporarily decreases the highest Federal ordinary income tax rate from 39.6% to 37% (in 2022, for individual taxpayers with taxable income over \$539,900, married individuals filing joint returns with taxable income over \$647,850, and trusts and estates with taxable income over \$13,450, all subject to annual inflation adjustments).<sup>9</sup>

b. TCJA temporarily increases the standard deduction in 2022 to \$12,950 for single filers and \$25,900 for joint return filers,<sup>10</sup> but also temporarily limits the deduction for state and local sales, income, or property tax to \$10,000.<sup>11</sup>

c. TCJA adds new subsection 67(g) of the Code that temporarily suspends all miscellaneous itemized deductions that are subject to the 2 percent of adjusted gross income floor (for example, unreimbursed employee expenses, tax preparation fees, and other expenses to produce or collect income or expenses to manage, conserve, or maintain property held to produce income).<sup>12</sup>

d. Effective as of 2018, TCJA permanently amends the measure of inflation used for indexing of both income and transfer tax purposes, relying on “chained CPI” (Chained Consumer Price Index for All Urban Consumers or C-CPU-I) rather than CPI (CPI-U) used prior to the enactment of TCJA.

3. Pertinent Changes to Transfer Taxation

a. Temporary Doubling of Transfer Tax Exclusions/Exemptions

(1) Effective for estates of decedents dying and gifts made after December 31, 2017, TCJA adds new subparagraph section 2010(c)(3) to the Code that temporarily doubles the basic exclusion amount from \$5 million to \$10 million, which means, as adjusted for inflation, the basic exclusion amount (or BEA) for 2022 is \$12.06 million per person.<sup>13</sup>

(2) As a result, the GST tax exemption amount for 2022 will also be \$12.06 million per person.<sup>14</sup>

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<sup>9</sup> § 1(j) and Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>10</sup> § 63(c)(7)(A) and Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>11</sup> § 164(b)(6).

<sup>12</sup> § 67(g).

<sup>13</sup> Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>14</sup> See § 2631(c).

b. Clawback and Anti-Clawback Regulations

(1) In order to address the issue of “clawback” (the risk that prior gifts covered by a gift tax exclusion that is greater than the estate tax exclusion available at the time of death, thereby giving rise to the risk of an additional estate tax liability), TCJA adds section 2001(g)(2) of the Code, which provides, “The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—(A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent’s death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.”<sup>15</sup>

(2) The estate tax calculation under section 2001(b) of the Code starts with a tentative tax on the combined amount of the taxable estate and adjusted taxable gifts (i.e., gifts made after 1976 that are not brought back into the gross estate) without any reduction due to credits.<sup>16</sup> From that amount, section 2001(b)(2) of the Code says to subtract the amount of gift tax that would have been payable if the rate schedule in effect at the decedent’s death had been applicable at the time of the gifts.<sup>17</sup> The Code does not make clear, in this part of the calculation, whether to use the unified credit amount that was applied at the time of the gift or apply the credit amount available at death, which is where the risk of clawback theoretically occurs.<sup>18</sup> The final step in the estate tax calculation applies the estate tax applicable credit amount.

(3) On November 26, 2019, the IRS issued final Treasury Regulations<sup>19</sup> (the “Anti-Clawback Regulations”) to “solve” the risk of clawback. The Anti-Clawback Regulations adopt the rule initially proposed in 2018<sup>20</sup> and provides:<sup>21</sup>

Changes in the basic exclusion amount that occur between the date of a donor's gift and the date of the donor's death may cause the basic exclusion amount allowable on the date of a gift to exceed that allowable on the date of death. If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the

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<sup>15</sup> § 2001(g)(2).

<sup>16</sup> § 2001(b)(1).

<sup>17</sup> § 2001(b)(2).

<sup>18</sup> The Form 706 instruction for “Line 7 Worksheet” provides that the basic exclusion amount available in each year using a Table of Basic Exclusion Amounts for each year in which gifts were made, from 1977 to date, (plus any applicable deceased spousal unused exclusion amount) is used in calculating the gift tax that would have been payable in that year (but using date of death tax rates). The effect is that the tentative tax on the taxable estate plus adjusted taxable gifts would NOT be reduced by any gift tax payable on those gifts if the gifts were covered by the Applicable Exclusion Amount at such time. Thus, the tentative estate tax would include a tax on the prior gifts that were sheltered by the Applicable Exclusion Amount.

<sup>19</sup> T.D. 9884, 84 Fed. Reg. 64,995 (11/26/19) (the “Anti-Clawback Regulations”).

<sup>20</sup> REG-106706-18 (the “Proposed Anti-Clawback Regulations”).

<sup>21</sup> Treas. Reg. § 20.2010-1(c).

extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts.

(4) The “solution” in the Anti-Clawback Regulations is to revise the unified credit against the estate tax under section 2010 of the Code, rather than the hypothetical gift tax under section 2001 of the Code. The preamble to the proposed Treasury Regulations published in 2018 asserts this approach was the “most administrable solution.”<sup>22</sup> The preamble to the proposed Treasury Regulations describes a 5-step process for calculating the Federal estate tax. The first three steps determine the net tentative tax due (tax on the gross estate reduced by gift tax calculated on taxable gifts after 1976, reduced by all credits available on such gifts). Step 4 requires a determination of the allowable estate tax credit equal to the Basic Exclusion Amount in effect at the date of death. To address clawback, the preamble explains that the Anti-Clawback Regulations modify the amount in Step 4 such that “As modified, Step 4 of the estate tax determination therefore would require the determination of a credit equal to the tentative tax on the AEA<sup>23</sup> as in effect on the date of the decedent’s death, where the BEA<sup>24</sup> included in that AEA is the larger of (i) the BEA as in effect on the date of the decedent’s death under section 2010(c)(3), or (ii) the total amount of the BEA allowable in determining Step 2 of the estate tax computation (that is, the gift tax payable).”<sup>25</sup> As explained by a 2018 release, “the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA applicable to gifts made during life or the BEA applicable on the date of death.”<sup>26</sup>

(5) The practical effect of the foregoing “solution” is that in order for taxpayers to take advantage of the temporary increase in the basic exclusion amount under TCJA,

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<sup>22</sup> The adjustment would be made to Step 4 in the calculation described in the preamble. Preamble to the Proposed Anti-Clawback Regulations.

<sup>23</sup> Applicable Exclusion Amount.

<sup>24</sup> Basic Exclusion Amount.

<sup>25</sup> The preamble also explains, “Some commenters suggested a BEA ordering rule, similar to that for DSUE, under which the increase in the BEA during the increased BEA period over the BEA in effect in 2017 (base BEA) is deemed to be allowable against gifts before the base BEA. They posited that this would allow donors to utilize the increase in the BEA without being deemed to have utilized the base BEA, so that the base BEA would remain available for transfers made after 2025. Specifically, a \$5 million gift made during the increased BEA period would use the temporary increase in the BEA and preserve or “bank” the base BEA of \$5 million so as to be available after 2025 for either gift or estate tax purposes. This suggestion was not adopted for several reasons.” Preamble to the Proposed Anti-Clawback Regulations.

<sup>26</sup> IR-2018-229 (Nov. 11, 2018).

taxpayers must first make a taxable gift that exhausts the original basic exclusion amount, or potentially the taxpayer's Basic Exclusion Amount. In other words, there is no opportunity for taxpayers to make a taxable gift of \$6.03 million (the temporary increase amount for 2022) "off the top" and still preserve the original \$6.03 million of exclusion that existed prior to the enactment of TCJA. The preamble to the Anti-Clawback Regulations provides:<sup>27</sup>

Specifically, the increased BEA<sup>28</sup> as adjusted for inflation is a "use or lose" benefit and is available to a decedent who survives the increased BEA period only to the extent the decedent "used" it by making gifts during the increased BEA period. The final regulations include Example 2 in § 20.2010-1(c)(2)(ii) to demonstrate that the application of the special rule is based on gifts actually made, and thus is inapplicable to a decedent who did not make gifts in excess of the date of death BEA as adjusted for inflation.

Example 2 provides a fact situation where A makes taxable gifts of \$4 million at a time when the basic exclusion amount (which includes the temporary increase under TCJA) is \$11.4 million (a gift in 2019). At the time of A's death, the BEA is \$6.8 million (after 2025). In this situation, the example concludes, "Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts is less than the credit based on the \$6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing A's estate tax is based on the \$6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d).

(6) For clients with taxable estates equal to or less than the original BEA, there is no need to make any taxable gifts (other than, perhaps, annual exclusion gifts). As discussed later in these materials, preserving the BEA for estate tax purposes in order to get a "free" step-up in basis on assets is recommended for these clients. For the ultra-wealthy with taxable estates far in excess of the temporarily doubled BEA, large taxable gifts that exhaust the original BEA and the temporary increase are likely to be the best advice. For the "middle class" wealthy, roughly defined as individuals with taxable estates of \$6.03 million to \$25 million (married couples with \$12.06 to \$50 million), the advice is much more complicated, highly dependent on a number of factors including whether the client can afford to make a gift in excess of the original BEA in order to get the transfer tax benefit of the temporary increase under TCJA. To that end, practitioners should consider spousal lifetime access trusts, preferred partnership freezes (i.e., retention of the preferred interest and transfer of the common interest), or other similar planning techniques that might allow the taxpayer indirect (or direct) access to gifted assets if needed. In addition, for married clients, careful consideration should be given to whether to make a "split-gift" election under section 2513 of the Code in one or more taxable years since when the election is in effect, all taxable gifts for the year (whether made by one spouse or the other) are deemed to be made one-half by each spouse.<sup>29</sup> For example, consider a married couple that makes an \$12.06 million taxable gift in 2022 from the assets owned by one of the spouses, intending to use a portion of the increased (bonus) exclusion before expiration at the

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<sup>27</sup> Preamble to the Anti-Clawback Regulations.

<sup>28</sup> Basic Exclusion Amount, which includes the temporary increase under TCJA.

<sup>29</sup> Treas. Reg. 25.2513-1(b).

end of 2025. If a split-gift election is in place, each spouse will be deemed to have made a \$6.06 million gift, exhausting each of their original BEAs, leaving each with no remaining exclusion in 2026 (other than any inflation-adjustment for that year). If, on the other hand, there is no split-gift election, then the gifting spouse will have utilized \$12.06 million of his or her exclusion, and the non-gifting spouse would still retain the original BEA.

(7) The preamble to the Anti-Clawback Regulations authorized the Treasury Department to issue an anti-abuse provisions to “prevent the application of the special rule to transfers made during the increased BEA period that are not true inter vivos transfers, but rather are treated as testamentary transfers for transfer tax purposes.”<sup>30</sup> To that end, on April 27, 2022, the IRS published proposed Treasury Regulations<sup>31</sup> that would add the following section 20.2010-1(c)(3):<sup>32</sup>

(3) *Exception to the special rule--(i) Transfers to which the special rule does not apply.* Except as provided in paragraph (c)(3)(ii) of this section, the special rule of paragraph (c) of this section does not apply to transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b), including without limitation the following transfers:

(A) Transfers includible in the gross estate pursuant to section 2035, 2036, 2037, 2038, or 2042, regardless of whether all or any part of the transfer was deductible pursuant to section 2522 or 2523;

(B) Transfers made by enforceable promise to the extent they remain unsatisfied as of the date of death;

(C) Transfers described in §25.2701-5(a)(4) or §25.2702-6(a)(1) of this chapter; and

(D) Transfers that would have been described in paragraph (c)(3)(i)(A), (B), or (C) of this section but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within 18 months of the date of the decedent’s death by the decedent alone, by the decedent in conjunction with any other person, or by any other person.

(ii) *Transfers to which the special rule continues to apply.* Notwithstanding paragraph (c)(3)(i) of this section, the special rule of paragraph (c) of this section applies to the following transfers:

(A) Transfers includible in the gross estate in which the value of the taxable portion of the transfer, determined as of the date of the transfer, was 5 percent or less of the total value of the transfer; and

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<sup>30</sup> Preamble to the Anti-Clawback Regulations.

<sup>31</sup> REG-118313-21, 87 Fed. Reg. 24918 (4/27/22) (the “Proposed Anti-Abuse Regulations”).

<sup>32</sup> Prop. Treas. Reg. § 20.2010-1(c)(3).

(B) Transfers, relinquishments, or eliminations described in paragraph (c)(3)(i)(D) of this section effectuated by the termination of the durational period described in the original instrument of transfer by either the mere passage of time or the death of any person.

The proposed Treasury Regulations contain a number of examples involving the gift of promissory notes that remain unpaid on the death of the donor, GRATs, and GRITs.<sup>33</sup>

C. Section 199A: Qualified Business Income of “Pass-Thru” Entities<sup>34</sup>

1. TCJA adds new section 199A of the Code (Qualified Business Income) for the benefit of any “taxpayer other than a corporation.”<sup>35</sup> As such, this provision applies to sole proprietors, independent contractors, disregarded entities, partnership, and S corporations. In short and in great simplification, section 199A of the Code provides a 20% deduction for the “qualified business income” from a “qualified trade or business,” which generally means any trade or business other than a “specified service trade or business” or the trade or business of “performing services as an employee” (other than a certain threshold amount). The section 199A deduction expires January 1, 2026.<sup>36</sup>

2. Generally, for taxpayers whose taxable income exceeds the threshold amounts (defined below) the section 199A deduction will be limited based, in whole or in part, on: (i) the type of trade or business engaged in by the taxpayer; (ii) the amount of W-2 wages paid with respect to the trade or businesses; and (iii) the unadjusted basis immediately after acquisition of qualified property held for use in the trade or business. The latter two limitations are often referred to as the “wages and basis” limitations, and these limitations can significantly limit the deduction under section 199A.

3. Qualified Business Income

a. “Qualified business income”<sup>37</sup> is the net amount of “qualified items” with respect to any “qualified trade or business” of the taxpayer but does not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income (such items of income are separately afforded a deduction under section 199A of the Code). In addition, qualified business income does not include:<sup>38</sup> (i) any reasonable compensation paid to the taxpayer for services rendered with respect to the trade or business; (ii)

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<sup>33</sup> Prop. Treas. Reg. § 20.2010-1(c)(3)(iii).

<sup>34</sup> See Melissa J. Willms, *Getting the 411 on IRC 199A: Just the Facts Ma’am*, 53<sup>rd</sup> Annual Heckerling Institute on Estate Planning (2019), published by LexisNexis Matthew Bender, Ch. 2, for a more comprehensive and complete discussion of section 199A.

<sup>35</sup> § 199A(a).

<sup>36</sup> § 199A(i).

<sup>37</sup> § 199A(c)(3)(A).

<sup>38</sup> § 199A(c)(4).

any guaranteed payment<sup>39</sup> for services rendered with respect to the trade or business; and (iii) to the extent provided in regulations, any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.<sup>40</sup>

b. “Qualified items” are only included in the definition of qualified business income to the extent such items of income that are effectively connected with the conduct of a U.S. trade or business within the meaning of section 864(c) of the Code.<sup>41</sup> Specific “investment items” are excluded, including:<sup>42</sup>

- (1) Any item of short-term and long-term capital gain or loss;
- (2) Any dividend, income equivalent to a dividend, or payment in lieu of dividends;
- (3) Any interest income, other than interest income which is properly allocable to a trade or business;
- (4) Any gain or loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business;
- (5) Any foreign currency gains from section 988 transactions, other than transactions directly related to the business needs of the business activity;
- (6) Net income from notional principal contracts, other than those clearly identified hedging transactions that are treated as ordinary income; and
- (7) Any amount received from an annuity that is not used in the trade or business of the business activity.

c. “Qualified trade or business” means any trade or business other than a “specified service trade or business,” or the “trade or business of performing services as an employee.”<sup>43</sup>

d. “Specified service trade or business” includes:

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<sup>39</sup> As described in section 707(c) of the Code.

<sup>40</sup> As described in section 707(a) of the Code.

<sup>41</sup> § 199A(c)(3)(A)(i).

<sup>42</sup> § 199A(c)(3)(B).

<sup>43</sup> § 199A(d)(1).

(1) Services that are excluded from the definition of “qualified trade or business” under section 1202(e)(3)(A) of the Code (qualified small business stock, as discussed in more detail later in these materials) but carves out engineering and architecture services for these purposes,<sup>44</sup> leaving services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners; or

(2) Services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.<sup>45</sup>

e. The foregoing exclusion from the definition of a qualified business for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a “threshold amount” and becomes fully effective once taxable income exceeds the threshold amount by \$50,000 (\$100,000 in the case of a joint return).<sup>46</sup> The initial “threshold amount” was \$157,500 for each taxpayer (twice the amount in the case of a joint return).<sup>47</sup> This amount has been adjusted for inflation since 2019,<sup>48</sup> and in 2022 the threshold amount is \$170,151.<sup>49</sup> For trusts and estates, the threshold amount is determined based on the highest income tax bracket for trusts and estates (for 2022, \$13,450).

f. The amount of the deduction for each taxable year of the taxpayer under section 199A of the Code is equal to the **SUM** of:

(1) The *lesser* of:

(a) The “combined qualified business income amount of the taxpayer,”<sup>50</sup> or

(b) 20 percent of “the excess (if any) of—(i) the taxable income of the taxpayer for the taxable year, over (ii) the sum of any net capital gain (as defined in section 1(h)) plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year,”<sup>51</sup> **PLUS**

(2) The *lesser* of:

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<sup>44</sup> § 199A(d)(2)(A).

<sup>45</sup> § 199A(d)(2)(B).

<sup>46</sup> § 199A(d)(3).

<sup>47</sup> § 199A(e)(2)(A).

<sup>48</sup> § 199A(e)(2)(B).

<sup>49</sup> Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>50</sup> § 199A(a)(1)(A).

<sup>51</sup> § 199A(a)(1)(B).

(a) 20 percent of the “aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year,”<sup>52</sup> or

(b) The “taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.”<sup>53</sup>

g. The foregoing resulting amount may not exceed the taxable income of the taxpayer for the taxable year (reduced by net capital gain).<sup>54</sup>

h. “Combined qualified business income” is the **SUM** of:

(1) The sum of “deductible amount for each trade or business,”<sup>55</sup>

**PLUS**

(2) 20 percent of the “aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.”<sup>56</sup>

i. The “deductible amount for each trade or business” is the *lesser* of:

(1) 20 percent of the taxpayer’s “qualified business income with respect to the qualified trade or business,”<sup>57</sup> or

(2) The “greater of—(i) 50 percent of the W–2 wages with respect to the qualified trade or business, or (ii) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.”<sup>58</sup>

j. “Qualified property” means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year.<sup>59</sup> The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (i) the date 10 years after that date, or (ii) the last day of the last full year in the applicable recovery period that would

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<sup>52</sup> § 199A(a)(2)(A).

<sup>53</sup> § 199A(a)(2)(B).

<sup>54</sup> § 199A(a) [flush language].

<sup>55</sup> §§ 199A(b) [title to the subsection] and 199A(b)(1)(A).

<sup>56</sup> § 199A(b)(1)(B).

<sup>57</sup> § 199A(b)(2)(A).

<sup>58</sup> § 199A(b)(2)(B).

<sup>59</sup> § 199A(b)(6)(A).

apply to the property under section 168 of the Code (without regard to section 168(g) of the Code—alternative depreciation for certain types of property).<sup>60</sup>

k. The foregoing alternative calculation with W-2 wage will allow real estate businesses with large capital investments (regardless of whether financed) but very few employees to qualify for the section 199A deduction. It should be noted that there does not seem to be a distinction between qualified property acquired before or after the effective date of the TCJA.

l. In the case of partnerships (and S corporations), the Code provides that section 199A of the Code will be applied at the partner (shareholder) level, each partner (shareholder) will take into account such person's allocable share of each qualified item, and each partner (shareholder) will be treated as having W-2 wages and unadjusted basis "immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W-2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary)."<sup>61</sup> For these purposes: (i) W-2 wages are determined in the same manner as the partner's (shareholder's) allocable share of wage expense; (ii) a partner's (shareholder's) allocable share of the unadjusted basis shall be determined in the same manner as the partner's (shareholder's) allocable share of depreciation; and (iii) for purposes of an S corporation, an allocable share shall be the shareholder's pro rata share of an item (wage expense or depreciation).<sup>62</sup>

m. Trusts and estates are eligible for the deduction under section 199A of the Code. To that end, the Code provides that rules similar to those under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W-2 wages and unadjusted basis immediately after acquisition of qualified property.<sup>63</sup>

n. Pertinent Provisions of the 199A Final Regulations

(1) Generally

(a) On February 8, 2019, the Treasury Department issued final Treasury Regulations under section 199A (the "199A Final Regulations"), along with anti-avoidance rules under section 643(f) of the Code (the "643(f) Final Regulations").<sup>64</sup> A complete discussion of all of the provisions of the final regulations is beyond the scope of these materials, but certain provisions are important to note.

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<sup>60</sup> § 199A(b)(6)(B).

<sup>61</sup> § 199A(f)(1)(A).

<sup>62</sup> *Id.* [flush language].

<sup>63</sup> § 199A(f)(1)(B),

<sup>64</sup> T.D. 9847, 84 Fed. Reg. 2952 (2-8-19) (collectively referred to as the "199A Final Regulations").

(b) The 199A Final Regulations provides needed guidance on the particulars of how the deduction is calculated and limited. However, it does not provide an expansive aggregation option to maximize the deduction, leaving entities with the question about whether a tax free merger or combination would be a better option.

(2) Trade or Business Defined

(a) Trade or business is not defined in section 199A of the Code. The 199A Final Regulations adopts a definition of “trade or business” as used in section 162(a) of the Code, dealing with the deductibility of ordinary and necessary business expenses. Thus, “trade or business” means “a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee.”<sup>65</sup>

(b) Solely for purposes of 199A, “trade or business” is extended to include the rental or licensing of tangible or intangible property to a related trade or business if the rental or licensing and the other trade or business are commonly controlled, as defined in the aggregation rule discussed below but regardless of whether such rental or licensing trade or business can be aggregated under the entire rule.<sup>66</sup>

(3) Aggregation

(a) As written, the section 199A deduction is limited and calculated based separately for each trade or business. However, a taxpayer can have a trade or business that is operated across multiple legal entities. Thus, with the wages and basis limitations applied at each trade or business, there could potentially be very little allowable deduction under section 199A. A question arose as to whether, in order to maximize the section 199A deduction, taxpayers would need to legally restructure (e.g., merge entities) some or all of their trades or businesses. In response, the 199A Final Regulations permits (but does not require) aggregation of separate trades or businesses.<sup>67</sup>

(b) Under the 199A Proposed Regulations, aggregation is permitted but only if the individual (which includes a non-grantor trust and an estate<sup>68</sup>) can satisfy the following requirements:

1. The same person or group of persons, directly or indirectly, by attribution under sections 267(b) or 707(b) of the Code, owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation,

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<sup>65</sup> Treas. Reg. § 1.199A-1(b)(14).

<sup>66</sup> *Id.*

<sup>67</sup> Each trade or business must itself be a trade or business as defined in section 1.199A-1(b)(14) of the Treasury Regulations.

<sup>68</sup> *See* Treas. Reg. § 1.199A-1(a)(2).

or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership;<sup>69</sup>

2. The ownership requirement described above exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income;<sup>70</sup>

3. All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;<sup>71</sup>

4. None of the trades or businesses to be aggregated is a specified service trade or business;<sup>72</sup> and

5. The trades or business to be aggregated satisfy at least two of the following (based on facts and circumstances): (i) the trades or businesses provide products and services that are the same or customarily offered together; (ii) the trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and (iii) the trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.<sup>73</sup>

(c) Once an individual chooses to aggregate businesses, the individual must consistently report the aggregated trades or business in all subsequent taxable years.<sup>74</sup> An individual may add a newly created or nearly acquired (whether through a non-recognition transaction or not) trade or business.<sup>75</sup> Furthermore, if there is a “significant change in facts and circumstances” and a previously aggregated trade or business no longer qualifies under the rules, then the trade or business will no longer be aggregated, but the individual can reapply for aggregation if allowable under the rules set above.<sup>76</sup>

(d) On the other end of the spectrum, the 199A Final Regulations have rules where an individual or “relevant passthrough entity”<sup>77</sup> (RPE) conducts multiple trades or businesses and has items of qualified business income that are properly

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<sup>69</sup> Treas. Reg. § 1.199A-4(b)(1)(i).

<sup>70</sup> Treas. Reg. § 1.199A-4(b)(1)(ii).

<sup>71</sup> Treas. Reg. § 1.199A-4(b)(1)(iii).

<sup>72</sup> Treas. Reg. §§ 1.199A-4(b)(1)(iv) and 1.199A-5 (for definition of a specified service trade or business).

<sup>73</sup> Treas. Reg. § 1.199A-4(b)(1)(v).

<sup>74</sup> Treas. Reg. § 1.199A-4(c)(1).

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> A partnership (other than a publicly traded partnership) or an S-corporation that is owned, directly or indirectly by at least one individual, estate, or trust. *See* Treas. Reg. § 1.199A-1(b)(10).

attributable to more than one trade or business, the taxpayer or entity must allocate those items among the several trades or businesses to which they are attributable using a “reasonable method based on all the facts and circumstances.”<sup>78</sup> The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the income of each trade or business. It remains to be seen whether pass-through entities that would not qualify under the aggregation option will choose to legally merge or otherwise combine and rely upon this rule instead.

D. Section 643(f) Final Regulations: Multiple Trust Provisions

1. The 643(f) Final Regulations provide, “A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A.”<sup>79</sup> This provision applies for taxable years ending after December 22, 2017.<sup>80</sup> The 199A Final Regulations then cite the 643(f) Final Regulations.

2. Section 643(f) of the Code authorizes the Treasury Department to issue Treasury Regulations pursuant to which 2 or more trusts would be treated as 1 trust if: (i) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries; and (ii) a principal purpose of such trust is the avoidance of a tax.<sup>81</sup> For this purpose, spouses (the Code section actually reads, husband and wife) are treated as one person.<sup>82</sup> Until now, Treasury Regulations had not been issued.

3. The 643(f) Final Regulations provide:<sup>83</sup>

For purposes of subchapter J of chapter 1 of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.

4. The proposed Treasury Regulations issued in 2018<sup>84</sup> provided a “principal purpose” provision which read, “A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit unless there is a significant non-tax (or

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<sup>78</sup> Treas. Reg. § 1.199A-3(b)(5).

<sup>79</sup> Treas. Reg. § 1.199A-6(d)(3)(vii).

<sup>80</sup> Treas. Reg. § 1.199A-6(e)(2)(i).

<sup>81</sup> § 643(f).

<sup>82</sup> *Id.* (flush language).

<sup>83</sup> Treas. Reg. § 1.643(f)-1(a).

<sup>84</sup> REG-107892-18 (the “643(f) Proposed Regulations”).

non-income tax) purpose that could not have been achieved without the creation of these separate trusts.”<sup>85</sup> This provision and the examples noted below were stricken from the 643(f) Final Regulations. The preamble to the 643(f) Final Regulations, in response to comments to the proposed regulations, explained:

[T]he Treasury Department and the IRS have removed the definition of “principal purpose” and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as “principal purpose” and “substantially identical grantors and beneficiaries” should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms. Nevertheless, the position of the Treasury Department and the IRS remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations.

5. The proposed regulations provided two examples. The first was a straightforward example where multiple and nearly identical trusts were created to solely maximize the section 199A deduction, and the trusts were aggregated into a single trust.<sup>86</sup> The second read, as follows:<sup>87</sup>

*Example 2.* (i) X establishes two irrevocable trusts: one for the benefit of X's son, G, and the other for X's daughter, H. G is the income beneficiary of the first trust and the trustee is required to apply all income currently to G for G's life. H is the remainder beneficiary of the first trust. H is an income beneficiary of the second trust and the trust instrument permits the trustee to accumulate or to pay income, in its discretion, to H for H's education, support, and maintenance. The trustee also may pay income or corpus for G's medical expenses. H is the remainder beneficiary of the second trust and will receive the trust corpus upon G's death.

(ii) Under these facts, there are significant non-tax differences between the substantive terms of the two trusts, so tax avoidance will not be presumed to be a principal purpose for the establishment or funding of the separate trusts. Accordingly, in the absence of other facts or circumstances that would indicate that a principal purpose for creating the two separate trusts was income tax avoidance, the two trusts will not be aggregated and treated as a single trust for Federal income tax purposes under this section.

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<sup>85</sup> Prop. Treas. Reg. § 1.643(f)-1(b).

<sup>86</sup> Prop. Treas. Reg. § 1.643(f)-(1)(c), *Ex. 1*.

<sup>87</sup> Prop. Treas. Reg. § 1.643(f)-(1)(c), *Ex. 2*.

6. Even though the foregoing example was removed, it seems to imply that the aggregation of multiple trusts into one trust would not be applicable if, for example, a grantor created separate trusts for each of his or her children (and their descendants as remainder beneficiaries) even if each of the trust provisions were otherwise identical. Moreover, if significant differences existed between different trusts for the same group of beneficiaries, it would seem that aggregation would not be applicable either. The issue is how significant must such non-tax differences be to avoid the application of aggregation of the trusts.

7. The effective date for the 643(f) Final Regulations apply to taxable years ending after August 16, 2018.<sup>88</sup> Although the preamble to the proposed regulation explains that it could apply to arrangements and trusts created prior to that point, “In the case of any arrangement involving multiple trusts entered into or modified before August 16, 2018, the determination of whether an arrangement involving multiple trusts is subject to treatment under section 643(f) will be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of section 643(f).”<sup>89</sup>

8. The preamble to the proposed regulation points out, “The application of proposed §1.643(f)-1, however, is not limited to avoidance of the limitations under section 199A and proposed §§1.199A-1 through 1.199A-6.”<sup>90</sup> Thus, for example, this rule might apply to one of the limitations on the sale of section 1202 (qualified small business stock) gain, as discussed in more detail below, which are limited to the definition a particular taxpayer.

#### E. Section 1061: Carried Partnership Interests

1. Effective for tax years beginning after December 31, 2017, TCJA inserts a permanent “replacement” section 1061 of the Code<sup>91</sup> for certain partnership interest held in connection with the performance of services, addressing the tax treatment of a profits interest in a partnership in exchange for the performance of services (often referred to as a carried interest). The provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer’s net long-term capital gain “with respect to”<sup>92</sup> one or more “applicable partnership interests”<sup>93</sup> that are held by a taxpayer at any time during the taxable year that exceeds the amount of such gain calculated as if a three-year holding period applies. The overall effect of the provision is that the preferential long-term capital gain rate applies to gain passed through to holders of carried interests only if the fund held the asset giving rise to the gain for more than three years.

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<sup>88</sup> Prop. Treas. Reg. § 1.643(f)-(1)(b).

<sup>89</sup> Preamble to 643(f) Proposed Regulations (Explanation of Provisions, VII. Proposed § 1.643(f)-1: Anti-avoidance Rules for Multiple Trusts).

<sup>90</sup> *Id.*

<sup>91</sup> Redesignating the current section 1061 to section 1062 of the Code.

<sup>92</sup> § 1061(a)(1) and (2).

<sup>93</sup> § 1061(a).

2. An “applicable partnership interest” is any interest in a partnership which, “directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person,”<sup>94</sup> in an “applicable trade or business.” An applicable partnership interest does not include any “capital interest” in the partnership, which provides the taxpayer with a “right to share in the partnership capital commensurate with—(i) the amount of capital contributed..., or (ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest.”<sup>95</sup> In addition, an applicable partnership interest does not include an interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.<sup>96</sup> There is also an exception for a partnership interest held directly or indirectly by a “corporation.”<sup>97</sup> The Conference report gives an example of two corporations that form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product.<sup>98</sup> The partnership interests held by the two corporations are not applicable partnership interests. The 2020 final Treasury Regulations<sup>99</sup> (“1061 Final Regulations”) make clear that the term “corporation” does not include an S corporation.<sup>100</sup>

3. An “applicable trade or business” is defined as “any activity conducted on a regular, continuous, and substantial basis which ... consists”<sup>101</sup> of:

a. “[R]aising or returning capital,”<sup>102</sup> and

b. Either: “(i) investing of in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets.”<sup>103</sup>

4. “Specified assets” means:<sup>104</sup>

a. Securities (as defined under rules for mark-to-market accounting for securities dealers);

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<sup>94</sup> § 1061(c)(1).

<sup>95</sup> § 1061(c)(4)(B).

<sup>96</sup> § 1061(c)(1).

<sup>97</sup> § 1061(c)(4)(A).

<sup>98</sup> Conf. Rep. on P.L. 115-97, ¶ 10,611.99 (12/22/2017).

<sup>99</sup> T.D. 9945.

<sup>100</sup> Treas. Reg. 1.1061-3(b)(2). In addition, the term does not include a passive foreign investment company as to which the shareholder has a qualified electing fund election in effect under section 1295 of the Code.

<sup>101</sup> § 1061(c)(2).

<sup>102</sup> § 1061(c)(2)(A).

<sup>103</sup> § 1061(c)(2)(B).

<sup>104</sup> § 1061(c)(3).

- b. Commodities (as defined under rules for mark-to-market accounting for commodities dealers);
- c. Real estate held for rental or investment;
- d. Cash or cash equivalents;
- e. Options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing.

5. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 of the Code applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified.<sup>105</sup>

6. If a taxpayer “transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer,”<sup>106</sup> then the taxpayer includes in gross income as short-term capital gain “so much of the taxpayer’s net long-term capital gain with respect to such interest for such taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to the interest.”<sup>107</sup> To avoid double counting, the amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of section 1061(a) of the Code.<sup>108</sup>

7. A “related person” for this purpose is:

a. A member of the taxpayer’s family within the meaning of the attribution rules under section 318(a)(1) of the Code (spouse, children, grandchildren, and parents),<sup>109</sup> or

b. A colleague of the taxpayer, defined as a “person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.”<sup>110</sup>

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<sup>105</sup> See § 475(c)(2).

<sup>106</sup> § 1061(d)(1).

<sup>107</sup> § 1061(d)(1)(A).

<sup>108</sup> § 1061(d)(1)(B).

<sup>109</sup> § 1061(d)(2)(A).

<sup>110</sup> § 1061(d)(2)(B).

8. Prior to the issuance of the 1061 Final Regulations, it was unclear how expansive the term “transfer” would be interpreted. It could have included gifts, transfers to grantor trusts, and sales or exchanges. The Treasury Regulations provide that the term “transfer” for these purposes only includes transfers that would be a taxable sale or exchange, or specifically, “the term transfer means a sale or exchange in which gain is recognized by the Owner Taxpayer under chapter 1 of the Internal Revenue Code.”<sup>111</sup> Thus, a gift of an applicable partnership interest to family members, directly or in trust (grantor or non-grantor), will not cause an acceleration of gain with respect to such interest. Planners should, however, be wary of sales to IDGTs and the loss of grantor trust status when the note is outstanding. As discussed later in these materials, if the debt obligation is still outstanding and the debt is in excess of the basis of the applicable partnership interest, gain may be recognized, causing an acceleration of income under section 1061(d)(1) of the Code.

F. Before TCJA and ATRA: When in Doubt, Transfer Out

1. Notwithstanding the enactment of TCJA, the year 2013, with the enactment of the American Taxpayer Relief Act of 2012<sup>112</sup> (“ATRA”) and the imposition of the 3.8% Medicare contribution tax on unearned passive income or net investment income<sup>113</sup> (hereinafter, the “3.8% Net Investment Income Tax”) that was enacted as part of the Health Care and Education Reconciliation Act of 2010 (“HCERA”),<sup>114</sup> which amended the Patient Protection and Affordable Care Act (“PPACA”),<sup>115</sup> marked the beginning of a significant change in perspective for estate planners.

2. For many years, estate planning entailed aggressively transferring assets out of the estate of high-net-worth individuals during their lifetimes to avoid the imposition of estate taxes at their deaths and consequently giving up a potential “step-up” in basis adjustment under section 1014 of the Internal Revenue Code of 1986, as amended (the “Code”). Because the estate tax rates were significantly greater than the income tax rates, the avoidance of estate taxes (typically to the exclusion of any potential income tax savings from any “step-up” in basis) was the primary focus of tax-based estate planning for wealthy individuals.

3. By way of example, consider the planning landscape in 2001. The Federal estate and gift tax exemption equivalent was \$675,000. The maximum Federal transfer tax (collectively, the estate, gift, and generation-skipping transfer tax) rate was 55%, and the law still provided for a state estate tax or inheritance tax Federal credit. Because virtually all of the states had an estate or inheritance tax equal to the credit, the maximum combined Federal and state transfer tax rate was 55%. The combined Federal and state income tax rates were significantly lower than that. Consider the maximum long-term capital gain and ordinary income tax rates of a highly taxed individual, a New York City taxpayer. At that time, the combined maximum

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<sup>111</sup> Treas. Reg. § 1.1061-5(b).

<sup>112</sup> P.L. 112-240, 126 Stat. 2313, enacted January 2, 2013.

<sup>113</sup> § 1411.

<sup>114</sup> P.L. 111-152, 124 Stat. 1029, enacted March 30, 2010.

<sup>115</sup> P.L. 111-148, 124 Stat. 119, enacted on March 23, 2010.

Federal, state, and local income tax rate for long-term capital gains was approximately 30% and for ordinary income, less than 50%.<sup>116</sup> As a result, the gap between the maximum transfer tax rate and the long-term capital gain tax rate for a New York City taxpayer was approximately 25%. In other words, for high income, high-net-worth individuals in NYC, there was a 25% tax rate savings by avoiding the transfer tax and forgoing any “step-up” in basis. Because this gap was so large (and larger in other states), estate planning recommendations often came down to the following steps, ideas and truths.

a. Typically, as the first step in the estate planning process, make an inter vivos taxable gift using the \$675,000 exemption equivalent, thereby removing all future appreciation out of the estate tax base.

b. Use the exemption equivalent gift as a foundation to transfer additional assets out of the estate during lifetime (for example, a “seed” gift to an IDGT to support the promissory note issued as part of an installment sale to the IDGT).<sup>117</sup>

c. Draft trusts and other estate planning structures to avoid estate tax inclusion for as many generations as possible (for example, leveraging the generation-skipping transfer (“GST”) tax exemption by applying it to the seed gift to the IDGT and establishing the trust in a jurisdiction that has abolished the rule against perpetuities).

d. Forgo any “step-up” in basis adjustment at death on the assets that have been transferred during lifetime, because the transfer tax savings were almost certainly much greater than any potential income tax savings that might result from the basis adjustment at death.

e. Know that the income tax consequences of the various estate planning techniques were appropriately secondary to avoiding the transfer tax.

f. Know that the state of residence of the decedent and the decedent’s beneficiaries would not significantly affect the foregoing recommendations or ideas because of the large gap between the transfer tax and the income tax existing consistently across all of the states.

g. As a result, there was an enormous amount of consistency in the estate planning recommendations across the U.S., where the only differentiating factor was the size of the gross estate. In other words, putting aside local law distinctions like community vs. separate property, almost all \$20 million dollar estates had essentially the same estate plan (using the same techniques in similar proportions).

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<sup>116</sup> Consisting of maximum Federal long-term capital gain tax rate of 28% and ordinary income tax rate of 39.1%, New York State income tax rate of 6.85%, and a New York City income tax rate of 3.59%. The effective combined tax rate depends, in part, on whether the taxpayer is in the alternative minimum tax, and the marginal tax bracket of the taxpayer.

<sup>117</sup> See, e.g., Stuart M. Horwitz & Jason S. Damicone, *Creative Uses of Intentionally Defective Irrevocable Trusts*, 35 Est. Plan. 35 (2008) and Michael D. Mulligan, *Sale to Defective Grantor Trusts: An Alternative to a GRAT*, 23 Est. Plan. 3 (1996).

4. The enactment of ATRA marked the beginning of a “permanent” change in perspective on estate planning for high-net-worth individuals. The large gap between the transfer and income tax rates, which was the mathematical reason for aggressively transferring assets during lifetime, has narrowed considerably, and in some states, there is virtually no difference in the rates. With ATRA’s very generous applicable exclusion provisions, the focus of estate planning has, for the time being, become less about avoiding the transfer taxes and more about avoiding income taxes.

G. ATRA: The “Permanent” Tax Landscape

1. Generally

a. As mentioned above, many of the income and transfer tax provisions of the TCJA affecting individuals will expire in 2026. As such, the “permanent” tax landscape for estate planners was transformed in 2013 due to increased income tax rates, and falling transfer tax liability, at both the Federal and state level. On the Federal side, the income and transfer tax provisions that became effective January 1, 2013, were enacted as part of ATRA, PPACA, and HCERA (the 3.8% Net Investment Income Tax). At the state level, many states increased their income tax rates,<sup>118</sup> and a number of states continued the trend of repealing their state death tax (estate and inheritance tax).<sup>119</sup>

b. A complete discussion of all of the provisions of the Federal laws and the state laws is beyond the discussion of this paper. So, this paper will limit the discussion to the most relevant provisions.

2. Pertinent Provisions of ATRA

a. Federal Transfer Tax Landscape (Assuming No TCJA)

(1) Summary of the Pertinent Transfer Tax Provisions

(a) The top estate, gift, and GST tax rate is 40%.<sup>120</sup>

(b) The Basic Exclusion Amount for each individual is \$5 million,<sup>121</sup> indexed for inflation after 2011<sup>122</sup> (\$6.03 million for 2022).<sup>123</sup>

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<sup>118</sup> For example, the California enactment in 2012 of the Temporary Taxes to Fund Education, commonly known as Proposition 30 that raised the highest marginal income tax bracket to 13.3%.

<sup>119</sup> For example, (i) effective January 1, 2018, the New Jersey estate tax was repealed but the inheritance tax remained; (ii) effective April 1, 2014, New York modified its state estate tax to immediately increase the state estate tax exemption from \$1,000,000 to \$2,062,500 per person to then have the exemption equal the Federal basic exclusion amount by 2019; (iii) on July 23, 2013, North Carolina repealed its estate tax (effective date of January 1, 2013); and (iv) on May 8, 2013, Indiana repealed its inheritance tax (effective date of January 1, 2013).

<sup>120</sup> § 2001(c) (for transfers above \$1 million) and § 2641(a)(1).

<sup>121</sup> § 2010(c)(3)(A).

(c) The applicable exclusion amount<sup>124</sup> (sometimes referred to as the “Applicable Exclusion Amount” or the “Applicable Exclusion”) is the sum of base exclusion amount and in the case of a surviving spouse, the deceased spousal unused exclusion amount (the “DSUE Amount”).<sup>125</sup>

(d) Reunification of the estate, gift and GST tax system (providing a GST exemption amount equal to the basic exclusion amount under section 2010(c)).<sup>126</sup>

(e) Repeal of the “sunset” provision with respect to the foregoing transfer tax provisions.<sup>127</sup>

## (2) Basic Exclusion Amount

(a) ATRA “permanently” provides for a cost-of-living increase to the Basic Exclusion Amount but does not provide for a decrease even in the event of deflation.<sup>128</sup> The Basic Exclusion Amount can grow to a very large number.

(b) By way of example, if the cost-of-living index increases at a compound rate of 2.7% over the next 10 and 20 years (the cost-of-living adjustment from 1983 to 2016 has averaged 2.6% and the median has been 2.7%<sup>129</sup>), the basic exclusion amount will grow as follows:

FORECASTED BASIC EXCLUSION AMOUNT (NO TCJA)			
(\$ MILLION)			
	2022	2032	2042
2.7% COLI	\$6.03	\$7.87	\$10.60

<sup>122</sup> § 2010(c)(3)(B).

<sup>123</sup> Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>124</sup> § 2010(c)(2).

<sup>125</sup> § 2010(c)(4). Enacted as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296 (“TRA 2010”). Section 101(a)(2) of ATRA struck the “sunset” provisions of TRA 2010 by striking section 304 of TRA 2010.

<sup>126</sup> § 2631(c).

<sup>127</sup> § 101(a)(1) of ATRA provides for a repeal of the “sunset” provision in the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16, 115 Stat. 38, (“EGTRRA”). The “sunset” provision of EGTRRA is contained in § 901 (“All provisions of, and amendments made by, this Act [EGTRRA] shall not apply... to estates of decedents dying, gifts made, or generation skipping transfers, after December 31, 2010,” and the “Internal Revenue Code of 1986... shall be applied and administered to years, estates, gifts, and transfers ... as if the provisions and amendments described [in EGTRRA] had never been enacted.”).

<sup>128</sup> Temp. Treas. Reg. § 20.2010-1T(d)(3)(ii).

<sup>129</sup> Determined and published by the Bureau of Labor Statistics.

b. Pertinent Income Tax Provisions (Assuming No TCJA)

(1) Increase of the highest Federal ordinary income tax bracket to 39.6%.<sup>130</sup>

(2) Increase of the highest Federal long-term capital gain bracket to 20%.<sup>131</sup>

(3) Increase of the highest Federal “qualified dividend income” rate to 20%.<sup>132</sup>

3. 3.8% Net Investment Income Tax: Generally

a. A full and complete discussion of the 3.8% Net Investment Income Tax (“NIIT”) is beyond the scope of this paper, but a general understanding is important. Fortunately, there are a number of better resources for that discussion.<sup>133</sup>

b. Section 1411 imposes a 3.8% excise tax on “net investment income”<sup>134</sup> (“NII”) which includes:

(1) “Gross income from interest, dividends, annuities, royalties, and rents,”<sup>135</sup> (passive income), other than such passive income that is “derived in the ordinary course of a trade or business”<sup>136</sup> that is not a “Passive Activity or Trading Company” (as defined below);

(2) Gross income derived from a “Passive Activity or Trading Company,” which is defined as:

(a) A trade or business that is “a passive activity (within the meaning of section 469) with respect to the taxpayer;”<sup>137</sup> or

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<sup>130</sup> § 1.

<sup>131</sup> § 1(h)(1)(D).

<sup>132</sup> § 1(h)(11) (allowing such income to be considered “net capital gain”).

<sup>133</sup> See Richard L. Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1 & Part 2*, Tax Notes, Aug. 12, 2013, p. 683 and Aug. 19, 2013, p. 785, and Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S.C. Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 Est. Plan. 3 (Apr. 2013).

<sup>134</sup> § 1411(c).

<sup>135</sup> § 1411(c)(1)(A).

<sup>136</sup> *Id.*

<sup>137</sup> § 1411(c)(2)(A).

(b) A trade or business that trades in “financial instruments or commodities (as defined in section 475(e)(2)).”<sup>138</sup>

(3) Gain “attributable to the disposition of property other than property held in a trade or business not described”<sup>139</sup> as a Passive Activity or Trading Company; or

(4) Gross income from the investment of working capital.<sup>140</sup>

c. In arriving at NII, the Code provides for “deductions . . . which are properly allocable to such gross income or net gain.”<sup>141</sup>

d. For individuals, the NIIT is imposed on the lesser of:<sup>142</sup>

(1) NII; or

(2) The excess of:

(a) “modified adjusted gross income for such taxable year”<sup>143</sup> (“MAGI”), over

(b) The “threshold amount”<sup>144</sup> (\$200,000 for individual taxpayers, \$250,000 for joint taxpayers, and \$125,000 for married taxpayers filing separately).<sup>145</sup>

e. For estates and trusts, the NIIT is imposed on the lesser of:<sup>146</sup>

(1) The undistributed NII for the taxable year, over

(2) The excess of:

(a) Adjusted gross income (as defined in §67(e)),<sup>147</sup> over

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<sup>138</sup> § 1411(c)(2)(B).

<sup>139</sup> § 1411(c)(2)(C).

<sup>140</sup> § 1411(c)(3), referencing § 469(e)(1)(B), which provides “any income, gain, or loss which is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.” See Prop. Reg. § 1.1411-6(a).

<sup>141</sup> § 1411(c)(1)(B).

<sup>142</sup> § 1411(a)(1)(A).

<sup>143</sup> § 1411(a)(1)(B)(i). Modified adjusted gross income is “adjusted gross income” as adjusted for certain foreign earned income. § 1411(d).

<sup>144</sup> § 1411(a)(1)(B)(i).

<sup>145</sup> § 1411(b).

<sup>146</sup> § 1411(a)(2).

(b) “[T]he dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year”<sup>148</sup> (\$13,450 of taxable income for 2022).<sup>149</sup>

f. The threshold amount for individuals does not increase with cost-of-living adjustments, but the taxable income amount threshold for trusts and estates does because it’s tied to the highest income tax bracket for those entities.

g. With respect to a disposition of a partnership interest or S corporation shares, the net gain will be subject to the NIIT but “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.”<sup>150</sup>

h. The following are excluded from the definition of NII:

(1) Distributions from “a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A or 457(b),”<sup>151</sup> specifically referring to:<sup>152</sup>

(a) A qualified pension, stock bonus, or profit-sharing plan under section 401(a);

(b) A qualified annuity plan under section 403(a);

(c) A tax-sheltered annuity under section 403(b);

(d) An individual retirement account (IRA) under section 408;

(e) A Roth IRA under section 408A; and

(f) A deferred compensation plan of a State and local government or a tax-exempt organization under section 457(b).

(2) Gain or other types of income that generally would not be taxable under the Code, including:<sup>153</sup>

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<sup>147</sup> § 1411(a)(2)(B)(i).

<sup>148</sup> § 1411(a)(2)(B)(ii).

<sup>149</sup> See Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>150</sup> § 1411(c)(4)(A).

<sup>151</sup> § 1411(c)(5).

<sup>152</sup> § 1411(c)(5) and Treas. Reg. § 1.1411-8(a). See also REG-130507-11, Preamble and Proposed Regulations under Section 1411 (December 5, 2012), Fed. Reg. Vol. 77, No. 234, p. 72612-33 (hereinafter, “Preamble to § 1411 Proposed Regulations”).

<sup>153</sup> See Preamble to § 1411 Proposed Regulations.

- 103.
- (a) Interest on state and local bonds (municipal bonds) under §
  - (b) Deferred gain under the installment method under § 453.
  - (c) Deferred gain pursuant to a like-kind exchange under § 1031 and an involuntary conversion under § 1033.
  - (d) Gain on the sale of a principal residence under § 121.

4. 3.8% Net Investment Income Tax: Trusts and Pass-Through Entities

a. Generally

(1) If an individual, estate, or trust owns or engages in a trade or business, the determination of whether the income is derived in an active or passive trade or business is made at the owner's level.<sup>154</sup>

(2) If an individual, estate, or trust owns an interest in a trade or business through a partnership or S corporation, the determination of whether the income is derived in an active or passive trade or business is made at the interest-holder level.<sup>155</sup> Provided, however, the issue of whether the gross income is derived from trading in financial instruments or commodities is determined at the entity level.<sup>156</sup>

(3) A trust, or any portion of a trust, that is treated as a grantor trust is not subject to the 3.8% Net Investment Income Tax.<sup>157</sup> The grantor will be deemed to have received all of the income from the trade or business. Hence, whether such trade or business is passive or active is determined at the grantor/owner level.

b. Non-Grantor Trusts

(1) The application of the 3.8% Net Investment Income Tax to trusts that own closely-held business interests is controversial, and there is considerable uncertainty how a fiduciary that owns interests in a closely-held business can materially participate and thereby avoid the imposition of the tax. Whereas for individuals a bright-line test exists to measure material participation, no such test exists for trusts and estates.

(2) In *Mattie K. Carter Trust v. U.S.*,<sup>158</sup> the court held that in determining material participation for trusts the activities of the trust's fiduciaries, employees,

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<sup>154</sup> Treas. Reg. § 1.1411-4(b)(1).

<sup>155</sup> Treas. Reg. § 1.1411-4(b)(2)(i).

<sup>156</sup> Treas. Reg. § 1.1411-4(b)(2)(ii).

<sup>157</sup> Treas. Reg. § 1.1411-3(b)(1)(v).

<sup>158</sup> 256 F. Supp. 2d 536 (N.D. Tex. 2003)

and agents should be considered. The government argued that only the participation of the fiduciary ought to be considered but the court rejected that argument. In *Frank Aragona Trust v. Commissioner*,<sup>159</sup> the Tax Court held that the trust qualified for the real estate professional exception under section 469(c)(7) (deemed material participation) because three of the six co-trustees were full time employees of the trust-wholly owned LLC that managed the rental properties. In addition, the Tax Court also considered the activities of co-trustees that had co-ownership interests in the entities held by the trust, reasoning that the interests of the co-trustees were not majority interests, were never greater than the trust's interests in the entities, and were compatible with the trust's goals.

(3) Notwithstanding the foregoing, the IRS ruling position is that only the fiduciary's activities are relevant. The IRS reaffirmed this ruling position in TAM 201317010. The ruling explains the IRS rationale as follows:

The focus on a trustee's activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. See S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] . . . are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).<sup>160</sup>

(4) At issue in the ruling were the activities of "special trustees" who did the day-to-day operations and management of the companies in question but lacked any authority over the trust itself. The ruling states:

The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-

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<sup>159</sup> 142 T.C. 165 (2014).

<sup>160</sup> TAM 201317010. See also TAM 200733023 and PLR 201029014.

day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.<sup>161</sup>

(5) The need for a trustee to be active may affect the organization of business entities held in trust. For instance, a member-managed LLC may be more efficient than a manager-managed LLC unless a fiduciary is the manager.

c. Pass-Through Entities

(1) The proposed Treasury Regulations issued in 2013<sup>162</sup> (the “2013 Proposed Regulations”) provide that the exception for certain active interests in partnerships and S corporations will apply to a “Section 1411(c)(4) Disposition.” A Section 1411(c)(4) Disposition is defined as the sale of an interest in any entity taxed as a partnership or an S corporation<sup>163</sup> (a “Pass-Through Entity”) by an individual, estate, or trust if: (1) the Pass-Through Entity is engaged in one or more trades or businesses, or owns an interest (directly or indirectly) in another Pass-through Entity that is engaged in one or more trades or businesses, other than the business of trading in financial instruments or commodities; and (2) one or more of the trades or businesses of the Pass-Through Entity is not a passive activity (defined under section 469 of the Code) of the transferor.<sup>164</sup> Therefore, if the transferor (e.g., the trustee of a non-grantor trust) materially participates in one or more of the Pass-Through Entity’s trades or businesses (other than trading in financial instruments or commodities), then some or all of the gain attributable to the sale of an interest in such entity would be exempt from the NIIT.

(2) The 2013 Proposed Regulations provide two possible methods of determining the amount of gain or loss from a Section 1411(c)(4) Disposition. The simplified method is available to a taxpayer if the gain of the transferor is \$250,000 or less (including gains from multiple sales that were part of a plan).<sup>165</sup> If the gain exceeds \$250,000, the transferor may use the simplified method if the sum of the transferor’s share during the “Section 1411 Holding Period” (generally, the year of sale and the preceding two years) of separately stated items of income, gain, loss, and deduction of a type that the transferor would take into account in calculating NII is 5% or less than the sum of all separately stated items of income, gain, loss, and deduction allocated to the transferor over the same period of time, and the gain is \$5 million or less.<sup>166</sup> Generally, the simplified method determines the amount gain or loss subject to NII by multiplying it by a fraction, the numerator of which is the sum of NII items over the Section 1411

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<sup>161</sup> *Id.*

<sup>162</sup> REG-130843-13. Generally, effective for taxable years beginning after December 31, 2013.

<sup>163</sup> Prop. Treas. Reg. § 1.1411-7(a)(2)(i)

<sup>164</sup> Prop. Treas. Reg. § 1.1411-7(a)(3).

<sup>165</sup> Prop. Treas. Reg. § 1.1411-7(c)(2)(ii) (all dispositions that occur during the taxable year are presumed to be part of a plan).

<sup>166</sup> Prop. Treas. Reg. § 1.1411-7(c)(2)(i).

Holding Period, and the denominator of which is the sum of all items of income, gain, loss, and deduction allocated to the transferor during the same period.<sup>167</sup>

(3) If the transferor does not qualify for the simplified method,<sup>168</sup> then the 2013 Proposed Regulations provide that the transferor must include gain or loss that the transferor would have taken into account if the Pass-Through Entity had sold all of its “Section 1411 Property” for fair market value immediately before the disposition of the interest.<sup>169</sup> Section 1411 Property generally is the property owned by the Pass-Through Entity that if disposed by the entity would result in net gain or loss allocable to the transferor (partner or S corporation shareholder) would be considered NII of the transferor (deemed sale of the activities, on an activity-by-activity basis, in which the transferor does not materially participate).<sup>170</sup>

(4) These rules apply in to all entities taxed as partnerships (limited liability companies, limited partnerships, general partnerships, etc.) and S corporations.

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<sup>167</sup> Prop. Treas. Reg. § 1.1411-7(c)(4).

<sup>168</sup> The 2013 Proposed Regulations provide certain exceptions for situations when a transferor will be ineligible to use the optional simplified reporting method, notwithstanding qualifying for such. Situations of exception would include if the transferor held the interest for less than 12 months or if the transferor transferred Section 1411 Property to the Pass-Through Entity or received a distribution of property that is not Section 1411 property during the Section 1411 Holding Period. *See* Prop. Treas. Reg. § 1.1411-7(c)(3).

<sup>169</sup> Prop. Treas. Reg. § 1.1411-7(a)(1).

<sup>170</sup> Prop. Treas. Reg. §§ 1.1411-7(a)(2)(iv), 1.1411-7(b), 1.469-2T.

## d. Qualified Subchapter S Trusts

(1) A qualified subchapter S trust (QSST)<sup>171</sup> is an eligible shareholder of an S corporation. Generally, a QSST may have only one beneficiary (who also must be a U.S. citizen or resident)<sup>172</sup> who may receive income or corpus during the beneficiary's lifetime, and all of its income<sup>173</sup> must be distributed (or required to be distributed) currently to that beneficiary while the trust holds S corporation stock.<sup>174</sup> 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 as to each share.<sup>175</sup> If the trust holds other assets in addition to the S corporation stock, all of the fiduciary accounting income must be distributed, not just amounts attributable to the S corporation distributions.<sup>176</sup> The beneficiary of a QSST is taxed on all of the QSST's income and losses from the S corporation reported on Schedule K-1 (as if the beneficiary was the grantor of the trust for grantor trust purposes under section 678 of the Code).<sup>177</sup> In contrast, when the QSST sells the S corporation stock, the QSST is taxable on any resulting gain.<sup>178</sup>

(2) For 3.8% Net Investment Income Tax purposes, the material participation (or lack thereof) of the beneficiary of a QSST determines to what extent the Schedule K-1 income from the S corporation will be subject to 3.8% Net Investment Income Tax at the beneficiary level. On the other hand, for sales of interests in an S corporation by the QSST, material participation (and the applicability of a Section 1411(c)(4) Disposition, as discussed above) is determined at the trust (trustee) level. The preamble to the 2013 Proposed Regulations provide, in pertinent part:<sup>179</sup>

In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361-1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST... For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as

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<sup>171</sup> § 1361(d)(1)(A) treating such QSSTs as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

<sup>172</sup> § 1361(d)(3)(A).

<sup>173</sup> Fiduciary accounting income, not taxable income. Treas. Reg. § 1.1361-1(j)(1)(i).

<sup>174</sup> § 1361(d)(3)(B).

<sup>175</sup> §§ 1361(d)(3) and 663(c).

<sup>176</sup> See PLR 9603007

<sup>177</sup> § 1361(d)(1)(B) and Treas. Reg. § 1.1361-1(j)(7)(i).

<sup>178</sup> Treas. Reg. § 1.1361-1(j)(8).

<sup>179</sup> Preamble to REG-130843-13.

explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469... [T]hese proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level. This treatment is consistent with the chapter 1 treatment of the QSST by reason of §1.1361-1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons. First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust.

e. Electing Small Business Trusts

(1) An electing small business trust (ESBT)<sup>180</sup> is another non-grantor trust that is an eligible S corporation shareholder. Unlike a QSST, an ESBT may have multiple beneficiaries<sup>181</sup> who can have discretionary interests in the income and principal of the trust.<sup>182</sup> For income tax purposes, an ESBT is treated as two separate trusts: (i) a portion that holds S corporation stock (the “S portion”); and (ii) a portion that holds all other assets (the “non-S portion”).<sup>183</sup> Notwithstanding the foregoing, the grantor trust rules take precedence over the ESBT rules.<sup>184</sup> The S portion is treated as a separate taxpayer, and income reported to the trust on the Schedule K-1 is taxed at the highest individual income tax rates for each type of income, and the distribution deduction is not taken into account.<sup>185</sup>

(2) For 3.8% Net Investment Income Tax purposes, the S and non-S portions continue to be calculated separately for determining the amount of undistributed NII but are combined for purposes of determining if, and to what extent, the ESBT will be subject to the 3.8% Net Investment Income Tax.<sup>186</sup> As discussed in more detail above, as with other non-grantor trusts, material participation (and the applicability of a Section 1411(c)(4) Disposition) is determined at the trustee level.

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<sup>180</sup> § 1361(c)(2)(A)(v).

<sup>181</sup> Must be individuals, estates, or charitable organizations described in § 170(c)(2) through (c)(5). § 1361(e)(1)(A)(i) and Treas. Reg. § 1.1361-1(m)(1).

<sup>182</sup> See §§ 1361(e)(1) and 1361(c)(2).

<sup>183</sup> § 641(c) and Treas. Reg. § 1.641(c)-1(a).

<sup>184</sup> Treas. Reg. § 1.641(c)-1(a).

<sup>185</sup> § 641(c)(1), (c)(2)(A), and Treas. Reg. § 1.641(c)-1(e).

<sup>186</sup> Treas. Reg. § 1.1411-3(c).

f. Charitable Remainder Trusts

(1) It is unknown how the 3.8% Net Investment Income Tax will be applied to charitable remainder trusts<sup>187</sup> (CRTs), particularly when dealing with commercial real property and how the income and gain therefrom will be taxed to the non-charitable beneficiary of the CRT.

(2) Because commercial real property is depreciable, planners should be aware of how the sale of such property in a CRT will affect the taxation of the distribution under the “tier” rules. Generally, the sale of most commercial real property will give rise to “unrecaptured § 1250 gain,”<sup>188</sup> which is taxed at a maximum Federal rate of 25%.<sup>189</sup> As a result, if commercial real property is sold in a CRT, the tier rules include gain taxed at 25%, as well as regular long-term gains at 20%. In addition, any gains and rental income from the property may or may not be considered NII, depending on the active (material participation) or passive participation of the parties involved (donor, recipient, or trustee) and the property in question.<sup>190</sup>

(3) It is unclear, at this point, how and whether the activities of the donor, recipient, and/or trustee will cause all or a portion of the income and gain attributable to the real property to be excluded or subject to the 3.8% Net Investment Income Tax when distributed from the CRT.<sup>191</sup> Many questions remain unanswered. For example, if the trustee is an active participant as to the rental property, does that immediately exclude all of the gain and income even if the donor/recipient is not materially participating? If the donor is an active participant as to the property prior to contribution, does that mean all of the gain on a subsequent sale by the trustee of the CRT is excluded from the 3.8% Net Investment Income Tax? Or does that mean only pre-contribution gain is excluded and post-contribution gain is NII? What if the active donor is also the sole trustee or co-trustee of the CRT?

5. Disparity among the States

a. The state estate and inheritance tax (collectively, “state death tax”) landscape has changed significantly since 2001 when almost every state had an estate and/or

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<sup>187</sup> § 664.

<sup>188</sup> § 1(h)(6)(A) (Defined as the amount of long-term capital gain that would be treated as ordinary income if Section 1250(b)(1) included all depreciation and the applicable percentage under Section 1250(a) were 100%. This convoluted definition essentially provides that the aggregate straight-line depreciation taken on the property will be considered unrecaptured Section 1250 gain. Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property. § 168(b)(3)(A), (B).

<sup>189</sup> § 1(h)(1)(E).

<sup>190</sup> The Treasury Department did not issue formal guidance on how the material participation will be determined in the final Treasury Regulations issued in 2013. It is unclear whether material participation will be determined at the trustee, donor, or recipient level.

<sup>191</sup> The Treasury Regulations provide the taxpayer’s activities conducted through C corporations, partnerships, and S corporations can be grouped for passive activity (and 3.8% Medicare Tax purposes). Trusts are excluded. *See* Treas. Reg. § 1.496-4(a).

inheritance tax that was tied to the then existing Federal state death tax credit.<sup>192</sup> As the law stands today, the Federal state death tax credit has been replaced by a Federal estate tax deduction under section 2058 of the Code, and only 15 states (including Washington, D.C.) still retain a generally applicable state death tax.<sup>193</sup> In those states with a death tax, the rates and exemption can vary significantly. For example, Washington's estate tax provides for a top rate of 20% and an exemption of \$2 million per person (indexed for inflation starting January 1, 2014). Pennsylvania, on the other hand, provides for an inheritance tax rate of 4.5% for transfers to descendants, with almost no exemption. When taken in conjunction with the transfer tax provisions of ATRA (both the top Federal tax rate at 40% and the high basic exclusion amount), the combined Federal and state transfer tax cost to high-net-worth individuals has significantly fallen, when compared to 2001, by way of example.

b. State and local income tax laws and rates vary as well. A number of states have no state and local income tax (Florida, Texas, Nevada, New Hampshire, and Washington) and other states (California, Hawaii, Minnesota, New Jersey, New York, and Oregon) have relatively high income tax rates. When taken in conjunction with the income tax provisions of ATRA and the 3.8% Net Investment Income Tax, the combined Federal and state income tax cost to most taxpayers has significantly risen since 2001.

c. Thus, the current estate planning landscape is characterized by significantly lower transfer tax costs, higher income tax rates, and significant disparity among the states when one compares the two taxes. As mentioned above, in 2001, for a New York City resident there was a 25% difference between the maximum transfer tax rate and the long-term capital gain tax rate. Today, that difference is approximately 13%.<sup>194</sup> In contrast, consider the tax rates in California. Because California does not have a state death tax, but currently has the highest combined income tax rate in the U.S., the difference between the transfer tax rate and the long-term capital gain tax rate is less than 4%.<sup>195</sup> Notably, the top combined ordinary and short-term capital gain tax rate in California is greater (approximately, 44% to 54%) than the transfer tax rate.

d. If one considers the “gap” (the difference between the transfer tax and the income tax rates) as a proxy for how aggressively estate planners will consider transferring assets out of an estate during lifetime, then one can see large differences among the states. On

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<sup>192</sup> §§ 531 and 532 of EGTRRA provided for a reduction of and eventual repeal of the Federal estate tax credit for state death taxes under § 2011, replacing the foregoing with a deduction under § 2058.

<sup>193</sup> Connecticut, District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, Nebraska (imposed by counties), New York, Oregon, Pennsylvania, Rhode Island, Vermont, and Washington. Iowa, New Jersey, and Kentucky have an inheritance tax, but the exemption to lineal heirs is unlimited.

<sup>194</sup> New York has a maximum estate tax rate of 16%, when added to the maximum Federal tax rate of 40% and deducted pursuant to § 2058, the combined maximum transfer tax rate is 49.6%, compared to a maximum long-term capital gain tax rate of 36.5% for New York City taxpayers in the alternative minimum tax (20% Federal, 3.8% Net Investment Income Tax, 8.82% state, and 3.876% local).

<sup>195</sup> Combined long-term capital gain tax rate of 36.1% for California taxpayers in the alternative minimum tax (20% Federal, 3.8% Medicare Tax, and 12.3% state).

one side, there is California, where there is a very small or negative difference, compared to Washington where there is a very large gap (approximately 28% difference above the long-term capital gain tax rate).<sup>196</sup>

e. As a result, the consistency that had existed across the U.S. for similarly situated clients (distinguished only by the size of the potential gross estate) no longer exists. Instead, estate plans vary based on the state of residence of the client. For example, arguably California residents should be more passive in their estate plans, choosing more often than not, to simply die with their assets, than Washington residents. This is because the income tax savings from a potential “step-up” in basis may, in fact, be greater than the transfer tax cost, if any.

#### H. Planning in the “Permanent” Landscape

1. Given how large the basic exclusion amount is and will be in the foreseeable future, it is clear that the focus of estate planning has moved away from simply avoiding the transfer tax and has become more focused on the income tax. Much of the planning analysis is about measuring the transfer tax cost against the income tax savings of allowing the assets to be subject to Federal and state transfer taxes. Plans should vary based upon a number of variables, such as:

- a. Time horizon or life expectancy of the client;
- b. Spending or lifestyle of the client, including charitable giving;
- c. Size of the gross estate;
- d. Future return of the assets;
- e. Tax nature of the types of assets (for example, to what extent will a potential “step-up” in basis benefit the client and the beneficiaries?);
- f. Expected income tax realization of the assets (for example, when is it likely that the asset will be subject to a taxable disposition?);
- g. State of residence of the client;
- h. State of residence and marginal income tax bracket of the likely beneficiaries; and
- i. Expectations about future inflation.

2. Ignoring (or prior to) the current uncertainty regarding changes to the existing transfer tax laws, including a potential reduction to the basic exclusion amount and elimination of a basis adjustment at death, estate planners should seek to use as little of a client’s basic

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<sup>196</sup> Washington does not have a state income tax.

exclusion amount as possible during lifetime because it represents an ever-growing amount that will provide a potential “step-up” in basis with little or no transfer tax cost at death. This conclusion assumes that “zeroed-out” estate planning techniques like installment sales to IDGTs and or “zeroed-out” grantor-retained annuity trusts<sup>197</sup> (“GRATs”) will still be available. These “zeroed-out” techniques can accomplish effectively the same amount of wealth transfer as a taxable gift but without using any or a significant portion of a client’s basic exclusion amount. A taxable gift that uses all or a portion of a taxpayer’s basic exclusion amount does not, in and of itself, reduce the taxpayer’s overall transfer tax liability. A reduction of transfer taxes occurs only if and when the gifted asset appreciates (including any appreciation effectively created by valuation discounts) outside of the donor’s estate. That is essentially the same concept as an installment sale to an IDGT and a GRAT, except that those techniques require appreciation above a certain rate, like the applicable federal rate<sup>198</sup> (“AFR”) or the section 7520 rate.<sup>199</sup>

3. Because the “step-up” in basis often comes at little or no transfer tax cost, estate planners will seek to force estate tax inclusion in the future and reduce income taxes by leveraging the basis adjustment under section 1014 of the Code. This is discussed in more detail later in these materials.

4. The state of residence of the client and his or her beneficiaries should also influence the estate plan. For instance, if a client is domiciled in California, and his or her beneficiaries live in California, then dying with the assets may be the extent of the tax planning. On the other hand, if the beneficiaries live in a state like Texas that has no state income tax, then transferring the assets out of the estate during the lifetime of the client may be warranted. As a result, estate planners should ask clients two questions that, in the past, did not significantly matter: (i) where are you likely to be domiciled at your death? and (ii) when that occurs, where is it likely that your beneficiaries (children and grandchildren) will reside, even in the future?

#### I. Portability Considerations

1. One of the newer features on the estate planning landscape is portability. A full discussion of the planning implications of portability is beyond the scope of this outline and there are resources publicly available that cover the subject in a comprehensive manner.<sup>200</sup> In the context of the “new paradigm” in estate planning discussed above, portability, at least in theory, can provide additional capacity for the surviving spouse’s estate to benefit from a “step-up” in basis with little or no transfer tax costs.

2. In traditional bypass trust planning, upon the death of an individual who has a surviving spouse, assets of the estate equal in value to the decedent’s unused basic exclusion amount fund a trust (typically for the benefit of the surviving spouse). The trust is structured to

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<sup>197</sup> Trust that provides the grantor with a “qualified annuity interest” under Treas. Reg. § 25.2702-3(b).

<sup>198</sup> § 1274.

<sup>199</sup> § 7520.

<sup>200</sup> See Franklin, Law and Karibjanian, *Portability—The Game Changer*, ABA-RPTE Section (January 2013) ([http://meetings.abanet.org/webupload/commupload/RP512500/otherlinks\\_files/TheGameChanger-3-12-13v11.pdf](http://meetings.abanet.org/webupload/commupload/RP512500/otherlinks_files/TheGameChanger-3-12-13v11.pdf)).

avoid estate tax inclusion in the surviving spouse's estate. The marital deduction portion is funded with any assets in excess of the unused Basic Exclusion Amount. The bypass trust avoids estate tax inclusion in the surviving spouse's estate. From an income tax standpoint, however, the assets in the bypass trust do not receive a basis adjustment upon the death of the surviving spouse. Furthermore, while the assets remain in the bypass trust, any undistributed taxable income above \$13,450 of taxable income (for 2022) will be subject to the highest income tax rates at the trust level.<sup>201</sup>

3. In portability planning, the decedent's estate would typically pass to the surviving spouse under the marital deduction, and the DSUE Amount would be added to the surviving spouse's basic exclusion amount, giving the surviving spouse an applicable exclusion amount. Because all of the assets passing from the decedent to the surviving spouse in addition to the spouse's own asset will be subject to estate taxes at his or her death, the assets will receive a basis adjustment. Additional income tax benefits might be achieved if the assets that would otherwise have funded the bypass trust are taxed to the surviving spouse, possibly benefiting from being taxed at a lower marginal income tax bracket. In addition, if the bypass trust would have been subject to a high state income tax burden (for example, California), having the assets taxed to a surviving spouse who moves to a low or no income tax state would provide additional income tax savings over traditional bypass trust planning.

4. Of course, there are other considerations, including creditor protection and "next spouse" issues, which would favor by-pass trust planning. However, from a tax standpoint, the trade-off is the potential estate tax savings of traditional by-pass trust planning against the potential income tax savings of portability planning. Because the DSUE Amount does not grow with the cost-of-living index, very large estates (\$20 million or above, for example) will benefit more with traditional by-pass trust planning because all of the assets, including any appreciation after the decedent's death, will pass free of transfer taxes. On the other hand, smaller but still significant estates (up to \$7 million, for example) should consider portability as an option because the combined exclusions, the DSUE Amount frozen at \$12.06 million (for death in 2022) and the surviving spouse's basic exclusion amount of \$12.06 million but growing with the cost-of-living index, is likely to allow the assets to pass at the surviving spouse's death with a full step-up in basis with little or no transfer tax costs (unless the assets are subject to significant state death taxes at that time).

5. In evaluating the income tax savings of portability planning, planners should consider that even for very large estates, the surviving spouse has the option of using the DSUE Amount by making a taxable gift to an IDGT. The Treasury Regulations make clear that the DSUE Amount is applied against a surviving spouse's taxable gift first before reducing the surviving spouse's basic exclusion amount.<sup>202</sup> The IDGT would provide the same estate tax benefits as the bypass trust would have, but importantly, the trust would be taxed to the surviving spouse as a grantor trust thus allowing the trust assets to appreciate out of the surviving spouse's estate without being burdened by income taxes.<sup>203</sup> If the assets appreciate, then this essentially

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<sup>201</sup> See Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

<sup>202</sup> Treas. Reg. § 25.2505-2(b).

<sup>203</sup> See Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

solves the problem of the DSUE Amount being frozen in value. Moreover, if the IDGT provides for a power to exchange assets of equivalent value with the surviving spouse,<sup>204</sup> the surviving spouse can exchange high basis assets for low basis assets of the IDGT prior to death and essentially effectuate a “step-up” in basis for the assets in the IDGT.<sup>205</sup> The ability to swap or exchange assets with an IDGT is discussed in more detail below.

6. Portability planning is slightly less appealing to couples in community property states because, as discussed below, both halves of all community property get a basis adjustment on the first spouse’s death. Thus, the need for additional transfer tax exclusion in order to benefit from a potential subsequent “step-up” in basis is less crucial. This is not true, however, for assets that are depreciable (commercial real property) or depletable (mineral interests). As discussed later in these materials, these types of assets might receive a “step-up” in basis but over time, the basis of the assets will be reduced by the ongoing depreciation deductions. As such, even in community property states, if there are significant depreciable or depletable assets, portability should be considered.

#### J. Transfer Tax Cost vs. Income Tax Savings from the “Step-Up”

1. One of the first steps in analyzing a client’s situation is trying to measure the potential transfer tax costs against the income tax savings that would arise from a “step-up” in basis at death. Under the current state of law, this is not an easy endeavor. First, the basic exclusion amount will continue to increase. Both the rate of inflation and the lifespan of the client are outside the planner’s control. In addition, as mentioned in the previous section, if the client dies in a state that has a death tax, the calculation of the transfer tax cost will be complicated by that state’s exemption and rate. Third, the income tax savings of a “step-up” in basis must be measured in relation to the beneficiaries who may live in a different state than the decedent.

2. Although a “step-up” in basis is great in theory, no tax will be saved if the asset is at a loss at the time of death resulting in a “step-down” in basis, the asset has significant basis in comparison to its fair market value at the time of death, or the asset will not benefit at all because it is considered income in respect of a decedent<sup>206</sup> (IRD). Furthermore, even if the assets will benefit from a significant “step-up” in basis, the only way to capture the income tax benefits of the basis adjustment is to sell the asset in a taxable disposition. Many assets, like family-owned businesses, may never be sold or may be sold so far in the future that the benefit of a “step-up” is attenuated. In addition, even if the asset will be sold, there may be a significant time between the date of death of the decedent when the basis adjustment occurs and the taxable disposition, so some consideration should be given to quantifying the cost of the deferral of the tax savings. Finally, the nature of the asset may be such that even if the asset will not be sold in a taxable disposition, it may confer economic benefit to the beneficiaries. For example, if the asset that receives a “step-up” in basis is either depreciable or depletable under the Code,<sup>207</sup> the

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<sup>204</sup> § 675(4)(C).

<sup>205</sup> Rev. Rul. 85-13, 1985-1 C.B. 184 and PLR 9535026.

<sup>206</sup> § 691.

<sup>207</sup> See e.g., § 1016(a)(2).

deductions that arise do result in tax benefits to the owners of that asset. In addition, an increase in the tax basis of an interest in a partnership or in S corporation shares may not provide immediate tax benefits, but they do allow additional capacity of the partner or shareholder to receive tax free distributions from the entity.<sup>208</sup> These concepts and how certain assets benefit or don't benefit from the basis adjustment at death are discussed in more detail below.

3. Estate planners should seek to maximize the “step-up” in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:

a. Benefit from a “step-up” (avoiding the inclusion of cash or property that has a basis greater than fair market value);

b. Benefit the most from the “step-up” (for example, very low basis assets, collectibles, and “negative basis” assets); and

c. Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after “step-up” or depreciable/depletable assets giving rise to ongoing income tax deductions).

4. In considering tax basis management in estate planning, estate planners will need to take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low-basis assets that would benefit the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around dying with the assets and benefiting from the “step-up” in basis. To the extent the assets will be subject to Federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner. Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a *Graegin*<sup>209</sup> loan.<sup>210</sup> For those clients who are likely to own assets that would not likely benefit from the “step-up” in basis (e.g., IRA assets, actively managed publicly-traded investment portfolios, or other high basis asset), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant Federal or state transfer tax liability. Finally, for those clients, who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the “swap” power proactively if the assets are held in a grantor trust, as discussed later in this article.

5. When clients are in a situation where no estate taxes will be due, referred to as a “free-base” situation, then estate planners should seek to maximize the value of certain assets because the “step-up” in basis is based on fair market value (rather than trying to reduce the value

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<sup>208</sup> See e.g., §§ 731(a)(1) and 1368(b).

<sup>209</sup> *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, 56 T.C.M. (CCH) 387 (1988).

<sup>210</sup> See Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 Tax Mgmt. Est. Gifts & Tr. J No. 4 (July 14, 2011).

for transfer tax purposes). A “free-base” situation can arise when the assets includible in the estate are less than the decedent’s remaining Basic Exclusion Amount (or potentially, remaining Applicable Exclusion Amount) or are because of a marital deduction transfer under section 2056 to the surviving spouse.<sup>211</sup> In these “free-basing” situations, practitioners will need to consider when valuation discounts are warranted and when the discounts should be removed.

6. In addition to the foregoing, estate planners will increasingly seek to:

a. Maximize the value of certain assets because the “step-up” in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and

b. Intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has a significant unused basic exclusion amount (or potentially, Applicable Exclusion Amount) above his or her assets.

#### K. Community Property Considerations

1. Given the pivotal role the “step-up” in basis has in estate planning now, community property states have a significant advantage over separate property states because both the decedent’s and the surviving spouse’s one-half interest in community property will receive a basis adjustment to fair market value under section 1014(b)(6) of the Code. Because the unlimited marital deduction under section 2056 essentially gives couples the ability to have no transfer taxes on the first spouse’s death, this “step-up” in basis provides an immediate income tax savings for the benefit of the surviving spouse (rather than the subsequent beneficiaries). Of course, community property states could cause a significant disadvantage for property that has decreased in value, which would cause a step-down in basis to both halves of community property.

2. This theoretically provides a bifurcated approach to estate planning for spouses with community property:

a. During the lifetimes of both spouses, limit inter vivos transfers and maximize value of the assets in order to benefit the most from the basis adjustment under section 1014(b)(6) of the Code.

b. During the lifetime of the surviving spouse, with assets in excess of the Available Exclusion Amount (taking into account any amounts that might have been “ported” to the surviving spouse), transfer as much wealth as possible out of the estate through inter vivos transfers and other estate planning techniques. Further, through the use of family limited partnerships (“FLPs”) and other techniques, attempt to minimize the transfer tax value of the assets that would be includible in the estate of the surviving spouse.

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<sup>211</sup> Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the ongoing income tax liability of the non-grantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust.

3. Notably, with the U.S. Supreme Court's decisions in *U.S. v. Windsor*<sup>212</sup> and *Obergefell v. Hodges*<sup>213</sup> and the issuance of Revenue Ruling 2013-17<sup>214</sup> and proposed regulations addressing definitions of terms related to marital status,<sup>215</sup> the tax ramifications are far reaching for same-sex couples owning community property. The basis adjustment at death for community property and other planning considerations, including electing into community property status, are discussed in more detail later in these materials.

4. The basis adjustment at death for community property and other planning considerations, including electing into community property status, are discussed in more detail later in these materials.

## II. VERY LONG-TERM GRATS

### A. Inclusion Amount if Grantor Dies During the Term

1. The Treasury Regulations provide that if a grantor dies during the term of a GRAT, then some or all of the assets in the GRAT will be includible in the estate of the grantor under Section 2036. In pertinent part the Treasury Regulations provide, in pertinent part:

a. "If a decedent transferred property into such a trust and retained or reserved the right to ... an annuity ... with respect to the property decedent so transferred ... for a period that does not in fact end before the decedent's death, then the decedent's right to ... the retained annuity ... (whether payable from income and/or principal) constitutes the retention of the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036."<sup>216</sup>

b. "The portion of the trust's corpus includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to provide the decedent's retained use or retained annuity ... (without reducing or invading principal) as determined in accordance with §20.2031-7 (or §20.2031-7A, if applicable). The portion of the trust's corpus includible in the decedent's gross estate under section 2036, however, shall not exceed the fair market value of the trust's corpus at the decedent's date of death."<sup>217</sup>

2. The examples in the Treasury Regulations provide that with GRATs, the amount includible is the "amount of corpus necessary to yield the annual annuity payment"<sup>218</sup>

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<sup>212</sup> 133 S. Ct. 2675 (2013).

<sup>213</sup> 135 S. Ct. 2584 (2015).

<sup>214</sup> Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

<sup>215</sup> Definition of Terms Relating to Marital Status, 80 Fed. Reg. 64378 (proposed Oct. 23, 2015).

<sup>216</sup> Treas. Reg. § 20.2036-1(c)(2)(i).

<sup>217</sup> *Id.*

<sup>218</sup> Treas. Reg. § 20.2036-1(c)(2)(iii), ex. 2.

regardless of the remaining GRAT term. The amount of corpus necessary is determined by dividing the annual annuity by the Section 7520 rate in effect at the time the grantor dies.<sup>219</sup>

3. Thus, if the interest rate is very high or the annual annuity payment is very low at the time of death, the amount includible may be significantly lower in value than the value of the assets in the GRAT. Remember, the amount includible cannot exceed the fair market value of the trust’s corpus. As such, this calculation can only serve to lower the amount includible for estate tax purposes.

**B. 100- or 365-Year GRAT?**

1. Because there is no limitation on how long the term of a GRAT can be under section 2702, taxpayers may want to consider creating a 100 year or 365 year GRAT. Obviously, this guarantees that the grantor will die during the term and some portion of the GRAT assets will be includible in the estate of the grantor. However, because of the foregoing calculation, it may result in a significant reduction of estate taxes. By extending the term to 100 or 365 years, it drastically reduces the size of the annuity payment needed to “zero-out” a contribution to a GRAT, especially when the Section 7520 rate is low. While today’s Section 7520 rate is not as low as it was at the end of 2020 and the beginning of 2021 (0.4%-0.6%), today’s rate of 3.6% for June 2022 is still below the historical average of 4.6%.

2. For example, in order to zero-out a \$10 million contribution to a 100-year GRAT at a section 7520 Rate of 3.6%, the grantor must retain a \$370,793 annuity. If the GRAT has a term of 365 years, the grantor must retain a \$360,001 annuity. When the grantor dies during the term, the amount includible under this computation is determined by the section 7520 rate at that time, as illustrated below:

<b>100 Year GRAT</b>		<b>7520 Rate at Death</b>		<b>§ 20.2036-1(c)(2) Inclusion</b>		<b>GRAT Asset Value</b>	
Annuity	\$ 370,793.35	1.0%	\$	37,079,335	Years	Annual Return	7%
7520 Rate	3.6%	2.0%	\$	18,539,668	5	\$ 11,893,182	
Years	100	3.0%	\$	12,359,778	10	\$ 14,548,467	
PV of Grantor’s Retained Interest	\$ 10,000,000	4.0%	\$	9,269,834	15	\$ 18,272,641	
Annuity Factor	26.96919971	5.0%	\$	7,415,867	20	\$ 23,495,989	
Life Factor	0.970891189	6.0%	\$	6,179,889	25	\$ 30,822,004	
Remainder Factor	0.029108811	7.0%	\$	5,297,048			

<b>365 Year GRAT</b>		<b>7520 Rate at Death</b>		<b>§ 20.2036-1(c)(2) Inclusion</b>		<b>GRAT Asset Value</b>	
Annuity	\$ 360,000.89	1.0%	\$	36,000,089	Years	Annual Return	7%
7520 Rate	3.6%	2.0%	\$	18,000,045	5	\$ 11,955,246	
Years	365	3.0%	\$	12,000,030	10	\$ 14,697,580	
PV of Grantor’s Retained Interest	\$ 10,000,000	4.0%	\$	9,000,022	15	\$ 18,543,845	
Annuity Factor	27.77770901	5.0%	\$	7,200,018	20	\$ 23,938,431	
Life Factor	0.999997524	6.0%	\$	6,000,015	25	\$ 31,504,616	
Remainder Factor	2.47565E-06	7.0%	\$	5,142,870			

3. If at the time the grantor dies, the assets in the 100-year GRAT are still \$10 million (the assets have only produced enough to pay the annuity) but the section 7520 Rate is

<sup>219</sup> The Treasury Department published final Treasury Regulations on the amount includible under particular situations, including annually increasing annuities. TD9555, 76 Fed. Reg. 69126 (Nov. 8, 2011). It should be noted that the calculation of the amount of inclusion with increasing annuities is not the same and will result in generally much larger values for estate tax inclusion.

5.0%, the amount includible is \$7.4 million, effectively a 26% valuation discount. If the assets in the GRAT are worth \$3.0 million, then only \$3.0 million will be includible. Remember, this is a “no lose” calculation.

4. For clients that seek to take advantage of the temporary increase in the Base Exclusion Amount (the “bonus” exclusion) and don’t feel comfortable with extremely long terms of 100 or 360 years, rather than making a “zeroed-out” gift, they should consider making a taxable gift to a long-term GRAT. If a taxpayer contributes \$10 million to a 50-, 60-, or 70-year GRAT and retains an annuity having a present value of \$3.97 million (resulting in a \$6.03 million taxable gift), the inclusion calculations are better than the 100 and 365-year “zeroed-out” GRAT calculations above:

50 Year GRAT		7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion	GRAT Asset Value	
Annuity	\$ 172,320.05	1.0%	\$ 17,232,005	Years	Annual Return
7520 Rate	3.6%	2.0%	\$ 8,616,002	5	7%
Years	50	3.0%	\$ 5,744,002	10	\$ 13,034,550
PV of Grantor's Retained Interest	\$ 3,970,000	4.0%	\$ 4,308,001	15	\$ 17,290,663
Annuity Factor	23.03852658	5.0%	\$ 3,446,401	20	\$ 23,260,081
Life Factor	0.829386957	6.0%	\$ 2,872,001	25	\$ 31,632,499
Remainder Factor	0.170613043	7.0%	\$ 2,461,715		\$ 43,375,249

60 Year GRAT		7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion	GRAT Asset Value	
Annuity	\$ 162,370.04	1.0%	\$ 16,237,004	Years	Annual Return
7520 Rate	3.6%	2.0%	\$ 8,118,502	5	7%
Years	60	3.0%	\$ 5,412,335	10	\$ 13,091,770
PV of Grantor's Retained Interest	\$ 3,970,000	4.0%	\$ 4,059,251	15	\$ 17,428,136
Annuity Factor	24.4503229	5.0%	\$ 3,247,401	20	\$ 23,510,115
Life Factor	0.880211624	6.0%	\$ 2,706,167	25	\$ 32,040,405
Remainder Factor	0.119788376	7.0%	\$ 2,319,572		\$ 44,004,577

70 Year GRAT		7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion	GRAT Asset Value	
Annuity	\$ 156,043.93	1.0%	\$ 15,604,393	Years	Annual Return
7520 Rate	3.6%	2.0%	\$ 7,802,197	5	7%
Years	70	3.0%	\$ 5,201,464	10	\$ 13,128,149
PV of Grantor's Retained Interest	\$ 3,970,000	4.0%	\$ 3,901,098	15	\$ 17,515,541
Annuity Factor	25.44155303	5.0%	\$ 3,120,879	20	\$ 23,669,084
Life Factor	0.915895909	6.0%	\$ 2,600,732	25	\$ 32,299,747
Remainder Factor	0.084104091	7.0%	\$ 2,229,199		\$ 44,404,698

C. Practical Considerations/Questions

1. The GRAT must be a valid trust under governing state law. Does governing state law allow for 100-year or 365-year term trusts or will the trust be invalid under the state’s applicable rule against perpetuities law?
2. How will the resulting estate tax be paid? What does the tax apportionment clause provide?
3. Ongoing annuity payments after the death of the grantor will need to be paid to the estate. Does the estate need to remain open for that entire time or can the right to the annuity payments be distributed in-kind to a remainder beneficiary?
4. If the remainder beneficiary, beneficiary of the remaining annuity payments for the term and the GRAT trustee are the same person, can the trust be terminated under state law under the merger doctrine, thereby negating the need to continue to administer the GRAT?

5. Is the termination of the GRAT a prohibited commutation of the retained interest?

6. If the term is too long, can the IRS argue that the term is actually a term for life, resulting in a taxable gift and a different amount includible upon the death of the grantor?

7. What are the income tax implications of having an amount includible determined under section 2036 that is different than the fair market value of the GRAT assets under section 1014? Will the assets in the GRAT be subject to a “step-down” in basis? What if the GRAT only holds life insurance and the only assets in the GRAT at death are the cash proceeds from the death benefit? Could a long-term GRAT be a viable alternative to a private split-dollar life insurance arrangement?

8. What are the GST Tax implications if and when an annuity payment and/or the remainder is distributed to a skip person?

9. What if a charitable organization is made the recipient of the ongoing annuity payments? Would doing so defer the GST tax implications far enough into the future that economically it would be OK having the remainder ultimately pass to a skip person?

### III. SECTION 1014 AND THE TAX NATURE OF CERTAIN ASSETS

#### A. General Rule: The “Step-Up” in Basis to Fair Market Value

1. Generally, under section 1014(a)(1), the “basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent” is the “fair market value of the property at the date of the decedent's death.”<sup>220</sup> The foregoing general rule is often referred to as the “step-up” in basis at death, under the assumption that assets generally appreciate in value. However, many assets depreciate in value, and this general rule will mean a loss of tax basis to fair market value at date of death (a “step-down” in basis). For purposes of this outline, we refer to the general rule of section 1014(a)(1) as a “step-up” in basis, whether the asset is appreciated or at a loss at the time of the decedent’s death.

2. The Code goes on to say that if the executor of the estate elects an alternate valuation date under section 2032 or special use valuation under section 2032A, then the basis is equal to the value prescribed under those Code sections.<sup>221</sup>

3. If land, or some portion thereof, that is subject to a qualified conservation easement is excluded from the estate tax under section 2031(c), then “to the extent of the

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<sup>220</sup> § 1014(a)(1).

<sup>221</sup> §§ 1014(a)(2) and (a)(3).

applicability of the exclusion,” the basis will be the “basis in the hands of the decedent”<sup>222</sup> (“carryover basis”).<sup>223</sup>

4. In the context of partnerships, typically the “step-up” in basis is reflected in the partnership interest owned by a decedent partner at the time of his or her death. If a section 754 election is made, then the basis of the assets inside the partnership will be adjusted to reflect the “step-up” in the partnership interest. As discussed later in these materials, how those basis adjustments are reflected and allocated is complex and often results in less than ideal results for individual taxpayers.

## B. Defining “Property Acquired From a Decedent”

### 1. Generally

a. The Treasury Regulations generally provide, “The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent that is equal to the value placed upon such property for purposes of the federal estate tax.”<sup>224</sup> In other words, the basis adjustment at death under Section 1014(a) of the Code is tied directly to the imposition of the estate tax.

b. However, there are a number of situations where the basis adjustment at death is available without inclusion of the property in a U.S. gross estate. As such, understanding some of the different ways in which property is “acquired from a decedent” is important, separate from the question of whether estate tax has or will be imposed on such property.

### 2. Section 1014(b)(1): Bequest, Devise, or Inheritance

a. Section 1014(b)(1) of the Code provides, “Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent”<sup>225</sup> is considered “to have been acquired from or to have passed from the decedent.”<sup>226</sup>

b. Property acquiring a “step-up” in basis under this subsection does not necessarily need to be included in a decedent’s gross estate, particularly when nonresident alien decedents are involved.<sup>227</sup>

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<sup>222</sup> § 1014(a)(4).

<sup>223</sup> § 1015.

<sup>224</sup> Treas. Reg. § 1.1014-1(a).

<sup>225</sup> § 1014(b)(1). *See also*, Treas. Reg. § 1.1014-2(a)(1).

<sup>226</sup> § 1014(b) [introductory language].

<sup>227</sup> Rev. Rul. 84-139, 1984-2 C.B. 168 (real property owned by a nonresident alien and not subject to U.S. estate tax will take a basis equal to its fair market value) and PLR 201245006 (assets held in a foreign revocable trust will receive a basis adjustment at death under section 1014(b)(1) of the Code even though the assets are not subject to U.S. estate tax). However, as discussed later in these materials, it is likely the IRS mistakenly cited (b)(1) in PLR 201245006 as the operative subsection for the basis adjustment at death.

3. Section 1014(b)(2): Revocable and Retained Income Trusts

a. Section 1014(b)(2) of the Code provides, “[p]roperty transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust”<sup>228</sup> is considered “to have been acquired from or to have passed from the decedent.”

b. As discussed later in these materials, except for certain assets (non-U.S. situs) held by trusts created by or controlled by nonresident aliens, these assets would be includible in the decedent’s gross estate under section 2036 of the Code (due to the retained income interest) or section 2038 of the Code (due to the right of revocation).

4. Section 1014(b)(3): Retained Control Trusts

a. Section 1014(b)(3) of the Code provides, “property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust”<sup>229</sup> is considered “to have been acquired from or to have passed from the decedent.”

b. As discussed later in these materials, except for certain assets (non-U.S. situs) held by trusts created by or controlled by nonresident aliens, these assets would be includible in the decedent’s gross estate under section 2038 of the Code (because of the retained powers over assets).

5. Section 1014(b)(4): Exercised Testamentary General Power of Appointment

a. Section 1014(b)(4) of the Code provides, “[p]roperty passing without full and adequate consideration under a general power of appointment exercised by the decedent by will”<sup>230</sup> is considered “to have been acquired from or to have passed from the decedent.”

b. Assets passing pursuant to the exercise of a testamentary general power of appointment would also be includible in the power holder’s estate under section 2041 of the Code, whether or not exercised, under section 2041 of the Code and entitled to a basis adjustment under section 1014(b)(9) of the Code.

c. If a nonresident alien is granted a testamentary power of appointment over appreciated non-U.S. situs property and the power is exercised in the will of the nonresident alien decedent, it is conceivable such property would receive a “step-up” in basis under section 1014(b)(4) of the Code.

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<sup>228</sup> § 1014(b)(2). *See also*, Treas. Reg. § 1.1014-2(a)(1) and Rev. Rul. 57-287, 1957-1 C.B. 517, *modifying* Rev. Rul. 55-502, 1955-2 C.B. 560.

<sup>229</sup> § 1014(b)(9).

<sup>230</sup> § 1014(b)(4). *See also*, Treas. Reg. § 1.1014-2(a)(4).

6. Section 1014(b)(6): Community Property

a. Section 1014(b)(6) of the Code provides, “[p]roperty which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax)”<sup>231</sup> is considered “to have been acquired from or to have passed from the decedent.”

b. Community property considerations, and planning opportunities with such property, are discussed in more other parts of these materials.

7. Section 1014(b)(9): Assets Subject to U.S. Estate Tax

a. Section 1014(b)(9) of the Code provides, “property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B”<sup>232</sup> is considered “to have been acquired from or to have passed from the decedent.”

b. This provision is essentially the catch-all provision that provides a basis adjustment at death under section 1014(a) of the Code if any asset, or portion thereof, is included in a decedent’s gross estate. Prior to its enactment, because a joint interest in property is deemed to have been acquired by lifetime transfer (not by “bequest, devise, or inheritance” as required by section 1014(b)(1) of the Code), the joint interest would have been included in the decedent’s gross estate for estate tax purposes but would not have been entitled to a “step-up” in basis. In enacting this provision, the legislative history states there is “no justification for denying property included in a decedent's gross estate for estate tax purposes a new basis at date of death.”<sup>233</sup>

c. Strangely, the Code provides a reduction of the “step-up” in basis on cost recovery-type property: “if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent.”<sup>234</sup> Unusually, any basis adjustment allowed solely by reason of section 1014(b)(9) of the Code is reduced by “the amount allowed to the taxpayer as deductions . . . for exhaustion, wear and tear, obsolescence, amortization and depletion on such property

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<sup>231</sup> § 1014(b)(6). *See also*, Treas. Reg. § 1.1014-2(a)(5), Rev. Rul. 87-98, 1987-2 C.B. 206, Rev. Rul. 66-283, 1966-2 C.B. 297, Rev. Rul. 59-220, 1959-1 C.B. 210, and Rev. Rul. 55-605, 1955-2 C.B. 382.

<sup>232</sup> § 1014(b)(9). *See also*, Treas. Reg. § 1.1014-2(a)(4).

<sup>233</sup> S. Rep. No. 1622, 83d Cong., 2d Sess. 107 (1954).

<sup>234</sup> § 1014(b)(9).

before the death of the decedent." This limitation apparently applies only when someone other than the decedent owns depreciable, amortizable or depletable property which is nevertheless includible in the decedent's taxable estate.

d. The Treasury regulation interpreting the provision is entitled, "Special rule for adjustment to basis when property is acquired from a decedent prior to his death." It appears to have originated at a time when assets given away within three years of death were taxed to the decedent under a prior version of section 2035 of the Code.<sup>235</sup> Its application is not, however, limited to that situation. Thus, for example, the provision has been applied to depreciated property held by the decedent and another as joint tenants with rights of survivorship<sup>236</sup> and property held by spouses as tenants by the entirety.<sup>237</sup> If an owner of the property was able to claim a deduction for depreciation, amortization or depletion during the decedent's lifetime, this provision prevents the owner from recouping that deduction as a result of having the property included in another person's estate. Thus, for example, assume that A made a gift of depreciable property with a basis of \$50,000 to B, and retained a life estate. Prior to A's death, B claimed depreciation deductions of \$20,000. When A dies, the property, valued at \$80,000, is included in determining the value of A's gross estate under Section 2036(a)(1). Pursuant to Section 1014(b)(9), B's adjusted basis in the property as of the date of the decedent's death is \$60,000 (\$80,000, the fair market value at the decedent's death, less \$20,000, the total depreciation deduction actually allowed to B).<sup>238</sup>

#### 8. Section 1014(b)(10): QTIP Marital Trusts

a. Section 1014(b)(10) of the Code provides, "[p]roperty includible in the gross estate of the decedent under section 2044 (relating to certain property for which marital deduction was previously allowed)"<sup>239</sup> is considered "to have been acquired from or to have passed from the decedent."

b. This provision provides the basis adjustment for assets held in qualified electing QTIP trusts under sections 2056(b)(7) and 2523(f) of the Code for which an estate or gift tax marital deduction was granted. There is some additional discussion regarding the basis adjustment at the death for assets subject to debt held in QTIP trusts later in these materials.

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<sup>235</sup> See Treas. Reg. § 1.1014-6(a)(3), Ex. 1.

<sup>236</sup> See Treas. Reg. § 1.1014-6(a)(2).

<sup>237</sup> Rev. Rul. 58-130, 1958-1 CB 121.

<sup>238</sup> See Treas. Reg. § 1.1014-6(c).

<sup>239</sup> § 1014(b)(10).

C. Basis Consistency and Reporting Rules for Property Acquired from a Decedent

1. Generally

a. On July 31, 2015, the President signed the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015<sup>240</sup> (commonly referred to as the “Highway Bill”) into law. Among the non-expiring provisions in the Highway Bill are provisions that create new sections 1014(f) and 6035 of the Code.<sup>241</sup> Pursuant to these provisions, taxpayers acquiring property from a decedent whose estate was required to file a Federal estate tax return must report their adjusted tax basis consistently with the value of the property as finally determined for Federal estate tax purposes, or if not finally determined, the value as reported by the statement made under section 6035 of the Code. Specifically, beneficiaries cannot claim a higher basis than the estate tax value. Further, the executor is required to furnish the IRS and to each person acquiring any interest in property included in the gross estate a statement of value and any other information prescribed by the IRS.

b. Section 6035 imposes reporting requirements for individuals who are required to file a Form 706 under section 6018(a) (e.g., an executor) or under section 6018(b) (e.g., a recipient of the decedent). If a Form 706 must be filed, the reporting party is now also required to report valuation information to the IRS and to each person acquiring any interest in property included in the decedent’s gross estate. The statement must be delivered within 30 days of the earlier of the date the return is filed or the date the estate tax return was due (with extensions). If the value is subsequently adjusted (e.g., by audit or amendment), a supplemental statement must be provided within 30 days. The penalty for each failure is \$250, to a maximum of \$3 million, and if the failure to report was intentional, the penalty is increased to \$500, with exceptions for reasonable cause.<sup>242</sup>

c. If a taxpayer claims a tax basis on his or her income tax return in excess of the basis reported under section 1014(f) of the Code, a 20% penalty<sup>243</sup> is applied to the underpayment arising from the “inconsistent estate basis reporting.”<sup>244</sup> The 6-year statute of limitations applies in the case of an overstatement of basis.<sup>245</sup>

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<sup>240</sup> P.L. 114-41 (the “Highway Bill”).

<sup>241</sup> § 2004 of the Highway Bill.

<sup>242</sup> §§ 6721, 6724(d)(1)(D), and 6724(d)(2)(II). The penalty under section 6721 of the Code for failing to file an information return was increased from \$100 to \$250 by the Trade Preferences Extension Act of 2015 (P.L. 114-27) on June 29, 2015. The penalty under section 6723 of the Code for failing to comply with a “specified information reporting requirement” does not apply, because “specified information reporting requirement” is a defined term limited under sections 6724(d)(3) of the Code, applying to circumstances which do not apply here.

<sup>243</sup> § 6662(a) (accuracy-related penalties on underpayments).

<sup>244</sup> § 6662(b)(8) and 6662(k).

<sup>245</sup> § 2005 of the Highway Bill and re-designated § 6502(e)(1)(B)(ii).

d. Note that section 1014(f)(1) of the Code limits application of the section to situations where Federal estate tax values have been determined. Section 1014(f)(3) defines “determined” in such a way that ordinarily a return would need to be filed. Furthermore, section 1014(f) of the Code only applies to “property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11.”<sup>246</sup>

e. These provisions apply to estate tax returns (and related income tax returns) filed after July 31, 2015.<sup>247</sup>

## 2. Temporary and Proposed Regulations<sup>248</sup>

### a. Introduction

(1) On March 4, 2016, the Department of Treasury published temporary and proposed regulations providing guidance regarding the basis consistency and information reporting rules of IRC §§ 1014(f) and 6035. The proposed regulations apply to property acquired from a decedent or by reason of the death of a decedent whose federal estate tax return is filed after July 31, 2015.

(2) The proposed regulations clarify various definitions contained in IRC §§ 1014(f) and 6035. “Information Return” means Form 8971, “Information Regarding Beneficiaries Acquiring Property from a Decedent,” and the “Statement” required to be furnished to each beneficiary. Prop. Reg. § 1.6035-1(g)(2). “Statement” means the payee statement described as Schedule A of the Information Return.<sup>249</sup>

(3) The proposed regulations also provide guidance on the following topics: (1) property subject to the basis consistency rules; (2) reporting requirements; (3) property subject to the reporting requirements; (4) reporting due dates; (5) the effect of post-death adjustments to basis; (6) identity of the beneficiaries who must receive a Statement; (7) supplemental information and treatment of subsequently-discovered property; (8) reporting subsequent transfers; and (9) beneficiaries’ inability to contest estate tax value.

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<sup>246</sup> § 1014(f)(2).

<sup>247</sup> §§ 2004(d) and 2005(b) of the Highway Bill.

<sup>248</sup> The following discussion comes from materials entitled, “Basis Bonanza: A Few Creative Ways to Generate Basis Step-Up,” prepared by Charles A. Redd of Stinson Leonard Street LLP who graciously gave the authors consent to reproduce them as part of these materials.

<sup>249</sup> Prop. Treas. Reg. § 1.6035-1(g)(2).

b. Property Subject to the Basis Consistency Rules

(1) Generally, all property included in the decedent's gross estate (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) that generates a federal estate tax in excess of allowable credits (other than a credit for a prepayment of tax) is subject to the basis consistency rules.<sup>250</sup> If the estate pays no federal estate tax, then none of the estate property is subject to the basis consistency rules.<sup>251</sup>

(2) Property that qualifies for an estate tax charitable or marital deduction under sections 2055, 2056 or 2056A of the Code are excluded from the property subject to the basis consistency rules because such property does not generate estate tax liability.<sup>252</sup>

(3) In addition, tangible personal property for which an appraisal is not required under section 20.2031-6(b) of the Treasury Regulations is not subject to the basis consistency rules. The proposed regulations are not clear whether this exception applies if the aggregate value of all tangible personal property is under the \$3,000.00 threshold provided in the regulations or whether the exception applies to each item of tangible personal property the value of which is under the \$3,000.00 threshold. However, an example in the proposed regulations indicates that this exception applies for any individual item the value of which is under \$3,000.00.<sup>253</sup> A further indication that the exception applies to each item the value of which is under \$3,000.00 is found in the Instructions to Form 706, which requires an appraisal only for those items valued at more than \$3,000.00.

c. Reporting Requirements

(1) An "executor" who is required to file a federal estate tax return pursuant to IRC § 6018(a) is required to provide an Information Return (i.e., Form 8971 and Schedule A) to the IRS and a Statement (i.e., Schedule A) to all beneficiaries who will receive property that was included in the decedent's gross estate.<sup>254</sup>

(2) This reporting requirement does not apply if the executor is not required by IRC § 6018(a) to file a federal estate tax return, but files a federal estate tax return for other reasons (e.g., to make a portability election, a GST exemption allocation or a protective filing to avoid any penalty if an asset value is later determined to require the filing of a return).<sup>255</sup>

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<sup>250</sup> Prop. Treas. Reg. § 1.1014-10(b)(1).

<sup>251</sup> Prop. Treas. Reg. § 1.1014-10(b)(3).

<sup>252</sup> Prop. Treas. Reg. § 1.1014-10(b)(2).

<sup>253</sup> Prop. Treas. Reg. § 1.6035-1(b)(2), *Ex. 1*.

<sup>254</sup> Prop. Treas. Reg. § 1.6035-1(a)(1).

<sup>255</sup> Prop. Treas. Reg. § 1.6035-1(a)(2).

(3) The due date for providing an Information Return and Statement to the IRS and the Statements to the beneficiaries is the earlier of 30 days after the due date of the federal estate tax return or 30 days after the date the federal estate tax return is actually filed.<sup>256</sup>

d. Property Subject to the Reporting Requirements

(1) Generally, all property required to be reported on a federal estate tax return (including property the basis of which is determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property or property subject to an involuntary conversion) is subject to the reporting requirement.<sup>257</sup> This includes property included in the gross estate but not held by the estate, such as property held in a revocable trust established by the decedent. Regarding property owned by a deceased nonresident alien, only the property that is subject to the U.S. estate tax is reportable.<sup>258</sup> For a decedent holding community property, the reporting requirement only applies to the decedent's one-half of community property.<sup>259</sup>

(2) Four classes of property are exempt from the reporting requirement: (a) cash (other than a coin collection or other coins or bills with numismatic value); (b) income in respect of a decedent (as defined in section 691 of the Code); (c) tangible personal property for which an appraisal is not required under section 20.2031-6(b) of the Treasury Regulations; and (d) property sold, exchanged or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in which capital gain or loss is recognized.<sup>260</sup>

e. Effect of Post Death Adjustments

(1) The proposed regulations recognize that post-death adjustments to a property's basis may still occur after the valuation date for estate tax purposes. A beneficiary's initial basis in property acquired from the decedent or as a result of the decedent's death will be the value of such property as reported on the federal estate tax return. However, the beneficiary's initial basis may be adjusted due to the operation of other provisions of the Code governing basis.<sup>261</sup>

(2) Such adjustments could include gain recognized by the decedent's estate upon distribution of the property, post-death capital improvements and depreciation and post-death adjustments to the basis of an interest in a partnership or S corporation.<sup>262</sup>

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<sup>256</sup> Prop. Treas. Reg. § 1.6035-1(d)(1).

<sup>257</sup> Prop. Treas. Reg. § 1.6035-1(b)(1).

<sup>258</sup> *Id.*

<sup>259</sup> *Id.*

<sup>260</sup> Prop. Treas. Reg. § 1.6035-(b)(1)(i)-(iv).

<sup>261</sup> Prop. Treas. Reg. § 1.1014-10(a)(2).

<sup>262</sup> *Id.*

(3) The basis of property subject to debt (whether recourse or non-recourse) is the gross up value of the property and thus, post-death payments on such debt will not result in an adjustment to the property's basis.<sup>263</sup>

f. Identity of the Beneficiaries Who Must Receive a Statement

(1) Statements must be provided to any person receiving reportable property (referred to as a “beneficiary”).<sup>264</sup> There is no exception to exclude reporting to a beneficiary who receives property which is not subject to the basis consistency rules (e.g., bequests that qualify for the marital or charitable deduction). If a beneficiary is a trust or another estate, the statement is provided to the trustee or the executor not the beneficiaries of that trust or estate.<sup>265</sup>

(2) If the executor has not identified the property that will be distributed to each beneficiary by the due date for submitting the Information Return and Statements, the executor must report on the Statement for each such beneficiary all of the reportable property that could be used to satisfy that beneficiary's interest.<sup>266</sup> The proposed regulations further provide, “Once an exact distribution has been determined, the executor may, but is not required to, file and furnish a supplemental Information Return and Statement.”<sup>267</sup>

(3) If a beneficiary cannot be located by the reporting due date, the executor must still file the Information Report and must explain the efforts made to locate the beneficiary. Prop. Reg. § 1.6035-1(c)(4). A supplemental report must be filed within 30 days of locating the beneficiary. Prop. Reg. § 1.6035-1(c)(4).

(4) For life estates, a beneficiary includes “the life tenant, the beneficiary of a remainder interest is remainderman(men) identified as if the life tenant were to die immediately after the decedent, and the beneficiary of a contingent interest is a beneficiary, unless the contingency has occurred prior to the filing of the Form 8971. If the contingency subsequently negates the inheritance of the beneficiary, the executor must do supplemental reporting...to report the change of beneficiary.”<sup>268</sup> The inclusion of a contingent beneficiary as a beneficiary who must receive a Statement may be a drafting error, but until such time as the proposed regulations are finalized or amended, executors must report the basis of life estate property to contingent beneficiaries.

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<sup>263</sup> *Id.*

<sup>264</sup> Prop. Treas. Reg. § 1.6035-1(c)(1).

<sup>265</sup> Prop. Treas. Reg. § 1.6035-1(c)(2).

<sup>266</sup> Prop. Treas. Reg. §§ 1.6035-1(c)(3) and 1.6035-1(e)(3)(ii), *Ex. 2*.

<sup>267</sup> Prop. Treas. Reg. § 1.6035-1(c)(3).

<sup>268</sup> Prop. Treas. Reg. § 1.6035-1(c)(1).

g. Supplemental Information and Subsequently-Discovered Property

(1) An executor must file supplemental Information Returns and Statements if any change occurs that causes the reported information to be incorrect.<sup>269</sup> No supplement is required to: (i) correct an inconsequential error or omission within the meaning of section 301.6772-1(b) of the Treasury Regulations; or (2) specify the actual distribution of property previously reported as being available to satisfy the interests of multiple beneficiaries.<sup>270</sup> The due date of the supplement is 30 days after: (1) the final value is determined, (2) incorrect or incomplete information is discovered or (3) a supplemental federal estate tax return is filed reporting additional assets.<sup>271</sup>

(2) If property is later discovered and reported on a supplemental federal estate tax return before the period of limitation on assessment of tax expires, such property's basis for basis consistency purposes will be the final value as shown on the supplement to the federal estate tax return.<sup>272</sup> However, if the discovered property is not reported on a supplemental federal estate tax return before the limitation period expires, the basis of such property is zero.<sup>273</sup>

h. Reporting Subsequent Transfers

(1) If property that previously was reported or is required to be reported is distributed or transferred (by gift or otherwise) by the beneficiary to a related transferee in a transaction in which the related transferee determines its basis, in whole or in part, by reference to the beneficiary/transferor's basis, the beneficiary/transferor must, within 30 days of the transfer, file with the IRS a supplemental Statement and furnish a copy to the transferee.<sup>274</sup>

(2) If the subsequent transfer occurs before the final value is determined for estate tax purposes, then the transferor must also give the executor a copy of the Statement.<sup>275</sup> "A related transferee means any member of the transferor's family as defined in section 2704(c)(2), any controlled entity...and any trust of which the transferor is a deemed owner for income tax purposes."<sup>276</sup>

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<sup>269</sup> Prop. Treas. Reg. § 1.6035-1(e)(2).

<sup>270</sup> Prop. Treas. Reg. § 1.6035-1(e)(3).

<sup>271</sup> Prop. Treas. Reg. § 1.6035-1(e)(4)(i).

<sup>272</sup> Prop. Treas. Reg. § 1.1014-10(c)(3)(i)(A).

<sup>273</sup> Prop. Treas. Reg. § 1.1014-10(c)(3)(i)(B).

<sup>274</sup> Prop. Treas. Reg. § 1.6035-1(f).

<sup>275</sup> *Id.*

<sup>276</sup> *Id.*

D. Section 1014(e): The One Year Conundrum

1. Section 1014(e) provides that if “appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death,”<sup>277</sup> and the property is “acquired from the decedent by (or passes from the decedent to) the donor of such property (or spouse of such donor),”<sup>278</sup> then the property will not receive a “step-up” in basis and it will have the basis in the hands of the decedent before the date of death.<sup>279</sup>

2. For purposes of the foregoing, the Code provides that carryover basis shall apply to any appreciated property “sold by the estate of the donor or by a trust of which the decedent was the grantor” but only “to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale.”<sup>280</sup>

3. This rule does not apply if the property passes to the issue of the original donor, and it is unclear whether this rule applies if the property is placed in trust where the original donor or donor’s spouse is a potential beneficiary.<sup>281</sup> In *Estate of Kite v. Commissioner*<sup>282</sup> prior to her husband’s death, the surviving spouse funded an inter-vivos QTIP trust for the benefit of her husband with appreciated assets. Her husband died a week after the QTIP trust was created and funded. The surviving spouse reserved a secondary life estate for the benefit of the surviving spouse, and the inclusion in her husband’s estate was offset with a QTIP election. As such, after her husband’s death, the appreciated assets were held in a marital trust for the surviving spouse, the original donor of the assets. Two other marital trusts were created for the benefit of the surviving spouse. The three marital trusts engaged in a series of transactions that effectively terminated the marital trusts, with a subsequent sale of the assets by the surviving spouse to the children for a deferred annuity. These transactions were at issue in the case, and the tax court concluded that a taxable gift was deemed to occur upon the sale of the marital trust assets under section 2519. However, in a footnote, the Tax Court provided that all of the assets in the marital trusts, including the appreciated assets gifted to him shortly before death, received a step-up in basis under section 1014 of the Code.<sup>283</sup> The decision and the result of the case (in particular the with respect to section 1014(e)) have been criticized by a number of commentators.<sup>284</sup>

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<sup>277</sup> § 1014(e)(1)(A).

<sup>278</sup> § 1014(e)(1)(B).

<sup>279</sup> § 1014(e)(1)(flush language).

<sup>280</sup> § 1014(e)(2)(B).

<sup>281</sup> See PLRs 200210051, 200101021, 9026036, and TAM 9302002.

<sup>282</sup> T.C. Memo 2013-43.

<sup>283</sup> “All of the underlying trust assets, including the OG&E stock transferred to Mr. Kite in 1995, received a step-up in basis under sec. 1014.” *Estate of Kite v. Commissioner*, T.C. Memo 2013-43, footnote 9.

<sup>284</sup> See Jeffrey N. Pennell, *Jeff Pennell on Estate of Kite: Will it Fly?*, LISI Estate Planning Newsletter #2062 (Feb. 11, 2013) and John J. Scroggin, *Understanding Section 1014(e)*, LISI Estate Planning Newsletter #2192 (Feb. 6, 2014).

E. Community Property and Elective/Consensual Community Property

1. The Code provides a special rule for community property. Section 1014(b)(6) provides that “property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate”<sup>285</sup> shall be deemed to have been acquired from or to have passed from the decedent.

2. There are currently nine community property states: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. There are two states that are separate property states but they allow couples to convert or elect to treat their property as community property: Alaska<sup>286</sup> and Tennessee.<sup>287</sup> Generally, these elective or “consensual community property” laws allow resident and nonresident couples to classify property as community property by transferring the property to a qualifying trust, and for nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary of such state, and specific language declaring the trust asset as community property.

3. Clearly, for residents of separate property states, taking advantage of the “consensual community property” laws of another state has the potential for a basis adjustment under section 1014(b)(6). There has been no direct ruling on whether that would be the case under the laws of Alaska or Tennessee. However, a number of commentators have argued that assets in such “consensual community property” arrangements would, indeed, receive a full “step-up” in basis under section 1014(b)(6).<sup>288</sup> A professional fiduciary must be designated in Alaska or Tennessee in order to invoke the respective statutes and the administrative expense ought to be weighed against the potential benefit, taking into consideration the uncertainty.

F. Establishing Community Property and Maintaining the Character

1. Given how valuable the full “step-up” in basis under section 1014(b)(6) can be for community property, practitioners should pay special attention to methods of transmuting separate property to community property and maintaining the community property even if the couple moves to a separate property state. Married couples who move from a separate property state and establish residence in a community property state can typically transmute their separate

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<sup>285</sup> § 1014(b)(6).

<sup>286</sup> Alaska Stat. 34.77.010 et al. (Alaska Community Property Act).

<sup>287</sup> Tenn. Code Ann. § 35-17-101 et al. (Tennessee Community Property Trust Act of 2010).

<sup>288</sup> Jonathan G. Blattmachr, Howard M. Zaritsky and Mark L. Ascher. *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Probate and Tr. J. 615 (Winter 1999). See also *Commissioner v. Harmon*, 323 U.S. 44 (1944) (an Oklahoma income tax case involving elective community property), *McCollum v. U.S.*, 58-2 USTC § 9957, 2 A.F.T.R.2d 6170 (N. D. Okla. 1958) (explaining what *Harmon* meant, and distinguishing it in the context of basis), and Rev. Rul. 77-359, 1977-2 C.B. 24.

property to community property by way of agreement.<sup>289</sup> By way of example, California provides “married persons may by agreement or transfer, with or without consideration... transmute separate property of either spouse to community property.”<sup>290</sup> As long as the couple has the intent to remain permanently in the community property state, the transmutation could occur immediately upon establishing residence in the state. In other words, there is no time requirement after establishing residency when transmutation would be considered valid.

2. Generally, if a couple moves from a community property state to a separate property state, the property will continue to maintain its community property status (but see below). However, maintaining that status to maximize the benefit of section 1014(b)(6) can be a challenge. For example, if community property is sold to purchase real property located in a separate property state, some courts have provided that the real property is held by the couple as tenants in common, notwithstanding the fact that the source of the funds is community property. Furthermore, if one spouse transfers assets to another spouse outright (as often happens in the estate planning process to “equalize” the estates of the spouses who are now living in a separate property state), the property is no longer considered community property. Generally income from community property and reinvestments of such income will retain its community property character. Money earned while domiciled in a separate property state will obviously be considered separate property. It is quite easy for commingling of funds to occur if, for example, an asset is bought with both community and separate property. Tracing of the funds and the income from such funds will be required from that point forward. As such, practitioners in separate property states should pay special attention to those clients who move from community property states and may want to consider ways to ensure and make clear how such property will continue to be held and reinvested.

3. Fourteen separate property states (Alaska, Arkansas, Colorado, Florida, Hawaii, Kentucky, Michigan, Montana, New York, North Carolina, Oregon, Utah, Virginia, and Wyoming) have enacted the Uniform Disposition of Community Property Rights at Death Act (“UDCPRDA”). UDCPRDA provides that property that was originally community property will retain its character as such for testamentary purposes. The UDCPRDA is limited in scope,<sup>291</sup> and is not a tax statute. It is not clear whether decedents with surviving spouses who live in a state that has enacted the UDCPRDA are in a better position to claim the “step-up” in basis under section 1014(b)(6), than those decedents who do not. Regardless, some practitioners worry that the UDCPRDA does not mandate community property treatment for section 1014 purposes at all, rather it merely means that the property will be treated “the same as” community property for state law purposes. Section 1014(b)(6) requires that property be treated as community property under the law of some state; if a state does not have the concept of community property, does the UDCPRDA treat non-community property as if it were community property, or does it transmute non-community property into community property? There appears to be no definitive Federal tax authority on the point.

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<sup>289</sup> Simply moving to a community property state will typically not automatically cause separate property to be considered community property.

<sup>290</sup> Cal. Fam. Code § 850.

<sup>291</sup> It is limited to real property, located in the enacting state, and personal property of a person domiciled in the enacting state.

G. Joint Revocable Trusts and the “JEST”

1. Following in the line of a number of rulings,<sup>292</sup> a planning technique referred to as the “Joint Exempt Step-Up Trust” (“JEST”) has arisen that seeks to give married couples residing in non-community property states some of the same “step-up” in basis enjoyed by couples who pass away with community property under section 1014(b)(6). The attorneys who developed this technique have published the details of the JEST, including the numerous tax, creditor protection, and other legal issues surrounding the technique.<sup>293</sup>

2. The basic structure of the JEST is:

a. Married couple funds a jointly-established revocable trust, with each spouse owning a separate equal share in the trust. Either spouse may terminate the trust while both are living, in which case the trustee distributes 50% of the assets back to each spouse. If there is no termination, the joint trust becomes irrevocable when the first spouse dies. The first dying spouse has a general power of appointment over all trust assets.

b. Upon the first death, all assets are includible in the estate of the first to die.

c. Upon the first death, assets equal in value to the first dying spouse’s unused Available Exemption Amount will be used to fund a bypass trust (“Credit Shelter Trust A”) for the benefit of the surviving spouse and descendants. These assets will receive a stepped-up basis and will escape estate tax liability upon the surviving spouse’s death. Any asset in excess of the funding of Credit Shelter Trust A will go into an electing qualified terminable interest property trust (“QTIP Trust A”) under section 2056(b)(7). The assets in the QTIP Trust receive a step-up in basis upon the first spouse’s death and on the surviving spouse’s death.

d. If the first dying spouse’s share is less than his or her Available Exemption Amount, then the surviving spouse’s share will be used to fund a “Credit Shelter Trust B” with assets equal to the excess exemption. According to the authors of this technique, the assets of the Credit Shelter Trust B will avoid estate taxation at the surviving spouse’s death, notwithstanding that the surviving spouse originally contributed the assets to the JEST and had the power to terminate the trust and reclaim the assets. The authors provide that in order to further assure a step-up in basis on the assets in the Credit Shelter Trust B, it is best that the surviving spouse is not a beneficiary of Credit Shelter Trust B or perhaps to only be a beneficiary that may be added by an independent trust protector in the future.

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<sup>292</sup>PLRs 200102021, 200210051, 200604028, 200413011, 200403094 and TAM 9308002

<sup>293</sup> Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1*, 40 Est. Plan. 3 (Oct. 2013), Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2*, 40 Est. Plan. \_\_\_\_ (Nov. 2013), and Gassman, Ellwanger & Hohnadell, *It’s Just a JEST, the Joint Exempt Step-Up Trust*, Steve Leimberg’s Estate Planning Email Newsletter-Archive Message #2086 (4/3/13).

e. Any assets remaining of the surviving spouse's share in excess of what is funded into Credit Shelter Trust B will be used to fund a QTIP Trust B.

f. The traditional concerns with this sort of planning have been whether there is one or more taxable gifts between the spouses in creating and funding the trust, and whether the desired "step-up" is available. Definitive guidance remains scarce.

#### H. Section 2038 Estate Marital Trusts

1. Another possible method of providing a "step-up" in basis for all marital assets on the death of the first spouse to die is using what is sometimes referred to as a "Section 2038 Estate Marital Trust." The basic features of a Section 2038 Estate Marital Trust are:

a. Grantor (the "Grantor Spouse") contributes assets to a trust for the benefit of his or her spouse (the "Beneficiary Spouse"). The Grantor Spouse can be the sole trustee or co-trustee of the trust. The trustee has the discretion to distribute income and principal only to the Beneficiary Spouse for such spouse's lifetime. Upon the Beneficiary Spouse's death, the trust assets pass to the Beneficiary Spouse's estate.

b. The Grantor Spouse retains a right to terminate the trust prior to the Beneficiary Spouse's death. Upon such termination, the trust assets must be distributed outright to the Beneficiary Spouse.

c. The Grantor Spouse retains the power, in a non-fiduciary capacity, to reacquire or "swap" the trust corpus by substituting other property of an equivalent value.

2. The trust does not provide for distribution of all income annually<sup>294</sup> or for the conversion of unproductive property<sup>295</sup> as would be required for a general power of appointment marital trust or QTIP Trust. However, the trust should qualify for the gift tax marital deduction because the trust funds are payable only to the Beneficiary Spouse's estate, and thus the spouse's interest is not a nondeductible terminable interest under section 2523(b).<sup>296</sup>

3. The contribution of assets to the trust should be a completed gift notwithstanding the Grantor Spouse's right to change the manner or time of enjoyment of the assets because the only beneficiary of the trust is the Beneficiary Spouse or the estate of the Beneficiary Spouse.<sup>297</sup>

4. During the lifetime of the Beneficiary Spouse, the trust will be treated as a grantor trust for income tax purposes with respect to the Grantor Spouse under section 677(a) which provides, in pertinent part, that the "grantor shall be treated as the owner of any portion of

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<sup>294</sup> See §§ 2056(b)(5), 2056(b)(7)(B)(ii)(I), Treas. Reg. § 20.2056(b)-7(d)(2), Rev. Rul. 72-333, 1972-2 C.B. 530, and Rev. Rul. 68-554, 1968-2 C.B. 412.

<sup>295</sup> See Treas. Reg. §§ 20.2056(b)-5(f)(4) and 20.2056(b)-5(f)(5).

<sup>296</sup> See Treas. Reg. §§ 25.2523(a)-1(b)(3), 25.2523(b)-1 and 20.2056(c)-2(b)(1)(iii).

<sup>297</sup> See Treas. Reg. § 25.2511-2(d).

a trust... whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor ... may be distributed to ... the grantor's spouse"<sup>298</sup> or "held or accumulated for future distribution to ... the grantor's spouse."<sup>299</sup> Because the Beneficiary Spouse and his or her estate is the sole beneficiary of the lifetime and the remainder interests, grantor trust treatment should be as to all of the assets in the trust and as to both income and principal.<sup>300</sup> Thus, no portion of the trust's income should be taxable as a non-grantor trust. However, in order to ensure grantor trust status as to all of the assets and tax items of the trust, practitioners might consider having the Grantor Spouse retain the power, in a non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.<sup>301</sup>

5. If the Beneficiary Spouse dies first, the trust assets will be payable to his or her estate and thus are includible in the gross estate under section 2031 and entitled to a "step-up" in basis.

6. If the Grantor Spouse dies first, the trust assets will be includible in the gross estate under section 2038. It provides, the gross estate will include the value of all property "[t]o the extent of any interest therein of which the decedent has at any time made a transfer ... by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death."<sup>302</sup>

#### I. The Tax Nature of Particular Assets

##### 1. Generally

a. Understanding how and to what extent assets will benefit from a "step-up" in basis is critical to the estate planning process. Obviously, certain assets like highly-appreciated assets will benefit more from the "step-up" in basis at death than cash (which has a basis equal to its face value which is equal to its fair market value) or property at a loss (a "step-down" in basis). Moreover, appreciated assets like gold that are considered "collectibles"<sup>303</sup> under the Code, benefit more from a step-up in basis than other appreciated capital assets because the Federal long-term capital gain tax rate for collectibles is 28%, rather than 20%.

b. A list of asset categories or types starting with those that benefit the most from the "step-up" in basis and ending with those that benefit the least (or actually suffer a "step-down" in basis), might look like this:

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<sup>298</sup> § 677(a)(1).

<sup>299</sup> § 677(a)(2).

<sup>300</sup> See Treas. Reg. § 1.677(a)-1(g).

<sup>301</sup> § 675(4)(C) and Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

<sup>302</sup> § 2038(a)(1).

<sup>303</sup> § 1(h)(4).

- (1) Creator-owned intellectual property (copyrights, patents, and trademarks), intangible assets, and artwork;
- (2) “Negative basis” commercial real property limited partnership interests;
- (3) Oil & gas investment assets (to be sold after date of death);
- (4) Investor/collector-owned artwork, gold, and other collectibles;
- (5) Low basis stock or other capital asset;
- (6) Roth IRA assets;
- (7) Oil & gas investment assets (to be held after date of death);
- (8) Qualified Small Business Stock (QSBS);
- (9) High basis stock;
- (10) Cash;
- (11) Passive Foreign Investment Company (PFIC) Shares;
- (12) Stock or other capital asset that is at a loss;
- (13) Variable annuities;
- (14) Qualified Opportunity Zone (QOZ) investments; and
- (15) Traditional IRA and qualified plan assets.

c. A full discussion of every asset type listed above is beyond the scope of these materials, but a number of them deserve additional consideration and discussion.

## 2. Creator-Owned Intellectual Property, Intangible Assets and Artwork

### a. Generally

(1) In the hands of the creator, intellectual property, intangible assets and artwork represent the type of asset that, from a tax standpoint, benefits greatly from the “step-up” in basis. For the most part, during the lifetime of the creator, these assets have little or no basis in the hands of the creator, and the sale, exchange, disposition, licensing or other exploitation of these types of assets are considered ordinary income to the creator. If the asset is transferred in a “carry-over” basis transaction like a gift, the tax attributes carry to the donee. On the other hand, if the creator of the asset dies with the asset, the asset is entitled to a “step-up” in basis and the asset becomes a long-term capital gain asset in the hands of the beneficiaries.

(2) Patents, copyrights, and trademarks are common assets, but intangible rights might also include the right of publicity, defined loosely as the right of an

individual to have a monopoly on his or her own name, likeness, attributes, etc. In the case of well-known artists, actors, and celebrities, this right of publicity can be quite valuable. Some states, like New York, do not recognize a postmortem right to publicity,<sup>304</sup> while approximately 19 states have specifically codified the postmortem right to publicity. Notably, California<sup>305</sup> has codified the postmortem right to publicity, which lasts for a term of 70 years after the death of the personality. Further, the California statute specifically provides that such rights are freely transferable during lifetime or at death.

(3) As one can see, each of these intangible assets has its own peculiarities (e.g., the duration of the intangible rights) that may affect its value at the date of transfer (whether during lifetime or at death) and that may affect whether the asset or particular rights can be transferred at all.

b. Copyrights

(1) Under U.S. law, copyright protection extends to “original words of authorship fixed in any tangible medium of expression,” which includes: “(1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works.”<sup>306</sup> The courts have ruled that computer software constitutes protected literary works.<sup>307</sup>

(2) Knowing the duration of an existing copyright is critical to understanding what value a copyright may have today and what value a copyright may have in the future.

(a) For works copyrighted on or after January 1, 1978, a copyright’s duration is based upon the life of the author plus 70 years.<sup>308</sup>

(b) For works copyrighted prior to January 1, 1978, a copyright’s duration was 28 years, with the author (and his or her estate) having the right to renew and extend the term for another 67 years (for a total of 95 years).<sup>309</sup>

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<sup>304</sup> See, *Milton H. Greene Archives Inc. v. Marilyn Monroe LLC*, No. 08-056471 (9<sup>th</sup> Cir. 8/30/12), *aff’g* 568 F. Supp. 2d 1152 (C.D. Cal. 2008). See <http://rightofpublicity.com> for a good discussion of statutes, cases, and current controversies, maintained by Jonathan Faber of the Indiana University McKinney School of Law.

<sup>305</sup> Ca. Civ. Code § 3344.

<sup>306</sup> 17 U.S.C. § 102(a)(1)-(8).

<sup>307</sup> See, e.g., *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1243 (3<sup>rd</sup> Cir. 1983).

<sup>308</sup> 17 U.S.C. § 302(a).

<sup>309</sup> 17 U.S.C. § 304.

(3) For works copyrighted on or after January 1, 1978, the author (or the author's surviving spouse or descendants if the author is deceased) has a right to terminate any transfer or assignment of copyright by the author 35 years after the transfer or assignment.<sup>310</sup> These termination rights apply "in the case of any work other than a work made for hire, the exclusive or nonexclusive grant of a transfer or license of copyright or of any right under a copyright, executed by the author on or after January 1, 1978, otherwise than by will."<sup>311</sup> Because only the author has the right of termination during his or her lifetime, even if a gift is made of the copyright, the author's continued right of termination calls into question how the copyright can be irrevocably transferred (especially since there seems no mechanism to waive the termination right) and appropriately valued for transfer tax purposes.

(4) Payments to the creator of a copyright on a non-exclusive license give rise to royalty income, taxable as ordinary income.<sup>312</sup> An exclusive license (use of substantially all of the seller's rights in a given medium) is treated as a sale or exchange. When the creator is the seller, it is deemed to be a sale of an asset that is not a capital asset,<sup>313</sup> so it is taxed at ordinary rates. By contrast, if the seller is not the creator, capital asset treatment under section 1221 is available if such seller is not a dealer.<sup>314</sup> Notwithstanding the foregoing, if the creator/author of the copyright, gifts the asset (carryover basis transaction), a sale or exchange by the donee is not afforded capital treatment either.<sup>315</sup> A gift for estate planning purposes, therefore, may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.

(5) In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a "step-up" in basis to full fair market value under section 1014 and the asset is transformed into a long-term capital gain asset. Because the basis of the copyright included in the creator's estate is no longer tied to that of the creator, the asset no longer falls within the exclusion from capital asset treatment under section 1221(a)(3) and, thus, are capital assets in the hands of the creator's beneficiaries. The copyright is deemed to immediately have a long-term holding period even if it is sold within 1 year after the decedent's death.<sup>316</sup>

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<sup>310</sup> 17 U.S.C. § 203(a).

<sup>311</sup> *Id.*

<sup>312</sup> § 61(a)(6). *See also* Treas. Reg. § 1.61-8. Rev. Proc. 2004-34, 2004-22 I.R.B. 964, allows certain taxpayers to defer to the next taxable year, certain payments advance royalty payments.

<sup>313</sup> § 1221(a)(3). § 1221(b)(3) provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have § 1221(a)(3) not apply to a sale or exchange.

<sup>314</sup> It could also be afforded § 1231 treatment (asset primarily held for sale to customers in the ordinary course of a trade or business).

<sup>315</sup> § 1221(a)(3)(C).

<sup>316</sup> § 1223(9).

c. Patents

(1) Individuals who patent qualifying inventions are granted the “right to exclude others from making, using, offering for sale, or selling”<sup>317</sup> such invention for a specified term. The term for a utility or plant patent is 20 years, beginning on the earlier of the date on which the application for the patent was filed.<sup>318</sup> The term for a design patent is 14 years from the date of grant.<sup>319</sup>

(2) Similar to the taxation of copyrights, payments received for a transaction that is not considered a sale or exchange or payments received for a license will be considered royalty income, taxable as ordinary income.<sup>320</sup>

(3) Prior to the enactment of TCJA, the sale or exchange of a patent could be afforded capital gain treatment if the transaction qualified under section 1235 of the Code or because the Treasury regulations specifically provide that a patent or invention are not considered “similar property”<sup>321</sup> to a copyright, which is excluded from capital gain treatment.<sup>322</sup> In addition, capital gain treatment under section 1231 of the Code would be possible but only if the patent is considered to have been “used in a trade or business.”<sup>323</sup>

(4) Effective for dispositions after December 31, 2017, TCJA amended section 1221(a)(3) of the Code providing that “a patent, invention, model or design (whether or not patented), and a secret formula or process”<sup>324</sup> which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will be specifically excluded from the definition of a capital asset. In addition, TCJA makes a conforming amendment to section 1231(b)(1)(C) of the Code, specifically listing “a patent, invention, model or design (whether or not patented), and a secret formula or process” (just like a copyright) as an asset that is excepted from the term “property used in a trade or business.”<sup>325</sup> As such the sale or exchange

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<sup>317</sup> 35 U.S.C. § 154(a)(1).

<sup>318</sup> 35 U.S.C. § 154(a)(2).

<sup>319</sup> 35 U.S.C. § 173.

<sup>320</sup> § 61(a)(6). *See also* Treas. Reg. § 1.61-8.

<sup>321</sup> “For purposes of this subparagraph, the phrase “similar property” includes for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.” Treas. Reg. § 1.1221-1(c)(1).

<sup>322</sup> Even with the exclusion from “similar property,” the individual generally had to be considered a non-professional inventor (otherwise the patent would be considered stock in trade or inventory in the hands of a professional inventor).

<sup>323</sup> § 1231(a)(3)(A)(i). The holding period is deemed to start when the patent is reduced to practice. *Kuzmick v. Commissioner*, 11 T.C. 288 (1948).

<sup>324</sup> § 1221(a)(3).

<sup>325</sup> § 1231(b)(1)(C).

of such property will no longer qualify for capital gain tax treatment unless it falls under section 1235 of the Code.

(5) Like the tax treatment of the creator of a copyright, if the creator dies with a patent, the asset is entitled to a “step-up” in basis to full fair market value under section 1014, and the asset is transformed into a long-term capital gain asset.

(6) Section 1235 Transactions

(a) The House bill of TCJA proposed a repeal of section 1235 of the Code, but the repeal did not make it the final version of TCJA.

(b) Section 1235 provides that a “transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 1 year.”<sup>326</sup>

(c) Only an individual may qualify as a holder, regardless of whether he or she is in the business of making inventions or in the business of buying and selling patents.<sup>327</sup> Specifically, a qualified “holder” includes (i) the creator of the patent,<sup>328</sup> or (ii) “any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent,”<sup>329</sup> provided that in such instance, the individual is not an employer of the creator or related to the creator.<sup>330</sup> As such, a trust, estate, or corporation will not qualify as a holder under section 1235, although a transfer to a grantor trust would not likely disqualify a subsequent sale or exchange to capital gain treatment.<sup>331</sup> An entity taxable as a partnership does not qualify as a holder, but each individual in the partnership may qualify separately as such.<sup>332</sup>

(d) A sale or exchange by a qualified holder to a “related person” will not qualify for capital-gain treatment under section 1235.<sup>333</sup> A “related person” is generally defined by reference to section 267(b) and includes (i) the holder’s spouse, ancestors,

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<sup>326</sup> § 1235(a).

<sup>327</sup> § 1235(a)(2) and Treas. Reg. § 1.1235-2(d)(3).

<sup>328</sup> § 1235(b)(1).

<sup>329</sup> § 1235(b)(2).

<sup>330</sup> § 1235(b)(2)(A)-(B).

<sup>331</sup> See Treas. Reg. § 1.671-2(c). If a holder sells his or her interest in a transfer qualifying under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as income in respect of a decedent.

<sup>332</sup> Treas. Reg. § 1.1235-2(d)(2). See also, PLRs 200135015, 200219017, 200219019, 200219020, 200219021, 200219026, 200506008, 200506009, and 200506019.

<sup>333</sup> § 1235(d).

and lineal descendants (but not siblings);<sup>334</sup> (ii) a fiduciary of any trust of which the holder is the grantor; (iii) any corporation, partnership, or other entity in which the holder (and other related persons) own 25% or more of the ownership interests.<sup>335</sup>

(e) Because of the foregoing limitations of who can qualify as a holder and the related person limitations on who can be the transferee, many standard estate planning techniques involving patents must be modified if capital gain treatment is to be retained.

(f) If a qualified holder sells his or her interest in a patent under section 1235 and later dies before all payments are received, the estate and/or beneficiary of the deceased reports the payments as long-term capital gain as IRD.<sup>336</sup>

d. Artwork

(1) The taxation of artwork in the hands of the artist is the same as it would be for the creator of a copyright, as discussed above. Generally, all payments pursuant to a license and a taxable sale or exchange of the artwork give rise to ordinary income.<sup>337</sup> A third-party collector or investor in the artwork might qualify for capital gain treatment or section 1231 treatment, as long as the property is not held out for sale in the ordinary course of a trade or business (inventory).<sup>338</sup> Similarly, capital gain treatment is not available to a donee of the artist because the donee's basis is determined by reference to the artist's basis.<sup>339</sup>

(2) Artwork in the hands of a collector or investor (third-party other than the creator or a donee of the creator) is considered a collectible under the Code and would be subject to the 28% long-term capital gain tax, rather than 20%.<sup>340</sup> Under the Code, a "collectible" is any work of art, rug, antique, metal, gem, stamp, coin, alcoholic beverage, or any other tangible personal property designated by the IRS as such.<sup>341</sup>

(3) As with copyrights and patents, the basis of property in the hands of a person acquiring property from a deceased artist is the fair market value of the property at the date of the artist's death or on the alternate valuation date, if so elected.<sup>342</sup> The artwork in the

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<sup>334</sup> § 1235(d)(2)

<sup>335</sup> § 1235(d)(1).

<sup>336</sup> § 691 and Treas. Reg. § 1.691(a)(3).

<sup>337</sup> §§ 1221(a)(3) and 61(a)(6). Section 1221(b)(3) of the Code provides a limited exception for copyrights in musical works, pursuant to which the taxpayer may elect to have section 1221(a)(3) not apply to a sale or exchange.

<sup>338</sup> § 1221(a)(1).

<sup>339</sup> §§ 1221(a)(5)(B) and 1015.

<sup>340</sup> § 1(h)(4).

<sup>341</sup> §§ 1(h)(5)(A) and 408(m)(2).

<sup>342</sup> § 1014(a).

hands of the estate or the artist's beneficiaries becomes a capital asset, qualifying for long-term capital gain treatment.<sup>343</sup>

3. “Negative Basis” and “Negative Capital Account” Partnership Interests

a. “Negative basis” is the colloquial phrase used to describe a situation where the liabilities in a partnership (as also shared by the partners) are in excess of the tax basis of the partnership assets (and consequently, often in excess of the basis of the partners' interests in the partnership). Of course, because the basis of an asset may not go below zero the phrase “negative basis” is technically incorrect. Regardless, often it is common in those situations for a taxable sale of the partnership property (or of the partnership interest) to create “phantom gain.” Even successful real property investment partnerships may have “negative basis” assets where the underlying developed real property has been fully depreciated and cash from one or more refinancings has been distributed to the owners or partners.

b. The following example illustrates how this “negative basis” problem can arise and how costly a taxable event would be from an income tax standpoint:

(1) Taxpayer borrows \$10 million to buy an office building in 1983 (assume for purposes of this example, the entire purchase price is properly allocated to the office building, which is depreciable). Over the next 30 years, the property appreciates in value, the taxpayer fully depreciates the original basis of \$10 million in the building to zero,<sup>344</sup> borrows against the property, and takes the borrowed funds tax free. As a result in 2014, the office building is worth \$20 million, has zero adjusted tax basis, and has a mortgage on the building of \$15 million (\$5 million of net equity in the property).

(2) Note, because the property was placed in service in 1983, an accelerated method of depreciation was allowable on the property.<sup>345</sup> As such, a taxable sale of the property will be subject to recapture under the Code. Because the property was placed in service prior to 1986, recapture is under section 1245 (rather than section 1250, which, as

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<sup>343</sup> See §§ 1221(a)(3) and 1223(9).

<sup>344</sup> §§ 1016(a)(2), 168(a), and Treas. Reg. § 1.1016-3(a)(1)(i).

<sup>345</sup> Accelerated Cost Recovery System (“ACRS”) was enacted in 1981 under the Economic Recovery Tax Act of 1982 (“ERTA”), P.L. 97-34. ACRS was later modified by the Tax Equity and Fiscal Responsibility Act of 1982 (“TEFRA”), P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, when the recovery period for most real property was extended from 15 to 18 years. In 1985, the real property recovery period was extended from 18 to 19 years, P.L. 99-121, § 103. ACRS generally applies to property placed in service after December 31, 1980, and before December 31, 1986. Prop. Treas. Reg. § 1.168-4(a). The Tax Reform Act of 1986, P.L. 99-514, (“TRA 1986”) dramatically changed the applicability of ACRS to real property investments and instituted the modified ACRS (“MACRS”). Notably, the “applicable recovery period” for most real property assets like buildings are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or 20-year recovery periods. § 168(c). In this example, because it was placed in service before 1984, the building would be considered 15-year real property, pursuant to which the applicable percentage of depreciation was 12% in the first year, reducing to 5% in from 11 to 15 years.

discussed above, generally applies to real property).<sup>346</sup> As such, the total amount of the depreciation deductions is subject to recapture as ordinary income.<sup>347</sup>

(3) If the building is sold for \$20 million in a taxable transaction, the gain would break down as follows:

Amount Recognized:	\$20,000,000
Adjusted Basis:	\$ -----
Recapture:	\$10,000,000 ordinary income
Long-Term Capital Gain:	\$10,000,000 long-term capital gain

Assuming the building is located in a high tax jurisdiction like New York City, and the taxpayer is in the highest income tax bracket, the ordinary rate would be approximately 48% and the long-term capital gain rate would be approximately 37%. The total tax liability would be \$8.5 million. After repayment of the \$15 million of debt, the taxpayer (who would net \$5 million in cash from the transaction before taxes) would actually be in deficit by approximately -\$3.5 million after the payment of income taxes.

(4) Compare the result if the taxpayer died owning the building (assume for simplicity's sake, the building no longer has a mortgage). The building would get a "step-up" in basis under section 1014(a) to fair market value, the recapture and long-term capital gain tax problem would be eliminated. If the taxpayer has \$6.03 million of Basic Exclusion Amount available, the maximum estate tax liability (assuming a top state death tax rate of 16% and state death tax exemption equal to the federal exclusion amount) is approximately \$6.9 million (maximum blended rate of 49.6%). If the Basic Exclusion Amount grows to \$8 million for example, then the estate tax liability falls to a bit less than \$6.0 million. If the foregoing building was in California, the income tax liability would be greater, and the estate tax cost would be even less because California does not have a death tax. With a Basic Exclusion Amount of \$6.03, the estate tax liability is less than \$5.6 million.

(5) Property placed in service after 1986 will not have as egregious of an income tax problem because the gain would not have recapture calculated under section 1245. Rather, section 1250 would be the applicable recapture provision. "Section 1250 property" means any real property, with certain exceptions that are not applicable,<sup>348</sup> that is or has been property of a character subject to the allowance for depreciation.<sup>349</sup> Section 1250(a)(1)(A)

<sup>346</sup> § 1245(a)(5) before being amended by TRA 1986, defines "§ 1245 recovery property" to include all recovery property under ACRS, real or personal, other than certain types of 19-year (18-year for property placed in service after March 15, 1984, and before May 9, 1985; and 15-year for property placed in service before March 16, 1984) real property and low-income housing: residential rental property, property used "predominantly" outside the United States, property as to which an election to use straight-line recovery is in effect, and certain low-income and Federally insured residential property. The foregoing types of property are subject to recapture under Section 1250. In this example, the office building does not fall within the listed categories, and as such is subject to recapture under Section 1245.

<sup>347</sup> See § 1245(a)(1).

<sup>348</sup> § 1245(a)(3).

<sup>349</sup> § 1250(c).

provides that if section 1250 property is disposed of, the “applicable percentage” of the lower of the “additional depreciation” in respect of the property or the gain realized with respect to the disposition of the property shall be treated as ordinary income. In short, section 1250 provides that all or part of any depreciation deduction in excess of straight-line depreciation is recaptured as ordinary income.<sup>350</sup> Under the current depreciation system, straight-line depreciation is required for all residential rental and nonresidential real property.<sup>351</sup> As such, section 1250 recapture is typically not a problem for property placed in service after 1986. The Code does, however, tax “unrecaptured section 1250 gain” at a 25% tax rate. Unrecaptured section 1250 gain is essentially the lesser of all depreciation on the property or the net gain realized (after certain losses) to the extent not treated as ordinary income under section 1250.<sup>352</sup>

(6) From an estate planning perspective, it is important to remember that even if recapture is inherent in an appreciated property, it does not apply to a disposition by gift or to a transfer at death, unless the recapture would be considered income in respect of a decedent.<sup>353</sup>

c. Today, most real property investments are not held individually, but are held in an entity taxable as a partnership (a limited liability company or limited partnership). When real property investments are subject to refinancing followed by a distribution of the loan proceeds, the partnership debt rules under section 752 must be considered when determining the income tax cost of selling such property. Any increase in a partner’s share of partnership liabilities (whether recourse or nonrecourse to such partner) is treated as a contribution of money by the partner to the partnership, resulting in an increase in the partner’s basis in his or her partnership interest (“outside basis”).<sup>354</sup> Any decrease in a partner’s share of partnership liabilities is treated as a distribution of money by the partnership to the partner, resulting in a decrease in the partner’s outside basis.<sup>355</sup> A partner’s outside basis may not be reduced below zero, so a deemed distribution of money that arises from a decrease in a partner’s share of liabilities will give rise to gain recognition.<sup>356</sup>

d. In the example above, consider if a limited partnership (or limited liability company taxed as a partnership) had borrowed the \$10 million on a nonrecourse basis to purchase the building. As *Crane* and *Tufts* held, the \$10 million of nonrecourse debt provides basis in the building,<sup>357</sup> which in turn provides depreciation deductions on the property. In the partnership context, this creates “nonrecourse deductions.”<sup>358</sup> Generally, nonrecourse deductions

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<sup>350</sup> § 1250(b)(1), (3), (5).

<sup>351</sup> § 168(b)(3)(A)-(B).

<sup>352</sup> § 1(h)(6).

<sup>353</sup> § 1250(d)(1) and (2).

<sup>354</sup> §§ 752(a) and 722. Treas. Reg. § 1.752-1(b).

<sup>355</sup> §§ 752(b) and 733. Treas. Reg. § 1.752-1(c).

<sup>356</sup> § 731(a) or 751.

<sup>357</sup> *Crane v. Commissioner*, 331 U.S. 1 (1947) and *Commissioner v. Tufts*, 461 U.S. 300 (1983).

<sup>358</sup> Treas. Reg. §§ 1.704-2(b)(1) and 1.704-2(c).

must be allocated in accordance with each partner's interest in the partnership.<sup>359</sup> The partnership debt also provides outside basis to the partners for their share of partnership liabilities.<sup>360</sup> As the partnership takes depreciation deductions, the basis of the property is reduced, and the outside basis of the partners is also reduced.<sup>361</sup> Eventually, in this simplified example, the basis of the building is zero, and so are the outside bases of the partners. In contrast to how basis is handled, the capital accounts of the partners start at zero and do not increase when the partnership borrows the \$10 million, because the partners have not made any contributions of money or property to the partnership and debt is ignored in determining each partner's capital accounts.<sup>362</sup> However, as the partnership takes depreciation deductions, the partners are allocated nonrecourse deductions, which reduce not only their outside bases, as mentioned, but also their capital accounts. In other words, assuming any income from the building is fully offset by interest expenses on the debt, the capital accounts of the partners go negative.<sup>363</sup> At the end of 30 years, the partners have a -\$10 million capital account balance and zero outside basis, and the partnership has a \$20 million building, collateralizing \$10 million of nonrecourse debt. When the partnership borrows an additional \$5 million against the net equity in the building in a refinancing, the partners get an additional \$5 million in outside basis, thereby allowing the partnership to distribute the \$5 million to the partners tax free.<sup>364</sup> In the end, the partners have zero outside basis and negative capital account balances of -\$15 million, and the partnership owns a \$20 million building with zero basis, which collateralizes \$15 million of debt. Debt is in excess of basis. As noted above, this paradigm is often referred to by the misnomer, "negative basis."<sup>365</sup>

e. A transfer by the taxpayer, whether a taxable sale or a gift to a non-grantor trust, will create "phantom gain" and *Tufts* and *Crane* tell us that any disposition will be considered a sale or exchange to the extent debt is in excess of basis. A partner who sells a partnership interest must include in income the partner's allocable share of the partnership's recapture from depreciated partnership property.<sup>366</sup> The transfer results in a decrease in the transferor partner's share of liabilities, which in turn is treated as a distribution of money to the partner when the partner has an outside basis of zero, resulting in gain in a donative transfer or additional gain in the case of taxable sale.<sup>367</sup>

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<sup>359</sup> Treas. Reg. § 10.74-1(b)(3).

<sup>360</sup> § 752(a).

<sup>361</sup> See § 705(a)(2).

<sup>362</sup> See Treas. Reg. § 1.704-1(b)(2)(iv)(b).

<sup>363</sup> *Id.*

<sup>364</sup> § 731(a).

<sup>365</sup> Partnership borrowings and payments of liabilities do not affect the capital accounts, because the asset and liability changes offset each other on the partnership balance sheet. See Treas. Reg. § 1.704-1(b)(2)(iv)(c).

<sup>366</sup> §§ 751 and 453(i)(2). Under § 751, unrealized receivables are deemed to include recapture property, but only to the extent the unrealized gain is ordinary income. Treas. Reg. § 1.751-1(e) and (g).

<sup>367</sup> Rev. Rul. 84-53, 1984-1 C.B. 159, Situation 4.

f. When dealing with highly appreciated, depreciable assets like real property and partnership debt, taxable sales of the property and inter vivos transfers of partnership interests can be problematic.<sup>368</sup> In recent years, given reduced transfer tax rates and large Basic Exclusion Amounts, it has often made more economic sense to die owning these assets than to transfer them during the partner's lifetime but decreases in the applicable exclusion could change that result. The transfer of a partner's interest on death is a disposition that does not result in gain or loss recognition, even if the liability share exceeds outside basis.<sup>369</sup> The outside basis of the decedent receives a "step-up" in basis to fair market value (net of liabilities) but is also increased by the estate's share of partnership liabilities.<sup>370</sup> Further, if the partnership makes an election under section 754, the underlying assets in the partnership will also receive a "step-up" in basis.<sup>371</sup>

g. Even if a section 754 election is not made, the estate or the successor beneficiaries of the partnership interest can get the benefit of a "step-up" in the underlying assets if the successor partner makes an election under section 732(d) and if the partnership distributes the assets for which there would have been a basis adjustment.<sup>372</sup> The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis in which has a tax significance.<sup>373</sup>

#### 4. Traditional IRA and Qualified Retirement Assets

a. At the end of 2017, the Investment Company Institute estimated that total retirement assets were over \$27 trillion (including government plans, private defined benefit plans, defined contribution plans and individual retirement accounts).<sup>374</sup> Assets in IRAs and defined contribution plans totaled more than ½ of the total at approximately \$16.3 trillion.

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<sup>368</sup> See Steve Breistone and Jerome M. Hesch, *Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution*, 53 Tax Mgmt. Memo. 311 (August 13, 2012).

<sup>369</sup> See Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

<sup>370</sup> §§ 1014(a), 1014(b), 742; Treas. Reg. §§ 1.1014-1(a), (b), and 1.742-1. The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3).

<sup>371</sup> § 743(a).

<sup>372</sup> § 732(d) and Treas. Reg. § 1.732-1(d)(1)(i)-(iii). The election is made by the distributee partner's attaching a schedule to the income tax return setting out (i) the election to adjust the basis of distributed property under Section 732(d), and (ii) the computation of the basis adjustment to the distributed properties. Treas. Reg. § 1.732-1(d)(3).

<sup>373</sup> Treas. Reg. § 1.732-1(d)(2).

<sup>374</sup> Investment Company Institute, *Release: Quarterly Retirement Market Data, Third Quarter 2017*, [http://www.ici.org/research/stats/retirement/ret\\_17\\_q3](http://www.ici.org/research/stats/retirement/ret_17_q3), as of September 30, 2017 (12/20/17).

Although IRA and qualified retirement assets make up one of the largest asset types of assets owned by individuals, they are one of the most problematic from an estate planning perspective.

b. IRA and qualified retirement assets are not transferable during the lifetime of the owner,<sup>375</sup> so the assets are never candidates for lifetime gifts unless the owner is willing to incur a taxable distribution of the assets. As such, to the extent not drawn-down prior to death, the assets are includible in the estate for transfer tax purposes,<sup>376</sup> and by definition, the assets will use some or all of the decedent's Basic Exclusion Amount, unless the assets are transferred to a surviving spouse under the marital deduction under section 2056 or to a charitable organization under section 2055.<sup>377</sup> To make things worse, IRA and qualified retirement assets are considered income in respect of a decedent (IRD) under section 691.<sup>378</sup> IRD assets are not entitled to a "step-up" in basis,<sup>379</sup> and all distributions (whether paid over time or not) to a beneficiary are taxable as ordinary income.<sup>380</sup> Even though the beneficiary is entitled to an income tax deduction<sup>381</sup> ("IRD deduction") for estate taxes payable by virtue of the inclusion of the assets, there is no Federal income tax deduction for state death taxes that might be payable, and given the reduced Federal transfer tax rate of 40% and the cost-of-living increase on the Basic Exclusion Amount, many taxpayers will have very little or no IRD deduction to shelter the on-going ordinary income tax problem.

c. A distribution from a decedent's IRA to a surviving spouse may be "rolled over" to another qualified retirement plan or IRA, thereby deferring the recognition of income.<sup>382</sup> In addition, if the surviving spouse is the beneficiary of all or a portion of the decedent's IRA, the surviving spouse may also elect to treat the decedent's IRA as his or her own IRA.<sup>383</sup> In both of the foregoing cases, the IRD problem discussed above continues after the death of the surviving spouse (unless the surviving spouse remarries).

d. Because of the income tax liability built-in to retirement plans and IRAs, they should be among the first assets considered for clients who intend to benefit charity at

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<sup>375</sup> See the anti-alienation provision in § 401(a)(13)(A).

<sup>376</sup> § 2039(a).

<sup>377</sup> The IRS has taken the position that qualified retirement assets used to fund a pecuniary bequest to a charitable organization will be considered an income recognition event, triggering ordinary income. CCA 200644020.

<sup>378</sup> See e.g., *Ballard v. Commissioner*, T.C. Memo 1992-217, *Hess v. Commissioner*, 271 F.2d 104 (3d Cir. 1959), Rev. Rul. 92-47, 1992-1 C.B. 198, Rev. Rul. 69-297, 1969-1 C.B. 131, PLR 9132021, and GCM 39858 (9/9/91).

<sup>379</sup> § 1014(c).

<sup>380</sup> §§ 61(a)(14), 72, 402(a) and 408(d)(1), assuming the decedent owner had no nondeductible contributions. See § 72(b)(1) and (e)(8).

<sup>381</sup> § 691(c)(1).

<sup>382</sup> § 402(c)(9).

<sup>383</sup> Treas. Reg. § 1.408-8, Q&A-5(a).

death. Many techniques are available beyond outright charitable gifts including, for example, testamentary funding of a charitable remainder trust.<sup>384</sup>

e. Contrast the foregoing treatment with Roth individual retirement plans (“Roth IRAs”).<sup>385</sup> Roth IRA assets are treated similarly to assets in a traditional IRA in that: (i) the account itself is not subject to income tax;<sup>386</sup> (ii) distributions to designated beneficiaries are subject to essentially the same required minimum distribution rules after the death of the original Roth IRA owner;<sup>387</sup> and (iii) surviving spouses may treat a Roth IRA as his or her own and from that date forward the Roth IRA will be treated as if it were established for the benefit of the surviving spouse.<sup>388</sup> In contrast to a traditional IRA, distributions to a qualified beneficiary are not taxable to the beneficiary,<sup>389</sup> and as discussed above, are not subject to the 3.8% Medicare Tax.<sup>390</sup> The overall result for decedents with Roth IRA assets, the qualified beneficiaries of the Roth IRA effectively receive the benefit of a “step-up” in basis. Since 2010,<sup>391</sup> all taxpayers regardless of adjusted gross income<sup>392</sup> can convert traditional IRA assets into a Roth IRA. The conversion is considered a taxable event causing the converted amount to be includible in gross income and taxable at ordinary income tax rates.<sup>393</sup> Taxpayers can also make direct taxable rollovers from qualified company-based retirement accounts (section 401(k), profit sharing, section 403(b), and section 457 plans) into a Roth IRA.<sup>394</sup> Individuals who have excess qualified retirement assets, have sufficient funds to pay the resulting tax liability from outside of the retirement account, and who are not planning to donate the asset to a charitable organization are should consider a Roth IRA conversion. Notwithstanding the clear benefits of passing the Roth IRA assets to children and grandchildren outside of the scope of the IRD provisions, not many individuals are willing to pay the income tax cost of the conversion.

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<sup>384</sup> See Paul S. Lee and Stephen S. Schilling, *CRTs Are Back (in Four Delicious Flavors)*, *Trusts & Estates* (Oct. 2014), p. 40-43.

<sup>385</sup> § 408A.

<sup>386</sup> Treas. Reg. § 1.408A-1, Q&A-1(b).

<sup>387</sup> Treas. Reg. § 1.408A-6, Q&A-14. One specific exception is the “at-least-as-rapidly” rule under § 401(a)(9)(B)(i).

<sup>388</sup> Treas. Reg. § 1.408A-2, Q&A-4.

<sup>389</sup> § 408A(d)(1).

<sup>390</sup> § 1411(c)(5).

<sup>391</sup> Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, effective for tax years beginning after December 31, 2009.

<sup>392</sup> Prior to this change, only taxpayers having less than \$100,000 in modified adjusted gross income could convert a Traditional IRA to a Roth IRA. Former § 408A(c)(3)(B).

<sup>393</sup> § 408A(d)(3)(A)(i).

<sup>394</sup> See Notice 2008-30, 2008-12 I.R.B. 638 (3/24/2008) and Notice 2009-75, 2009-39 I.R.B. 436 (9/28/2009). § 408A(d)(3)(A).

5. Passive Foreign Investment Company (PFIC) Shares

a. A PFIC is a foreign corporation, 75% or more of the gross of which is “passive,”<sup>395</sup> or the average percentage of assets that produce passive income of which is at least 50%.<sup>396</sup> The PFIC rules do not apply to any U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation.<sup>397</sup>

b. The PFIC rules generally provide that when a U.S. shareholder receives a distribution from a PFIC, rather than treating them under the normal rules of U.S. taxation (e.g., dividend treatment), a special tax regime applies. Under the PFIC tax regime, distributions from a PFIC will be treated either as “excess” or “nonexcess” distributions.

(1) An excess distribution is any portion that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder’s shares within the 3 preceding years (or shorter if the shareholder has held the shares for less than 3 years).<sup>398</sup> All other distributions or portions thereof are treated as nonexcess distributions.

(2) With respect to nonexcess distributions, the normal rules of U.S. taxation apply, which generally results in dividend treatment.<sup>399</sup> However, the dividend will not be considered a qualified dividend taxable at 20% because a PFIC will never be a “qualified foreign corporation.”<sup>400</sup>

c. The portion of any distribution that is considered an excess distribution will first be allocated to each day in the shareholder’s holding period for the shares.<sup>401</sup> Any portion so allocated to the current year and the non-PFIC years will be included in the year of receipt as ordinary income (not qualified dividends).<sup>402</sup>

d. The portion of the excess distribution that is allocated to other years (the “PFIC years”) is not included in the shareholders income, but is subject to a “deferred tax.”<sup>403</sup> The deferred tax is added to the tax that is otherwise due. In computing the “deferred tax” the shareholder multiplies the distribution allocated to each PFIC year by the top marginal

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<sup>395</sup> § 1297(a)(1). Generally, “passive income” is foreign personal holding company income, as provided in § 954(c). § 1297(b).

<sup>396</sup> § 1297(a)(2).

<sup>397</sup> § 1297(e).

<sup>398</sup> § 1291(b)(2)(A).

<sup>399</sup> Prop. Treas. Reg. § 1.1291-2(e)(1).

<sup>400</sup> See § 1(h)(11)(C)(iii).

<sup>401</sup> § 1291(a)(1)(A).

<sup>402</sup> § 1291(a)(1)(B).

<sup>403</sup> § 1291(c).

tax rate in effect for that year.<sup>404</sup> The shareholder then adds all of the “unpaid” tax amounts for all of the PFIC years, and then computes interest on those unpaid tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate.<sup>405</sup> The deferred tax and interest are separate line items on the individual shareholder’s income tax return.<sup>406</sup>

e. The sale of PFIC shares are considered excess distributions to the extent the consideration for the sale is in excess of the shareholder’s tax basis in the PFIC shares.<sup>407</sup> Thus, effectively the gain is treated as ordinary income, which is treated as realized ratably over the seller’s holding period for purposes of determining the deferred tax and interest for prior years.

f. U.S. shareholders of a PFIC may make a “qualified elective fund” (QEF) election to avoid the excess distribution regime. If the shareholder makes a QEF election, the shareholder must include in gross income a pro rata share of the PFIC’s ordinary income and net capital gain each taxable year.<sup>408</sup> If a shareholder makes this election, he or she must have access to the PFIC’s books and records so the allocable share of the PFIC’s income and gain can be calculated.

g. The death of a U.S. shareholder is not a taxable disposition of the PFIC shares if the death results in a transfer to a domestic U.S. estate or directly to another U.S. taxpayer.<sup>409</sup> By contrast, a transfer upon the death of a U.S. shareholder to a testamentary trust or to a foreign person will be considered a taxable disposition.<sup>410</sup> The proposed Treasury Regulations treat a transfer upon death as a transfer by the shareholder immediately prior to death and thus reportable in the decedent’s last tax return.<sup>411</sup>

h. If the PFIC shares are held in a grantor trust, the grantor’s death is a taxable disposition unless one of the exceptions applies.<sup>412</sup>

i. PFIC shares are nominally eligible for a “step-up” in basis. However, section 1291(e)(1) provides that a succeeding shareholder’s basis in PFIC shares is the fair market value of the shares on date of death but then reduced by the difference between the new basis under section 1014 and the decedent’s adjusted basis immediately before date of death.<sup>413</sup>

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<sup>404</sup> § 1291(c)(1).

<sup>405</sup> § 1291(c)(1) through (c)(3).

<sup>406</sup> § 1291(a)(1)(C).

<sup>407</sup> § 1291(a)(2).

<sup>408</sup> § 1293(a).

<sup>409</sup> Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A).

<sup>410</sup> Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B).

<sup>411</sup> Prop. Treas. Reg. § 1.1291-6(d)(2).

<sup>412</sup> Prop. Treas. Reg. § 1.1291-6(c)(3)(iv).

<sup>413</sup> § 1291(e)(1).

Thus, a succeeding shareholder's basis in PFIC shares received from a decedent is limited to the adjusted basis of the decedent prior to death.

j. The foregoing basis reduction rule does not apply to PFIC shares received by a succeeding U.S. shareholder upon the death of a nonresident alien decedent if the decedent was a nonresident alien during his or her entire holding period.<sup>414</sup>

6. Qualified Small Business Stock (QSBS)<sup>415</sup>

a. Section 1202 of the Code excludes a percentage of gain (50%, 75%, or 100%, depending on the original acquisition date) on the sale or exchange of "Qualified Small Business Stock" (QSBS) held for more than five years, and the percentage of exclusion (hereinafter referred to as the "Exclusion Percentage") depends on the date on which the QSBS was acquired. Although a certain percentage of gain is excluded, the non-excluded gain, defined in the Code as "section 1202 gain," is taxed at a maximum 28% rate,<sup>416</sup> not the 20% preferential long-term capital gain rate. Section 1202 gain is defined as the excess of "the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a)," over "the gain excluded from gross income under section 1202"<sup>417</sup> (hereinafter referred to as, "Section 1202 Gain"). The following chart shows the maximum effective exclusions and rates, including the NII 3.8% tax and the AMT:<sup>418</sup>

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<sup>414</sup> § 1291(e)(2).

<sup>415</sup> For a more complete discussion of QSBS, see Paul S. Lee, L. Joseph Comeau, Syida C. Long, and Julie Miraglia Kwon, *Qualified Small Business Stock (The Next Big Bang)—The Quest for Quantum Exclusions: (Queries, Qualms, and Qualifications)*, 53rd Annual Heckerling Institute on Estate Planning (2019), published by LexisNexis Matthew Bender.

<sup>416</sup> See §§ 1(h)(1)(F) and 1(h)(4)(A)(ii).

<sup>417</sup> § 1(h)(7).

<sup>418</sup> The chart excludes the 60% exclusion with respect to QSBS of certain empowerment zone businesses acquired after December 21, 2000 since the enactment of the 75% and 100% exclusions have made the 60% exclusion of no value to taxpayers. See §§ 1202(a)(2) and 1397C(b).

Acquisition Date	Exclusion Percentage	Maximum QSBS Rate	Maximum QSBS AMT Rate <sup>419</sup>	Maximum Rate (No QSBS)
Aug. 11, 1993 to Feb. 17, 2009	50% <sup>420</sup>	15.90%	16.88%	23.80%
Feb. 18, 2009 to Sep. 27, 2010	75% <sup>421</sup>	7.95%	9.42%	23.80%
<b>After Sep. 27, 2010</b>	<b>100%<sup>422</sup></b>	<b>0.00%</b>	<b>0.00%</b>	<b>23.80%</b>

b. The maximum tax savings from QSBS comes from stock acquired after September 27, 2010. Interestingly, under some circumstances the sale of QSBS stock might be subject to a higher rate than if section 1202 did not apply (e.g., stock entitled to a 50% exclusion under section 1202 sold during a time when the taxpayer's highest tax bracket is 15%). It's important to note that section 1202 is not elective. Section 1202 is not elective, thus in those instances, a taxpayer would be better off intentionally losing QSBS status by, for example, failing the 5-year holding requirement or making a disqualifying transfer, as discussed in more detail below.

c. In calculating any tax liability associated with the sale of QSBS, it is important to make a distinction between Section 1202 Gain (as defined above), gain that is excluded under section 1202(a) of the Code (the "Excluded Section 1202 Gain"), and the taxable gain that is not subject to section 1202 (the "Non-Section 1202 Gain"). As noted above, Section 1202 Gain is taxed at a maximum rate of 28% (31.8%) and is carefully defined in terms of gain that would be excluded but for the percentage limitations noted above. By consequence, Section 1202 Gain is also limited by the "Per-Issuer Limitation," discussed below, which limits the total amount of gain that is subject to the percentage exclusions. Any other gain, namely Non-Section 1202 Gain is taxed at the preferential 20% (23.8%) long-term capital gain tax rate. Non-Section

<sup>419</sup> For taxpayers who acquired their stock on or before September 27, 2010, 7% of the excluded gain is a preference item. See §§ 57(a)(7) and 1202(a)(4)(C), which is only applicable to QSBS acquired after September 27, 2010. The taxable portion of the gain is subject to the maximum AMT rate of 28% plus the 3.8% excise tax on net investment income, but the 7% preference item is subject only to the AMT tax, not the excise tax. As a result, the 50% exclusion results in a maximum AMT rate of 16.88%, as follows:  $\{[50\% \text{ taxable gain} + (7\% \times 50\% \text{ of excluded gain})] \times 28\% \text{ AMT rate}\} + (50\% \text{ taxable gain} \times 3.8\% \text{ excise tax})$ . The 75% exclusion results in a maximum AMT rate of 9.42%, as follows:  $\{[25\% \text{ taxable gain} + (7\% \times 75\% \text{ of excluded gain})] \times 28\% \text{ AMT rate}\} + (25\% \text{ taxable gain} \times 3.8\% \text{ excise tax})$ .

<sup>420</sup> § 1202(a)(1).

<sup>421</sup> § 1202(a)(3).

<sup>422</sup> § 1202(a)(4).

1202 Gain can include the unrecognized gain inherent in appreciated assets contributed to the corporation in exchange for stock in the corporation under section 351 of the Code. Under section 358 of the Code, the stock received in the corporation will receive a carryover basis, but for purposes of the Per-Issuer Limitation, discussed below, the fair market value of the contributed property is used in calculating the tenfold multiplier of the “Per-Issuer Limitation.”

d. The Code provides a “Per-Issuer Limitation,” which prescribes the maximum gain that can be excluded under section 1202(a) of the Code. Section 1202(b)(1) of the Code provides, “If the taxpayer has eligible gain for the taxable year from 1 or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation which may be taken into account ... for the taxable year shall not exceed the greater of—”<sup>423</sup>

(1) “\$10,000,000 reduced by the aggregate amount of eligible gain taken into account by the taxpayer . . . for prior taxable years and attributable to dispositions of stock issued by such corporation” (the “\$10 Million Per Taxpayer Limitation”),<sup>424</sup> or

(2) “10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year” (the “10 Times Basis Limitation”).<sup>425</sup>

e. A taxpayer that receives QSBS “by gift” or “at death” retains its character as QSBS, and the taxpayer is treated as having acquired the stock in the same manner as the transferor with a tacking of the transferor’s holding period.<sup>426</sup> If the transfer is “at death,” the QSBS receives a “step-up” in basis under section 1014, but appreciation after date of death would continue to be eligible for gain exclusion under section 1202. Because of the gain exclusion and gain rollover aspects of QSBS, most taxpayers should seek to make inter vivos transfers of these assets out of their gross estates to the extent they exceed their transfer tax exclusions (both state and Federal). Simply put, heirs will not benefit as much from a “step-up” in basis because of the gain exclusion features of QSBS, and QSBS status can be retained and transferred through donative transfers to donees. One possible planning technique to multiply the benefit of the QSBS exclusion which is subject to the \$10 Million Per Taxpayer Limitation (for QSBS shares that have less than \$1 million of adjusted basis) is to make gifts to family members (e.g., children, but not spouses<sup>427</sup>) and non-grantor trusts (treated as separate taxpayers and might include inter vivos marital deduction trusts for the benefit of a spouse).

f. There is potential for shareholders of a QSBS corporation to exclude as much as \$500 million of gain (assuming the \$50 million gross asset limitation is met but not exceeded, and depending on how certain provisions are interpreted, perhaps even more) if tax

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<sup>423</sup> § 1202(b)(1).

<sup>424</sup> § 1202(b)(1)(A).

<sup>425</sup> § 1202(b)(1)(B).

<sup>426</sup> §§ 1202(h)(1), (2)(A) and (B).

<sup>427</sup> § 1202(b)(3).

basis management is carefully considered prior to the (and maybe even after) original issuance of the QSBS.

(1) For purposes of the 10 Times Basis Limitation, the Code provides that “the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued.”<sup>428</sup> For that reason, a “step-up” in basis at death or a partnership basis shift (discussed later in these materials) during lifetime are unhelpful in increasing the exclusion tenfold.

(2) In order for a company to qualify for QSBS status, the “aggregate gross assets” of the corporation before and after the original issuance must not exceed \$50 million. For purposes of this calculation, the term “aggregate gross assets” means the “amount of cash and the aggregated adjusted bases of other property held by the corporation.”<sup>429</sup> As such, a corporation can qualify for QSBS status even if the fair market value at the time of issuance is greater than \$50 million. However, the Code further provides that for these purposes, “the adjusted basis of any property contributed to the corporation (or other property with a basis determined in whole or in part by reference to the adjusted basis of property so contributed) shall be determined as if the basis of the property contributed to the corporation (immediately after such contribution) were equal to its fair market value as of the time of such contribution.”<sup>430</sup> This latter provision presumably added to prevent shareholders (or partners in predecessor entities) from “stuffing” the corporation with low basis, high value assets.

g. It is common for companies that eventually become corporations that are eligible for QSBS status to start as entities taxed as a partnership (e.g., limited liability company). The conversion from partnership to C corporation can be accomplished a number of different ways, including making an election under a state law statute. Most conversions are non-taxable events for income tax purposes, often involving contribution of assets under section 351 of the Code, liquidations of the partnership, or distribution of assets from the partnership in some combination. Under most circumstances, the end result is the original partners receive shares in the new C corporation equal to the inside basis of the assets of the partnership or to the outside basis in their partnership interests (but without credit for partnership liabilities reflected in the outside basis).<sup>431</sup> Notwithstanding that treatment on conversion, section 1202 of the Code provides two special rules with respect to basis for QSBS purposes:

(1) “In the case where the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation—such stock shall be treated as having been acquired by the taxpayer on the date of such exchange, and the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.”<sup>432</sup>

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<sup>428</sup> § 1202(b)(1) [flush language].

<sup>429</sup> § 1202(d)(2)(A).

<sup>430</sup> § 1202(d)(2)(B).

<sup>431</sup> See Rev. Rul. 84-111, 1984 C.B. 88.

<sup>432</sup> § 1202(i)(1).

(2) “If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.”<sup>433</sup>

h. These special provision ostensibly allow taxpayers to calculate basis for purposes of section 1202 purposes (and possibly multiplying that basis benefit tenfold):

(1) Based on the fair market value of contributed assets at the time of contribution (e.g., assets held by the LLC when the conversion to C corporation occurred), and

(2) Based on the fair market value of property contributed even after the original issuance.

i. Owners of companies seeking QSBS status have an opportunity prior to conversion to C corporation status to leverage the “10 times” exclusion by increasing basis in the company (and the resulting stock) without violating the Aggregate Gross Asset Requirement. Strategies that should be considered including:

(1) Valuation of appreciated assets (e.g., technology or other intellectual property) at full fair market value;

(2) Contributions of cash to the company by one or more of the owners because each dollar has the potential of excluding ten dollars of gain;

(3) A contribution of cash to the company by one or more of the owners. Each dollar has the potential of excluding \$10 dollars of gain;

(4) Contributions of funds borrowed by the owners and then contributed to the company. However, borrowing at the company level when the company is a partnership in order to increase the cash within the company is likely not to work because even though the partnership liability increases outside basis for the partners the conversion to C corporation results in a reduction of each partner’s share of liabilities (lowering outside basis and possibly triggering gain);<sup>434</sup> and

j. The sale of assets for a taxable gain or otherwise triggering gain at the company or owner level (consideration should be given to qualifying for installment sale treatment to provide an immediate basis boost but defer the taxable income).

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<sup>433</sup> § 1202(i)(2).

<sup>434</sup> *Id.*

7. Qualified Opportunity Zone (QOZ) Investments

a. TCJA enacted section 1400Z-2 of the Code, providing significant tax benefits for taxpayers who have capital gain from the sale or exchange (with an unrelated person) of any type of property (including section 1231 property). Section 1400Z-2 of the Code allows a taxpayer to defer invest an amount equal to the capital gain in a qualified opportunity zone (QOZ) fund during the 180-day period following the sale or exchange. The taxpayer's potential benefits include a tax free rollover of the capital gain (at the election by the taxpayer),<sup>435</sup> an exclusion of up to 15% of the gain (through an increase in basis),<sup>436</sup> deferral of the remaining gain until December 31, 2026,<sup>437</sup> and permanent exclusion of gain due to post-investment appreciation in the QOZ investment, if held for 10 years or more (through an increase in basis to fair market value upon a sale or exchange).<sup>438</sup>

b. Gain deferred pursuant to an investment in a qualified opportunity fund under section 1400Z-2(a) of the Code will be included in income if such investment is “sold or exchanged” prior to December 31, 2026.<sup>439</sup> Notwithstanding the “sold or exchanged” language of the Code, the Treasury Regulations restate “sold or exchanged” in terms of an “inclusion event.”<sup>440</sup> An “inclusion event” is generally any transfer to a different taxpayer and includes a “taxpayer's transfer of a qualifying investment by gift, as defined for purposes of chapter 12 of subtitle B of the Code, whether outright or in trust, ... regardless of whether that transfer is a completed gift for Federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.”<sup>441</sup>

c. With regard to grantor trusts, the Treasury Regulations provide, “If the owner of a qualifying investment contributes it to a trust and, under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code (grantor trust rules), the contributing owner of the investment is the deemed owner of the trust (grantor trust), the contribution to the grantor trust is not an inclusion event. Similarly, a transfer of the investment by the grantor trust to the trust's deemed owner is not an inclusion event.”<sup>442</sup> The Treasury Regulations go on to say, “Such contributions may include transfers by gift or any other type of transfer between the grantor and the grantor trust that is a nonrecognition event as a result of the application of the grantor trust rules (that is, subpart E of part I of subchapter J of chapter 1 of subtitle A of the Code).”<sup>443</sup> In

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<sup>435</sup> § 1400Z-2(a)(1).

<sup>436</sup> The QOZ investment has an initial basis of zero, but there is an increase in basis equal to 10% of the deferred gain if the QOZ investment is held for five years, and an additional 5% after seven years. § 1400Z-2(b)(2)(B).

<sup>437</sup> § 1400Z-2(b)(1)(B).

<sup>438</sup> § 1400Z-2(c).

<sup>439</sup> § 1400Z-2(b)(1).

<sup>440</sup> Treas. Reg. § 1.1400Z2(b)-1(c).

<sup>441</sup> Treas. Reg. § 1.1400Z2(b)-1(c)(3).

<sup>442</sup> Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i).

<sup>443</sup> *Id.*

other words, an inclusion event does not include, for example, a grantor's sale of a QOZ investment to his or her IDGT. With respect to changes in grantor trust status, the Treasury Regulations provide, "In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event."<sup>444</sup> If grantor trust status is changed by reason of the death of the grantor, it is not considered an inclusion event but certain rules applicable to the death of a taxpayer otherwise apply.<sup>445</sup>

d. Section 1400Z-2(e)(3) of the Code provides, "In the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691."<sup>446</sup> In other words, the QOF investment, at least with respect to the deferred gain, will be considered IRD and, to that extent, there is no step-up in basis. If the decedent's investment in a QOF exceeds the elected deferred gain, the investment is considered a mixed-funds investment that is treated as two separate investments—a qualifying investment subject to section 1400Z-2 of the Code, and a non-qualifying investment.<sup>447</sup> Because section 1400Z-2 of the Code is inapplicable to the non-qualifying investment, the recipient's basis in the non-qualifying investment will be entitled to a step-up in basis.

e. A recipient of a decedent's qualifying investment is still subject to section 1400Z-2. As such, the basis of the qualifying investment is initially zero, with specified increases for gain recognized at the time of an inclusion event and for qualifying investments held for at least five or seven years. As such, a recipient of a decedent's qualifying investment is can be zero, zero plus 5%, 10%, or 15% of the deferred gain under section 1400Z-2(b)(2)(B) of the Code (depending on how long the investment is held), or if held for at least 10 years (including the decedent's holding period)<sup>448</sup> adjusted upwards to reflect the post-investment appreciation under section 1400A-2(c).<sup>449</sup> As such, section 1014 of the Code does not apply to the qualifying investment portion of a QOZ investment of a decedent.

f. The Treasury Regulations provide the following examples:<sup>450</sup>

(A) Example 1. Taxpayer A, an individual, contributed \$50X to a QOF in exchange for a qualifying investment in the QOF in January 2019. This \$50X was capital gain that was excluded from A's gross income under section 1400Z-2(a)(1)(A). A's basis in the qualifying investment is zero. As of January 2024, A's basis in the QOF is increased by an amount equal to 10 percent of the amount of

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<sup>444</sup> Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii).

<sup>445</sup> See Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii) and -1(c)(4).

<sup>446</sup> § 1400Z-2(e)(3).

<sup>447</sup> See Preamble to T.D. 9889, 85 Fed. Reg. 1866 (01-13-20).

<sup>448</sup> Treas. Reg. § 1.1400Z2(b)-1(d)(1)(iii).

<sup>449</sup> Treas. Reg. § 1.1400Z2(b)-1(g)(6)(i).

<sup>450</sup> Treas. Reg. § 1.1400Z2(b)-1(g)(6)(ii).

gain deferred by reason of section 1400Z-2(a)(1)(A), so that A's adjusted basis in 2024 is \$5X. A dies in 2025 and A's heir inherits this qualifying investment in the QOF. A's death is not an inclusion event for purposes of section 1400Z-2. The heir's basis in the qualifying investment is \$5X.

(B) Example 2. The facts are the same as in paragraph (g)(6)(ii)(A) of this section (Example 1), except that A dies in November 2027, when the fair market value of the qualifying investment was \$75X. A was required to pay the tax on the excess of the deferred capital gain over A's basis as part of A's 2026 income. Therefore, at the time of A's death, A's basis in the qualifying investment is the sum of three basis adjustments: The adjustment made in January 2024 described in paragraph (g)(6)(ii)(A) (Example 1) (\$5X); an additional adjustment made as of January 2026 equal to 5 percent of the amount of gain deferred by reason of section 1400Z-2(a)(1)(A) (\$2.5X); and the adjustment as of December 31, 2026, by reason of section 1400Z-2(b)(1)(B) and (b)(2)(B)(ii) (\$42.5X). Accordingly, the basis of the qualifying investment in the hands of A's heir is \$50X.

#### IV. MAXIMIZING AND MULTIPLYING THE “STEP-UP” IN BASIS

##### A. Generally

1. As discussed above, estate planning has increasingly focused on the income tax savings resulting from the “step-up” in basis. Estate planners should seek to maximize the “step-up” in basis by ensuring that the assets that are includible in the estate of a decedent are the type of assets that will:

a. Benefit from a “step-up” (avoiding the inclusion cash or property that has a basis greater than fair market value)

b. Benefit the most from the “step-up” (for example, very low basis assets, collectibles, and “negative basis” assets); and

c. Provide significant income tax benefits to the beneficiaries (assets are likely to be sold in a taxable transaction after “step-up” or depreciable/depletable assets giving rise to ongoing income tax deductions).

2. In considering tax basis management in estate planning, estate planners should take a bifurcated approach based upon the tax nature of the assets. For clients who are likely to own primarily low-basis assets that would benefit the most from a step-up in basis (e.g., creators of intellectual property or real estate developers), the estate plan will be centered around inclusion of those assets and benefiting from the “step-up” in basis. Then, to the extent the assets will be subject to Federal or state transfer taxes, then consideration must be given to ensuring that estate taxes can be paid on a timely or orderly manner. Thus, common features of the plan might include maintaining life insurance held by an irrevocable life insurance trust, qualifying for the payment of transfer taxes pursuant to the deferral provisions of section 6166, or securing a

*Graegin*<sup>451</sup> loan.<sup>452</sup> For those clients who are likely to own assets that would not likely benefit from the “step-up” in basis (e.g., IRA assets, actively managed publicly-traded investment portfolios, or other high basis asset), then transferring the assets out of the estate would be paramount to the extent the assets would be subject to a significant Federal or state transfer tax liability. Finally, for those clients, who have both types of assets and whose assets would be subject to a significant transfer tax liability, the strategy would involve transferring the high basis assets out of the estate through a combination of zeroed-out transfer strategies and exercising the “swap” power proactively if the assets are held in a grantor trust, as discussed later in these materials.

3. When clients are in a situation where no estate taxes will be due (a “free-base” situation), then estate planners should seek to maximize the value of certain assets because the “step-up” in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes). A “free-base” situation can arise when the assets includible in the estate are less than the decedent’s remaining Basic Exclusion Amount or a marital deduction transfer under section 2056 to the surviving spouse.<sup>453</sup> In these “free-basing” situations, practitioners will need to consider when valuations discounts are warranted and when the discounts should be removed. Of course, what is a free-base situation today may become an estate tax situation tomorrow. The estate tax on \$6.03 million, the difference between an \$12.06 million basic exclusion and a \$6.03 million basic exclusion is \$2,412,000 (20% of the total \$12.06 million estate).

4. In addition to the foregoing, estate planners should seek to: (a) maximize the value of certain assets because the “step-up” in basis is based on fair market value (rather than trying to reduce the value for transfer tax purposes); and (b) intentionally create estate tax inclusion, especially if the decedent lives in a state with no state death tax and if the decedent has significant unused Available Exclusion Amount above his or her assets.

## B. Swapping Assets with Existing IDGTs

### 1. Generally

a. Many wealthy individuals have made significant taxable gifts, using all or a significant portion of their Basic Exclusion Amounts because of the risk of that the exemptions would “sunset” back to lower levels. Many of those gifts were made to IDGTs.

b. A common power used to achieve grantor trust status for the IDGT is one described under section 675(4)(C) of the Code, namely giving the grantor, the power, in a

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<sup>451</sup> *Estate of Graegin v. Commissioner*, 56 T.C.M. (CCH) 387 (1988).

<sup>452</sup> See Stephanie Loomis-Price, Paul S. Lee, Charles E. Hodges, *Asset Rich, Cash Poor: Addressing Illiquidity with Graegin Loans, as Well as Sections 6166 and 6161*, 36 Tax Mgmt. Est. Gifts & Tr. J No. 4 (July 14, 2011).

<sup>453</sup> Another free-base situation could arise with a testamentary transfer to a zeroed-out charitable lead annuity trust. The creation of basis would significantly lower the on-going income tax liability of the non-grantor charitable lead trust. However, increasing the value would also increase the payments to charity that are required to zero-out the testamentary transfer to the trust.

non-fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value.<sup>454</sup> For income tax purposes, transactions between the grantor and the IDGT will be disregarded.<sup>455</sup> As such, grantors may exercise the power to swap high basis assets for low basis assets without jeopardizing the estate tax includibility of the assets and without having a taxable transaction for income tax purposes.

c. To maximize the benefits of the swap power, it must be exercised as assets appreciate or are sold over time. When exercised properly, this can ensure that only those assets that benefit the most from the step-up will be subject to estate inclusion.

(1) If grantor does not have sufficient other assets, repurchase will be difficult - although the donor could borrow cash from a third party.

(2) The grantor could use a promissory note in exchange for the property in the IDGT, but as discussed below, it is unclear what the tax basis of the promissory note will be to the IDGT after the death of the grantor, if any portion of the note remains outstanding at such time.

(3) Because the sudden or unexpected death of the grantor may make a repurchase difficult or impossible, estate planners may want to consider drafting “standby” purchase instruments to facilitate fast implementation of repurchase.

d. While the Federal income tax consequences of a swap for equivalent value seem clear, practitioners should consult whether the transaction will also be ignored for other local law purposes.

(1) Some states do not recognize grantor trust status or only recognize it under certain circumstances. By way of example, Pennsylvania does not recognize grantor trust status if the trust is irrevocable. Thus, in Pennsylvania, an IDGT will be subject to state income taxation, and all transactions between the IDGT and the grantor would be taxable events for state tax purposes.<sup>456</sup>

(2) While New York recognizes grantor trust status for income tax purposes, the New York Department of Taxation and Finance has ruled that an exchange of

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<sup>454</sup> § 675(4)(C) and Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

<sup>455</sup> See Rev. Rul. 85-13, 1985-1 C.B. 184 and PLR 9535026.

<sup>456</sup> Arkansas, the District of Columbia, Louisiana, and Montana tax the grantor only in a limited set of circumstances. See Ark. Inc. Tax Reg. § 4.26-51-102, D.C. Code §§ 47-1809.08 to 47-1809.09, La. Rev. Stat. Ann. § 47:187, and Mont. Code Ann. § 15-30-2151(5). Tennessee recently clarified an issue regarding grantor trusts, so effective for tax returns filed on or after May 20, 2013, a grantor, instead of a trustee, of a grantor trust may file the Hall income tax (on interest and dividends) return and pay the tax if the grantor reports the trust income on his or her own individual Federal tax return. See Public Chapter 480 and T.C.A. § 67-2-102.

assets between a grantor and his IDGT was a sale for sales tax purposes if the assets transferred would be subject to sales tax for any unrelated taxpayers.<sup>457</sup>

2. Swapping with a Promissory Note of Grantor

a. If, under the swap power, a grantor exchanges his or her own promissory note (rather than assets individually owned by the grantor) for assets in an IDGT, the exchange and all payments on the promissory note will be ignored for Federal income tax purposes, as long as grantor trust status remains. However, it is unclear what tax basis the IDGT has in the promissory note if the grantor dies, thereby terminating grantor trust status. As discussed later in this outline, the death of the grantor is likely not a recognition event, and it is likely that the assets in the IDGT (the promissory note) will not get a step-up in basis. Rather, the promissory note will have the same basis that the grantor had in the note at the time of the exchange.

b. The issue at hand is whether a grantor has basis in his or her own promissory note. If not, then the basis is likely to be zero. If the grantor does have basis, then the basis is likely to be the amount of the indebtedness. If the basis in the promissory note is zero, then when grantor trust is terminated, the IDGT will have a zero basis in the note, such that when the note is ultimately satisfied by the debtor (the estate or beneficiaries of the estate), capital gain will be recognized by the trust, which will be a non-grantor taxable trust at such time.

c. The IRS position is that a debtor has no basis in his or her own promissory note.<sup>458</sup> The Tax Court has consistently held when partners have contributed promissory notes to the entity, the contributing partner does not get increased adjusted basis in his or her partnership interest because the partner has no basis in the note.<sup>459</sup> In *Gemini Twin Fund III v. Commissioner*, the Tax Court wrote, “Even assuming, as petitioner argues, that a note is property under State law and for other purposes, a taxpayer has no adjusted basis in his or her own note. Until the note is paid, it is only a contractual obligation to the partnership. The existence of collateral does not change this result.”<sup>460</sup>

d. However, in other contexts, the courts have held that an unsecured promissory note does, in fact, create basis, as long as the note represents a genuine indebtedness.

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<sup>457</sup> New York State Department of Taxation and Finance Advisory Opinion (TSB-A-14(6)S) (Jan. 29, 2014).

<sup>458</sup> See, e.g., Rev. Rul. 80-235, 1980-2 C.B. 229 (liability created by the written obligation of a limited partner does not create basis in the limited partnership interest), and Rev. Rul. 68-629, 1968-2 C.B. 154 (contribution of promissory notes to a corporation did not create tax basis, resulting in gain under section 357(c) of the Code because the taxpayer contributed other assets with liabilities in excess of tax basis).

<sup>459</sup> *Vision Monitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182, *Dakota Hills Offices Ltd. Part. v. Commissioner*, T.C. Memo. 1998-134, *Gemini Twin Fund III v. Commissioner*, T.C. Memo. 1991-315, aff’d without published opinion, 8 F.3d 26 (9<sup>th</sup> Cir. 1993), *Bussing v. Commissioner*, 88 T.C. 449 (1987), *Oden v. Commissioner*, T.C. 1981-184, aff’d without published opinion, 678 F.2d 885 (4<sup>th</sup> Cir. 1982).

<sup>460</sup> *Gemini Twin Fund III v. Commissioner*, T.C. Memo. 1991-315.

In *Peracchi v. Commissioner*,<sup>461</sup> the taxpayer contributed real property to a corporation. The real property was encumbered by debt in excess of basis. Under section 357(c) of the Code, any liabilities in excess of basis will be considered gain upon contribution to a corporation (NAC) controlled by the taxpayer under section 351 of the Code. To avoid this gain, the taxpayer also contributed a promissory note in an amount equal to the excess liabilities, claiming the note has a basis equal to its face amount. The IRS argued that the note has a zero basis. The Ninth Circuit agreed with the taxpayer. The opinion provides:

We are aware of the mischief that can result when taxpayers are permitted to calculate basis in excess of their true economic investment. *See Commissioner v. Tufts*, 461 U.S. 300 (1983). For two reasons, however, we do not believe our holding will have such pernicious effects. First, and most significantly, by increasing the taxpayer's personal exposure, the contribution of a valid, unconditional promissory note has substantial economic effects which reflect his true economic investment in the enterprise. The main problem with attributing basis to nonrecourse debt financing is that the tax benefits enjoyed as a result of increased basis do not reflect the true economic risk. Here *Peracchi* will have to pay the full amount of the note with after-tax dollars if NAC's economic situation heads south. Second, the tax treatment of nonrecourse debt primarily creates problems in the partnership context, where the entity's loss deductions (resulting from depreciation based on basis inflated above and beyond the taxpayer's true economic investment) can be passed through to the taxpayer. It is the pass-through of losses that makes artificial increases in equity interests of particular concern. *See, e.g., Levy v. Commissioner*, 732 F.2d 1435, 1437 (9th Cir. 1984). We don't have to tread quite so lightly in the C Corp context, since a C Corp doesn't funnel losses to the shareholder.

The court then goes on to point out that if the note has a zero basis, then the corporation also will have a zero basis in the note,<sup>462</sup> which would create a subsequent gain if the note then was sold to a third party:

We find further support for *Peracchi's* view by looking at the alternative: What would happen if the note had a zero basis? The IRS points out that the basis of the note in the hands of the corporation is the same as it was in the hands of the taxpayer. Accordingly, if the note has a zero basis for *Peracchi*, so too for NAC. *See* I.R.C. section 362(a). But what happens if NAC--perhaps facing the threat of an involuntary petition for bankruptcy--turns around and sells *Peracchi's* note to a third party for its fair market value? According to the IRS's theory, NAC would take a carryover basis of zero in the note and would have to recognize \$1,060,000 in phantom gain on the subsequent exchange, even though the note

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<sup>461</sup> 143 F.3d 487 (9<sup>th</sup> Cir. 1997). *But see Seggerman Farms Inc. v. Commissioner*, 308 F.3d 803 (7<sup>th</sup> Cir. 2002) and *Alderman v. Commissioner*, 55 T.C. 662 (1971).

<sup>462</sup> *See Lessinger v. Commissioner*, 872 F.2d 519 (2<sup>d</sup> Cir. 189). The court agreed with the IRS's argument that the note had a zero basis, but then concluded the note had a basis in the corporation's hands equal to its face value.

did not appreciate in value one bit. That can't be the right result. [Footnote omitted]

The dissenting judge in the *Perrachi* opinion remarked, “The taxpayer has created something -- basis -- out of nothing.”

e. It is unclear what this means for swap transactions with an IDGT and the tax ramifications upon repayment of the debt when the IDGT becomes a non-grantor trust. What is clear is that the IRS will claim that the grantor's note has no tax basis. There are sound arguments on both sides of the debate.<sup>463</sup> It can validly be argued that none of the authorities mentioned above are on point. For example, if creditor loans \$1 million to debtor and creditor is deemed to have zero basis in the promissory note, then why is there no income or gain when the creditor is paid back in full or why is the creditor entitled to realize a loss if the debt is not paid back in full? Further, in the installment sale to IDGT context, if the death of the grantor is treated as a sale immediately after the date of death, then a zero basis in the note would be a taxable gain event. Yet, very few practitioners believe that should be the case. As such, there is a clear argument for giving the IDGT a basis in the note equal to the basis in the assets sold.

### C. Valuation Discounts On or Off?

#### 1. Generally

a. A common “free-base” situation occurs when the first spouse passes away, and assets are transferred to or for the benefit of the spouse in a transfer that qualifies for the marital deduction under section 2056. In community property states, as mentioned above, the “step-up” in basis will also apply to the assets held by the surviving spouse. Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse's estate are significantly above the Basic Exclusion Amount (including any ported amount), then valuation discounts will likely save more in estate taxes than the income tax savings from the subsequent “step-up” at the surviving spouse's estate. If a quick succession of deaths is a worry, practitioners should be prepared to layer valuation discounts immediately after the first death, so post-mortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate.

b. Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of Available Exemption Amount in order to increase the income tax basis of the assets.

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<sup>463</sup> See Stuart Lazar, *Lessinger, Peracchi, and the Emperor's New Clothes: Covering a Section 357(c) Deficit with Invisible (or Nonexistent) Property*, 58 Tax Lawyer No. 1, 41 (Fall 2004); Elliott Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries*, 39 Tax L. Rev. 159 (1984); and Jerred G. Blanchard Jr., *Zero Basis in the Taxpayer's Own Stock or Debt Obligations: Do Those Instruments Constitute 'Property'?*, 2005 Tax Notes 1431 (March 21, 2005).

c. Family limited partnerships or other entities that create valuation discounts could be dissolved or restated to allow the parties to the entity to withdraw for fair value or to remove restrictions on transferability.

(1) An option could be given to a parent allowing the sale of the parent's interest to a child or children for undiscounted fair market value at death. Giving such an option to a parent would be a gift unless accompanied by adequate and full consideration.

(2) If undivided interests in property are owned, family control agreements could be entered into that require all generations to consent to the sale of the property as one tract, and join in paying the expenses of a sale, if any one owner wanted to sell. Quite obviously such agreements may be contrary to other estate planning or ownership goals of the family.

d. The ability of the IRS to ignore provisions of an agreement that increase the value of assets in the hands of a parent, but not in the hands of a child, is uncertain. By its literal terms section 2703 applies only to provisions that reduce value and to restrictions on the right to sell or use property. To illustrate, in *Estate of James A. Elkins, Jr., et al. v. Commissioner*,<sup>464</sup> the Tax Court applied section 2703 to ignore a family co-tenancy agreement requiring all owners of fractional interests in art to agree before the art could be sold. The purpose of that agreement was to limit the marketability of each fractional interest. But what might the effect on value be of an agreement which provided, instead, that any fractional owner could compel the sale of the entire asset? Similarly, a provision that allows a shareholder in business to put stock to the business at death for fair market value would seem to be outside the scope of the section. In many instances amending old agreements to include such provisions will be more likely to create gifts from the younger owners to the older owners than would terminating an old agreement and creating a new one.

## 2. Conversion to General Partnership

a. One option for eliminating valuation discounts with family limited partnership interests is to “convert” the limited partnership (or limited liability company) to a general partnership.

(1) Section 2704(b) of the Code will disregard certain “applicable restrictions” on the ability of the partnership to liquidate. However, an exception exists for “any restriction imposed . . . by any Federal or State law.”<sup>465</sup> Since the effective date of section 2704 of the Code, many states have amended their limited partnership and limited liability company statutes to provide for significant restrictions on an owner's ability to liquidate his or her ownership interest in those entities, thereby rendering section 2704(b) inapplicable.<sup>466</sup> Proposed

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<sup>464</sup> 140 T.C. 86 (2013), *rev'd*, *Estate of James A. Elkins, Jr. v. Commissioner*, 767 F.3d 443 (5<sup>th</sup> Cir. 2014).

<sup>465</sup> § 2704(b)(3)(B).

<sup>466</sup> *See, e.g., Kerr v. Commissioner*, 113 T.C. 449 (1999) (The Tax Court held section 2704(b) of the Code was not applicable because the partnership agreement was no more restrictive than § 8.01 of the Texas Revised Limited Partnership Act, which generally provides for the dissolution and liquidation of a limited

Treasury Regulations issued in August 2016 would have enabled the IRS to disregard certain features of applicable state law that limited the application of section 2704. Those proposed regulations were roundly criticized and were ordered to be withdrawn in their entirety.<sup>467</sup> The proposed regulations were officially withdrawn as of October 20, 2017.<sup>468</sup>

(2) General partnership statutes, on the other hand, provide much more liberal provisions for liquidation and dissolution of a partnership and for the withdrawal of a partner. For example:

(a) Section 801 of the Uniform Partnership Act (UPA)<sup>469</sup> provides in a partnership at will, dissolution occurs upon a person's express will to withdraw.

(b) Under section 601(1) of the UPA, a person is dissociated as a partner when the partnership has notice of the person's express will to withdraw as a partner.

(c) Section 602(a) of the UPA points out that a person has the power to dissociate as a partner at any time, rightfully or wrongfully.

(d) Sections 701(a) and (b) of the UPA provide, upon dissociation, the partnership is required to purchase the person's interest in the partnership for a buyout price that is the *greater* of liquidation value or the value based on a sale of the entire business as a going concern without the person.<sup>470</sup>

(3) Furthermore, nothing under section 2704(b) of the Code prohibits being less restrictive in the partnership agreement.

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partnership pursuant to the occurrence of events specified in the agreement or upon the written consent of the partners.), *aff'd* 292 F.3d 490 (5<sup>th</sup> Cir. 2002) (The Fifth Circuit affirmed the decision that section 2704(b) of the Code is inapplicable under section 2704(b)(2)(B)(i) of the Code. Section 2704(b)(2)(B)(i) provides that "the transferor or any member of the transferor's family, either alone or collectively, must have the right to remove the restriction" immediately after the transfer for the restriction to be one that would be disregarded. In the case, the University of Texas was a partner in the partnership.)

<sup>467</sup> Steven T. Mnuchin, Secretary of Treasury, *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789*, 2018-03004 (Rev. 1), (October 2, 2017) [[https://www.treasury.gov/press-center/press-releases/Documents/2018-03004\\_Tax\\_EO\\_report.pdf](https://www.treasury.gov/press-center/press-releases/Documents/2018-03004_Tax_EO_report.pdf)].

<sup>468</sup> FR Doc. 2017-22776, 82 Fed. Reg. 48779.

<sup>469</sup> Uniform Partnership Act, as adopted in 2007 and last amended in 2013, by the National Conference of Commissioners on Uniform State Laws (hereinafter, UPA).

<sup>470</sup> The comment to section 701(b) of the UPA provides, "Liquidation value is not intended to mean distress sale value. Under general principles of valuation, the hypothetical selling price in either case should be the price that a willing and informed buyer would pay a willing and informed seller, with neither being under any compulsion to deal. The notion of a minority discount in determining the buyout price is negated by valuing the business as a going concern. Other discounts, such as for a lack of marketability or the loss of a key partner, maybe appropriate, however. For a case applying the concept, see *Fotouhi v. Mansdorf*, 427 B.R. 798, 803-05 (Bankr. N.D. Cal. 2010)."

(4) Where retaining limited liability of a partner is important, the partner should consider utilizing a wholly-owned limited liability company that is treated as a disregarded entity for Federal tax purposes.<sup>471</sup> The use of disregarded entities is discussed in more detail later in these materials. In this instance, the partner would first contribute his or her limited partnership or limited liability company interest into the disregarded entity and then the limited partnership or limited liability company would “convert” to a general partnership. The conversion can be accomplished under a conversion power,<sup>472</sup> interest exchange<sup>473</sup> and dissolution, or other merger transaction.

(5) Because all of the limited partners and limited liability company members retain the same proportionate interest in the resulting entity, there is no gift for transfer tax purposes because of the “vertical slice” exception to section 2701 of the Code.<sup>474</sup>

### 3. The *Powell* “Solution”

a. Another planning option that could cause inclusion of FLP assets without valuation discounts is to argue that section 2036(a) of the Code applies, relying on the argument set forth in *Estate of Powell v. Commissioner*.<sup>475</sup>

(1) Pursuant to the facts, the decedent’s son, acting under a power of attorney for the benefit of the decedent, contributed \$10 million of cash and securities to a FLP in return for 99% limited partnership interest. The decedent’s two sons contributed unsecured promissory notes to the FLP in exchange for a 1% general partnership interest. The son, acting under the power of attorney, contributed the 99% limited partnership interest to a lifetime charitable lead annuity trust (CLAT) that would pay an annuity amount to charity for the lifetime of the decedent with the remainder passing to the decedent’s sons at the death of the decedent. The son may not have had the authority to make the transfer to the CLAT because the power of attorney only allowed gifts to the principal’s issue up to the federal gift tax annual exclusion. The value of the taxable gift of the remainder interest to the sons was calculated with a 25% valuation discount on the limited partnership interest due to lack of control and marketability. The decedent died 7 days after the contribution to the CLAT.

(2) The IRS argued that the \$10 million of contributed assets were includible in the decedent’s estate under the following Code sections: (i) section 2036(a)(1) (retained enjoyment of income); (ii) section 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income); (iii) section 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent’s death; and (iv) section 2035(a) (transfer of property within three years of death that otherwise would have been includible sections 2036-

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<sup>471</sup> A single owner entity that has not elected to be classified as an association (corporation). See § 7701 and Treas. Reg. §§ 301.7701-1(a), -2(c)(2), -3(b)(1)(ii).

<sup>472</sup> See § 1141(a)(1) of the UPA

<sup>473</sup> See § 1131(a) of the UPA.

<sup>474</sup> See Treas. Reg. § 25.2701-1(c)(4).

<sup>475</sup> *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017).

2038 of the Code or section 2042 (inclusion of life insurance proceeds). Interestingly, the taxpayer did not contest the application of section 2036(a)(2) or argue that the bona fide transfer for full and adequate consideration exception to section 2036 applied. Rather, the taxpayer contended that section 2036 and 2038 could not apply because the decedent did not own any interest in the FLP at death.

(3) The Tax Court agreed that section 2036(a)(2) applied. In the majority opinion, the Tax Court held that (i) the decedent, in conjunction with all other partners, could dissolve the partnership, and (ii) the decedent, through her son acting under the power of attorney and as a general partner of the FLP, could control the amount and timing of distributions. In previous cases, the courts had applied section 2036(a)(2) to certain FLP cases,<sup>476</sup> but this was the first application of section 2036(a)(2) where the decedent exclusively owned a limited partnership interest.

(4) The majority opinion goes on to explain that the inclusion amount under section 2036 must be adjusted under section 2043(a) of the Code. Although the majority opinion admits that “read in isolation” section 2036(a)(2) would require that the amount includible in the estate would be the full date of death value of the cash and securities transferred to the FLP, it asserts that section 2036(a)(2) must be read in conjunction with section 2043(a) of the Code.

(a) Section 2043(a) of the Code provides, in pertinent part, if there is a transfer of an interest includible under section 2036 “for a consideration in money or money’s worth, but is not a bona fide sale for adequate and full consideration in money or money’s worth,”<sup>477</sup> then the amount includible in the gross estate is “only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.”<sup>478</sup>

(b) As such, the amount includible under sections 2036 and 2043 of the Code is the valuation discount due to lack of control and marketability—the value of the contributed assets (\$10 million) less the value of the limited partnership interest received (\$7.5 million due to valuation discount of 25%), assuming no change in the value of the transferred assets. The majority opinion refers to this amount as the “hole” in the doughnut. The court refers to the limited partnership interest as the “doughnut,” which would be included in the gross estate if the transfer was deemed void or included in the gift amount if the gift is recognized. The court concluded, in this instance, that the transfer was void or revocable, and as such, the limited partnership was includible in the estate of the decedent.

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<sup>476</sup> See *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-15, *aff’d*, 417 F.3d 468 (5<sup>th</sup> Cir. 2005) and *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209 (both cases involved a decedent owning a general partnership interest). *But see Kimball v. U.S.*, 371 F.3d 257 (5<sup>th</sup> Cir. 2004), *rev’g*, 244 F. Supp 2d 700 (N.D. Tx. 2003) and *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74.

<sup>477</sup> § 2043(a).

<sup>478</sup> *Id.*

(c) If there had been a change in the value of the transferred assets between the transfer and the date of death, the net inclusion amount would be increased by any appreciation or reduced by any depreciation. According to the majority opinion:

Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the value of the partnership interest on the date of the transfer. To the extent that any post-transfer increase in the value of the transferred assets is reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.)<sup>479</sup>

(d) In other words, the date of death value of the limited partnership interest would also be included under section 2033 of the Code, so all of the post-contribution appreciation would also be subject to estate tax. Thus, more value may be included in the gross estate than if the decedent had never contributed assets to the FLP.

(5) The concurring opinion, which was joined by seven judges, asserts that the planning involved in this case is “best described in aggressive deathbed tax planning.” It then agrees that section 2036(a)(2) of the Code applies because the decedent made a transfer of the \$10 million in cash and securities (to the partnership), but the decedent “retained the proverbial ‘string’ that pulls these assets back into her estate.” However, as the concurring opinion provides:

This is where I part company with the Court, because I do not see any “double inclusion” problem. The decedent's supposed partnership interest obviously had no value apart from the cash and securities that she allegedly contributed to the partnership. The partnership was an empty box into which the \$10 million was notionally placed. Once that \$10 million is included in her gross estate under section 2036(a)(2), it seems perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the \$10 million of cash and securities.

This is the approach that we have previously taken to this problem. *See Estate of Thompson*, 84 T.C.M. (CCH) at 391 (concluding that the decedent's interest in the partnership had no value apart from the assets he contributed to the partnership); *Estate of Harper v. Commissioner*, T.C. Memo. 2002-121, 83 T.C.M. (CCH) 1641, 1654; cf. *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property cannot constitute consideration under section 2043(a)). And this is the approach that I would take here. There is no double-counting problem if we read section 2036(a)(2), as it always has been read, to disregard a “transfer with a string” and

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<sup>479</sup> *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), footnote 7.

include in the decedent's estate what she held before the purported transfer—the \$10 million in cash and securities.

Rather than take this straightforward path to the correct result, the Court adopts as the linchpin of its analysis section 2043(a). Neither party in this case advanced any argument based on section 2043(a); indeed, that section is not cited in either party's briefs. And as the Court recognizes, *see op. Ct. p. 28*, we have not previously applied section 2043(a), as the Court does here, to limit the amount includible in a decedent's gross estate under section 2036(a). *See, e.g., Estate of Harper*, 83 T.C.M. (CCH) at 1654 (ruling that section 2043(a) “is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration”).<sup>480</sup>

(6) While asserting that section 2043(a) is inapplicable in this case, the concurring opinion goes on to opine that even if section 2043(a) did apply, it is not clear that the decedent's partnership interest (the result of a now disregarded transfer) can constitute consideration in money or money's worth within the meaning of section 2043(a).

(7) It is unclear how future cases will resolve the double inclusion issue. The Powell majority opinion was not joined by a majority of the Tax Court judges. Eight judges represented the majority opinion, seven judges agreed with the result but rejected the double inclusion issue, and two judges concurred with the result only.

b. If assets are deemed includible for estate tax purposes under section 2036, it's been held that the assets in a partnership should receive a basis adjustment under section 1014 of the Code without the need for a section 754 election providing an inside basis adjustment under section 743.<sup>481</sup> Under the majority opinion's theory, a portion of the partnership assets would be included under section 2036, reduced by section 2043(a) (the valuation discount), and a portion would be included under section 2033 (the partnership interest). As such, in order to “step-up” the basis of the underlying assets, a section 754 election may in fact be needed. Of course, as discussed later in these materials, a liquidating distribution of partnership assets would accomplish the same thing.

c. From a planning standpoint, intentionally claiming applicability of section 2036 of the Code to partnership interests held by a decedent should accomplish the desired result of a “step-up” in basis on the assets in the partnership. However, if the majority opinion's view of the double inclusion problem is correct, claiming section 2036 should be done with caution. If the partnership assets have not appreciated or have depreciated in value since the contribution, then claiming section 2036 should provide a full step-up in basis. Further, if there is a double inclusion problem because assets have appreciated, then if there is sufficient Basic Exclusion Amount available to cover the additional inclusion, then there is effectively no cost and the estate would still be in a “free-base” situation.

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<sup>480</sup> *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017), concurring opinion.

<sup>481</sup> *See Order, Hurford Investments No. 2, Ltd. v. Commissioner*, No. 23017-11, 2017 BL 138848 (T.C. Apr. 27, 2017) and PLR 200626003.

D. General Powers of Appointment

1. Generally

a. A general power of appointment, as defined in the Code,<sup>482</sup> is a power exercisable in favor of: (i) the power holder, (ii) his or her estate, (iii) his or her creditors, or (iv) creditors of his or her estate. From a transfer tax standpoint, the mere existence of an exercisable general power of appointment at the death (a testamentary general power) of the power holder will cause assets subject to the power to be includible in the power holder's estate.<sup>483</sup> Moreover, the lack of knowledge of the existence of a general power of appointment will not exclude the property subject to the power from being included in the estate of the deceased power holder.<sup>484</sup>

b. From an income tax standpoint, if the holder of the power exercises a testamentary general power, the property passing under the power is deemed to have passed from the deceased power holder without full and adequate consideration, and the property will get a "step-up" in basis.<sup>485</sup> If the holder of the power dies without exercising the testamentary general power of appointment, the property that was subject to the power is also deemed to have been acquired from the deceased power holder and such property will receive a "step-up" in basis.<sup>486</sup>

c. Given the potential income tax savings from the "step-up" in basis and growing Basic Exclusion Amounts in the future, estate planners will need to consider how, under what circumstances and to what extent a testamentary general power of appointment should be granted to future trust beneficiaries, even if the assets have been correctly transferred into a vehicle (like a dynasty trust) that is structured to avoid estate tax inclusion at every generation. So-called "limited general powers" may be helpful in this respect. For example, a power to appoint only to the creditors of the power holder's estate may be less susceptible to undesirable appointment than a power to appoint more broadly. Further, the exercise of a power may be subject to the consent of another person so long as the person does not have a substantial interest adverse to the exercise of the power in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate.<sup>487</sup>

d. Consideration should be given to using a "circumscribed general power" that has the following characteristics: (1) a testamentary power, (2) in favor of the creditor of the powerholder's estate, (3) with the consent of a non-adverse party, (4) only over assets with a fair market value in excess of basis, and (5) capped such that the amount subject to the power when added to the other assets of the powerholder produces a total that is \$1,000 less than the powerholder's basic exclusion amount.

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<sup>482</sup> §§ 2041(b)(1) and 2514(c).

<sup>483</sup> § 2041(a)(2) and Treas. Reg. § 20.2041-3(b).

<sup>484</sup> *Freeman Estate v. Commissioner*, 67 T.C. 202 (1976).

<sup>485</sup> Treas. Reg. § 1.1014-2(a)(4).

<sup>486</sup> Treas. Reg. § 1.1014-2(b)(2).

<sup>487</sup> Treas. Reg. § 20.2041-3(c)(2).

2. Rights of Creditors

a. The rights of creditors to property over which a powerholder has a testamentary general power is worth considering. The majority view at common law is that the powerholder of a power, conferred on the powerholder by another, is treated as the beneficial owner of the appointive property for purposes of creditors' rights only if (1) the power is general *and* (2) the powerholder exercises the power. No distinction is made between a testamentary and a presently exercisable power. Creditors of a powerholder of a *non*-general power, on the other hand, cannot reach the appointive assets even if the power was effectively exercised. The theory is that the donor who creates a non-general power did not intend to benefit the powerholder.

b. Explaining the distinction between the exercise and non-exercise of a general power for purposes of creditor access, one court noted:

When a donor gives to another the power of appointment over property, the [powerholder]... does not thereby become the owner of the property. Rather, the appointee of the power [meaning, the powerholder], in its exercise, acts as a "mere conduit or agent for the donor." The [powerholder], having received from the owner of the property instructions as to how the power may be utilized, possesses nothing but the authority to do an act which the owner might lawfully perform.<sup>488</sup>

c. When the powerholder of a general power exercises the power by will, the view that the appointed property is treated as if it were owned by the powerholder means that the creditors of the powerholder's estate can reach the appointed property for the payment of their claims.<sup>489</sup> The rule prevails even if this is contrary to the expressed wishes of the donor of the power.<sup>490</sup>

d. The exercise of the power by will does not confer actual beneficial ownership of the appointive assets on the powerholder for all purposes. The assets do not ordinarily become part of the powerholder's probate estate. Thus, in terms of priority, the powerholder's own estate assets are ordinarily used first to pay estate debts, so that the appointive assets are used only to the extent the powerholder's probate estate is insufficient.

e. Under the majority view at common law, the powerholder's creditors can reach the appointive assets only to the extent the powerholder's exercise was an *effective* exercise. A few states, however, follow the view that even an ineffective exercise entitles the powerholder's creditors to reach the appointive assets.<sup>491</sup> Moreover, even in states adhering to the majority view, an ineffective exercise can sometimes "capture" the appointive assets for the

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<sup>488</sup> *Univ. Nat'l Bank v. Rhoadarmer*, 877 P.2d 561 (Colo. App. 1991).

<sup>489</sup> *See, e.g., Clapp v. Ingraham*, 126 Mass. 200 (1879).

<sup>490</sup> *See, e.g., State Street Trust Co. v. Kissel*, 19 N.E.2d 25 (Mass. 1939).

<sup>491</sup> *See, e.g., Estate of Breault*, 211 N.E.2d 424 (Ill. App. Ct. 1965).

powerholder's estate, in which case the appointive assets become part of the powerholder's probate estate for all purposes, including creditors' rights.

f. When the powerholder of a general power makes an inter vivos appointment, treating the appointed assets as if they were owned by the powerholder does not automatically mean that the powerholder's creditors can subject the appointed assets to the payment of their claims. If the appointment is in favor of a *creditor*, the powerholder's other, unsatisfied creditors can reach the appointed assets only by having the appointment avoided as a "preference" in bankruptcy proceedings. Apart from bankruptcy, the powerholder can choose to pay one creditor rather than another with his or her owned assets, and the same is true with respect to appointive assets. If the appointment is in favor of a *volunteer* (i.e., the appointment is gratuitous), the powerholder's creditors can reach the appointed assets only if the transfer is the equivalent of a fraudulent transfer under applicable state law.

g. In a minority of jurisdictions, the powerholder of a general power, conferred on him or her by another, is *not* treated as the owner of the appointive property even if the power is exercised.<sup>492</sup> Of course, if the powerholder exercises the power in favor of himself or herself or his or her estate, the appointed property becomes owned in the technical sense, and creditors even in states adhering to the minority view would be able to subject the assets to the payment of their claims to the same extent as other property owned beneficially by the powerholder. A minority of states has enacted legislation that affects the rights of the powerholder's creditors. The legislation is not uniform. Some of the legislation expands the rights of the powerholder's creditors and some contracts them. The following is a sampling of the legislation:

(1) Michigan legislation expands the rights of the creditors of the powerholder of an unexercised general power. During the powerholder's lifetime, the powerholder's creditors can subject the appointive property to the payment of their claims if the power is presently exercisable. If the powerholder has actually made an *inter vivos* exercise of the power, the rules explained above with respect to inter vivos exercises presumably would be applied. At the powerholder's death, the powerholder's creditors can subject the appointive property to the payment of their claims. In both instances, however, the appointive property is available only to the extent that the powerholder's owned property is insufficient to meet the debts.<sup>493</sup>

(2) New York legislation expands the rights of the powerholder's creditors in some particulars but restricts them in others. The legislation adopts the same rules as the Michigan legislation, but limits their application to general powers presently exercisable. As to general testamentary powers, the powerholder's estate creditors can subject the appointive property to the payment of their claims only if the powerholder, as donor, reserved the power in himself or herself; as to general testamentary powers conferred on the powerholder by another,

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<sup>492</sup> See, e.g., *St. Matthews Bank v. DeCharette*, 83 S.W.2d471 (Ky. 1935).

<sup>493</sup> See Mich. Comp. Laws § 556.123.

the powerholder's estate creditors cannot reach the appointive property even when the powerholder's will exercises the power.<sup>494</sup>

h. The Uniform Powers of Appointment Act takes the following position. If the power is conferred by another, the rights of the powerholder's creditors depend on whether the power is general or non-general. If the power is general, the appointive property is subject to a claim of (1) a creditor of the powerholder, to the extent the powerholder's property is insufficient, if the power is presently exercisable (whether or not actually exercised), and (2) a creditor of the powerholder's estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid.<sup>495</sup> If the power is non-general, the general rule is that creditors have no rights in the appointive property.<sup>496</sup>

### 3. Formula

a. One option is to draft a testamentary general power of appointment that by formula absorbs any unused portion of a beneficiary's unused Applicable Exclusion Amount (including any DSUE Amount). This would provide a "step-up" in basis to those assets subject to the power without causing any Federal estate tax liability. In theory, this formula can be drafted with great precision. However, in practice, it is quite difficult to draft, particularly if the drafting occurs many years from the anticipated and likely exercise (or death of the power holder). Further, as discussed below, the formula may be subject challenge by the IRS.<sup>497</sup>

b. A testamentary general power of appointment that attempted to achieve the maximum favorable tax results would seem to require the following features:

(1) A formula that determines the size or amount of the general power of appointment. As mentioned above, in theory, the starting amount of the formula is the Applicable Exclusion Amount as defined in section 2010(c)(2), which would include the Basic Exclusion Amount under section 2010(c)(3)(A), including any increases due to the cost-of-living increase, and any DSUE Amount.

(2) The starting amount would then need to be reduced by any reductions due to taxable gifts that reduced the Applicable Exclusion Amount prior to death and any testamentary transfers that would not otherwise be deductible for Federal estate tax purposes (marital transfers under section 2056 and charitable transfers under section 2055).

(3) Once the size of the power of appointment has been so determined, the formula would need to provide that the power is not simply exercisable against all of the assets in trust, but that it is only exercisable against those assets in the trust that would benefit the most from a "step-up" in basis, given the tax nature of the asset (as discussed above).

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<sup>494</sup> See N.Y. Est. Powers & Trusts Law §§ 10-7.1, *et seq.*

<sup>495</sup> See Uniform of Powers of Appointment Act § 502.

<sup>496</sup> See Uniform of Powers of Appointment Act § 504(a).

<sup>497</sup> The IRS has ruled favorably on other formula general powers of appointment dealing with estate inclusion in lieu of a generation-skipping transfer. See, e.g., PLRs 9527024 and 911054.

For example, if the trust only held publicly-traded assets, the formula would need to ensure that the power is exercisable against the lowest basis lots of securities, not against the securities that have unrealized losses or the cash. The formula would likely need to determine the total income tax cost (including state income taxes) to the trust in a constructive liquidation of the assets in a taxable transaction for fair market value and then segregate those assets or portion of assets (like a separate lot of stock) that have the highest relative income tax cost compared to fair market value (the highest “effective” income tax cost). Without this refinement, the basis adjustment under section 1014(a) will be applied across all of the assets whether they benefit from the “step-up” in basis or not, and if the total value of the assets exceed the size of the general power of appointment, no asset will get a full “step-up” in basis.<sup>498</sup>

(4) The formula would likely also distinguish between assets that are and are not likely to be sold or redeemed in a taxable transfer (for example, closely-held C corporation shares in a family-owned business) and those assets that are not likely to be sold but provide some ongoing income tax benefits by virtue of the “step-up” in basis (for example, depreciable and depletable assets).

(5) In determining the “effective” income tax cost in a constructive liquidation of the trust assets, the formula may need to reduce the original size of the power of appointment to take into account any state death tax costs (if the beneficiary dies in a state with a state death tax) that would result from the existence of the general power of appointment. Most states with a death tax have an exemption that is smaller than the Federal Basic Exclusion Amount, and no state provides for “portability” of a deceased spouse’s unused state death tax exemption. As such, formula would need to take into account the “effective” state death tax cost (in comparison to the fair market value of the asset) and compare that to the income tax savings from the “step-up” in basis for the assets with the highest “effective” income tax cost on the date of death. The formula might then reduce the size of the general power of appointment to so that at the very least the “effective” state death tax cost equals (but likely is less than) the “effective” income tax cost of those assets that would be subject to the power of appointment. Note, some states provide that a general power of appointment is not subject to state death tax.<sup>499</sup> Because of the foregoing, drafters may choose to limit the size of the general power of appointment to the lesser of the Applicable Exemption Amount and any applicable state death tax exemption.

(6) To complicate things further, in determining the size of the general power of appointment, the formula will need to consider differences between the Applicable Exclusion Amount and the any remaining GST exemption the beneficiary may have at the time of death. If, for example, Applicable Exclusion Amount is greater than the beneficiary’s GST exemption, should the general power of appointment be reduced to the lesser

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<sup>498</sup> Similar to the basis adjustment under section 743 upon the death of a partner when the partnership makes or has a section 754 election. *See also* Rev. Proc. 64-19, 1964-1 C.B. 682, in the marital funding area, which requires that the assets selected for distribution be fairly representative of the appreciation and depreciation between the decedent’s death and the funding.

<sup>499</sup> Pennsylvania provides that mere existence of a general power of appointment does not cause inclusion of the assets subject to the power for inheritance tax purposes. Under § 9111(k) of Title 72 of the Pennsylvania Consolidated Statutes, property subject to a power of appointment is exempt from Pennsylvania inheritance tax in the estate of the donee of the power of appointment.

of the two amounts thereby foregoing some portion of the available “free” step-up in basis? Or should the general power of appointment be the greater of the two amounts but provide a different disposition of those assets depending on whether GST exemption is applied to such “transfer” (even in the failure to exercise the power of appointment)? In other words, assets receiving both a “step-up” in basis and application of the beneficiary’s GST exemption would continue to stay in the dynasty trust, for example, and assets that only receive “step-up” in basis would be held in a separate “non-exempt” GST trust.

c. Even if the formula could be so written with such precision, there is a chance that the IRS would challenge the general power of appointment (especially if the beneficiary has a surviving spouse) as indeterminable at the time of death of beneficiary or subject to a contingency or condition precedent, and as such, the formula does not give rise to an exercisable general power of appointment.

(1) As noted above, the size of the general power of appointment should be reduced by any transfers that would not otherwise be deductible for Federal estate tax purposes (marital transfers under section 2056 and charitable transfers under section 2055). Whether a transfer will qualify for the marital deduction or a charitable deduction may be dependent on a QTIP election under section 2056(b)(7)(B)(v) or a qualified disclaimer under section 2518, both of which occur after the date of death. A QTIP election is made on a timely filed estate tax return,<sup>500</sup> and a qualified disclaimer is made 9 months after date of death.<sup>501</sup>

(2) The IRS’s argument might be that despite the crux of the Fifth Circuit’s ruling in *Clayton v. Commissioner*,<sup>502</sup> a QTIP election relates back to the date of death and the same could be said about qualified disclaimers,<sup>503</sup> these actions do not relate to a general power of appointment under section 2041. The election and disclaimer do, however, affect the size of the general power of appointment. As such, they are similar to a contingency that has not yet occurred on the date of death.

(3) In Private Letter Ruling 8516011, the IRS ruled that a marital bequest that was conditioned upon the surviving spouse’s survival of the decedent’s admission to probate would not be included in the surviving spouse’s estate because the spouse died prior to the will being admitted to probate. In the ruling, the IRS stated that even though the spouse had the power to admit the will to probate and thus had a power of appointment, this power of appointment was subject to the formal admission to probate, which in turn requires a substantive determination by the court regarding the validity of the will. As such, the general power of appointment was deemed not to exist for estate tax purposes.<sup>504</sup>

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<sup>500</sup> § 2056(b)(7)(B)(v).

<sup>501</sup> § 2518(b)(2).

<sup>502</sup> 976 F.2d 1486 (5th Cir. 1992), *rev’g* 97T.C. 327 (1991).

<sup>503</sup> *See* § 2518(a) and Treas. Reg. § 25.2518-1(b).

<sup>504</sup> *See* TAM 8551001 and *Kurz Estate v. Commissioner*, 101 T.C. 44 (1993), *aff’d*, 68 F.3d 1027 (7<sup>th</sup> Cir. 1995).

d. In addition, if the formula allows the grantor to alter the amount subject to the general power of appointment, then there is a potential issue under section 2036 of the Code. For example, if the amount subject to the power is reduced by subsequent taxable gifts or by the taxable bequests under the will, then by choices reserved to the grantor, the general power of appointment may cover more or less assets. On the other hand, if the general power of appointment is not modified by these subsequent factors, it will likely not function as intended. There is a risk that too much will be subject to the general power of appointment (e.g., if grantor leaves 100% of estate to charity or to a spouse) or too little (e.g., if the grantor makes large taxable gifts/bequests).

#### 4. Trust Director

a. Because of the complexities of the formula and the risk of challenge by the IRS, estate planners may want to rely upon an independent person to grant or modify the terms of a limited power of appointment and expand it to a general power of appointment.<sup>505</sup> This has the obvious benefit of allowing the trust protector to determine the size of the testamentary power of appointment and the assets that will be subject to the power as the situation and the tax laws change in the future. Such person is referred to in the Uniform Directed Trust Act as a “trust director” but other names include “trust protector” or “trust advisor.”

b. The power would need to be granted prior to the death of the beneficiary and in writing, in all likelihood. Because of the problems with relying on a formula as discussed above, a trust director may choose to grant a general power of appointment to each beneficiary equal to a fixed pecuniary amount based upon the beneficiary’s estate situation (value of assets, existence of a surviving spouse, structure of the beneficiary’s estate plan, state of domicile, etc.) and the nature of the assets in the trust (making the general power of appointment exercisable only against certain assets or portions of assets). The trust director could provide that the power of appointment will be exercisable at the death of the beneficiary, but can be revoked or modified at any time by the trust director. The trust director might modify such power of appointment, for example, if the beneficiary’s estate situation changed or if certain trust assets are sold.

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<sup>505</sup> See, e.g., Alaska Stat. § 13.36.370(b)(4) (“modify the terms of a power of appointment granted by the trust”); Idaho Code § 15-7-501(6)(c) (“To modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument.”); S.D. Codified Law § 55-1B-6(3) (“Modify the terms of any power of appointment granted by the trust. However, a modification or amendment may not grant a beneficial interest to any individual or class of individuals not specifically provided for under the trust instrument.”); Wyo. Stat. § 4-10-710(a)(xi) (“to grant a power of appointment to one (1) or more trust beneficiaries or to terminate or amend any power of appointment granted by the trust; however... of a power of appointment may not grant a beneficial interest to any person or class of persons not specifically provided for under the trust instrument or to the trust protector, the trust protector’s estate or for the benefit of the creditors of the trust protector.”).

E. Forcing Estate Tax Inclusion

1. Different Strategies for Causing Estate Tax Inclusion

a. Give someone—trustee, trust director, or person with a power of appointment—the discretion to grant a general power of appointment or to expand a special power of appointment so it becomes general. The power could be granted shortly before death if the step up in basis is desirable given the tax rates in effect at that time (considering, of course, that when a potential power holder is “shortly before” death may not always be easy to determine). Should the person with the power to grant or expand the power be a fiduciary? Should protection be given for a decision to grant or not to grant the power of appointment? Should the general power be able to be rescinded or modified by the person granting the power? Where the circumstances are clearly defined, a formula grant of a general power may be easier, and more successful, than a broadly applicable formula.

b. Terminate the trust and distribute the assets to one or more beneficiaries. If a beneficiary does not have a taxable estate, then there may be no transfer tax reason to maintain the trust and there may be a negative income tax consequence to such maintenance. Quite obviously, there may be non-tax detriments to a beneficiary having outright ownership of such assets. In such instances, transferring assets from a trust that is not includible in the beneficiary’s estate into a new trust over which the beneficiary has a general power of appointment – perhaps one exercisable only with the consent of a non-adverse party to the creditors of the beneficiary’s estate – may produce a step-up with minimal risk of asset diversion or dissipation.

c. Include a formula in the trust agreement which would cause estate tax inclusion if appreciation is not sufficient for estate tax benefits to outweigh income tax benefits of a step up

(1) Example: I make a gift of \$5 million of stock with a basis of zero to a trust for my children. Trust agreement provides that on my death, if 40% of the excess of the date of death value of any asset over the date of gift value of the asset is less than 23.8% of the excess of the date of death value of the asset over the basis of the asset, the asset is distributable to my estate. The formula could be written as follows if  $(E) \cdot (D - G) < (I) \cdot (D - B)$ , asset is distributable, where E=estate tax rate, I=income tax rate, D=date of death value, G=date of gift value, B=basis. If the value of the stock is \$7.5 million at my death, the stock would be distributed to my estate so that I get the income tax benefit of the step up, which exceeds my transfer tax savings.

(2) Formula creates an “estate tax inclusion period”<sup>506</sup> (“ETIP”) so GST exemption cannot be allocated to the trust.

d. Appoint the donor as trustee, although many trust agreements provide that the donor may never be named as trustee.

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<sup>506</sup> § 2642(f).

e. Move the trust from an asset protection jurisdiction to a jurisdiction where donor's creditors can reach the assets. This would also require that the donor have some beneficial interest in the trust that would cause it to be a self-settled trust.

f. Estate could take the position that there was an implied agreement of retained enjoyment under section 2036(a)(1). For example, donor begins living in a home gifted to the trust (perhaps pursuant to a qualified residence trust) without paying rent and takes the position that there was an implied agreement at the outset that the donor would be able to do so.

(1) A recent Federal district court case could help in this context. In the 1970's two cases dealing with the Goodwyn family established the principle that if a trust agreement prohibited the grantor from acting as de facto trustee, the mere fact that the grantor did in fact act as de facto trustee would not established a retained interest under section 2036 of the Code.<sup>507</sup> In the 1973 opinion the court stated:

Under the terms of the deeds creating these trusts, the trustees were granted broad discretionary powers with respect to both the distribution of income to the beneficiaries and the investment and management of the corpus of the trusts. Notwithstanding the designation of Richards and Russell as trustees, it further appears that at all times from the establishment of the trusts until his last illness, the decedent exercised complete control with respect to the purchase and sale of trust assets, investment of any proceeds, and the determination of the amounts, if any, to be distributed to the respective beneficiaries.

The assets of the various trusts, together with other trusts, as well as property owned by the decedent, were accounted for by a single set of records maintained in the offices of the decedent. Except for the Federal income tax returns prepared and filed by the decedent on behalf of the various trusts, no separate records were maintained showing the assets and income of any of these trusts.

The respondent argues that the decedent should be treated as trustee, in fact, possessing such rights and powers as to cause the inclusion of the assets thereof in his gross estate, relying on sections 2033, 2036 (a)(2), and 2038. Section 2033 requires a finding that the decedent had an interest in the assets of the trusts at the time of his death. There is no basis for such a finding. Section 2038(a)(1) relates to "a power" exercisable by the decedent "to alter, amend, revoke, or terminate," the trusts. No such power was reserved by the decedent. Accordingly, in the final analysis the respondent's position is predicated on the determination that by reason of the de facto control exercised by the decedent the trusts are includable in his estate pursuant to section 2036(a)(2). It is clear that the powers granted to the trustees would, if reserved by the decedent, be such as to require the inclusion of the assets of the trusts in the estate of the decedent. *United States v. O'Malley* [66-1 USTC ¶ 12,388], 383 U.S. 627 (1966). Does the fact that the decedent was able to exercise such powers through the cooperation of unrelated trustees require

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<sup>507</sup> *Estate of Goodwyn*, T. C. Memo. 1973-153, nor a power for the grantor trust provisions of sections 671, et seq., of the Code, *Estate of Goodwyn v. Commissioner*, T.C. Memo. 1976-238.

a different result? The question thus presented for decision is whether the value of such trusts is includable in the estate of the decedent by reason of the de facto control over the trusts exercised by the decedent, notwithstanding that no power to exercise such control was reserved to or by the decedent once he resigned his duties as trustee of certain of these trusts.

In the course of the trial of this case, and in his briefs, respondent made no secret of the fact that support for respondent's position was to come from the decision of the U.S. Supreme Court in the case of *United States v. Byrum* then pending on writ of certiorari from the U.S. Circuit Court of Appeals for the Sixth Circuit ([71-1 USTC ¶ 12,763] 440 F.2d 949). The Supreme Court has since rendered its decision in that case. [72-2 USTC ¶ 12,859] 408 U.S. 125 (1972). By that decision, the Supreme Court has rejected the position of the respondent in the instant case that the de facto exercise of control over the management and investment of the trust res is within the ambit of section 2036.

In distinguishing *United States v. O'Malley, supra*, the Supreme Court in the Byrum case said:

In our view, and for the purposes of this case, *O'Malley* adds nothing to the statute itself. The facts in that case were clearly within the ambit of what is now § 2036(a)(2). That section requires that the settlor must have "retained for his life \* \* \* the right \* \* \* to designate the persons who shall possess or enjoy the property or the income therefrom." *O'Malley* was covered precisely by the statute for two reasons: (1) there the settlor had reserved a legal right, set forth in the trust instrument; and (2) this right expressly authorized the settlor, "in conjunction" with others, to accumulate income and thereby "to designate" the persons to enjoy it.

It must be conceded that Byrum reserved no such "right" in the trust instrument or otherwise. The term "right," certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and legally enforceable power, such as that involved in *O'Malley*. Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to "regulate the flow of dividends" to the trust. That "right" was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.

The right or power upon which the tax is predicated must thus be a legal right reserved in the trust instrument, or at least by some form of agreement between the trustees and the settlor. Admittedly, such a right did not exist in the case of the Richards and Russell Trusts. To hold otherwise would not only be contrary to the reasoning of the Supreme Court in the *Byrum* case but would present the insuperable problem of determining to what degree compliance on the part of unrelated trustees with the wishes of the grantor would be sufficient to constitute requisite control over the trust res within the meaning of section 2036.

It would indeed be an unusual situation for a grantor to appoint trustees, whether corporate or otherwise, in the expectation that such trustees would, where given a choice, act contrary to the wishes and intent of the grantor. Notwithstanding that Richards and Russell permitted the decedent full discretion in the management of

these trusts, as a matter of law the trustees were responsible and answerable for the decedent's acts on their behalf. *See* 2 Scott, Trusts 1388 (3d ed., 1967); 3 Scott, Trusts 1794 (3d ed., 1967). Had they so elected, Richards and Russell could have taken control of the trust res at any time.

(2) The 1977 opinion renders an identical holding bolstered by certain legislative history:

There is nothing in the record to show that the trustees could not have undertaken exclusive control of the trust res if they had elected to do so. Whatever power Goodwyn exercised over the trust assets, administration or distribution, he did so on the trustee's behalf and not in his own right.

Because of Goodwyn's failure to have a legally enforceable right, we have already held, following *Byrum*, that the assets of these trusts were not includable in the decedent's estate under 2036(a)(2). Since a similar legal right or power is a prerequisite under section 674(a), consistency appears to require the same decision with respect to the applicability of this section. We see no other possible decision.

Section 671 precludes attributing the income to Goodwyn on any other theory of dominion and control under the definition of gross income, including the Clifford doctrine. We interpret this limitation to mean that if Goodwyn cannot be considered as a trustee, in fact, under the statutory provisions of subpart E, he cannot be considered as such by virtue of the judicial doctrines arising from the Clifford case which Congress intended to limit through the enactment of subpart E. But the protection of section 671, as explained in the House Ways and Means Committee Report, cited *supra*, does not extend to situations involving the assignments of future income.

(3) With respect to the legislative history of the Internal Revenue Code of 1954, the 1977 opinion states:

While the record indicates that the legal formalities have been complied with, it also indicates that the designated "independent" trustees, whether by agreement or otherwise, entrusted the management of the trusts' assets and the distribution of income therefrom to the sole discretion of the decedent. The decedent kept all the records, made all of the investments and decided the amount to be distributed to beneficiaries. The trustees merely acquiesced in these actions.

On the basis of these facts, the judicial decisions following the Supreme Court's decision in *Helvering v. Clifford* [40-1 USTC ¶ 9265], 309 U.S. 331 (1940), and the later so-called *Clifford* regulations might well warrant the attribution of the income from these trusts to the decedent. However, to the extent these previous principles are not embodied in the present statutory provisions of the Code, they must be considered no longer applicable. Section 671 provides that subpart E represents the sole criterion of dominion and control under section 61 (relating to the definition of gross income) and thereby also under the *Clifford* doctrine.

The Report of the Committee on Ways and Means on the Internal Revenue Code of 1954 explains clearly that this exclusivity was the intent of Congress:

It is also provided in this section [671] that no items of a trust shall be included in computing the income or credits of the grantor (or another person) solely on the grounds of his dominion and control over the trust under the provisions of section 61 (corresponding to sec. 22(a) of existing law). The effect of this provision is to insure that taxability of *Clifford* type trusts shall be governed solely by this subpart. However, this provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the trust. Thus, this subpart has no application in situations involving assignments of future income to the assignor, as in *Lucas v. Earl* [2 USTC ¶ 496] (281 U.S. 111), *Harrison v. Schaffner* [41-1 USTC ¶ 9355] (312 U.S. 579), and *Helvering v. Horst* [40-2 USTC ¶ 9787] (311 U.S. 112), whether or not the assignment is to a trust; nor are the rules as to family partnerships affected by this subpart.

Consequently, in order for a grantor to be held taxable pursuant to subpart E on the income of a trust which he has established, he must have one of the powers or retained interests proscribed by subpart E.

(4) So, that's where the law has stood for many years. Along comes a bad facts makes bad law case, that of *Securities and Exchange Commission v. Wyly*.<sup>508</sup> The issue there was whether certain trusts should be considered grantor trusts for income tax purposes, thus causing the grantors to owe income tax, or whether the trusts were properly considered to be offshore, managed by an Isle of Man trustee. The opinion states:

Section 674(a) provides that: “[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.” Quoting a prominent tax treatise, defendants concede that the “power of disposition” includes “powers to ‘effect such major changes in the enjoyment of a trust's income and corpus as the addition and elimination of beneficiaries’ as well as ‘minor and customary power[s]’ over income and corpus distribution.” Because a non-beneficiary trustee is considered a non-adverse party under the statute, “[s]ection 674(a) captures virtually every trust, including the [IOM] trusts.” Thus, defendants concede that “[u]ltimate liability under [s]ection 674[] ... turns on whether any of the statutory exceptions apply.” In his treatise, defendants' expert confirms that the Wyllys' had a power of disposition under this statute. *See* Robert T. Danforth, Norman H. Lane, and Howard M. Zaritsky, *Federal Income Taxation of Estates and Trusts* §9.04[1] (“A right to use trust funds without adequate compensation also affects beneficial enjoyment, because the holder can reduce the assets from which the named beneficiaries can benefit. Thus, a grantor's right to live rent-free in a house owned by the trust is a power of disposition under Section 674(a).”).

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<sup>508</sup> *Securities and Exchange Commission v. Wyly*, 2014 WL 4792229 (S.D.N.Y. Sept. 25, 2014).

According to defendants, the Bulldog Trusts are not grantor trusts because they fall under the section 674(c) exemption. Under that exemption, section 674(a) does not apply to “certain powers that are exercisable by independent trustees.” According to the corresponding IRS regulation, which summarizes the statute, [t]he powers to which section 674(c) apply are powers (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or (b) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries). In order for such a power to fall within the exception of section 674(c) it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. To determine whether the Bulldog Trusts are covered by this exception, it is necessary to answer three questions: 1) Did the IOM trustees have the power to “distribute, apportion, or accumulate income” or “pay out corpus” to or for a beneficiary or beneficiaries?; 2) Were the IOM trustees a) the grantor, or b) a “related or subordinate” party as defined by the statute?; and 3) Were the trustees able to “exercis[e] [those powers] solely (without the approval or consent of any other person)?”

The first two questions are straightforward. First, the IOM trustees certainly had the power, as set out in the trust deeds, to “distribute, apportion, or accumulate income” or “pay out corpus” to or for a beneficiary. Second, the IOM trustees were neither the grantor, nor one of the individuals on the exclusive list of “related or subordinate” parties defined by the statute. The only remaining question is whether the IOM trustees were able to exercise those powers “solely” or “without the approval or consent of any other person.”

Defendants argue, citing a 1976 Tax Court case, that a grantor may only be taxed on “a power reserved by instrument or contract creating an ascertainable and legally enforceable right, not merely the persuasive control which he might exercise over an independent trustee who is receptive to his wishes.” As such, defendants contend that the Wylys did not share in the power to distribute, apportion, or allocate income, or to pay out corpus, because the trust deeds allocated those powers solely to the IOM trustees. Thus, the Bulldog Trusts fall within the shelter of 674(c)’s “independent trustees exception.”

I disagree. “Such a rigid construction is unwarranted. It cannot be squared with the black-letter principle that ‘tax law deals in economic realities, not legal abstractions.’” As Professor Robert Danforth, the defendants' own expert, writes in his treatise, “[i]t would certainly violate the purpose of the independent trustee rule to require an independent trustee to act with the consent of the grantor or a related or subordinate person.” The Wylys, through the trust protectors who were all loyal Wyly agents, retained the ability to terminate and replace trustees. The Wylys expected that the trustees would execute their every order, and that is exactly what the trustees did.

The evidence amply shows that the IOM trustees followed every Wyly recommendation, whether it pertained to transactions in the Issuer securities, making unsecured loans to Wyly enterprises, or purchases of real estate, artwork, collectibles, and other personal items for the Wylys and their children.

The trustees made no meaningful decisions about the trust income or corpus other than at the behest of the Wyls. On certain occasions, such as the establishment of the Bessie Trusts, the IOM trustees actively participated in fraudulent activity along with the Wyls. The Wyls freely directed the distribution of trust assets for personal purchases and personal use. Because the Wyls and their family members were beneficiaries, the IOM trustees were thus “distributing” income for a beneficiary at the direction of the grantors—the Wyls.<sup>509</sup>

(5) *Wyly* presents potential problems for ordinary trusts if the advisors routinely follow a grantor or beneficiaries “advice.” The *Goodwyn* rule was clear, but if you believe *Wyly* then in many trusts we would likely discover that the grantor or beneficiaries were “pulling the strings” although they had no legal right to do so. However, in the context of obtaining basis for grantors, *Wyly* could be helpful by enabling a grantor to argue for the application of section 2036 unexpectedly. Note particularly that the *Goodwyn* rationales appear to be based on a trustee having authority; if an advisor who is not a fiduciary can direct a trustee, and the trustee must follow the direction, then will *Goodwyn* protect the grantor whose advisor follows the grantor’s advice regularly.

g. Use a freeze partnership so that grantor’s retained preferred interest gets a basis adjustment at death.

(1) Transfers cash flow and appreciation in excess of the donor’s preferred return and liquidation preference

(2) Section 754 election (discussed below) would allow a corresponding step up to partnership’s inside basis.

(3) Requires payment of a preferred return to donor, which may be difficult if yield on underlying assets is not sufficient

(4) Preferred interest valued at zero unless an exception to section 2701 exists or if an exemption to the zero valuation rule exists (for example, a qualified payment interest)

(5) Even if the section 2701 requirements are not met and preferred interest has a zero value (e.g. because non-cumulative) so that the value of the gift equals the donor’s entire interest in the partnership, at donor’s death the value of preferred is includible in

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<sup>509</sup> Because I conclude that both the Bulldog and Bessie Trusts were grantor trusts under Section 674, I need not reach the issue of whether they were also grantor trusts under Section 679. Although the SEC contends that the trading profits on sales of Issuer securities should be taxed at the ordinary income rate, I decline to do so. Rather, I will approximate unpaid taxes by applying the rate the Wyls would have had to pay if they owned the shares personally, which requires applying the ordinary income or capital gains rate for the taxable year. Thus, the “reasonable approximation” of disgorgement is \$111,988,622.76 for Sam Wyly and \$58,896,281.97 for Charles Wyly when using the lower capital gains rate. See JX 9904A and JX 9904B (“Calculations Using the Ordinary and Capital Gains Tax Rates for All Transactions in Registered Securities Attributable to Sam and Charles Wyly”).

gross estate (put right can ensure that the value at least equals liquidation preference) and there is no transfer tax on the income and appreciation to the extent it exceeds the donor's preferred return.

2. Tax consequences of estate tax inclusion

a. Value of property at death is includible in gross estate.

b. Section 2001(b) provides that adjusted taxable gifts do not include gifts that are includible in the gross estate. Thus, there is a distinction between including assets in the estate of a beneficiary and including gifted assets in the estate of the donor.

c. There is no reduction available for gifts treated as having been made by a spouse because of a split-gift election, so estate tax inclusion generally should not be used for property for which a splitgift election was made.

d. Question of how much is excluded from adjusted taxable gifts where less than all of the gifted property is includible in the estate (e.g. because of distributions of income or distributions of appreciation)?

(1) This does not seem to be addressed under sections 2001, 2701 and 2702 and the Treasury Regulations thereunder.

(2) Example: I make a completed gift of \$5 million of stock with a zero basis to a trust for my children and the stock is included in my estate as a result of one of the methods described above. During my lifetime any income and appreciation in excess of \$5 million is distributed to my children free from transfer tax. On my death, the remaining \$5 million of stock is includible in my gross estate and is not included in my adjusted taxable gifts. The basis in the stock will be stepped up to the value on the date of death and the stock can be sold free from capital gains tax.

(3) Example: Same as the previous except that I retain the right to receive trust income during my lifetime. My income interest does not reduce the value of the gift because it does not meet the requirements of section 2702. All appreciation is distributed to my children during my lifetime. On my death, I receive a basis "step-up" and my adjusted taxable gifts are reduced. Under the Treasury Regulations,<sup>510</sup> however, my adjusted taxable gifts are only reduced by the value of my income interest and not by the full \$5 million value of the stock.

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<sup>510</sup> Treas. Reg. § 25.2702-6.

F. “Reverse” Estate Planning: Turning your Poorer Parent into an Asset

1. Generally

a. Many clients who have taxable estates also have a surviving parent or parents who lack a taxable estate. A child of a parent whose taxable estate is less than the parent’s Basic Exclusion Amount may make use of the excess to save income, estate, and generation-skipping taxes if the child can transfer assets upstream, from child to parent, in such a way that the assets are included in the parent’s estate with little likelihood that the parent will divert the transferred assets away from the child or child’s descendants.

b. Although the benefits of such planning have always existed, the permanent increase in the Applicable Exemption Amount recently has enhanced the benefits of such planning.

2. Estate and Generation-Skipping Tax Benefits.

a. To the extent a child transfers assets to an ancestor, the ancestor will include those assets in the ancestor’s estate and may shelter those assets with the ancestor’s estate and GST tax exemptions. Transfers can be made without using the child’s Applicable Exclusion Amount:

(1) Annual exclusion gifts may be made to the ancestors. The gifts may be made outright or in trust depending on circumstances (e.g. ancestors may be given *Crummey*<sup>511</sup> withdrawal rights). Discounted gifts may be made although doing so will add benefits to the transaction only if the discount is unlocked prior to the ancestor’s death. The benefits of annual exclusion gifts may be significant. To illustrate, \$14,000 per year for 10 years at 5% equals \$176,000. If child is married and there are even two living parents, then \$56,000 for 10 years at 5% exceeds \$700,000.

(2) Child could make adjusted taxable gifts to the ancestor. Although it may appear that such would be a wasted use of the child’s gift tax exemption, if the ancestor is able to leave the given amount to child and child’s descendants without estate or generation-skipping tax then the only waste would be opportunity cost to the extent that other methods could be found to transfer assets to a parent without making a gift.

(3) Child may create a GRAT that has a vested remainder in ancestor. That is, the GRAT assets, after the annuity term ends, will be paid to ancestor or to ancestor’s estate. The value of the remainder will be included in the ancestor’s estate and will pass in accordance with the ancestor’s estate plan.

(a) The ancestor’s executor may allocate generation-skipping tax exemption to the remainder interest without regard to any ETIP under section 2642(f) because the ancestor has not made an inter vivos transfer of property that would be included in the estate immediately after the transfer. The amount allocated would be equal to the fair market value of

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<sup>511</sup> See *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

the remainder interest. Where the GRAT term is 10 years (or longer), and is back-weighted, the remainder value will remain a comparatively small percentage of the GRAT for the first several years of the term. Upstream GRATs will, in general, have longer terms than GRATs that are designed to transfer assets immediately to children. Commentators have speculated that a GRAT may be created with a vested interest in a child, with that child immediately transferring the remainder interest to that child's children and allocating that child's GST exemption at the time of transfer. There is no authority on whether such a transaction achieves the intended result. Private Letter Ruling 200107015 ruled negatively on the assignment of a remainder interest in a charitable lead annuity trust primarily on the grounds that section 2642(e) is specifically designed to limit the ability to leverage generation-skipping tax exemption by using a charitable lead annuity trust. Here the GRAT remainder is not being transferred at the time of its creation, but rather at its fair market value at a later time (the death of the parent owner), which is arguably not abusive.

(b) Use of an Upstream GRAT presents several advantages compared with a child's assignment of a remainder interest to grandchildren. Because GST exemption that would otherwise be wasted is being used there is no, or certainly less, pressure to keep the remainder interest in parent's estate at zero or a de minimis value and the value changes depending on when parent dies (a date that in almost all instances will be uncertain). If a concern is that the value of the remainder interest could exceed the threshold beyond which parent's estate would be required to pay Federal estate tax (or file an estate tax return), then the amount vested in parent could be fixed by a formula tied to the remaining assets in parent's estate. Suppose a 10 year GRAT is funded with \$1,000,000 with annual payments that increase at 20% per year is created in a month when the section 7520 rate is 2.0%. The annual payments required to zero-out the GRAT are \$44,125. Further, suppose that parent dies at the end of year 5 when the section 7520 rate is 5.0% and the value of the trust assets have grown at 6% per year. The value of the GRAT will be \$975,740 with five years of payments remaining and the value of the remainder will be about \$403,000.

### 3. Income Tax Benefits

Assets included in a parent's estate for estate tax purposes obtain a new income tax basis under section 1014(b)(9) but not if assets acquired by the parent from a child by gift within one year of the parent's death pass back to the child or the child's spouse.<sup>512</sup> Suppose that the assets pay into a trust for descendants but a third party has a power of appointment to add beneficiaries to the trust?

### 4. Creditor Protection for Child

a. Assets that a parent transfers in trust to a child may be insulated from the child's creditors so long as the child's rights in the trust are properly limited. The sine qua non is that parent must make the transfer into the trust for state law purposes.

b. The lapse of a *Crummey* withdrawal right may be a state law transfer, although most practitioners and trustees do not treat it as such, except in those states which

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<sup>512</sup> § 1014(e).

provide specifically to the contrary (such as under the Uniform Trust Code). A safer approach would be to have parent exercise parent's power of appointment in favor of a new trust for the benefit of child. If the power is general the parent should become the grantor of the trust for state law purposes.

5. Limiting Parent's Ability to Divert Assets

a. The strategies called for require that parent have a testamentary general power of appointment. A power limited to the appointment of assets to the creditors of a parent's estate will be a general power under section 2041(b)(1). If it is desirable that a parent have additional discretion the parent could be given a power to appoint to descendants, with or without charities, and such additional powers could be conditioned on the consent of child or others because all that is required in order to capture the tax benefits is the limited testamentary general power.

b. If a child desires to receive an interest in the assets transferred to parent back from parent (e.g. parent transfers the assets into a trust for child and child's descendants that is not available to child's creditors), then giving parent a power that is broader than a power to appoint to the creditors of parent's estate may be desirable. For example, a parent could be given a power to appoint to parent's children and the creditors of parent's estate. Child could ensure that assets were not diverted to a sibling by purchasing from the siblings an assignment of any rights the siblings receive in assets appointed by parent that originated with child. The assignment would be independent of parent but would limit the ability of a creditor (or the government) to argue that the child transferred the assets to parent in a manner that did not give parent any true control. The ability to reach such an agreement with minors is limited.

6. Parent's Creditors.

a. A parent who has or is likely to have creditors will not be a good candidate for these sorts of transactions. Creditors could include health-care providers or Medicaid, tort victims (for example, if parent is still driving), and beneficiaries of legally binding charitable pledges.

b. In addition, by definition, a parent who is married to someone who is not also child's parent has a potential creditor at death although in limited instances marriage agreements coupled with state law limitations on the rights of a surviving spouse to take property over which a decedent has a testamentary general power of appointment may make these transactions feasible.

7. Upstream Sale to a Power of Appointment Trust (UPSPAT)

a. Suppose a child creates a grantor trust, sells assets to the trust for a note, gives the child's parent a testamentary general power of appointment over the trust assets so that the assets will be included in the parent's estate at the parent's death and receive new basis, and then the trust (which remains a grantor trust with respect to the child ever after the parent's death) uses the assets to pay off the note. The net effect is that the parent's net estate is increased by zero or a small amount yet the child receives new basis.

b. Because the contemplated transaction is not designed to remove assets from the child's estate for estate tax purposes, the issues under section 2036 that require that the grantor trust be appropriately "seeded" would not apply. However, a sale to an unseeded trust

could result in a note having a value less than its stated face value, thus causing child to make a gift. Parent's guarantee of the note could reduce that risk.

c. Does the existence of the parent's general power cause the assets to be stepped-up to full fair market value, or will the value of the note reduce the amount of the step-up? section 2053(a)(4) provides that the value of the taxable estate will be reduced by indebtedness in respect of property included in a decedent's estate. The Treasury Regulations provide, in relevant part:

A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth.<sup>513</sup>

d. Thus the net increase to parent's estate would seem to be zero. If parent guaranteed the obligation then this concern would be reduced. Arguably such a step is unnecessary because the regulations may be read as discretionary or optional. Further, outside the trust context, the Supreme Court decision in *Crane v. Commissioner*<sup>514</sup> suggests that the basis increase is based on the fair market value of the property regardless of the associated debt.

e. If the amount over which parent has a testamentary general power of appointment is limited by formula to an amount that would not increase parent's taxable estate to more than the federal estate tax exclusion taking into consideration parent's other assets, then a basis adjustment can be obtained for that amount because there is no need for the debt to offset the assets included in parent's estate. The trust should provide that it is for the benefit of the child's descendants, not the child, to avoid the one year prohibition of section 1014(e), as discussed in more detail above.

f. Might the IRS argue that payment on the note is an indirect return of assets to the child? To the extent the note is not for fair market value that would be a direct return of assets. Suppose the terms of the trust and the sale provided that no assets could be used to pay off the note beyond those required to satisfy the fair market value of the note as

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<sup>513</sup> Treas. Reg. § 20.2053-7.

<sup>514</sup> *Crane v. Commissioner*, 331 U.S. 1 (1947) (holding that the proper tax basis of the property acquired by bequest subject to a mortgage "is the value of the property, undiminished by mortgages thereon.")

determined for federal gift tax purposes. The desired result would be that the amount of the child's gift would be trapped in the trust and pass other than to a child.

g. Supposed child “sells” cash to the grantor trust for a promissory note. Section 1014(e) applies, by its terms, only to “appreciated property” acquired by the decedent by gift within one year prior to the decedent's death. If the cash in the grantor trust is later swapped for child's appreciated property that would not be appreciated property acquired by gift. The cash might have acquired in part by gift – if the note were not valued at par – but not the appreciated property. Is this extra step valuable in minimizing a challenge?

h. Does the death of a parent terminate the grantor trust status of the trust? If yes, that would cause the sale to be recognized by child as of that moment, thus undoing the benefits of the transaction. This is unlike a sale to a grantor trust where grantor trust status terminates because the grantor dies where, as discussed later in this outline, the consensus appears to be that death cannot, or ought not, trigger a taxable transaction. The Treasury Regulations provide that a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer – defined as any transfer other than one for fair market value – of property to a trust.<sup>515</sup> Section 678 by its terms confers grantor trust status (or status that is substantially similar to grantor trust status) only in situations involving inter-vivos general powers. The IRS ruling position is that an inter-vivos right to withdraw makes the power holder a grantor under section 678 but not replacing the true grantor if one still exists. What is the effect of parent's testamentary general power of appointment? The Treasury Regulations contain two examples that are close but not directly on point:<sup>516</sup>

Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

Example 8. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

i. Note that this is the same issue which exists with respect to creating a lifetime QTIP trust that is a grantor trust with respect to the creating spouse. After the

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<sup>515</sup> Treas. Reg. §1.671-2(e)(1).

<sup>516</sup> Treas. Reg. §1.671-2(e)(6).

beneficiary spouse dies, the property may remain in trust for the benefit of the creating spouse and the couple's descendants becoming, essentially, a credit-shelter trust. However, if the creator spouse remains the grantor of the trust for income tax purposes that will produce a substantial additional transfer tax benefit.<sup>517</sup>

j. An UPSPAT may be “ready to go” to minimize the risks of delay when a parent (or ancestor) becomes ill. The descendant may create the UPSPAT and transfer assets to it retaining lifetime and testamentary powers of appointment to ensure that the gift is incomplete. An instrument by which the descendant gives up those powers of appointment may be drafted as may the form of a note, leaving only the date and interest rate blank. Thus, on short notice, the descendant may contact the trustee, deliver the instrument surrendering the powers of appointment and, in exchange for that gift, receiving the note. Obviously, a sale document could be completed at the same time if desirable. Prudence suggests that the note be transferred immediately to another party to minimize the risk that the IRS recharacterizes the sale-note-payoff as a return of assets to the descendant.

k. As in all instances when a general power of appointment is being created for income tax basis purposes, a circumscribed general power of appointment, described earlier, should be used.

#### 8. Accidentally Perfect Grantor Trust

a. Similar in many respects to the UPSPAT discussed above is a technique that has been called the “Accidentally Perfect Grantor Trust” (APGT).<sup>518</sup> The transferor uses a parent's unused Applicable Exemption Amount and GST exemption, benefits from a “step-up” in basis, but still retains grantor trust status after the parent's death. Pursuant to this technique, a younger generation establishes an IDGT and moves wealth into the IDGT (e.g., pursuant to an installment sale as with the UPSPAT) the terms of which provide that the parent is a beneficiary of the IDGT and is granted a testamentary general power of appointment over the IDGT's appreciated assets equal to the parent's unused Applicable Exemption Amount and GST exemption (e.g., pursuant to a formula provision, as discussed above). Upon the death of the parent, the assets may be held for the benefit of the younger generation grantor and his or her descendants.

b. In order to be successful, the APGT must avoid estate tax inclusion at the younger generation's level under sections 2036 through 2038, cause estate tax inclusion at the parent's passing, and provide for a “step-up” in basis for the estate tax includible assets.<sup>519</sup>

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<sup>517</sup> See Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, *Supercharged Credit Shelter Trust*, 21 Prob. & Prop. 52 (July/Aug. 2007).

<sup>518</sup> For an excellent discussion of this technique, see Mickey R. Davis & Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% “Medicare” Tax: What Estate and Trust Professionals Need to Know*, The Univ. of Tex. School of Law 61st Ann. Tax Conf. – Est. Pl. Workshop (2013).

<sup>519</sup> But see PLR 200101021 on the applicability of Section 1014(e).

c. From an income tax standpoint, according to the proponents of the APT, whether the ongoing trust will continue to be a grantor trust with respect to the younger generation or a non-grantor trust depends on whether the parent exercises the general power of appointment or allows it to lapse. The Treasury Regulations provide:

If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.<sup>520</sup>

d. Thus, if the ongoing trust arises because the parent exercises the general power of appointment, then the parent is the grantor for income tax purposes, and the ongoing trust will be a non-grantor trust for income tax purposes. More significantly, the argument goes, if the ongoing trust is created as a result of the failure to exercise or lapse of the general power of appointment, then the trust will continue to be a grantor trust with respect to the younger generation who is also a potential beneficiary of such trust ongoing trust.

e. In addition, it would be a challenge for the IRS to know that the grantor/beneficiary is claiming ongoing grantor trust status. From an income tax reporting standpoint, prior to the death of the holder of the testamentary general power of appointment, the Form 1041 (if one believes one should, in fact, be filed) simply states the trust is a grantor trust and all tax items are being reported on the grantor's personal income tax return. In the year of the power holder's death, the Form 1041 would be reported the same way with no change in taxes obviously and with, perhaps, a disclosure that grantor trust status will continue to be claimed. All of the changes to tax basis would occur on the grantor's personal income tax return.

## G. The Upside of Debt

### 1. Generally

a. As mentioned above, the analysis around estate planning will be measuring the estate and inheritance tax cost (if any) of having an asset includible in the estate against the income tax savings from a "step-up" in basis on the asset. Because both the estate tax liability and the adjusted tax basis at death are measured by the fair market value of the assets, the two taxes are typically in contradistinction to each other. The estate tax cost is offset, in whole or in part, by the "step-up" in basis. The judicious use of debt or other encumbrances may allow taxpayers to reduce estate tax cost but still maintain or increase the "step-up" in basis.

b. Consider the following examples:

(1) Taxpayer owns an asset worth \$10 million and has a \$0 adjusted tax basis (for example, fully depreciated commercial real property). At the taxpayer's death, the

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<sup>520</sup> Treas. Reg. § 1.671-2(e)(5).

amount includible in the gross estate for estate tax purposes under section 2031 and the new adjusted tax basis of the asset under section 1014(a) will each be \$10 million. Assuming no estate tax deductions, the taxable estate under section 2051 (taxable estate is determined by taking the gross estate and reducing it by the appropriate deductions) is also \$10 million.

(2) Same as above, except the taxpayer has a plan to transfer \$9 million of assets out of the taxpayer's estate prior to death (could be a gift or a GRAT or a discounted sale, or any other bit of cleverness). If the taxpayer transfers the zero basis asset, the taxpayer faces the income tax basis problem. Suppose, therefore, that the taxpayer borrows \$9 million, using the asset as collateral for the debt. Ignoring for the moment the \$9 million of borrowed cash (which would be includible in the estate), at the taxpayer's death, the amount includible in the gross estate due to the asset is \$10 million, and the adjusted tax basis of the asset is also \$10 million.<sup>521</sup> Next, the taxpayer disposes of the \$9 million using the preferred technique (gift, GRAT, etc.). Now, the taxable estate is \$1 million because the estate is entitled to a deduction under section 2053(a)(4), "for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate."<sup>522</sup> Thus, the taxpayer's estate would receive a full "step-up" in basis of \$10 million for a taxable estate of \$1 million. Of course, if the debt proceeds remained in the estate in full, then gross estate is \$19 million (asset + debt) reduced by \$9 million of debt on the asset, resulting in a taxable estate of \$10 million.

(3) Same as above, except after the loan but prior to death, the taxpayer engages in a series of "zeroed-out" transfers like GRATs or installment sales to IDGTs, with the result that only \$4 million of the original \$9 million of debt proceeds remain in the estate. The overall result, including the debt proceeds, is the asset would still receive a "step-up" in basis to \$10 million but the taxable estate would only be \$5 million. The gross estate would be \$14 million (asset + debt proceeds) reduced by \$9 million of debt on the asset.

(4) Same as above, except after the loan, instead of engaging in "zeroed-out" transfers, the taxpayer exchanges the \$9 million of cash from the loan with a \$9 million/\$0 tax basis asset that is in an IDGT (assets not otherwise includible in the taxpayer's estate). The overall result is both the \$10 and \$9 million assets would receive a "step-up" in basis to fair market value (totaling \$19 million of basis adjustment), but the taxable estate would be \$10 million (\$19 million gross estate, reduced by \$9 million of debt).

c. As the foregoing examples show, the key to reducing estate tax exposure and maximizing the "step-up" in basis is (i) ensuring the deductibility of the debt, and (ii) engaging in an additional transaction that reduces estate tax exposure of the debt proceeds or exchanges the debt proceeds (cash) for something that would benefit from a "step-up" in basis. Of course, one of the easiest ways to reduce the estate tax exposure on the loan proceeds is simply to spend it aggressively.

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<sup>521</sup> See *Crane v. Commissioner*, 331 U.S. 1 (1947).

<sup>522</sup> § 2053(a)(4).

2. Qualified Unpaid Mortgages and Indebtedness

a. In order for an estate to obtain a full estate tax deduction for debt owed by the decedent, the Treasury Regulations states that the full value of the asset must be included in the gross estate and the indebtedness must be a liability of the estate:

A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. If the decedent's estate is liable for the amount of the mortgage or indebtedness, the full value of the property subject to the mortgage or indebtedness must be included as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. But if the decedent's estate is not so liable, only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth.<sup>523</sup>

b. The full value of the unpaid mortgage may be deducted under section 2053(a)(4), even if the property is valued at less than fair market value pursuant to the special use provisions under section 2032A.<sup>524</sup>

c. The liability underlying the indebtedness must be bona fide and for adequate and full consideration.<sup>525</sup>

d. As mentioned, if the liability is a charge against the property but the property is not included in the gross estate, there is no estate tax deduction. As such, if a decedent only owned a one-half interest in property, the estate is not entitled to a deduction for the liability.<sup>526</sup> Furthermore, if the asset is real property located outside of the U.S. and is not includible in the gross estate, no deduction may be taken for any unpaid mortgage.<sup>527</sup>

e. The Treasury Regulations distinguish between a mortgage or indebtedness for which the estate is not liable but which only represents a charge against the

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<sup>523</sup> Treas. Reg. § 20.2053-7.

<sup>524</sup> Rev. Rul. 83-81, 1983-1 C.B. 230.

<sup>525</sup> See *Feiberg Estate v. Commissioner*, 35 T.C.M. 1794 (1976), *Bowers Estate v. Commissioner*, 23 T.C. 911 (1955), *acq.*, 1955-2 C.B. 4, and *Hartshorne v. Commissioner*, 48 T.C. 882 (1967), *acq.*, 1968-2 C.B. 2.

<sup>526</sup> See *Courtney Estate v. Commissioner*, 62, T.C. 317 (1974) and *Fawcett Estate v. Commissioner*, 64 T.C. 889 (1975).

<sup>527</sup> Treas. Reg. § 20.2053-7

property. Under those circumstances, the Treasury Regulations provide that only the “equity of redemption”<sup>528</sup> (value of the property less the debt) will be included in the gross estate.

3. Debt on Assets in Trust

(1) Given the foregoing, would the same full “step-up” in basis be available for assets in a trust that would be includible for estate tax purposes (or subject to a general power of appointment) if the assets were encumbered by debt? For example, consider a QTIP trust that holds a \$5 million asset with an adjusted tax basis of \$1 million (perhaps an inter vivos QTIP trust funded with a highly appreciated asset or a testamentary QTIP funded with a \$1 million asset that appreciated significantly). The trustee of the QTIP trust borrows \$3 million, using the \$5 million asset as collateral for the loan, and then distributes the \$3 million of loan proceeds to the surviving spouse as a principal distribution. Upon the death of the surviving spouse, does the \$5 million asset in the QTIP trust receive an adjusted tax basis of \$5 million (fair market value) or \$2 million (the net value and the net amount taxable in the surviving spouse’s estate)?

(2) Assets held by a QTIP trust (for which a marital deduction was granted upon funding)<sup>529</sup> are includible under section 2044(a), which provides “[t]he value of the gross estate shall include the value of any property to which this section applies in which the decedent had a qualifying income interest for.”<sup>530</sup> For these purposes, section 2044(c) provides that for purposes of calculating the amount includible in the gross estate of the decedent, the property “shall be treated as property passing from the decedent.”<sup>531</sup> Does the foregoing provision mean that only the net value is includible, similar to the “equity of redemption”<sup>532</sup> concept of section 2053(a)(4) discussed above because the debt is not a legal obligation of the surviving spouse?

(3) The basis adjustment at death on the QTIP property is conferred by section 1014(b)(10). For these purposes, it provides that “the last 3 sentences of paragraph (9) shall apply as if such property were described in the first sentence of paragraph (9).”<sup>533</sup> The latter reference to section 1014(b)(9) is the basis adjustment at death for “property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), if by reason thereof the property is required to be included in determining the value of the decedent's gross estate under chapter 11 of subtitle B or under the Internal Revenue Code.”<sup>534</sup>

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<sup>528</sup> *Id.*

<sup>529</sup> *See* § 2044(b).

<sup>530</sup> § 2044(a).

<sup>531</sup> § 2044(c).

<sup>532</sup> Treas. Reg. § 20.2053-7.

<sup>533</sup> § 1014(b)(10).

<sup>534</sup> § 1014(b)(9).

(4) Section 1014(b)(9) provides for a reduction of tax basis for property acquired before the death of the decedent. It provides the tax basis must be “reduced by the amount allowed to the taxpayer as deductions in computing taxable income ... for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent.”<sup>535</sup> This is in contrast to the basis adjustment under section 1014(b)(4),<sup>536</sup> which applies when a general power of appointment is exercised and which does not require a similar reduction in basis. That being said, section 1014(b)(9), which applies when no other paragraph of section 1014 applies, does not require any other basis reduction (for debt, by way of example). As such, the basis adjustment under section 1014(a) applies which provides the basis shall be the “fair market value of the property at the date of the decedent’s death.”<sup>537</sup>

(5) Does this mean, in the foregoing example, the basis on the asset in the QTIP trust should be \$5 million because that is the fair market value of the property at the surviving spouse’s death or can the fair market value of the asset be interpreted as the “net value” of \$2 million?

#### H. NINGs/DINGs/WINGs and Other Things

1. Taxpayers in high income tax states often look for opportunities to defer or avoid their state income tax exposure. In light of this objective, the use of “incomplete gift, non-grantor trusts” has arisen in states that do not have an income tax. Most prevalently, practitioners have taken advantage of the laws of Delaware (Delaware incomplete non-grantor trust or “DING”), Nevada (“NING”), and Wyoming (“WING”).<sup>538</sup> Pursuant to this technique, as long as the assets are retained in the DING or NING, the income from such assets will not be subject to state income tax.

2. Taxpayers may also seek to transfer assets to another taxpayer with the objective of creating another “taxpayer” for Federal income tax purposes and possibly getting certain tax additional tax benefits allowable on a per taxpayer benefit. For example, as mentioned earlier in these materials, under section 1202 of the Code, the QSBS exclusion is, in part, limited to \$10 million per taxpayer. If a donor can transfer shares of QSBS to an incomplete gift, non-grantor trust, the trust, as a separate taxpayer, may be able to claim its own \$10 million exclusion on the subsequent sale of the QSBS. Ostensibly, this can be accomplished without making a taxable gift. Other tax planners have considered using an incomplete gift, non-grantor trust to get around the \$10,000 limitation on deductions for state and local sales, income, or property tax to \$10,000.<sup>539</sup> As discussed later in these materials, incomplete gift, non-grantor trusts, given their particular tax characteristics (e.g., incomplete gift, taxpayer separate from the

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<sup>535</sup> *Id.*

<sup>536</sup> It applies to “Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will.” § 1014(b)(4).

<sup>537</sup> § 1014(a)(1).

<sup>538</sup> See Peter Melcher and Steven J. Oshins, *New Private Letter Ruling Breathes Life into Nevada Incomplete Gift Non-Grantor Trusts*, Wealthmanagement.com, the digital resource of REP. and Trusts & Estates (Apr. 16, 2013), and Steven J. Oshins, *NING Trusts Provide Tax and Asset Protection Benefits*, CCH Estate Planning Review - The Journal, Page 150 (Aug. 20, 2013).

<sup>539</sup> § 164(b)(6).

grantor, and estate tax includible) might be helpful in the allocation of outside basis when partnership interest are transferred.

3. The salient features of NING, DING, and WING planning are:
  - a. The taxpayer creates a non-grantor trust;
  - b. The taxpayer contributes assets to the trust that the taxpayer no longer wants to be subject to state income tax (or taxable to the taxpayer);
  - c. The trust provides that the taxpayer/grantor is a permissible beneficiary of the trust;
  - d. The contribution of assets to the non-grantor trust are not considered a taxable gift; and
  - e. The assets in the non-grantor trust will be includible in the taxpayer/grantor's estate for estate tax purposes.

4. Typically, the incomplete gift, non-grantor trust is structured as an irrevocable trust for the benefit the grantor and specified family members. The beneficial interests of the beneficiaries are purely discretionary. During the grantor's life, distributions can be made only as directed by the holder of a power specifically granted in the trust instrument, and any undistributed income must be accumulated and added to corpus. The trustee's functions are administrative, and trustee has no discretionary powers affecting beneficial enjoyment. At the grantor's death, the remaining trust property is payable as directed by the grantor pursuant to a limited testamentary power of appointment, or in default of appointment specified family members.

5. The trust instrument authorizes distributions to be made during the grantor's life pursuant to any of three distinct powers: (i) a power, exercisable by unanimous agreement of a distribution committee consisting of two or more beneficiaries (other than the grantor), to distribute trust income or corpus to any one or more beneficiaries (including the grantor); (2) a power, exercisable by a majority of the distribution committee with the grantor's consent, to distribute trust income or corpus to any one or more beneficiaries (including the grantor); and (3) a power, exercisable by the grantor in a nonfiduciary capacity, to distribute corpus to any one or more beneficiaries (other than the grantor or the grantor's spouse) for their health, education, support, and maintenance. The distribution committee is required to have at least two members throughout the grantor's life, and the committee's existence automatically terminates at the grantor's death.

6. Prior to 1997, a self-settled trust (a trust that provides for the benefit of the grantor) like the one described above would not have qualified as a non-grantor trust. The Treasury Regulations provide, "Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor." Thus, if under state law creditors of the grantor can reach the assets of the trust, then the trust will be considered a grantor trust for income tax purposes. Prior to 1997, all of the states provided that creditors of a grantor could reach the assets of any self-settled trust. Since 1997, a number of states like Alaska, Delaware, Nevada, and Wyoming have enacted "domestic asset protection trusts" that

purportedly allow grantors to create self-settled trusts but prohibit creditors of the grantor from reaching the assets in the trust.

7. A number of rulings under Delaware law affirmed the non-grantor trust status of the DING.<sup>540</sup> All of the rulings relied upon an incomplete gift predicated upon the grantor retaining a special testamentary power of appointment to redirect the trust assets.<sup>541</sup> Notwithstanding that the grantor was a permissible beneficiary of the trust, the rulings avoided grantor trust status through the use of a distribution committee that had to approve any distribution to the grantor. The members of the distribution committee were deemed to be adverse parties (for example, trust beneficiaries) under section 672(a), and as a result, the trust was not a grantor trust.

8. In 2007, the IRS announced that it was re-examining the question of whether the distribution committee members have a general power of appointment.<sup>542</sup> In 2012, the IRS ruled that the retention of a testamentary power of appointment makes the original transfer incomplete but only with respect to the remainder interest but not the lead interest.<sup>543</sup> Subsequent rulings have confirmed that practitioners have “settled on” typical approaches.<sup>544</sup> Notwithstanding the foregoing, in 2021 and subsequently for 2022, the IRS placed incomplete gift, non-grantor trusts on its list of areas under study in which rulings will not be issued until the service resolves the issue through the publication of a revenue ruling, revenue procedure, regulation, or otherwise.<sup>545</sup> An ING trust is an opportunity to avoid state income tax that would have been paid by the taxpayer anyway. Accordingly, the transaction should be structured to minimize the risk of the taxpayer making a taxable gift even if doing so increases the risk of incurring state income tax. Forum and fiduciary shopping is wise; some corporate fiduciaries “new business” officers tout planning that the “fiduciary” officers are unwilling to carry out, and the institution manages this dichotomy by claiming sophistication while imposing various unnecessary burdens on ING transactions (among others).

9. In 2014, New York enacted a statute that provides “incomplete gift non-grantor trusts” will be treated as grantor trusts, for New York state income tax purposes.<sup>546</sup> An

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<sup>540</sup> PLRs 200148028, 200247013, 200502014, 200612002, 200637025, 200647001, 200715005, and 200731019. Other rulings and jurisdictions, *see* PLRs 200647001, 200715005, 200731019, 201310002-20131000, 201410001-201410010, 201426014, 201430003-201430007, 201436012-201436032, 201636027-201636032, 201650005, 201729009, 201742006, 201836006, 201848002, 201848009, 201908003-201908005, and 201925005-201925010.

<sup>541</sup> *See* Treas. Reg. §§ 25.2511-2(b) and 25.2511-2(c).

<sup>542</sup> IR-2007-127.

<sup>543</sup> CCA 201208026.

<sup>544</sup> *See* PLRs 200647001, 200715005, 200731019, 201310002-20131000, 201410001-201410010, 201426014, 201430003-201430007, 201436012-201436032, 201636027-201636032, 201650005, 201729009, 201742006, 201836006, 201848002, 201848009, 201908003-201908005, and 201925005-201925010.

<sup>545</sup> Rev. Proc. 2022-3, 2022-1 I.R.B. 140, Section 5.01(10) and (18).

<sup>546</sup> N.Y. Tax Law § 612(b)(41). The provision does not apply to income of such trusts that were liquidated before June 1, 2014. 2014 N.Y. Laws 59, Part I, § 9 (Mar. 31, 2014).

“incomplete gift non-grantor trust” is defined as a New York resident trust (generally, created by a New York resident or domiciliary) that meets the following conditions:

a. “the trust does not qualify as a grantor trust under section six hundred seventy-one through six hundred seventy-nine of the internal revenue code,” and

b. “the grantor’s transfer of assets to the trust is treated as an incomplete gift under section twenty-five hundred eleven of the internal revenue code, and the regulations thereunder.”<sup>547</sup>

I. Private Derivative Contracts to “Transfer” but Still Own for the “Step-Up”

1. Financial derivatives are a staple in the capital markets. On the other hand, the use of financial derivatives for estate planning purposes is relatively new. The primary benefit of using a derivative (as opposed to the actual underlying asset form which its returns are “derived”) is that the underlying asset does not need to be transferred or even owned.

2. In the estate planning context, derivatives or contractual rights have been used to “transfer” carried interests in private equity, leveraged buyout, and venture capital funds.<sup>548</sup> The use of a derivative is usually required because the investors in the fund require that the transferor (holder of the carried interest) to retain the carried interest or because the carried interest of the grantor may be subject to a vesting schedule. Furthermore, the use of the derivative arguably avoids complications under section 2701 of the Code.

3. Generally, “carry derivative” planning involves the creation of an IDGT, and entering into a contractual arrangement with the IDGT. Under the contract, the grantor would be required to pay the IDGT, at a stated future date, an amount based on the total return of the carry (the sum of the distributions the grantor receives and the fair market value of the carried interest on that future date). The contract is typically settled on an expiration date (e.g., 5 years) or upon the death of the grantor, if earlier. The IDGT will typically be funded with a taxable gift, and then pay “fair market value” for the rights under the contract. A professional appraiser determines the fair market value of the contractual rights based upon the particulars of the carried interest (e.g., type of fund, experience of the general partner, strategy, hurdle parameters, etc.), current interest rates, and terms of the contract. Upon settlement, the grantor would pay the trust an amount of cash (or property) equal to the value of the carried interests, plus an amount equal to the distributions (net of any claw backs) less hurdle/strike price (if any).

4. Private derivatives may be used in estate planning with more common assets where for practical and tax reasons, the taxpayer ought to retain ownership of the property. Consider the following examples.

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<sup>547</sup> *Id.*

<sup>548</sup> In a different context, contractual rights tied to or deriving value to the return of endowment funds have been used with charitable remainder trusts to avoid unrelated business taxable income. *See, e.g.*, PLRs 200922061, 200703037, 200733032, 200733033, 201022022, 201016082, 201016085, 201016086, 201011035, 201007063, 201003023, 201003024, 200952059, 200951037, 200913063, 200913065, and 200824021.

a. “Negative basis” commercial real property interests.

(1) If the property is transferred to an IDGT (either by installment sale or taxable gift), upon the death of the grantor the debt in excess of basis will trigger taxable gain. In addition, because the property is held in the IDGT, there will be no “step-up” in basis for the benefit of the grantor’s heirs.

(2) The “step-up” in basis would have eliminated both the “negative basis” problem and recapture of the depreciation under section 1250, which is taxed at 25% (and sometimes under section 1245, which is taxed at ordinary income tax rates).<sup>549</sup>

(3) The transfer of legal title has certain transactional costs (e.g., legal fees and documentary stamp tax), may require consent from a lender, and might trigger a costly reassessment for real property tax purposes.<sup>550</sup>

b. Creator-owned copyrights.

(1) As mentioned above, it is unclear if the author’s continued right of termination calls into question how the copyright can be irrevocably transferred (especially since there seems no mechanism to waive the termination right) and appropriately valued for transfer tax purposes.

(2) A gift of a copyright may have the unintended effect of prolonging ordinary income treatment after the death of the author/creator of the copyright.

(3) In contrast, upon the death of the author/creator who still owns the asset at death, the copyright is entitled to a “step-up” in basis to full fair market value under section 1014 and the asset is transformed into a long-term capital gain asset.

c. If the foregoing can be the underlying property in a private derivative, can the contract be leveraged in a way that can double or triple the amount of the potential wealth transfer? For example, if the underlying property is worth \$1 million, can a contractual right be structured so that grantor must pay to the IDGT 2 times or 3 times the return of the underlying property?

5. Potential Issues or Problems

a. Valuation of the “contractual right” vs. valuation of the underlying property?

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<sup>549</sup> See Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995), and Louis A. del Cotto and Kenneth A. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

<sup>550</sup> For example, Proposition 13, California Constitution Article XIII(A).

b. Economic risk of loss, particularly to the party (e.g., IDGT) that was expected to benefit from appreciation.

c. If contract is not settled prior to death, is the decedent's obligation deductible for estate tax purposes under section 2053?

d. Income tax issues upon settlement after death?

e. Potential Chapter 14 implications, in particular section 2701 as an applicable retained interest and section 2703?

f. Financial risks that grantor (or IDGT) will be unable to meet the obligations under the contract (or installment note if purchased by the IDGT).

6. Given some of the foregoing issues, it is highly recommended that the obligor grantor settle the contract prior to death. For example, if the contract is not settled prior to death, it is likely the payments to the IDGT will be taxable as ordinary income.

7. Chapter 14 Issues

a. Section 2701

(1) The IRS might argue that the contract/derivative rights held by the IDGT (or the note held by the grantor if the transaction involves an installment sale) are an applicable retained interest.

(2) It is unlikely that the interests in the contract will be fall under the definition of an applicable retained interest, which requires a distribution right or a liquidation, put, call, or conversation right.<sup>551</sup>

(3) A number of private letter rulings have held that an option to acquire an equity interest is not an equity interest to which section 2701 would apply.<sup>552</sup>

b. Section 2703

(1) Section 2703 provides that for transfer tax purposes, the value of any property is determined without regard to any right or restriction relating to the property.<sup>553</sup> A right or restriction means any option, agreement, or other right to acquire or use the property at a price less than the fair market value (determined without regard to the option, agreement, or right) or any restriction on the right to sell or use such property.<sup>554</sup>

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<sup>551</sup> *But see* CCA2014442053. *See also* Richard L. Dees, *Is Chief Counsel Resurrecting the Chapter 14 'Monster'?*, 145 Tax Notes 11, p. 1279 (Dec. 15, 2014).

<sup>552</sup> *See* PLRs 9350016, 9616035, 9722022, 199952012, 199927002 and 200913065.

<sup>553</sup> § 2703 and Treas. Reg. § 25.2703-1(a).

<sup>554</sup> Treas. Reg. § 25.2703-1(a)(2).

(2) A right or restriction will not be disregarded if it satisfies three conditions:

(a) The right or restriction is a bona fide business arrangement;

(b) The right or restriction is not a device to transfer property to members of the decedent's family for less than full and adequate consideration; and

(c) The terms of the right or restriction are comparable to similar arrangements entered into by persons in an arm's length transaction.<sup>555</sup>

(3) Could the IRS argue that the property in the decedent's estate is being reduced in value by virtue of the existence of the contract?

(a) It is unlikely that this argument would prevail particularly because no property would be specifically required to settle the contract. There is a claim that will be satisfied with property (that would have received a "step-up" in basis), which is simply the fulfillment of the grantor's obligations under the contract. What if the contract provides that the claim may only be satisfied in cash? How can cash be "reduced" in value?

(b) In Revenue Ruling 80-162,<sup>556</sup> the IRS held that a gift is made upon the grant of an option (if not received for full and adequate consideration), and not when the option is exercised. Under these circumstances, a gift might have been made upon the signing of the contract/derivative but for which full and adequate consideration was received.

## V. GRANTOR TRUSTS, IDGTs, AND CONVERSIONS

### A. Generally

1. A complete discussion of the grantor trust rules of Part E of Subchapter J (section 671-679 of the Code) is beyond the scope of these materials.<sup>557</sup> From an income and estate planning perspective, based on the IRS's position in Revenue Ruling 85-13 (discussed earlier), grantor trust status has two significant results: (i) the grantor is deemed to own all of the assets of the trust for all Federal income tax purposes; and (ii) any transaction between the grantor and the grantor trust will be ignored for all Federal income tax purposes. From a

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<sup>555</sup> § 2703(b).

<sup>556</sup> Rev. Rul. 80-162, 1980-2 C.B. 280. See also Rev. Rul. 84-25, 1984-1 C.B. 191. The IRS held that, "In the case of a legally enforceable promise for less than an adequate and full consideration in money or money's worth, the promisor makes a completed gift under section 2511 of the Code on the date when the promise is binding and determinable in value rather than when the promised payment is actually made."

<sup>557</sup> For an excellent article on the grantor trust rules, see Stephen R. Akers, Jonathan G. Blattmachr, and F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 *Real Prop., Tr. and Est. Law J.* 207 (Summer 2009).

practical standpoint this means the grantor reports all of the trust's tax items on his or her income tax return, and the grantor is responsible for paying any resulting income taxes. Furthermore, the grantor's payment of the resulting income taxes is not considered a gift to the trust's beneficiaries, and if the trustee has discretion to reimburse the grantor for the income tax liability, the mere existence of that discretion by itself (whether or not exercised) will not cause the trust's assets to be included in the grantor's gross estate.<sup>558</sup> That being said, the most significant result is that the grantor and the grantor trust can participate in a myriad of transactions that otherwise would be taxable events had the parties been separate taxpayers. Instead, they are simply disregarded. All of this remains true as long as the grantor is still alive, and the powers or interests that trigger grantor trust treatment remain in effect.

2. Importantly, the trust must also be a grantor trust as to the entire trust. Frequently overlooked are the "portion" rules which point out that grantor trust status does not necessarily apply to the entire trust.<sup>559</sup> The Code provides that the grantor is treated as the owner of only that portion of a trust as to which the requisite power or interest exists, and "portion" can be defined in a number of ways. For example, a grantor with a reversion or a power to revoke the trust in its entirety may be treated as the owner of the entire trust under section 676 of the Code, meaning that every item of income, deduction, and credit in the trust is attributed to that deemed owner. Similarly, the grantor (or any nonadverse party who is a trustee) with unrestricted powers over income and corpus would generate entire trust portion treatment under section 674 of the Code. On the other hand, if grantor trust status is conferred by section 677(a) of the Code alone (income that may be paid to the grantor or the grantor's spouse), the trust is a grantor trust only as to the income portion (not the corpus).<sup>560</sup> Not only must grantor trust status apply to both income and corpus of the trust but it must apply to all of the assets of the trust. For example, under section 675(3) of the Code (borrowing of the trust's assets by the grantor), it is unclear whether grantor trust status relates only to amounts actually borrowed and not repaid by the end of the taxable year, or whether it applies to all income or corpus that could have been borrowed.<sup>561</sup>

3. For purposes of this discussion, let's assume grantor trust status is over the entire trust and over all income and corpus. Indeed, the most common power retained by grantors who intend on transacting with their grantor trusts is under section 675(4)(C) of the Code (the power, exercisable in a nonfiduciary capacity, to reacquire assets by substituting assets of equivalent value). If this power is, as often is the case, over all of the assets of the trust, the grantor is deemed the owner of the entire trust, including all of the income and corpus.

4. To further complicate matters, grantor trust status can be conferred on taxpayers who are not grantors at all. Section 678 of the Code describes certain situations where a person other than a grantor will be treated as the owner of trust assets. Section 678(a) of the Code provides a person (other than the grantor) will be treated as the owner of any portion of a trust if (i) the person has a "power exercisable solely by himself to vest the corpus or the income

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<sup>558</sup> Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

<sup>559</sup> See Treas. Reg. § 1.671-3.

<sup>560</sup> See § 677(a) and Treas. Reg. § 1.677(a)-1(g), Ex. 1.

<sup>561</sup> See *Bennett v. Commissioner*, 119 T.C. 157 (2002) with *Benson v. Commissioner*, 76 T.C. 1041 (1981).

therefrom in himself,”<sup>562</sup> or (ii) the person “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.”<sup>563</sup> Under section 678(b) of the Code, traditional grantor trust status will trump this “third party” ownership status, if the actual grantor is regarded as the owner of the same portion of the trust, thereby avoiding taxation of the same items of taxable income to two different taxpayers.<sup>564</sup> Section 678(a) of the Code is the linchpin of planning with Beneficiary Deemed Owner Trusts (BDOTs) and Beneficiary Defective Inheritor’s Trusts (BDITs).

## B. Income Tax Consequences of Changes in Grantor Trust Status

### 1. Introduction

a. When grantor trust status is terminated or when a non-grantor trust becomes a grantor trust, the obvious end result is that the “owner” of the trust asset for Federal income tax purposes changes. When grantor trust is terminated, the trust becomes a separate taxable entity (non-grantor trust), and when a non-grantor trust becomes a grantor trust, the grantor (or someone other than the grantor under section 678 of the Code) becomes the owner of the trust’s assets for Federal income tax purposes. From an income tax perspective, how does that change in ownership occur?

b. If the change in ownership is treated like a gift, then as previously discussed, the receipt of the trust property is not income to the recipient, and the property will have a carryover basis under section 1015 of the Code? If the change in ownership is caused by the death of the grantor, then like bequests or other transfers at death, do the trust assets get a basis adjustment under section 1014 of the Code? Could the change in ownership be considered a taxable sale or exchange, with gain and possibly loss recognition? Or could this transfer of ownership be akin to a tax free exchange? If the change in ownership is not a taxable event, if debt is in excess of basis, do the holdings in *Crane* and *Tuft* require a recognition gain?

### 2. Grantor to Non-Grantor Trust During Grantor’s Lifetime

a. In Revenue Ruling 77-402,<sup>565</sup> the IRS held that when grantor trust is terminated during the grantor’s lifetime, the grantor is deemed to have transferred the trust property to a separate taxable entity. If the transferred property is subject to debt and the debt is in excess of basis, then the grantor, as the transferor, will recognize gain. In the ruling, A, an individual, created a T, an irrevocable trust (IDGT for the benefit of A’s descendants) which is a grantor trust as to the entire trust due to certain retained powers. A contributed some funds to T,

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<sup>562</sup> § 678(a)(1).

<sup>563</sup> § 678(a)(2).

<sup>564</sup> By its terms, section 678(b) of the Code only refers to grantor powers over income, commentators have stated that limiting this to just income (and not items of corpus) is nonsensical and akin to a drafting error. Ferguson, Freeland, & Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries*, § 10.16[C] (3d ed. 2011). See also PLRs 201235006, 200730011, 200606006, and 200603040.

<sup>565</sup> Rev. Rul. 77-402, 1977-2 C.B. 222.

and the trustee used those funds to purchase a partnership interest in P, a partnership with a principal activity of investing in real property, using both recourse and nonrecourse financing. P elected accelerated depreciation. The resulting deduction were allocated to the partners of P, including T and in turn, deducted on A's income tax returns.

b. When the adjusted basis of the partnership interest was nearly zero (deductions and other losses are limited to the amount basis in the partnership interests) and the real property had started generating net income, A, as grantor, renounced the powers that made T a grantor trust. The IRS ruled, "at the time A renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust, with the result that A was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, A is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor, A."<sup>566</sup>

c. When a partner transfers an interest in a partnership and the transferor's share of partnership liabilities are reduced or eliminated, the transferor is treated as having sold the partnership interest for an amount equal to the amount of reduced or eliminated liabilities. The IRS thus concluded, "A realized an amount equal to the share of partnership liabilities that existed immediately before T converted from grantor to nongrantor status for Federal income tax purposes. The gain or loss realized by A is the difference between the amount realized from the reduction of the share of P's liabilities and the adjusted basis in the partnership interest ... immediately prior to the change in T's tax status."<sup>567</sup> The ruling went on to say, the result would be the same if the termination of grantor trust status occurred due to the expiration or lapse of the powers or due to the exercise, release, renunciation, expiration or lapse of certain powers held by party other than the grantor.

d. In 1980, the IRS issued section 1.1001-2 of the Treasury Regulations which addressed the discharge of liabilities in determining gain or loss on a sale, exchange, or other disposition. The Treasury Regulations provide, "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."<sup>568</sup> In particular, the Treasury Regulations provide the following special rules:<sup>569</sup>

--(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;

--(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);

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<sup>566</sup> *Id.*

<sup>567</sup> *Id.* See also G.C.M. 37228 for a more detailed discussion of the reasoning supporting the revenue ruling.

<sup>568</sup> Treas. Reg. § 1.1001-2(a)(1).

<sup>569</sup> Treas. Reg. § 1.1001-2(a)(4)(i) through (v).

--(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

--(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

--(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

e. These Treasury Regulations also include an example<sup>570</sup> that is similar to Revenue Ruling 77-402. In the example, C, an individual, creates an irrevocable wholly owned grantor trust. The trustee bought an interest in a partnership. C deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. When the adjusted basis of the partnership interest held by the trust was \$1,200, C renounced the grantor trust powers, and the trust then ceased to be a grantor trust. At the time of the renunciation all of the partnership's liabilities are nonrecourse liabilities on which none of the partners have assumed any personal liability. The trust's proportionate share of the partnership liabilities was \$11,000. The example concludes when C renounced the grantor trust powers, the trust no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property for income tax purposes. Consequently, C was considered to have transferred ownership of the partnership interest to the trust, which was now a separate taxable entity, independent of C. On the transfer, C's share of partnership liabilities (\$11,000) was treated as the amount realized by C. C's resulting gain was \$9,800 (\$11,000 - \$1,200).

f. The taxpayers in *Madorin v. Commissioner*<sup>571</sup> challenged the validity of the foregoing example in the Treasury Regulations, essentially taking the position of the *Rothstein* court (discussed earlier). Bernard Madorin was the grantor of four trusts. The trustee of each of the four trusts had the power to sprinkle income and principal among a class of beneficiaries, and the power to add charitable beneficiaries. The four trusts were, therefore, grantor trusts pursuant to section 674(a) of the Code. The trusts bought limited partnership interests in a limited partnership, which in turn purchased a partnership interest in Saintly Associates. Bernard recognized losses generated by Saintly Associates. When Saintly Associates began generating income, the trustee renounced his power to add beneficiaries and the trusts ceased to be grantor trusts. The grantor argued that he should be treated as the owner of the trust only to attribute to him items of income, deductions, and credits (the *Rothstein* ruling). The IRS disagreed with the taxpayer and assessed a deficiency. Basing its position on the aforementioned example in the Treasury Regulations, the IRS contended that the grantor was the owner of the partnership interests and when the trusts ceased to be grantor trusts there was a disposition of the trusts' assets (the partnership interests) on which gain would be recognized to the extent that the underlying debt from which the trust was released exceeded the taxpayer's basis in the partnership interests. The Tax Court ruled for the IRS. In coming to that conclusion, the court

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<sup>570</sup> Treas. Reg. § 1.1001-2(c), Ex. 5

<sup>571</sup> *Madorin v. Commissioner*, 84 T.C. 667 (1985).

stated, “Absent a clear and unambiguous legislative directive in this matter, limiting the usage of the word “owner,” we will apply the usual, ordinary, and everyday meaning of the word.”<sup>572</sup>

g. Given all of the foregoing precedents, the termination of grantor trust status during the grantor’s lifetime is treated as a transfer by the grantor of the trust’s assets to the trust (now a separate taxpayer) in exchange for any consideration the trust may give to the grantor. The foregoing consideration will include any discharge of liabilities of the grantor that results from such transfer. In particular, if nonrecourse debt encumbers the trust property and such debt exceeds basis, then grantor will recognize gain on the deemed transfer. If the property is not encumbered with debt, the transfer is akin or may actually be a gift for income tax purposes. The result is that the trust will not realize income when the deemed transfer occurs, no sale or exchange occurs, and the trust will take a basis in the property as determined under section 1015 of the Code.

### 3. Grantor to Non-Grantor Trust Due to Grantor’s Death

a. If grantor trust status is terminated due to the grantor’s death, clearly the grantor-decedent is no longer considered the owner of the trust property for income tax purposes. The IRS has ruled that upon the death of the grantor, the trust springs into existence as a separate taxpayer.<sup>573</sup> Clearly, the trust assets are deemed to be transferred to the new taxpayer, but it’s not clear what type of transfer it is, and whether, under some circumstances, it could be considered a taxable event.

b. Notably, while acknowledging there is no Code section that explicitly addresses the issue, some commentators have asserted categorically that gain or loss is not recognized by a transfer in connection with the death of the owner.<sup>574</sup> They cite *Crane, Diedrich*,<sup>575</sup> section 1.1001-2 of the Treasury Regulations (all previously discussed) in support of the claim that dispositions of property with debt in excess of basis only results in gain recognition with lifetime transfers, although they do not, collectively or individually, say that. This view is exacerbated by an IRS ruling that gratuitously stated “death ... is generally not treated as an income tax event,”<sup>576</sup> even though the ruling itself was not addressing the income tax

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<sup>572</sup> *Id.* at 673.

<sup>573</sup> Rev. Rul. 57-51, 1957-1 C.B. 171. *See also* Treas. Reg. 1.671-4(h) (“Following the death of the decedent, the trust or portion of a trust that ceases to be treated as owned by the decedent, by reason of the death of the decedent, may no longer report under this section.”).

<sup>574</sup> *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death*, 96 J. Tax’n 149 (2002) and Elliott Manning and Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gifts & Tr. J. 3 (1999).

<sup>575</sup> *Diedrich v. Commissioner*, 643 F.2d 499 (8th Cir. 1981) (when a “net gift” is made (i.e., the gift taxes on the transfer, which are the legal obligation of the donor, are instead assumed by the donee as a condition of the gift), the donor will realize gain to the extent the gift tax paid exceeds the donor’s adjusted basis in the property).

<sup>576</sup> CCA 200923024 (Dealing with a conversion from non-grantor to grantor trust status, discussed later in these materials).

consequences of a conversion of a trust's status due to the death of any individual. In furtherance of this notion that a transfer at death is never a recognition event, some commentators have pointed to Revenue Ruling 73-183.<sup>577</sup> In the ruling, a taxpayer purchased stock at \$30 per share and later died when the stock had a fair market value of \$20 per share. Under section 1014 of the Code, the stock's basis was adjusted to \$20 per shares. Notwithstanding the foregoing, the estate of the taxpayer sought guidance on whether a loss is recognized on the taxpayer's final income tax return as a result of the transfer of the stock to the estate. The ruling held that no gain or loss is recognized when stock is transferred from the decedent to the estate, whether the adjusted basis prior to death was less than or in excess of the fair market value on the date of death. These arguments ignore the fact that most transfers at death result in a basis adjustment to fair market value under section 1014 of the Code. If a decedent dies with appreciated property, subject to a nonrecourse debt that is in excess of the property's tax basis prior to death, when the property is "stepped-up" to fair market value, the property no longer has debt in excess of basis.

c. Estates of decedents who died in 2010 could elect to apply the modified carryover basis regime of now repealed section 1022 of the Code instead of being subject to the estate tax regime that had been reinstated retroactively for that year.<sup>578</sup> Generally, section 1022 of the Code provided that recipients of property from estates that elected out of the estate tax would receive property with a basis equal to the lesser of the adjusted basis of the decedent or the property's fair market value.<sup>579</sup> It provided for certain modifications including the ability to increase the aggregate adjusted basis of estate property up to \$1.3 million,<sup>580</sup> with additional increases of up to \$3.0 million for property passing to a surviving spouse, outright or to a QTIP trust.<sup>581</sup> The drafters of the Code section clearly understood that if property passes by death but with carryover basis, rather than with a basis adjustment under section 1014 of the Code, gain would be recognized if any property had debt in excess of basis. To that end, they added a specific provision which provides, "In determining whether gain is recognized on the acquisition of property from a decedent by a decedent's estate or any beneficiary other than a tax-exempt beneficiary, and from the decedent's estate by any beneficiary other than a tax-exempt beneficiary, and in determining the adjusted basis of such property, liabilities in excess of basis shall be disregarded."<sup>582</sup> What is particularly telling is, as written, if property with debt in excess of basis had passed from the estate to a tax exempt beneficiary (i.e., charitable organization), gain would have been recognized.

d. In the mid-1970's, with the 1976 Tax Reform Act,<sup>583</sup> Congress eliminated the step-up in basis and enacted a carryover basis regime under predecessor section 1023 of the Code which would have been applied for decedents dying after December 31, 1979.

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<sup>577</sup> Rev. Rul. 73-183, 1973-1 C.B. 364.

<sup>578</sup> The election out of the estate tax regime is not in the Code. *See* Notice 2011-66, 2011-35 I.R.B. 184, Rev. Proc. 2011-41, 2011-35 I.R.B. 188, and Notice 2011-76, 2011-40 I.R.B. 479.

<sup>579</sup> § 1022(a)(2).

<sup>580</sup> § 1022(b)(2)(B)

<sup>581</sup> § 1022(c)(1).

<sup>582</sup> § 1022(g)(1).

<sup>583</sup> P.L. 94-455 (Oct. 4, 1976). *See also* P.L. 95-600 (Nov. 6, 1978).

At that time, learned commentators noted that, on the death of the decedent, gain will be recognized upon a transfer of the decedent's property in an amount equal to the difference between basis and liability.<sup>584</sup> In coming to that conclusion they concluded, "transfer effected at death should not be taxed any differently so far as the decedent transferor is concerned than are inter vivos transfers. Any gain or loss recognized on a transfer at death should be reported on the decedent's final return."<sup>585</sup> The carryover basis regime at death was repealed retroactively in 1980, so it never came into effect.<sup>586</sup> One of the reasons for the repeal was likely the debt in excess of basis issue.

e. The debatable issue at hand does not involve property included in the gross estate of a decedent and which gets a basis adjustment under section 1014 of the Code. There is no question that upon the death of the grantor, property in a revocable living trust, for example, that is "transferred" to a trust that is now a non-grantor trust, even if encumbered by a mortgage that is in excess of its basis, will not be considered a recognition event.<sup>587</sup> That is because of the basis adjustment at death. The issue is what happens when IDGT assets, which are designed not to be included in the estate of the grantor-decedent, are "transferred" to a non-grantor trust. What is the resulting basis of the assets in the IDGT? Is there recognition of gain if the assets are subject to a debt (i.e., the IDGT installment obligation) that is in excess of the basis of the assets?

f. Notwithstanding arguments to the contrary,<sup>588</sup> the conventional view is that if the assets in the IDGT are not included in the grantor's gross estate, the trust assets will not receive a "step-up" in basis under section 1014. In Chief Counsel Advice 200937028<sup>589</sup> a taxpayer transferred assets into a trust and reserved the power to substitute assets, and the trust assets did not qualify for a basis adjustment under section 1014(b)(1) through (b)(10) of the Code. In the ruling, the Chief Counsel quotes from section 1.1014-1(a) Treasury Regulations: "The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]" From this the Chief Counsel concludes, "Based on my reading of the statute and the regulations, it would seem that

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<sup>584</sup> Louis A. DelCotto and Kenneth F. Joyce, *Inherited Excess Mortgage Property: Death and the Inherited Tax Shelter*, 34 Tax L. Rev. 569 (1979).

<sup>585</sup> *Id.* at 569.

<sup>586</sup> P.L. 96-223 (Apr. 2, 1980).

<sup>587</sup> Query what would happen if the amount of nonrecourse debt exceeded both basis and the fair market value of the property? Would the holding in *Tufts* require a recognition of gain to the extent of the debt in excess of fair market value?

<sup>588</sup> See Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobsen, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 96 J. Tax'n 149 (2002). This is not true for nonresident alien decedents; a basis adjustment is allowed regardless of whether assets are includable in the gross estate. Rev. Rul. 89-139, 1984-2 C.B. 168.

<sup>589</sup> CCA 200937028.

the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9).”<sup>590</sup>

g. Most practitioners and commentators take the position that whatever assets owned by the IDGT at the time of the grantor’s death carry their historical tax basis. Hence, the reason swapping high basis assets with low basis assets in existing IDGTs will continue to be so important prior to the death of the grantor. A termination of grantor trust status upon the death of the grantor is effectively a transfer of the underlying trust assets, as if the assets had been transferred by gift under section 1015(a) or, alternatively, section 1015(b), as proposed in an excellent article (but which gets to the same result). In that article, the authors argue that section 1015(b) of the Code specifically should apply to determine the basis of assets in IDGTs when termination of grantor trust status is caused by the death of the grantor. Section 1015(b) of the Code provides if property is acquired “by transfer in trust (other than by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer.”<sup>591</sup> Thus, if the death of the grantor is not a taxable event for income tax purposes, then the acquired basis is simply the donor’s basis prior to death. In addition, if the property secures a nonrecourse debt that is in excess of the property’s basis, then gain will be recognized (and the amount of gain will be added to the resulting adjusted basis of the property). The IRS has implied this result already. For example, the IRS ruled that when property transferred to a grantor trust is transferred to the grantor under the terms of the trust instrument at the termination of the trust, its basis is the same as the basis of the property in the hands of the grantor upon the original contribution.<sup>592</sup>

h. One possible alternative view about what happens when grantor trust status is terminated (and an the installment note is still outstanding) is that the trustee of the IDGT is deemed to purchase the assets for the outstanding amount of the installment note at the time of the grantor’s death. The basis of the assets would thus be determined under section 1012 of the Code. However, this necessarily requires practitioners to take the position that an exchange occurs at the death of the grantor, which may give rise to adverse income tax consequences to the estate with respect to the note. That does not seem to be the position of the IRS. In a private letter ruling involving a sale from one grantor trust to another, the IRS provided, “when either Trust 1 or Trust 2 ceases to be treated as a trust owned by A under § 671 by reason of A’s death or the waiver or release of any power under § 675, no opinion is expressed or implied concerning whether the termination of such grantor trust treatment results in a sale or disposition of any property within the meaning of § 1001(a), a change in the basis of any property under § 1012 or § 1014, or any deductible administration expense under § 2053.”<sup>593</sup>

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<sup>590</sup> *Id.*

<sup>591</sup> § 1015(b)

<sup>592</sup> Rev. Rul. 72-406, 1972-2 C.B. 462. *See also Pierre S. Du Pont v. Commissioner*, 18 B.T.A. 1028 (1930).

<sup>593</sup> PLR 200434012.

i. In 2015, the IRS added “Whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code” to the list of “areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise.”<sup>594</sup> This continues to be an area of study to this day. In the 2020-2021 Priority Guidance Plan of the IRS, in the “General Guidance” section, it listed those projects “that will be the focus of efforts during the 12-month period from July 1, 2020, through June 30, 2021.” It specifically listed, “Guidance on basis of grantor trust assets at death under §1014,” in the Gifts and Estates and Trusts section.<sup>595</sup> Guidance on this issue was not provided, and surprisingly, the 2021-2022 Priority Guidance Plan omits this item.<sup>596</sup>

j. In the foreign trust context, there are some conflicting, possibly misleading, rulings. In PLR 201544002, husband and wife (both of whom are foreign citizens and non-residents of the United States) funded a joint foreign revocable trust with their community and separate property. Each spouse retained the right to revoke the trust with respect to his or her community property and separate property held in trust. Under the trust agreement, the surviving spouse has the power to appoint the trust assets to his or her estate by will. The IRS held that upon the first death of a spouse, the surviving spouse would receive a step-up (or step-down) in basis under section 1014(b)(2) of the Code with respect to the decedent’s spouse’s separate property and one-half share of the community property. The IRS further held that upon the death of the surviving spouse (who held a general power of appointment), to the extent the surviving spouse exercises the general power of appointment by will, the trust assets will receive a step-up (or step-down) in basis under section 1014(b)(4) of the Code. The ruling acknowledged the no-rule policy as mentioned above, but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced in 2015 and became effective.

k. In PLR 201245006, the taxpayer asked the IRS how to determine the basis of property upon the death of the grantor for property owned by an irrevocable non-U.S. situs (foreign) trust. The taxpayer (“Taxpayer”) was a foreign citizen and non-resident of the United States. Taxpayer proposed to transfer assets to an irrevocable trust (“Trust”) established under the laws of Taxpayer’s country (“Country”). The assets of Trust were to include cash and stock in two companies that are publicly traded in Country and on the New York Stock Exchange. The trustees of Trust are Taxpayer and X, an unrelated party (“Trustees”). Trustees were to pay all Trust income to Taxpayer during his lifetime and could distribute principal to Taxpayer in their absolute discretion. Upon Taxpayer’s death, Taxpayer had a special testamentary power of appointment over the income and principal of Trust in favor of his issue. If

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<sup>594</sup> Rev. Proc. 2015-37, 2015-26 I.R.B. 1196 (effective for all requests received after June 15, 2015). Continued in section 5.01(12) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126.

<sup>595</sup> 2020-2021 Priority Guidance Plan which can be obtained at <http://www.irs.gov/uac/Priority-Guidance-Plan>.

<sup>596</sup> See 2021-2022 Priority Guidance Plan which can be obtained at <https://www.irs.gov/pub/irs-utl/2021-2022-pgp-initial.pdf>.

Taxpayer did not exercise his special power of appointment, Trust property would be held in further trust for the benefit of Taxpayer's issue.

(1) The IRS ruled that the foreign trust was a grantor trust for U.S. income tax purposes. The IRS then ruled that the basis of the property held in trust would be the fair market value of the assets as provided under section 1014(a) of the Code.

(2) Significantly, the IRS ruled that section 1014(b)(9) of the Code (requiring the property to be included in determining the value of the decedent's gross estate) was inapplicable. Rather, the assets received by the grantor's issue would fall under section 1014(b)(1) of the Code (property acquired by bequest, devise, or inheritance). The IRS reasoned:

Taxpayer's issue will acquire, by bequest, devise, or inheritance, assets from Trust at Taxpayer's death. The assets acquired from Trust are within the description of property acquired from a decedent under § 1014(b)(1). Therefore, Trust will receive a step-up in basis in Trust assets under § 1014(a) determined by the fair market value of the property on the date of Taxpayer's death. See Rev. Rul. 84-139, 1984-2 C.B. 168 (holding that foreign real property that is inherited by a U.S. citizen from a nonresident alien will receive a step-up in basis under § 1014(a)(1) and 1014(b)(1)). This rule applies to property located outside the United States, as well as to property located inside the United States.

(3) In coming to the conclusion, the ruling points out that “Section 1014(b)(9)(C) provides that § 1014(b)(9) shall not apply to property described in any other paragraph of § 1014(b).” In other words, inclusion in the gross estate may not necessarily be the only avenue to receive a “step-up” in basis.

(4) While some practitioners may seek to interpret this ruling as allowing a “step-up” in basis for assets in an irrevocable grantor trust that are not otherwise included in the gross estate of the grantor, in actuality, it appears the drafters of the ruling at the Treasury Department may have mistakenly referred to section 1014(b)(1) of the Code (“Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.”) in the ruling. Based on conversations with the attorney that acquired the private letter ruling, the ruling should have referred to section 1014(b)(3), which provides for a “step-up” in basis for “property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.”<sup>597</sup> While not clear in the ruling, the grantor retained the power to alter beneficial enjoyment from and after his death, not during his lifetime.<sup>598</sup> As such, this ruling may

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<sup>597</sup> § 1014(b)(3).

<sup>598</sup> The drafters of the trust could not provide for a lifetime power to change beneficial enjoyment without losing foreign grantor trust status. The Code provides grantor trust status with respect to a foreign person for a portion of any trust if “the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.” § 672(f)(2)(A)(ii).

not stand for the proposition that assets in an IDGT can receive a “step-up” in basis, notwithstanding the fact the assets are not includible in the estate of the grantor.

4. Non-Grantor to Grantor Trust

a. A few private rulings have discussed the income tax consequences of a conversion of a non-grantor trust to a grantor trust.<sup>599</sup> Chief Counsel Advice 200923024 involved trusts created by a parent and three adult children, all of whom held S corporation shares. The S corporation had filed with the SEC to do an initial public offering. Each taxpayer transferred their shares to a partnership, then formed an irrevocable non-grantor trust, funded with \$100,000 in cash, and sold his or her partnership interest to his or her respective trust, in exchange for unsecured private annuities. The partnership had a section 754 election in place and, as a result, the partnership increased the basis of the partnership’s stock to fair market value (based on the purchase price of the partnership interests) under section 734 of the Code, and then the partnership sold all the shares of the corporation after the IPO for an amount roughly equal to the partnership’s basis in the shares (due to the inside basis adjustment). In other words, the partnership (and the trust) recognized little or no gain on the sale of the stock after the IPO. After the sale, the trust advisor removed the corporate trustee of the non-grantor trust and replaced by a person who would be considered a “subordinate party” under section 672(c) of the Code, thereby converting the trusts into grantor trusts under section 674(a) and (c) of the Code. After the trusts became grantor trusts, the taxpayers claimed to “own” all of the partnership interests and reported no gain or other taxable income attributable to any future payments on the private annuity sales.

b. The IRS agent sought to treat the conversion from non-grantor to grantor trust as a transfer of the underlying assets (partnership interest) to the grantor trusts (the new owner) as a taxable exchange. The non-grantor trusts would recognize little or no gain on the transfer because the outside basis of the partnership interests were equal to their fair market value. On the other hand, the transferee (grantor trusts) would realize taxable income on the receipt of the partnership interests. To that end, the IRS agent cited Revenue Ruling 77-402, section 1.1001-2(c), example 5, of the Treasury Regulations, and *Madorin* (as discussed earlier, all of the foregoing cited authorities stand for the proposition that when converting from a grantor to a non-grantor trust, there is a deemed transfer from the grantor to the trust, and if debt is in excess of basis, there is recognition of gain to the extent of such excess). The IRS Chief Counsel rejected this argument because the authorities only deal with recognition of income to the transferor (not the transferee). In its discussion, the IRS stated the rule set forth in the foregoing authorities is narrow in that it only applies to inter vivos lapses of grantor trust status and then inexplicably and gratuitously adds “not that caused by the death of the owner which is generally not treated as an income tax event.”<sup>600</sup> It’s the foregoing phrase that consistently gets quoted to stand for the proposition that the IRS does not believe termination of grantor trust caused by the death of the grantor is not a taxable event, despite the fact that the ruling itself does not involve the death of any taxpayer and the conversion in question is the opposite of the termination of grantor trust status. As to the first issue, whether the conversion of a non-grantor trust to a grantor trust is a transfer for income tax purposes of the property held by the non-grantor trusts to

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<sup>599</sup> CCA 200923024 and PLR 201730018

<sup>600</sup> *Id.*

the owners of the grantor trusts requiring recognition of gain to the owners, the IRS Chief Counsel ruled that it is “not a transfer for income tax purposes of the property held by the nongrantor trusts to the owner of the grantor trust that requires recognition of gain to the owner.”<sup>601</sup>

c. According to the IRS Chief Counsel, asserting that a conversion like this results in taxable income to the grantor would have an impact on non-abusive situations. The IRS Chief Counsel then provides examples of how a non-grantor trust can become a grantor trust; “examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§ 674); a borrowing of the trust corpus under § 675(3) (discussed below in ISSUE 2 with regard to the application of Rev. Rul. 85-13); or the payment of the grantor's legal support obligations under § 677(b).” The rule in Revenue Ruling 85-13 provided that the grantor could not engage in a taxable transaction with the grantor trust. Thus, while the IRS Chief Counsel agreed that the transaction at hand was abusive, the IRS should not take the position that it results in taxable income to the grantor.

d. On the second issue, the IRS agent asserted that the private annuity transaction (the sale of the partnership interests to the trusts) should be treated as an indirect borrowing of the trust assets, causing the trusts to be grantor trusts under section 675(3) of the Code. As a result, under Revenue Ruling 85-13, the IRS agent argued, the trusts did not get a cost basis upon purchase of the partnership interests and there would be no inside basis adjustment to the stock held by the partnership. The IRS Chief Counsel ruled that this private annuity transaction could not be recast as a loan under section 675(3) of the Code. Despite the positive results for the taxpayer, the memorandum concludes, “Please note that we are not opining on the possible applicability of the step transaction, the economic substance doctrine or other judicial doctrines to the transaction in the present case... Because the case presents an apparent abuse, however, we would like to explore with you further case development that may lead to other arguments to challenge the transaction.”<sup>602</sup>

e. It's unclear what practitioners can take away, if anything, from Chief Counsel Advice 200923024. It could be interpreted to mean that a conversion from non-grantor trust to grantor trust is not a transfer for income tax purposes at all or, at the very least, not a transfer that will result in a recognition event to the grantor. In the one other ruling which, involved the conversion of a non-grantor charitable lead annuity to a grantor trust, the IRS wrote, “Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision.”<sup>603</sup> In any case, it's hard to see how the Chief Counsel Advice 200923024 can be read to stand for the proposition “the death of the owner ... is generally not treated as an income tax event,” as is so often quoted by commentators.

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<sup>601</sup> *Id.*

<sup>602</sup> *Id.*

<sup>603</sup> PLR 201730018.

C. Section 678 Ownership by Beneficiaries or Other Entities

1. As mentioned above, section 678(a) of the Code provides a person (other than the grantor) will be treated as the owner of any portion of a trust if (i) the person has a “power exercisable solely by himself to vest the corpus or the income therefrom in himself,”<sup>604</sup> or (ii) the person “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.”<sup>605</sup>

2. A trust where a person other than the grantor is conferred “grantor trust” by a “power exercisable solely by himself to vest the corpus or the income therefrom in himself” under section 678(a)(1) of the Code is more commonly referred to as a beneficiary deemed owner trust or BDOT.<sup>606</sup> Common examples of this type of situation include section 2056(b)(5) marital trusts pursuant to which the spouse has a general power of appointment over the entire trust or trusts that permit withdrawal by a beneficiary as an alternative to mandatory termination or distribution when the beneficiary reaches a certain age. The foregoing examples involve the power to vest corpus. An example of a power to vest “the income therefrom” is described in Private Letter Ruling 201633021.<sup>607</sup> The ruling involved Trust 1 and Trust 2 which were non-grantor trusts because the grantor had died. The assets of Trust 1 and Trust 2 are held for the benefit of the same beneficiaries. The governing document of Trust 2 provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year. Trust 2 further provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under section 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months. The ruling provides that the trustee “proposes to transfer funds from Trust 1 to Trust 2.”<sup>608</sup> The IRS concluded, “Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2.”<sup>609</sup>

3. The ruling unfortunately does not provide any insight on what the income tax consequences would be when Trust 1 “transfers funds” to Trust 2. The language of the ruling

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<sup>604</sup> § 678(a)(1).

<sup>605</sup> § 678(a)(2).

<sup>606</sup> For an in-depth discussion of the BDOT, see Edwin P. Morrow, *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)* (2020) available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3165592](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592) and a large portion of which was published previously as LISI Estate Planning Newsletter #2587 (Sept 5, 2017).

<sup>607</sup> PLR 201633021.

<sup>608</sup> *Id.*

<sup>609</sup> *Id.*

implies the Trust 1 will be treated as a beneficiary of Trust 2 but also “as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a).” The language doesn’t necessarily (but it could) mean that Trust 1 is the deemed owner entirely of Trust 2 and all of its assets. If Trust 1 is treated as the owner entirely of Trust 2, then theoretically Trust 1 could engage in a sale of the assets of Trust 1 to Trust 2 in exchange for an installment note, and the transaction would be disregarded for income tax purposes under Revenue Ruling 85-13. This would be the result if Trust one could withdraw all the assets of Trust 2 at any time. If, however, Trust 1 is merely an entity that must report the income, capital gain, expenses, and other items used to compute DNI, then such a transaction could, in part, be considered a taxable event. Even if the latter interpretation is correct, if Trust 1 is a non-GST exempt trust and Trust 2 is a GST exempt trust, the tax liability borne by Trust 1 from all of Trust 2’s income and capital gain could significantly increase Trust 2’s trust assets over time and decrease the assets in Trust 1.

4. In a more recent ruling,<sup>610</sup> the trust agreement of a Trust 1 prohibited the distribution of Shares (perhaps of a closely-held company) to the beneficiaries, but allowed for the distribution of the proceeds from the sale of Shares. Trust 1 contributed all of its Shares to LLC, a newly formed entity classified as partnership for Federal tax purposes, in exchange for membership interest in LLC. The same restrictions on the Shares were placed on the membership interests of LLC. Trust 1 then transferred a portion of its LLC interest to a Subtrust for the sole benefit of A. After A reached the age of 40, A exercised a withdrawal right to take all of the Subtrust’s assets, except the LLC interests. The Subtrust agreed to sell a portion of its LLC interests to Trust 2 in exchange for cash and a promissory note. Trust 2 is a grantor trust with respect to A. A also has the authority to withdraw the cash and promissory note from Subtrust after the sale. The IRS concluded, “because A has a power exercisable by herself to vest the proceeds of Subtrust’s LLC interest in herself and that those proceeds are Subtrust’s only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A.”<sup>611</sup>

## VI. PLANNING WITH NON-U.S. GRANTORS, TRUSTS, AND HOLDING COMPANIES

### A. Introduction

1. In the case of decedents who are not U.S. citizens and who are not domiciled in the United States, U.S. gift and estate tax is imposed only on U.S. situs assets.<sup>612</sup> The gift and estate tax rates are the same as for U.S. donors and U.S. decedents but the applicable credit amount is zero for gifts and only \$60,000 for estates.<sup>613</sup> The annual gift tax exclusion is available

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<sup>610</sup> PLR 202022002.

<sup>611</sup> *Id.*

<sup>612</sup> §§ 2103, 2511(a).

<sup>613</sup> §§ 2101, 2102(b)(3) and 2505. The unified credit for decedents who were residents of certain treaty countries is equal to that portion of the unified credit in effect under § 2010(c) that the U.S. estate bears to the worldwide estate. § 2102(b)(3). Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Amended by Protocol, U.S.–Can, art. 29, Sep. 21, 2007.

to nonresident alien donors,<sup>614</sup> but, gift splitting is not allowed unless each spouse is a U.S. citizen or resident.<sup>615</sup> Charitable deductions are more limited than for U.S. persons.<sup>616</sup> A charitable deduction is allowed only for gifts and bequests to U.S. charities (unless a treaty allows a deduction). Deductions, administration expenses, debts, and taxes are allowed to a nonresident alien decedent's estate in the proportion the U.S. estate bears to the worldwide estate (except for nonrecourse debt), and are not allowed at all unless an estate tax return is filed.<sup>617</sup> Use of a partnership or LLC may allow only the equity to be taxed and avoid the proportionality rule.

2. Situs rules are different for gift and estate tax purposes.<sup>618</sup> For example, stock of a U.S. corporation is U.S. situs for estate tax purposes. Nonresident aliens are not subject to U.S. gift tax on gifts of intangible personal property.<sup>619</sup> Gift tax applies to gifts of real property and tangible personal property located in the U.S.<sup>620</sup> U.S. estate tax applies to stock of a U.S. corporation and debt obligations of U.S. persons or governmental entities, subject to exceptions.<sup>621</sup> The proceeds of life insurance on a nonresident alien, bank deposits and certain other debt obligations, art on loan to a museum, and RICs (to the extent of foreign situs assets) are foreign situs.<sup>622</sup>

3. Situs rules for some types of property are unclear. Trusts don't change the situs of trust assets — a "look through" rule applies.<sup>623</sup> A cash gift is treated as tangible personal property in some old rulings.<sup>624</sup> Checks are treated as gifts of cash made when donor parts with control.<sup>625</sup> Therefore, a gift made by a check, even if drawn on a foreign bank account, that is deposited in a U.S. bank might be deemed to be a taxable gift of a U.S. situs asset, but the opposite conclusion may apply to a wire transfer from foreign bank that is beyond recall when issued. It is not clear whether the situs of interests in partnerships is determined based on the situs of the partnership interest, the situs of partnership assets, the place where it was organized, or the place where it does business. Revenue Ruling 55-701<sup>626</sup> found that the situs of a partnership interest is determined on the basis of where the entity does business. Of course, a

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<sup>614</sup> § 2503.

<sup>615</sup> § 2513(a)(1).

<sup>616</sup> §§ 2106(a)(2) and 2522(b).

<sup>617</sup> §§ 2106(a)(1) and 2106(b).

<sup>618</sup> §§ 2104, 2105, 2501(a)(2), and 2511(b).

<sup>619</sup> §§ 2104(a) and 2511(b)(1); Treas. Reg. § 25.2511-3(b).

<sup>620</sup> §§ 2501(a)(2) and 2511.

<sup>621</sup> § 2104.

<sup>622</sup> See § 2105.

<sup>623</sup> *Comm'r v. Nevius*, 76 F.2d 109 (2d Cir.), cert. denied, 296 U.S. 591 (1935).

<sup>624</sup> Rev. Rul. 55-143, 1955-1 C.B. 465.

<sup>625</sup> GCM 36860 (9/24/76).

<sup>626</sup> Rev. Rul. 55-701, 1955-2 CB 836.

partnership may do business in more than one country. In the case of retirement plans, the situs may depend upon nature of the plan. Is the arrangement a “debt” of a U.S. person, which is U.S. situs,<sup>627</sup> or is it a trust to which a “look through” rule applies?

4. If the assets of a trust would be includable in the estate of a nonresident alien if he or she were a U.S. person (such as a revocable trust), the situs of trust assets that in fact are subject to U.S. estate tax is determined by looking at the trust assets both when the trust was funded and at the time of the grantor’s death.<sup>628</sup>

## B. Foreign Holding Companies

1. Foreign corporations are frequently used to change the situs of assets for estate and gift tax purposes.<sup>629</sup> A foreign corporation may also be used to shift the source of income of an exempt individual who is present in the United States for 183 days or more and who therefore is taxable on certain U.S. source capital gains.<sup>630</sup>

2. If income effectively connected with the conduct of a trade or business in the U.S. (ECI) is earned by a corporation, the nonresident alien individual shareholder avoids having an obligation to file U.S. income tax returns to report ECI. However, typically the foreign corporation holds the U.S. business interest through a domestic subsidiary to avoid the branch profits tax and partnership withholding on ECI.<sup>631</sup>

3. A liquidation of a foreign corporation at the time of the death of a nonresident alien owner who leaves all or a portion of his or her estate to a U.S. beneficiary may be used to “re-base” assets owned by a corporation. A liquidation causes the shareholder to receive a basis in the assets received from the corporation at fair market value.<sup>632</sup> The corporation has recognized gain but if the corporation is foreign, the gain is not taxed unless it holds assets subject to U.S. income tax (such as real estate) or an interest in a partnership with ECI.<sup>633</sup> However:

a. If the shares are held in a non-grantor trust, any shareholder level gain realized in the liquidation increases the trust’s income, and therefore its DNI (and potentially

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<sup>627</sup> § 2104(c).

<sup>628</sup> § 2104(b).

<sup>629</sup> See Lewis J. Saret, *International Issues in Estate Planning: Part 1 – Estate Planning for Nonresident Aliens*, 28 Tax Mgmt. Est., Gifts & Tr. J. 230 (Sept./Oct. 2003); Jeffrey M. Colon, *Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy*, 34 San Diego L. Rev. 1 (1997); See also *Fillman v. U.S.*, 355 F.2d 632 (Cl. Ct. 1966) (highlighting the need for the following of corporate formalities in using foreign corporations to change situs of assets).

<sup>630</sup> § 871(a)(2). An “exempt individual” is a person who is not a resident under the substantial presence test by reason of his or her visa status (such as students, teachers and diplomats).

<sup>631</sup> §§ 884 and 1446.

<sup>632</sup> § 301(d).

<sup>633</sup> §§ 311(b) and 897.

UNI), and the gain may be significant if the death of the nonresident alien did not cause a basis step up in the shares of the foreign corporation;

b. If the company is a controlled foreign corporation (“CFC”), corporate level gain realized on liquidation of the corporation, applying U.S. tax principles, might flow through to a U.S. shareholder who owns the shares or who is deemed to own the shares indirectly (e.g., such as because he or she is a beneficiary of a foreign trust that owns the shares);

c. If the holding company is a passive foreign investment company (“PFIC”) or owns shares of a PFIC, gain realized on liquidation of the holding company might be subject to excess distribution treatment because it would be a deemed disposition by a U.S. person who is deemed to indirectly own the PFIC shares;<sup>634</sup> and

d. Any U.S. real property interests held by the holding company will be taxed as if the U.S. real property interest were sold and would be taxable to the foreign corporation.

4. A liquidation of a holding company may be easier if the foreign corporation qualifies for a check-the-box (“CTB”) election.<sup>635</sup> Not all foreign corporations qualify for a CTB election.<sup>636</sup> If a CTB election is made, the entity becomes either disregarded (if there is only one shareholder) or a partnership (if there is more than one owner). If the classification of the entity was relevant for U.S. tax purposes before the election was made, the election by a corporation to be a disregarded entity or a partnership is a deemed liquidation.<sup>637</sup> When a corporation liquidates, gain is realized and the shareholder acquires a basis equal to fair market value of the assets distributed in liquidation.<sup>638</sup> A CTB is easier than a real liquidation because it has no consequences under foreign law and because an election can be retroactive for up to 75 days before the election is filed. On the other hand, the election does require that Form 8832 be filed. Timing is important because, if a U.S. person who owns or is treated as owning at least 10% of the voting stock or 10% of the value of all stock of a CFC for any day in a year, the U.S. shareholder must include in income his or her share of the CFC’s subpart F income for the entire year of the corporation.<sup>639</sup> Thus, a CTB that has an effective date prior to the death of its 100%

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<sup>634</sup> §§ 1291(b), 1298(a)(3) and 1298(b)(5).

<sup>635</sup> Treas. Reg. § 301.7701-3.

<sup>636</sup> Treas. Reg. § 301.7701-2 contains a list of foreign entities classified as “per se corporations” for which a CTB election is not allowed.

<sup>637</sup> Treas. Reg. § 301.7701-3(g)(1). Classification is relevant if it affects the liability of any person for federal tax or information purposes. Classification is relevant if it affects the determination of the amount of tax to be withheld by a withholding agent, the type of tax or information return to file or how the return must be prepared. Treas. Reg. §§ 301.7701-3(b)(ii) and -3(d)(i).

<sup>638</sup> §§ 311(b) and 301(d).

<sup>639</sup> § 951(a)(1) and (2); Treas. Reg. § 1.951-1(a). Prior to 2018, a U.S. person was not subject to tax on the subpart F income of a CFC unless the corporation was a CFC for an uninterrupted period of 30 days or more during the year, and a U.S. person was not a “U.S. Shareholder” exposed to tax unless he or she owned (or was treated as owning) at least 10% of the voting stock. TCJA expanded the circumstances in which U.S. persons are exposed to tax on Subpart F income by eliminating the 30-day rule and exposing a

nonresident alien owner may protect the U.S. individual who inherits the stock from tax on subpart F income, including the gain realized by the CFC on the distribution of appreciated assets to a shareholder.<sup>640</sup> A company will not be a CFC unless more than 50% of the value of the shares or the voting power of the shares is owned by U.S. shareholders.<sup>641</sup> For this purpose, a U.S. shareholder is a U.S. person who owns or is considered as owning 10% or more of the voting power of all classes of stock entitled to vote shares of the corporation or 10% or more of the value of all classes of stock.<sup>642</sup> If the CFC ceases to be a corporation prior to the death of its 100% nonresident alien shareholder, it will never be a CFC. However, it also will fail to be an effective estate tax blocker for any U.S. situs assets that may be owned by the corporation.

C. Qualifying for a Basis Adjustment at the Grantor's Death

1. Under some circumstances, assets transferred by a nonresident alien to a trust will qualify for an adjustment to basis under section 1014 even though the assets are not subject to U.S. estate tax at the grantor's death.<sup>643</sup> A basis adjustment under section 1014(a) of the Code is possible under three different subsections of section 1014(b) for:

a. "Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust,"<sup>644</sup>

b. "[P]roperty transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust,"<sup>645</sup> and

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shareholder to tax if he or she owns (or is treated as owning) 10% or more of the value of the shares, even if he or she owns no voting stock.

<sup>640</sup> §§ 311(b), 952(a)(2), and 954(c)(i)(B)(i). Gains for the sale of property other than inventory, is foreign personal holding company income, which is one type of subpart F income.

<sup>641</sup> § 957(a).

<sup>642</sup> § 951(b). Prior to 2018, a U.S. person was not a "U.S. Shareholder" unless he or she owned (or was treated as owning) 10% or more of the voting stock.

<sup>643</sup> Rev. Rul. 84-139, 1984-2 C.B. 168; PLRs 8904046 and 201245006. In Rev. Proc. 2015-37 the IRS revised the list of areas of the Code relating to matters on which it will not issue letter rulings or determination letters, adding whether the assets in a grantor trust will receive an adjustment to basis under section 1014 at the death of the deemed owner for income tax purposes when those assets are not includible in the gross estate of the owner at death. The no-rule position applies to requests for guidance received after June 15, 2015. Rev. Proc. 2015-37, 2015-26 I.R.B. 1196 (June 15, 2015). Paragraph (9) of section 1014(b), requires that assets be included in the gross estate of the decedent to obtain a basis adjustment, but this paragraph is expressly made inapplicable to property described in any other paragraph of that subsection.

<sup>644</sup> § 1014(b)(2). *See also*, Treas. Reg. § 1.1014-2(a)(1) and Rev. Rul. 57-287, 1957-1 C.B. 517, *modifying* Rev. Rul. 55-502, 1955-2 C.B. 560.

<sup>645</sup> § 1014(b)(9).

c. “Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will.”<sup>646</sup>

2. The requirements of sections 1014(b)(2) and (3) are different from the requirements to qualify a nonresident alien grantor as the owner of the trust under section 672(f). First, it is not clear that a revocable trust that omits the language “payable to or on the order or direction of the grantor” will qualify under section 1014(b)(2). As a matter of tax policy, this should not be a problem because the power to revoke in substance includes the power to direct the payment of income. Second, in the case of an irrevocable trust that has a nonresident alien grantor, the grantor’s retained power to alter, amend or terminate a trust should not be exercisable to allow payment to anyone other than the grantor or the grantor’s spouse during the grantor’s lifetime. This power would fail to satisfy the requirement of section 672(f) that payment be limited to the grantor and/or the grantor’s spouse. However, section 1014(b)(3) should be satisfied even where the grantor’s power to alter, amend or terminate the trust applies only to distributions made after the grantor’s death.<sup>647</sup>

3. If a basis adjustment is not possible under sections 1014(b)(2), (3), or (4), another possible way to adjust the basis of assets is to invest trust assets through a foreign entity that is eligible to make a check the box election under section 301.7701-3 of the Treasury Regulations, as discussed above. If the election is treated as a deemed liquidation, the assets may acquire a new basis equal to the fair market value of such assets on the deemed liquidation date.<sup>648</sup>

#### D. Basis Planning with Controlled Foreign Corporations

1. If U.S. beneficiaries receive shares of foreign corporations that are or become CFCs on the death of a nonresident alien, their retention of the shares will subject them to current income tax at ordinary income tax rates on their pro rata shares of certain corporate income whether or not the income is distributed to them. If, in order to avoid this result, they liquidate the corporation, they will be taxed on their shares of the unrealized appreciation in the

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<sup>646</sup> § 1014(b)(4). *See also*, Treas. Reg. § 1.1014-2(a)(4).

<sup>647</sup> PLRs 8904046 and 201245006. PLR 201245006 is often cited as support for the proposition that any assets deemed owned by the grantor under Subpart E of Subchapter J of the Code qualify for a basis step adjustment under section 1014 at the grantor’s death even if such assets are not includable in the grantor’s gross estate. The wording of the PLR lends credibility to this proposition. However, in fact, the trust involved in that ruling satisfied the requirements of section 1014(b)(3) for a basis adjustment and the ruling does not support allowing a basis adjustment when neither section 1014(b)(2) nor (b)(3) is applicable.

<sup>648</sup> Treas. Reg. § 301.7701-3(g). However, if the U.S. classification of the foreign entity as a corporation or disregarded entity was never relevant for U.S. tax purposes, the filing of the election could be treated as establishing the initial classification of the entity rather than as a liquidation, so that a basis adjustment would not be allowed. Treas. Reg. § 301.7701-3(d)(2).

corporation's assets on liquidation and, if their shares of the value of the assets received on liquidation exceeds their basis in the stock of the corporation, on that gain as well.<sup>649</sup>

2. The tax on the unrealized appreciation in the corporation's assets can be avoided by liquidating the corporation before the death of the non-U.S. shareholder.<sup>650</sup> Because the date of death cannot be known until death occurs, and the non-U.S. shareholder may prefer to keep the corporation in effect during his or her lifetime, the practical way to control the effective date of a liquidation is to make a CTB election after death and to select an effective date before death. This election will prevent the corporation from being a CFC at any time. The election may be effective before death if filed within 75 days after death. For example, if a nonresident alien dies on September 1 and her will bequeaths her 100% ownership in a foreign corporation to her U.S. daughter, a liquidation of the corporation on or before September 1 would be timely because the decedent is deemed to own shares on the date of "disposition" and the U.S. Shareholder's holding period does not include the date the shares are acquired.<sup>651</sup> An election effective September 2 is a deemed liquidation on September 1.<sup>652</sup> The election would have to be filed not more than 75 days after September 2, which is November 15. Despite the holding period rules, it would be more conservative to make the election effective on a day prior to the decedent's death.

3. A CTB election is available for certain types of foreign corporations, and the consequence of an election is to reclassify the elected entity either as a disregarded entity, if there is only one owner, or as a partnership if it has more than one owner.<sup>653</sup> If the classification was relevant for U.S. tax purposes before the election was made, the effect of the election will be to

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<sup>649</sup> If the liquidation takes place shortly after the death of the nonresident alien, the basis adjustment normally applicable under section 1014 will often eliminate the tax on the unrealized gain with respect to the shares of stock.

<sup>650</sup> As discussed herein, an election effective one day after death may be a deemed liquidation on date of death and because the holding period of the U.S. Shareholder begins the day after acquisition, technically an effective date one day after death may avoid CFC classification.

<sup>651</sup> The date the shares are acquired are not counted in the U.S. shareholder's holding period but the date of disposition is counted. Treas. Reg. § 1.951-1 (f).

<sup>652</sup> Treas. Reg. § 1.7701-3(g)(3).

<sup>653</sup> Treas. Reg. § 301.7701-2 classifies, for U.S. income tax purposes, a foreign business entity, other than an entity that is automatically classified as a corporation under Treas. Reg. § 301.7701-2(b), as a partnership if it has more than one member at least one of which does not have limited liability, or as an association taxable as a corporation if all of its members have limited liability. If the entity has only one member and that member does not have limited liability, the entity is disregarded as an entity separate from its owner. A business entity is, generally, any entity other than an entity properly classified as a trust. Foreign entities that are automatically classified as corporations include the Societe Anonyme in Belgium, France, and Switzerland, the Aktiengesellschaft in Austria, Germany and Switzerland, the Sociedad Anonima in Mexico and Spain, and the Public Limited Company in the United Kingdom. If a foreign entity is not automatically classified as a corporation, but is classified as an association taxable as a corporation because all of its members have limited liability, it may elect to be classified as a partnership by filing Form 8832 with the appropriate IRS service center. The election made on Form 8832 will be effective on the date specified on the form, provided that the effective date may not be more than 75 days prior to or more than 12 months after the form is filed.

treat the corporation as having distributed all of its assets and liabilities to its nonresident alien shareholder in complete liquidation of the corporation on the day before the effective date of the election.<sup>654</sup> The corporation will be treated as recognizing gain to the extent the fair market value of its assets exceeds its basis in those assets, but will not pay U.S. income tax on this gain because it is not subject to U.S. income tax.<sup>655</sup> The basis of the corporation's assets in the hands of its non-U.S. shareholder will be the fair market value of the assets on the day before the effective day of the election.<sup>656</sup> The deemed receipt by the shareholder of the corporation's assets will be treated as amounts received in exchange for her stock.<sup>657</sup> Any gain recognized, however, should avoid tax if it is not U.S. source income as long as the shares are owned by a non-U.S. individual or owned by a foreign grantor trust with a non-U.S. grantor. However, if the shares are held by a foreign non-grantor trust, then the gain may be subject to U.S. tax when it is distributed to U.S. beneficiaries or pursuant to the constructive ownership rules at the time of the liquidation.

#### E. Estate Tax Issues

1. If U.S. beneficiaries receive shares of CFCs on the death of a nonresident alien, their retention of the shares will subject them to current income tax at ordinary income tax rates on their pro rata shares of certain corporate income whether or not the income is distributed to them. If, in order to avoid this result, they liquidate the corporation, they will be taxed on their shares of the unrealized appreciation in the corporation's assets on liquidation and, if their shares of the value of the assets received on liquidation exceeds their basis in the stock of the corporation, on that gain as well.<sup>658</sup>

2. U.S. real property interests and interests in a partnership that has ECI that are held in a holding company will incur U.S. income tax if the holding company is deemed liquidated because all dispositions of U.S. real property interests and interests in a partnership that has ECI are subject to U.S. income tax.<sup>659</sup> Therefore, these interests should not be held in a holding company for which a CTB election is contemplated.

3. Making the CTB election effective before death causes the foreign corporation to be treated as a disregarded entity or a partnership, which eliminates the "shield" that may protect the assets from exposure to U.S. estate tax.<sup>660</sup> This is not a problem if the

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<sup>654</sup> Treas. Reg. § 301.7701-3(g)(1)(iii). Therefore, if a post-death effective date is desired, the effective date should be two days after death so that the liquidation is deemed to occur the day after death.

<sup>655</sup> § 311(b).

<sup>656</sup> § 334(a).

<sup>657</sup> § 331(a).

<sup>658</sup> If the liquidation takes place shortly after the death of the nonresident alien, the basis adjustment normally applicable under section 1014 will often eliminate the tax on the unrealized gain with respect to the shares of stock.

<sup>659</sup> §§ 897 and 865(c)(8) (added by TCJA).

<sup>660</sup> An estate tax treaty may protect the assets from U.S. estate tax but the Code is unclear about the situs of a partnership interest, as discussed above.

investments owned by the foreign corporation are foreign situs for estate tax purposes. On the other hand, if the assets owned by the foreign corporation are U.S. situs, a pre-death effective date exposes the assets to U.S. estate tax. For this reason, it is advisable to segregate assets that are U.S. and non-U.S. situs in separate corporations so that the pre-death election can be safely made for the corporation that holds assets that would not be exposed to U.S. estate tax.

4. The following tiered structure may be used to minimize income tax to the U.S. shareholder who acquires stock in a foreign corporation and preserve the corporate estate tax shield for U.S. situs assets: A nonresident alien or foreign grantor trust with a nonresident alien grantor owns 100% of the stock of two foreign corporations – A and B. A and B each own 50% of the stock of C, a foreign corporation. C owns U.S. investments. Assume that the shares of A and B receive a fair market value basis upon the death of the grantor. The trustee makes a CTB election for C effective before the grantor's death. Assume that the classification of C was relevant for U.S. purposes before the election was made. The assets of C in the hands of A and B have a new basis equal to value, as explained above.<sup>661</sup> A and B make a CTB election effective two days after the grantor's death so that A and B may shield the U.S. situs assets deemed to be owned by A and B from U.S. estate tax.<sup>662</sup> An election two days after death is a deemed liquidation one day after death.<sup>663</sup> Gain realized by A and B on the liquidation of C (because the amount received by A and B exceeded their bases in the stock of C) will be apportioned and taxable to the U.S. Shareholders who inherit the shares based on the number of days in the taxable years of A and B that they owned shares.<sup>664</sup> The additional benefit of the tiered structure is that if the decedent dies in the first 75 days of the calendar year (on or before March 16), it may be possible to make the deemed liquidation of C as a result of the CTB election occur in the prior taxable year and thereby avoid any allocation of gain realized by A and B to the U.S. Shareholder who acquires the shares in the following year.<sup>665</sup> If the decedent dies more than 75 days into the calendar year so that the deemed liquidations of A, B, and C occur in the same taxable year, and A and B are liquidated promptly after death, a fraction of the gain will be apportioned to the U.S. Shareholders, but the fraction is likely to be 1/77 or less. For example, if the decedent died March 17, the CTB election is effective March 19, the deemed liquidation is March 18, the fraction is 1/77 because (i) the decedent's holding period should include the date

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<sup>661</sup> § 332(a) should not apply to the liquidation of C because there is no common parent as described in § 1504(a). If § 332 is not applicable, then the assets of C that are deemed to have been received by A and B are treated as received in exchange for stock of C and acquire a new basis. A and B have gain on the liquidation but the gain is foreign source and A and B are foreign persons.

<sup>662</sup> "Immediately after death" means that the effective date should be two days after death because the deemed liquidation is deemed to occur at the end of the day before the effective date of the election. Treas. Reg. § 1.7701-3(g)(3). The U.S. shareholder's holding period still should be one day because the holding period excludes the date of acquisition, and includes the date of disposition.

<sup>663</sup> Treas. Reg. § 301.7701-3(g)(3).

<sup>664</sup> § 951(a)(2).

<sup>665</sup> § 898(c) adopts a default rule that a CFC has the same tax year as the majority U.S. Shareholder and may elect a year ending one month earlier. We assume that U.S. individuals who are beneficiaries of a trust or estate will be deemed to be the majority U.S. Shareholders and will have a calendar year as their taxable year. If there is no majority U.S. Shareholder, then the Treasury Regulations under section 441 determine the taxable year of the CFC.

of his or her death, (ii) the U.S. Shareholder's holding period does not include the date he or she acquired the stock, (iii) the U.S. Shareholder's holding period includes the date of disposition which should be the date the liquidation of A and B is deemed to have occurred, which is the end of the day on March 18, the day before the effective date of the election, and (iv) there are only 77 days in the taxable years of A and B as corporations (January 1 to March 18).<sup>666</sup> There should be no further gain on the liquidation of A and B because there should have been little or no gain on the assets that are deemed to have been distributed by A and B to the U.S. Shareholder as a result of the increase in the basis of those assets that occurred on the taxable liquidation of C, and there also should be no shareholder level gain due to the date of death basis adjustment to the shares of A and B.

5. Another approach is to follow the structure in paragraph 4 above, but to incorporate A and B under a foreign statute that permits them to be classified as disregarded entities or partnerships by default, and to make a CTB election for A and B filed after death but effective before death to classify A and B as corporations. Corporation C also would make an election filed after death but effective before death and before the effective date of the elections filed by A and B to cause a taxable deemed liquidation. This structure avoids the allocation of any gain from the taxable liquidation of C being apportioned to the U.S. Shareholder who acquires the shares of A and B. Any income from the taxable liquidation of C would be taxable to the decedent because at the time of the liquidation of C, A and B were flow-through entities. For example, if the decedent died March 16, the election for C would be effective 4 days before death and the elections for A and B would be 2 days before death. However, the U.S. Shareholder is left owning the shares of two foreign C corporations. The U.S. shareholder will incur tax under subpart F until A and B are liquidated. More importantly, however, the transitory existence of A and B as corporations may be ignored.<sup>667</sup> If A and B are not treated as corporations, then the estate tax shield is less likely to be effective to avoid U.S. estate tax. This risk seems unwise given the low fraction of income exposed to tax under the previous alternative.

## VII. PARTNERSHIP PITFALLS, MISCONCEPTIONS, AND OPPORTUNITIES

### A. Introduction

1. It is beyond the scope of these materials to write a full and comprehensive discussion of partnership taxation. However, entities tax as partnerships (i.e., limited liability companies and limited partnerships) are the most common vehicles utilized to transfer assets in estate planning. There are many reasons why that is the case. One of those reasons is the flexibility that subchapter K gives to taxpayers to allocate tax items and to manage tax basis.

2. The partnership rules provide sufficient planning flexibility to shift and change the basis of property through distributions (both non-liquidating and liquidating distributions) and the use of certain elections like the section 754 election. For example, a partnership could distribute a high basis asset into the hands of a partner with zero outside basis. The basis of the property in the hands of the partner generally would become a zero basis asset

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<sup>666</sup> Treas. Reg. §§ 1.951-1(f) and 1.7701-3(g)(3).

<sup>667</sup> Rev. Ruls. 67-274, 1967-2 C.B. 141; 2004-83, 2004-2 C.B. 157; and 2008-25, 2008-1 C.B. 986.

eligible for a “step-up” in basis on the subsequent death of the partner.<sup>668</sup> With a section 754 election, the “stripped” basis (i.e., the partnership’s basis in the asset immediately prior to the distribution) would allow an upward basis adjustment to the other assets remaining inside the partnership.<sup>669</sup> Furthermore, because partnership debt can create tax basis to certain partners, the careful management of each partner’s allocable share of that debt can increase or decrease basis.<sup>670</sup> Notwithstanding the general rules above, other provisions of subchapter K must be considered, including the “mixing bowl” transaction and disguised sale rules.<sup>671</sup>

3. Flexibility unfortunately also means complexity and the risk of unintended tax consequences. This section of the materials will attempt to highlight common misconceptions, pitfalls, and planning opportunities in partnership taxation with a focus on the estate planning techniques and transactions that have become so popular. Our hope is that these materials will give estate planners a working knowledge of the following subjects pertaining to subchapter K and the income tax treatment of partners in a partnerships:

- a. Allocation of tax items among partners;
- b. Capital accounts;
- c. Unitary basis rule;
- d. Calculating inside and outside basis;
- e. Non-liquidating “current” distributions of partnership property;
- f. Liquidating distributions of partnership property;
- g. “Mixing Bowl” transactions and “Disguised Sale” rules;
- h. Treatment of partnership liabilities and their effect on basis;
- i. Section 754 election and inside basis adjustments;
- j. Partnership divisions; and
- k. Anti-abuse rules.

#### B. Entity Classification

1. These materials focus on income tax planning opportunities with entities classified as partnerships (and to a certain extent, disregarded entities) for Federal tax purposes.

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<sup>668</sup> §§ 732(a)(2) and 1014(a).

<sup>669</sup> § 734(b).

<sup>670</sup> § 752.

<sup>671</sup> §§ 704(c)(1)(B), 707(a)(2)(B), 731(c), 737, and 751(b).

However, just because an entity is, under state law, a partnership (general or limited) or a limited liability company, it may not be classified as partnership for Federal tax purposes. Estate planners must not assume that these entities are treated as partnerships for tax purposes.

2. An unincorporated entity (e.g., limited liability company or limited partnership) with two or more owners may elect to be classified as an association (taxed as a corporation)<sup>672</sup> or, by default, as a partnership. An unincorporated entity with a single owner (only limited liability companies because partnerships must have two or more partners) may elect to be treated as an association (taxed as a corporation) or disregarded as an entity separate from its owner (disregarded entity).<sup>673</sup> Unless the unincorporated entity elects otherwise, a domestic eligible entity is a partnership if it has two or more owners or is a disregarded entity if it has (or deemed to have) a single owner.<sup>674</sup>

3. As noted above, an entity whose default classification is a partnership or a disregarded entity may elect to be classified as an S corporation.<sup>675</sup> An eligible entity that makes a timely and valid election to be classified as an S corporation will be deemed to have elected to be classified as an association taxable as a corporation.<sup>676</sup>

### C. Anti-Abuse Rules and Estate Planning

1. In 1995, the IRS issued “anti-abuse” Treasury Regulations<sup>677</sup> that permit the IRS to recharacterize any transaction that involves a partnership if a principal purpose of the transaction is to reduce the present value of the partners’ “aggregate Federal tax liability” in a manner inconsistent with the intent of subchapter K.<sup>678</sup> The breadth of these provisions are potentially infinite, but generally apply to artificial arrangements.

2. The Treasury Regulations provide that the following requirements are implicit in the “intent” of subchapter K:

a. The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose;<sup>679</sup>

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<sup>672</sup> See Treas. Reg. § 301.7701-2(b)(2).

<sup>673</sup> See Treas. Reg. § 301.7701-3(a).

<sup>674</sup> Treas. Reg. § 301.7701-3(b). Form 8832 and an election to be an S corporation under section 1362(a) of the Code (Form 2553, Election by a Small Business Corporation)

<sup>675</sup> Treas. Reg. § 301.7701-3(c)(1)(i).

<sup>676</sup> *Id.*

<sup>677</sup> Treas. Reg. § 1.701-2.

<sup>678</sup> Treas. Reg. § 1.701-2(b).

<sup>679</sup> Treas. Reg. § 1.701-2(a)(1).

b. The form of each partnership transaction must be respected under substance over form principles;<sup>680</sup> and

c. The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income) or “the application of such a provision [of subchapter K] to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.”<sup>681</sup>

3. The Treasury Regulations provide that certain of the factors that may be taken into account in determining whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate Federal tax liability in a manner inconsistent with the intent of subchapter K. Some of those factors are:

a. The fact that substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;

b. The present value of the partners' aggregate Federal tax liability is substantially less than it would have been had the partners owned the partnership's assets and conducted the partnership's activities directly;

c. The benefits and burdens of ownership of contributed property are retained by the contributing partner, or the benefits and burdens of ownership of partnership property are shifted to the distributee partner, before and after the property actually distributed;

d. The present value of the partners' aggregate Federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction; and

e. Partners who are necessary to claiming a certain tax position but who have a nominal interest in the partnership, are substantially protected from any risk of loss, or have little or no participation in profits other than a preferred return that is a payment for the use of capital.<sup>682</sup>

4. Pertinent to the concept of changing the tax basis of property, the Treasury Regulations provide 2 examples of situations that generally indicate that basis shifts resulting from property distributions are allowable under the anti-abuse provisions:

a. The first example involves a liquidating distribution of appreciated, nonmarketable securities from a partnership without a section 754 election in place. The distribution resulted in a stepped-up basis in the securities. Because no section 754 was in place,

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<sup>680</sup> Treas. Reg. § 1.701-2(a)(2).

<sup>681</sup> Treas. Reg. § 1.701-2(a)(3).

<sup>682</sup> Treas. Reg. § 1.701-2(c).

there was no downward basis adjustment by the amount of untaxed appreciation in the asset distributed. The example acknowledges that the remaining partners will enjoy a timing advantage because the adjusted bases of the remaining assets were not adjusted downward. Further, the example provides that the partnership and the liquidating partner had as a principal purpose to take advantage of the basis shift. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.<sup>683</sup>

b. The second example involves a liquidating distribution of an appreciated, non-depreciable asset, and depreciable property with a basis equal to its fair market value. The distribution resulted in a shift of basis from the non-depreciable asset to the depreciable asset (adding basis in excess of fair market value). This resulted in additional depreciation deductions and tax benefits to the liquidated partner. The example provides that the partnership and the liquidating partner had as a principal purpose the foregoing tax advantage to the liquidating partner. Notwithstanding the foregoing, the Treasury Regulations conclude this does not violate the anti-abuse provisions.<sup>684</sup>

5. The Treasury Regulations do provide an example of an abusive situation. In that example, a partner contributes property with inherent loss to a partnership formed for the purpose by related parties, who contribute cash, used to purchase a nonmarketable security with a value and inside basis equal to the value of the contributed property. The contributor will have a section 704(c) allocation of the inherent loss and an outside basis equal to the value of the contributed loss property. The property is leased for three years to a prospective purchaser, who has an option to purchase at the value at the time of the contribution. Three years later, but before the sale under the option, the contributor receives a liquidating distribution of the other property with an inside basis equal to the value of the contributed property,<sup>685</sup> but that will have a distributed transferred basis equal to the basis of the contributed property, so that the contributor still has the original inherent loss. The sale by the partnership of the contributed loss property, recognizing the loss after the contributor has withdrawn from the partnership, results in a partnership loss that is allocated to the related partners since the loss that would have been allocated under section 704(c) to the contributor is no longer a partner. The Treasury Regulations conclude that this situation is abusive.<sup>686</sup>

6. Notwithstanding the existence of these anti-abuse rules, the IRS may also rely on non-statutory principles like substance-over-form, step-transaction, and sham-transaction

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<sup>683</sup> Treas. Reg. § 1.701-2(d), Ex. 9.

<sup>684</sup> Treas. Reg. § 1.701-2(d), Ex. 10.

<sup>685</sup> This transaction might have a different result today. Section 704(c)(1)(C), enacted in the American Jobs Creation Act of 2004, P.L. 108-357, provides that contributed property has a “built-in loss,” for purposes of allocating income to other partners, the inside basis will be treated as being equal to its fair market value at the time of contribution.

<sup>686</sup> Treas. Reg. § 1.701-2(d), Ex. 8. *See also* FSA 200242004 (Transfer of loss property to tax partnership, a sale of the partnership interest to unrelated party with no section 754 election in effect, followed by sale of loss property by the partnership. The transaction was recharacterized under Treas. Reg. § 1.701-2 as sale of assets).

doctrines to recast certain partnership transactions.<sup>687</sup> Further, as mentioned at the beginning of these materials, the economic substance doctrine under section 7701(o) of the Code<sup>688</sup> could be invoked.

D. Unitary Basis Rules and Estate Planning

1. Unitary Basis Rule

a. Estate planners are often surprised to learn that each partner in a partnership has a “unitary basis” in his or her partnership interest, even if the partner has different classes of partnership interest (general and limited, preferred and common, etc.) and even if the partner acquired the partnership interests in different transactions.<sup>689</sup> This is in stark contrast to the “separate lot” rules applicable to shares of corporate stock when such separate lots can be “adequately identified.”<sup>690</sup>

b. The unitary basis rule is based and explained in Revenue Ruling 84-53,<sup>691</sup> which described four different situations involving the sale of a partnership interest, three of which involve liability shifts. The underlying authority for the position taken in the ruling is section 1.61-6(a) of the Treasury Regulations, which provides:

When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of.

c. The four situations described in the ruling are based on the following common facts:

(1) In 1978, Partnership Y was formed for the purpose of investing and trading in stocks and securities. Y has a calendar taxable year.

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<sup>687</sup> Treas. Reg. § 1.701-2(i).

<sup>688</sup> Health Care and Education Reconciliation Act of 2010, P.L. 111-152, § 1409 (Mar. 30, 2010).

<sup>689</sup> Rev. Rul. 84-53, 1984-1 C.B. 159. *Cf.* PLR 200909001 (the unitary basis rule does not apply to publicly-traded partnership interests).

<sup>690</sup> *See* Treas. Reg. § 1.1012-1(c). Even if lots cannot be identified, then a first-in, first-out accounting convention is used to determine gain or loss.

<sup>691</sup> Rev. Rul. 84-53, 1984-1 C.B. 159. *See also* Rev. Rul. 84-52, 1984-1 C.B. 157, endorses the unitary basis concept and which involved a general partnership converted to a limited partnership. Two of the general partners in the general partnership converted their interest into a general partner interest and a limited partner interest in the limited partnership.

(2) A contributed \$50x to Y in exchange for a general partner interest, entitling A to a 50 percent interest in all partnership distributions and in partnership income, gain, loss, and deduction. B contributed \$50x to Y in exchange for a limited partner interest, entitling B to a 50 percent interest in all partnership distributions and in partnership income, gain, loss, and deduction.

(3) Since formation, the partnership has made cash distributions in amounts equal to its total income (including tax-exempt income).

d. Situation 1

(1) In situation 1, on January 1, 1980, when the stock and securities of Y had decreased in value from \$100x to \$64x, B sold to A one half of B's limited partner interest for \$16x, which interest A holds as a limited partner. On January 1, 1982, when the stock and securities of Y has risen in value from \$64x (its 1980 value) to \$120x, A sold to C one-half of A's general partner interest for \$30x. Immediately prior to the sale, A's entire partnership interest had a fair market value of \$90x and the transferred portion of the interest had a fair market value of \$30x.

(2) The IRS concluded, prior to the sale of one-half of B's limited partner interest to A, the adjusted basis of B's entire partnership interest was \$50x. Because the fair market value of the transferred portion of B's interest (\$16x) is one-half of the fair market value of B's entire partnership interest (\$32x), \$25x (1/2 of \$50x) of adjusted basis must be allocated to the interest transferred by B. B sustained a \$9 loss (\$16x - \$25x) on the sale to A. The adjusted basis of the remainder of B's partnership interest is \$25x.

(3) In addition, the IRS concluded, prior to the sale of one-half of A's general partner interest to C, the adjusted basis of A's entire partnership interest was \$66x. Because the fair market value of the transferred portion of A's interest (\$30x) is one-third of the fair market value of A's entire partnership interest (\$90x), \$22x (1/3 of \$66x) of the adjusted basis must be allocated to the portion of the interest transferred by A. A realizes an \$8x gain (\$30x - \$22x) on the sale to C. The basis of the remainder of A's partnership interest is \$44x.

(4) Significantly, the IRS also stated the results would be the same to A if A, instead, sold to C the limited partner interest acquired earlier from B.

e. Situation 2

(1) The facts are the same as in situation 1, except that, in 1981, Y borrowed \$80x recourse which was invested in securities that became worthless on December 31, 1981. Furthermore, immediately prior to A's sale to C, A's entire partnership interest had a fair market value of \$30x and the transferred portion of A's interest had a fair market value of \$10x.

(2) The tax consequences of B's sale of B's limited partnership interest to A are the same as situation 1.

(3) As to the sale to C, in 1981, A's basis in A's entire partnership interest was increased from \$66x to \$146x as a result of the \$80x recourse borrowing (which increases only the basis of A, the sole general partner, under sections 752(a) and 722 of the Code, and was decreased to \$86x as a result of the \$60x loss allocated to A (75% partner) that year when the securities became worthless). Thus, prior to the sale of one-half of A's general partner

interest to C, the adjusted basis of A's entire partnership interest was \$86x. To take into account the effect of the partnership liability sharing rules, \$80x (A's share of all partnership liabilities) is subtracted from \$86x, leaving \$6x. Because the fair market value of the transferred portion of A's interest (\$10x) is one-third of the fair market value of the entire interest (\$30x), \$2x (1/3 of \$6x) of the remaining adjusted basis must be allocated to the transferred portion of A's general partner interest. The sum of that amount (\$2x) plus the amount of partnership liabilities from which A is discharged on the disposition of the transferred portion of A's general partner interest (\$40), or \$42x, equals the adjusted basis of the transferred portion of the interest. A realizes an \$8x gain (\$10x + \$40x - \$42x) on the sale to C.

(4) The basis of the remainder of A's partnership interest is \$44x (\$86x - \$42x).

f. Situation 3

(1) The facts are the same as in situation 2 except that, on January 1, 1982, A sold A's entire limited partner interest to C for its fair market value of \$10x (rather than one-half of A's general partner interest).

(2) The tax consequences of B's sale of B's limited partnership interest to A are the same as situation 1.

(3) As to the sale to C, prior to the sale of A's limited partner interest to C, the adjusted basis of A's entire partnership interest was \$86x. To take into account the effect of the partnership liability sharing rules, \$80x (A's share of all partnership liabilities) is subtracted from \$86x, leaving \$6x. Because of the fair market value of the transferred portion of A's limited partner interest (\$10x) is one-third of the fair market value of A's entire interest (\$30x), \$2x (1/3 of \$6x) of the remaining adjusted basis must be allocated to the transferred limited partner interest. The sum of that amount (\$2x) plus the amount of partnership liabilities from which A is discharged on the disposition of the transferred limited partner interest (\$0x), or \$2x, equals the adjusted basis of the transferred portion of the interest. A realizes an \$8x gain (\$10x - \$2x) on the sale to C.

(4) The basis of the remainder of A's partnership interest is \$84x (\$86x - \$2x).

g. Situation 4

(1) The facts are the same as in situation 1 except that, in 1981, Y borrowed \$96x recourse which is invested in securities that became worthless on December 31, 1981. Furthermore, immediately prior to A's sale to C, A's entire partnership interest had a fair market value of \$18x and the transferred portion of A's interest had a fair market value of \$6x.

(2) The tax consequences of B's sale of B's limited partnership interest to A are the same as situation 1.

(3) As to the sale to C, in 1981, A's basis in A's entire partnership interest was increased from \$66x to \$162x as a result of the \$96x recourse borrowing and was decreased to \$90x as a result of the \$72x loss allocated to A that year when the securities became worthless. Thus, prior to the sale of one-half of A's general partner interest to C, the adjusted basis of A's entire partnership interest was \$90x. In this situation, A's share of all partnership

liabilities (\$96x) exceeds the adjusted basis of A's entire interest (\$90x). Thus, the adjusted basis of the transferred portion of A's general partner interest equals \$45x, the amount which bears the same relation to A's adjusted basis in the entire interest (\$90x) as the amount of partnership liabilities from which A is discharged on the disposition of the transferred portion of the general partner interest (\$48x) bears to A's share of all partnership liabilities (\$96x). A realizes a \$9x gain ( $\$48x + \$6x - \$45x$ ) on the sale of C.

(4) The basis of the remainder of A's partnership interest is \$45x ( $\$90x - \$45x$ ).

h. As an explanation for its holdings, the IRS explains a two-step process for determining the total amount of basis allocated to the sold partnership interest.

In cases where the partner's share of all partnership liabilities does not exceed the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the transferor partner shall first exclude from the adjusted basis of such partner's entire interest an amount equal to such partner's share of all partnership liabilities, as determined under section 1.752-1(e) of the regulations. A part of the remaining adjusted basis (if any) shall be allocated to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of the interest to the fair market value of the entire interest. The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest (under section 752(d) of the Code and section 1.1001-2 of the regulations) equals the adjusted basis of the transferred portion of the interest.

On the other hand, if the partner's share of all partnership liabilities exceeds the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the adjusted basis of the transferred portion of the interest equals an amount that bears the same relation to the partner's adjusted basis in the entire interest as the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest bears to the partner's share of all partnership liabilities, as determined under section 1.752-1(e).

i. Unitary basis is determined on a partnership-by-partnership basis even, so it seems, if a partner has an interest in 2 or more partnerships that are identical in all respects (including the interests of other partners), except perhaps the assets in the partnership, there does not seem to be a statutory rule that the unitary basis of the partner must be aggregated. This may have important planning implications in estate planning as it bears to reason that it might make sense for taxpayers to segregate low basis and high basis assets into different partnerships.

## 2. Unitary Basis with Grantors and Grantor Trusts

a. In estate planning, it is common for grantors to simultaneously own interests in FLPs individually and deem to own, for income tax purposes, FLP interests in an IDGT due to grantor trust status. As discussed earlier, Revenue Ruling 85-13 provides that a "defective grantor trust" will be "ignored" for all Federal income tax purposes.

b. As such, because of the unitary basis rule, subsequent contributions of high basis property by the grantor will result in proportional increases (in a pro rata FLP) to the outside basis of the IDGT partnership interests. Given that the FLP interests held by the IDGT

will generally not benefit from a “step-up” in basis at the death of the grantor, this can have the advantage of increasing the basis of the FLP interests without requiring an additional transfer to the trust or estate tax inclusion. Of course, if the grantor has a power to swap assets of equivalent value, exchanging high basis assets for the FLP interests is likely to be more advantageous from a basis increase standpoint.

c. Another apparent effect of the unitary basis rule is that distributions of cash or property (as discussed later in these materials) must take into account the aggregate outside basis of a grantor and his or her grantor trusts regardless of who actually receives the distribution. For example, if a grantor and IDGT are equal partners in a partnership and collectively they share \$100x of outside basis, then the IDGT could receive \$100x of cash distribution without recognizing any gain.

d. The ramifications of the unitary basis rule are seemingly unlimited.<sup>692</sup> For example, if a grantor redeems his or her entire interest in a partnership for property but an IDGT continues to have an interest in the partnership, it seemingly means that the distribution is considered a current distribution, rather than a liquidating distribution (because the grantor is deemed to still have an interest in the partnership). This could mean the grantor would not be able to take a capital loss upon exiting the partnership and it might affect the basis that the grantor has in the distributed property. What then are the tax consequences if grantor trust status is terminated?

## E. Contributions of Property to a Partnership

### 1. Contributions Are Usually Not Taxable Events

a. Generally, a contribution of property<sup>693</sup> to a partnership in exchange for a partnership interest is a non-recognition event for tax purposes. As such, there is typically no gain or loss at the time of contribution.<sup>694</sup>

b. Under section 723 of the Code, upon a contribution of property, the partnership has a transferred basis (inside basis) in the property received, increased by any gain recognized under section 721(b) (discussed below).<sup>695</sup> Accordingly, under section 722 of the Code, the contributing partner receives an exchanged basis (outside basis) in his or her

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<sup>692</sup> See H. Grace Kim, *Application of Unitary Basis in Partnership Interests*, 54 Tax Mgmt. Memo. 103 (2013) for an excellent discussion of the complications caused by the unitary basis rule in conjunction with other provisions of subchapter K including allocations of income under section 704(d) of the Code, distributions of cash and property to partners under sections 731 and 732 of the Code, and other situations involving transfers of partnerships.

<sup>693</sup> A partner may also contribute services to the partnership in exchange for an interest in the partnership, but a discussion of those rules is beyond the scope of this outline.

<sup>694</sup> § 721(a).

<sup>695</sup> See also § 7701(a)(42) and (43) (definition of “substituted basis property” and “transferred basis property”).

partnership interest equal to the adjusted basis of the contributed property plus any contributed money.<sup>696</sup>

c. Furthermore, under section 1223(2) of the Code, the partnership “tacks” or continues the contributing partner’s holding period for any assets received in a nonrecognition contribution with a transferred basis.<sup>697</sup> A contributing partner tacks the holding period of the contributed property to the holding period of the partnership interest received in the exchange.<sup>698</sup> A partner will have a split holding period in his or her partnership interest if the partner acquires his or her partnership interest by contributing assets with different holding periods or by subsequent contributions. The split holding periods are allocated generally in proportion to the fair market value of the property in question.<sup>699</sup> Under the unitary basis principle, the holding period of the interest will not be affected by subsequent adjustments for allocations of partnership tax items.<sup>700</sup>

d. Under section 704(c) of the Code, the contributing partner remains responsible for the tax consequences when the unrecognized gains or losses from the contributed property are realized by the partnership after contribution. As such, the contributing partner is taxed on any inherent gain (difference between the adjusted basis in the property and the fair market value of the property at the time of contribution) when the gain is realized, and the contributing partner is entitled to any deductions or losses inherent in any obligations transferred.<sup>701</sup> Section 704(c) of the Code is discussed in more detail later in these materials.

e. It may be determined that a purported contribution to a partnership in exchange for a partnership interest is, in fact, a transfer of property in a disguised sale. As discussed later in these materials, if it is determined that a transfer of property by a partner to a partnership and transfer of consideration by a partnership to the partner is a sale exchange of that property (disguised sale), then such transfers are not treated as a contribution and distribution under section 721 and 731 of the Code. Rather, the purported distributions in a disguised sale are treated as payments by the partnership to the disguised seller, acting in an independent capacity, and not as a partner.

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<sup>696</sup> See also § 7701(a)(44) (definition of “exchanged basis property”).

<sup>697</sup> See Rev. Rul. 68-79, 1968-1 C.B. 310 (new partner contributing cash for an interest in a continuing partnership is entitled to long-term capital gain on a allocable share of gain on partnership long-term capital asset sold one month after admission). *But see Citizens Nat’l Bank of Waco v. U.S.*, 417 F.2d 675 (5<sup>th</sup> Cir. 1969) (tacking permitted in part gift, part sale transfer to trust even though liability transferred exceeded transferor’s basis, and transferee’s basis was determined by a amount of liability, not transferor’s basis).

<sup>698</sup> See *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948) (holding period of partnership interest is not determined by partnership’s holding period of assets; partners do not split holding period for increase in percentage interest on withdrawal of a partner), *aff’d* 7 T.C. 1088 (1946).

<sup>699</sup> See Treas. Reg. § 1.1223-3.

<sup>700</sup> See *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), *aff’d* 7 T.C. 1088 (1946).

<sup>701</sup> See § 704(c)(1)(A) and Treas. Reg. §§ 1.704-1(b)(4)(i) and 1.704-3(a)(4).

2. Exception: Contributions to an “Investment Company”

a. Under section 721(b) of the Code, gain is realized on the contribution of property to a partnership if the partnership would be treated as an “investment company” under section 351(e) of the Code. Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor’s interests, and the transferee is, in pertinent part, a corporation (partnership, in this case) more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts.

b. Said another way, a contribution (e.g., stocks and securities) to partnership would not result in taxable gain if (i) the portfolio constitutes a “diversified portfolio” at the time of the transfer, and (ii) such contribution is not part of a plan whereby another person contributes an “undiversified” portfolio of stock and securities to the same investment partnership.<sup>702</sup> There is an exception for contributions of assets which, in the aggregate, are an insignificant part of the total value of assets transferred. There have been a number of rulings on the issue of whether the contribution is insignificant. The rulings have generally held that if the contribution makes less than 5% of the total value, then it will be considered insignificant and thus will not trigger a taxable event.<sup>703</sup>

Example: Partner A contributes Assets A and Partner B contributes Asset B to the AB Partnership in exchange for partnership interests. Whether gain is recognized on the contribution under section 721(b) is set out in the following chart:

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<sup>702</sup> A contribution of stocks and securities will be considered diversified if, taken in the aggregate, (a) the stock or securities of any one issuer do not constitute more than 25% of the value of the contributed assets and (b) the stock and securities of 5 or fewer issuers do not constitute more than 50% of the value of the transferred assets. *See* Treas. Reg. 1.351-1(c)(6)(i).

<sup>703</sup> *See* Rev. Rul. 87-9, 1987-1 C.B. 133 (contribution of cash representing 11% the total contribution was held to be significant, resulting in diversification), PLR 9451035 (cash in excess of 5% of the aggregate assets are considered significant, resulting in diversification) and PLR 9504025 (cash equal to 1% of the value of assets contributed is insignificant) and PLR 200006008 (contributions of stock portfolios to an LLC are insignificant because the assets constitute less than 5% of the company’s total value after the transfer).

Asset A	Asset B	Result
Stock X	Stock Y	Gain
Stock X	Stock X	No Gain
Diversified Portfolio	Diversified Portfolio	No Gain
Diversified Portfolio	Stock Y	Gain to Partner B
Stock X	Stock Y + Real Property (value is 20% of AB Partnership)	No Gain
Stock X (value less than 5% of AB Partnership)	Diversified Portfolio	No Gain

c. If the contributing partners are spouses, one of the easiest ways of avoiding gain under section 721(b) is to have the spouses swap ½ of their respective securities with each other prior to their contribution to the partnership. Section 1041 of the Code provides no gain or loss is recognized by either spouse, and each spouse receives carryover basis in the securities. Section 2523 of the Code ensures that the spousal transfers qualify for the gift tax marital deduction.

### 3. Exception: Property Encumbered by Recourse Debt

a. Gain or loss may be recognized upon certain contributions of encumbered property<sup>704</sup> and contributions of property that are treated as disguised sales (discussed later in these materials).<sup>705</sup>

b. When property encumbered by a recourse liability is contributed to a partnership, generally, the liability is transferred to the partnership (to the extent of the fair market value of the property).<sup>706</sup> The contribution is treated as two separate transactions, a contribution of property and contribution of the liability. The contribution of the liability will decrease the contributing partner's outside basis in his or her partnership interest (due to a deemed distribution to the partner) by the share of liability shifted to other partners.<sup>707</sup> A contributing partner will recognize gain under these circumstances when the deemed distribution exceeds the adjusted basis of the property contributed (or the pre-existing outside basis of the partner).<sup>708</sup>

c. It's important to understand that even if the contributed property has debt in excess of basis, it does not necessarily mean that gain will be recognized. The U.S.

<sup>704</sup> § 731(a) (gain is recognized when a partner receives actual or constructive cash distribution from the partnership in excess of the adjusted basis in the partnership interest) and § 752(b) (gain may be recognized upon contribution when there is a decrease in a partner's share of partnership liabilities, causing a deemed distribution of money and reducing the outside basis below zero). *See also* Treas. Reg. § 1.752-1(g), *Ex. 1*.

<sup>705</sup> *See* § 707(a)(2) and Treas. Reg. § 1.707-3.

<sup>706</sup> § 752(c) and Treas. Reg. § 1.752-1(e).

<sup>707</sup> §§ 705(a)(2), 752(b), 733(1), and Treas. Reg. §§ 1.722-1, *Ex. 1*, 1.733-1, and 1.752-1(f).

<sup>708</sup> §§ 752(b), 731(a), 705(a)(2), and Treas. Reg. § 1.722-1, *Ex. 2*.

Supreme Court decisions in *Crane v. Commissioner*<sup>709</sup> and *Commissioner v. Tufts*<sup>710</sup> established that a sale, disposition, or other transfer of property subject to nonrecourse debt (whether a sale, gift, distribution, assignment or any other situation where a different taxpayer takes ownership of the property) is treated as a “sale or other disposition” under section 1001(a) of the Code, and the amount realized on such “sale or other disposition” is the amount of the nonrecourse debt, even if such amount exceeds the fair market value of the property. Despite the foregoing, the Treasury Regulations provide an exception to the this rule, “Contributions... of property between a partner and a partnership are not sales or other dispositions.”<sup>711</sup> Because the partnership liability sharing rules control, recognition of gain generally only occurs when the following are true: (i) contributed property has a very low basis; (ii) the property is highly mortgaged; (iii) the contributing partner has a relatively small interest in the partnership; and (iv) the debt is recourse. Consider the following examples:

Example 1: In exchange for a 20% interest in a partnership, P contributes property having a fair market value of \$100x and an adjusted basis of \$40x. The property is subject to recourse debt of \$60x. P will recognize \$8 of gain on the contribution. P’s initial outside basis under section 722 of the Code is \$40x. As a 20% partner, P’s share of the partnership’s nonrecourse is reduced from \$60x to \$12x. Under section 752(b) of the Code, P’s outside basis is reduced by the reduction of P’s share in liabilities of \$48x (80% of the debt is deemed discharged), which is considered a distribution of money to the partner. Because P’s outside basis is only \$40x, under section 731(a)(1) of the Code, P recognizes \$8x of gain. P’s resulting outside basis is \$0.

Example 2: Same facts as example 1, except P has a 40% interest in the partnership. P will not recognize gain on the contribution. P’s initial outside basis under section 722 of the Code will be \$40x. As a 40% partner, P’s share of the partnership’s nonrecourse is reduced from \$60x to \$24x (only 60% of the debt is deemed discharged). Under section 752(b) of the Code, P’s outside basis is reduced by the reduction of P’s share in liabilities of \$36x, which is considered a distribution of money to the partner. P’s initial outside basis of \$40x is reduced by \$36x, and P’s resulting outside basis is \$4.

Example 3: Same facts as example 1, except P personally guarantees (with no right of reimbursement from the other partners) \$10x of the \$60x of total debt. P will not recognize gain on the contribution. P’s initial outside basis under section 722 of the Code is \$40x. P is personally responsible for \$10x, so only 80% of the remaining \$50x of debt is discharged. P’s net discharge is \$40x, which is which is considered a distribution of money to the partner. P’s initial outside basis of \$40x is reduced by \$40x, and P’s resulting outside basis is \$0.

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<sup>709</sup> *Crane v. Commissioner*, 331 U.S. 1 (1947).

<sup>710</sup> *Commissioner v. Tufts*, 461 U.S. 300 (1983).

<sup>711</sup> § 1.1001-2(a)(4)(iv).

d. As discussed in more detail later in these materials, if the partnership has a section 754 election in place, the partner's gain upon contribution of encumbered property will provide an upward inside basis adjustment to the partnership property.<sup>712</sup> The inside basis adjustment, however, will not necessarily be allocated to the contributed property because of how section 755(b) allocates the basis adjustment (essentially to all partnership property). The gain should decrease the amount of built-in gain to be allocated under section 704(c).<sup>713</sup> If there is no section 754 election in place, the partnership's basis in the contributed asset is not increased, and the contributing partner may experience a temporary "doubling" of gain, the tax on the deemed distribution and an eventual tax on the allocation under section 704(c).<sup>714</sup>

4. Not an Exception: Property Encumbered by Nonrecourse Debt

a. All of the foregoing examples related to recourse debt. What if the debt was nonrecourse? It turns out that if a partner contributes property encumbered by a nonrecourse liability, the partner will not receive a deemed distribution under section 752(b) that exceeds the basis of the partnership interest. It's not immediately obvious why that is the case, but it has to do with how nonrecourse liabilities are shared and with section 704(c) "minimum gain." The Treasury Regulations provide, "A partner's share of nonrecourse liabilities of a partnership"<sup>715</sup> equals the sum of:

(1) "The partner's share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;"<sup>716</sup>

(2) "The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration;"<sup>717</sup> and

(3) "The partner's share of the excess nonrecourse liabilities... of the partnership as determined in accordance with the partner's share of partnership profits."<sup>718</sup>

b. As discussed above, section 704(c) of the Code ensures that a contributing partner remains responsible for any unrecognized gains or losses inherent in contributed property. Partnership "minimum gain" is the sum of the gains the partnership would realize, under *Crane* and *Tufts*, if the partnership disposed of all assets that are subject to

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<sup>712</sup> § 734(b).

<sup>713</sup> § 704(c)(1)(A) and Treas. Reg. § 1.704-3(a).

<sup>714</sup> See §§ 723, 734, 754 and Rev. Rul. 84-15, 1984-1 C.B. 158.

<sup>715</sup> Treas. Reg. § 1.752-3(a).

<sup>716</sup> Treas. Reg. § 1.752-3(a)(1).

<sup>717</sup> Treas. Reg. § 1.752-3(a)(2).

<sup>718</sup> Treas. Reg. § 1.752-3(a)(3).

nonrecourse liabilities, solely in satisfaction of those liabilities.<sup>719</sup> In the sum above, the second addend is referred to as the “second tier” allocation of nonrecourse liabilities. Under the foregoing “second tier” allocation, nonrecourse liabilities are allocated in accordance with section 704(c) minimum gain. Section 704(c) minimum gain represents a partner's share of gain allocated under section 704(c) to the partner contributing appreciated property computed based on the hypothetical sale of the property subject to the nonrecourse loan in satisfaction of the nonrecourse liability for no consideration other than relief from the nonrecourse liability. Thus, the section 704(c) minimum gain allocated to the contributing partner is the excess amount of the nonrecourse debt over the adjusted basis of the property. The result is that the excess of the nonrecourse debt over the basis is allocated to the contributing partner's outside basis,<sup>720</sup> which in turn reduces the liability shift.<sup>721</sup> If the nonrecourse debt is in excess of the fair market value of the contribute property, there is no liability shift because, under the Treasury Regulations,<sup>722</sup> the liability shift is only to the extent of the fair market value.

Example: In exchange for a 20% interest in a partnership, P contributes property having a fair market value of \$100x and an adjusted basis of \$40x. The property is subject to nonrecourse debt of \$60x. The section 704(c) minimum gain allocated to P is \$20x (amount of debt in excess of basis). The remaining \$40x of nonrecourse debt is allocated amount the partners according to the allocation partnership profits (the third addend of the sum above). As a result, as a 20% partner, P's residual allocation of nonrecourse debt is \$8x (20% of remaining \$40x of nonrecourse debt). P's resulting share of nonrecourse liability is \$28x and the net decrease in P's share of liabilities is \$32x (\$60x of total nonrecourse debt less \$28x of P's share of debt after the contribution). P's resulting outside basis is \$8x (\$40x minus deemed distribution of \$32x under section 752(b) of the Code).

c. When the basis of the contributed property exceeds the nonrecourse liability encumbering the property, there is no section 704(c) minimum gain and the entire nonrecourse liability is allocated according to the profit-sharing ratios or, if the partnership agreement so provides, in accordance with one of the safe harbors in the regulations.<sup>723</sup> In all such cases, the portion of the liability shifted to other partners as a result of the contribution will never exceed the contributing partner's outside basis, which initially is equal to the basis of the contributed property.

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<sup>719</sup> Treas. Reg. § 1.704-2(d)(1). See Rev. Rul. 95-41, 1995-1 C.B. 132, and PLR 9507023.

<sup>720</sup> *Id.*

<sup>721</sup> See Treas. Reg. § 1.752-3(a)(2). The lower the basis of the contributed property relative to encumbrance, the less the liability shift is because the section 704(c) minimum gain is more.

<sup>722</sup> Treas. Reg. § 1.752-1(e).

<sup>723</sup> See Treas. Reg. 1.752-3(a)(3).

F. Distributions to Partners: Rules and Exceptions

1. Non-Liquidating “Current” Distributions

a. Cash Distributions May Result in Gain and Ordinary Income

(1) Unless a distribution (or a series of distributions) results in a termination of a partner’s interest in a partnership, it will be considered a non-liquidating or “current” distribution.<sup>724</sup> Since most FLPs are structured as “pro rata” partnerships,<sup>725</sup> it is important to recognize that, generally, there is no gain or loss on pro rata current distributions regardless of the type of asset being distributed,<sup>726</sup> unless cash distributed exceeds the outside basis of the partnership interest of any of the partners.<sup>727</sup>

(2) Distributions of cash (including a reduction in a partner’s share of liabilities and distributions of marketable securities)<sup>728</sup> to a partner reduces the partner’s outside basis, with gain recognized to the extent the cash distributed exceeds outside basis.<sup>729</sup> No loss is ever recognized on a current distribution.<sup>730</sup> Any gain resulting from a current distribution of cash is considered capital gain that would result from a sale of the partner’s interest.<sup>731</sup>

(3) The gain may be ordinary income if the distribution results in a disproportionate sharing of certain “unrealized receivables” and “inventory items” of the partnership (section 751 assets).<sup>732</sup> The definitions of these types of assets (sometimes referred to as “hot assets”) include more things than might be obvious. Unrealized receivables include rights to payment for goods or services not previously included in income,<sup>733</sup> and recapture property, but only to the extent unrealized gain is ordinary income (as discussed above). “Inventory items” include any property described in section 1221(a)(1) (inventory or other property held for sale to customers in the ordinary course of business and any other property that would not result in capital gain or gain under section 1231 (accounts receivables)).

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<sup>724</sup> Treas. Reg. § 1.761-1(d).

<sup>725</sup> This is generally due to the “same class” exception under § 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, “A class is the same class as is (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).” Treas. Reg. § 25.2701-1(c)(3).

<sup>726</sup> § 731(a)(1) and Treas. Reg. §§ 1.731-1 and 1.732-1(b).

<sup>727</sup> § 731(a)(1) and Treas. Reg. § 1.731-1(a).

<sup>728</sup> § 731(c) and Treas. Reg. § 1.731-2.

<sup>729</sup> § 733(a) and Treas. Reg. § 1.733-1.

<sup>730</sup> §§ 731(a)(2) and 731(b). A loss may only occur with a liquidating distribution. Treas. Reg. § 1.731-1(a)(2).

<sup>731</sup> § 731(a).

<sup>732</sup> § 751.

<sup>733</sup> § 751(b) and Treas. Reg. § 1.751-1(b)(2), (d)(1).

(4) The holding period of any gain from the distribution of cash is determined by the partner's holding period in his or her partnership interest.<sup>734</sup> If the partner acquired his or her partnership interest by contributing property to the partnership (typically in a nonrecognition<sup>735</sup> transaction), the holding period of the property transferred is added to the partnership interest's holding period.<sup>736</sup> If the partner acquires the partnership interest at different times, the partnership interest will have different holding periods, allocated in proportion to the fair market value of the contributed property.<sup>737</sup>

(5) It should be noted that if a partner transferred his or her partnership interest in exchange for cash (or other property), the tax rate on capital gain may be different than if the partner received cash from the partnership in liquidation/redemption of the partnership interest. The planning opportunities that might arise as a result of this anomaly is discussed in more detail later in this outline.

(a) Upon a sale or exchange, the transferor recognizes gain under rules similar to section 1001.<sup>738</sup> The transferee of the partnership interest takes a cost basis in the partnership interest equal to the consideration paid,<sup>739</sup> and carries over the transferor's capital account and share of forward and reverse section 704(c) gain in the partnership assets, if any.<sup>740</sup>

(b) The character of the gain is capital subject to recharacterization under section 751(a). The transferor partner recognizes ordinary income or loss in an amount equal the income or loss that would be allocated to the partner if the partnership sold all of the partnership assets at fair market value.<sup>741</sup> Capital gain or loss is recognized in an amount equal to the gain or loss that would be calculated under section 1001 minus the ordinary income (or plus the ordinary loss) computed under section 751(a).<sup>742</sup>

(c) All of the foregoing provides for similar results to a cash distribution to a partner. For determining the rate of tax on the capital gain, on the other hand, one looks through to the underlying partnership assets.<sup>743</sup> Thus, depending on the assets held by

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<sup>734</sup> See GCM 36196 and *Commissioner v. Lehman*, 165 F.2d 383 (2d Cir. 1948), *aff'd* 7 T.C. 1088 (1946), *cert. denied*, 334 U.S. 819 (1948).

<sup>735</sup> § 721.

<sup>736</sup> §§ 1223(1), 1223(2), and 723; Treas. Reg. §§ 1.1223-1(b) and 1.723-1.

<sup>737</sup> Treas. Reg. § 1.1223-3(a), (b) and (f), Ex. 1; See T.D. 8902, *Capital Gains, Partnership, Subchapter S, and Trust Provisions*, 65 Fed. Reg. 57092-57101 (Sept. 21, 2000).

<sup>738</sup> See § 741.

<sup>739</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(b).

<sup>740</sup> Treas. Reg. § 1.704-3(a)(7).

<sup>741</sup> Treas. Reg. § 1.751-1(a)(2).

<sup>742</sup> *Id.*

<sup>743</sup> See § 1(h)(5)(B), (h)(9), and (h)(10). Treas. Reg. § 1.1(h)-1(a).

the partnership, the transferor partner may recognize capital gain at a 20%, 25%, and 28% federal rate.

b. Property Distributions Are Generally Non-Taxable

(1) Neither the partner nor the partnership will recognize any gain or loss upon a distribution of property,<sup>744</sup> unless the property is a marketable security (treated as cash)<sup>745</sup> or is a “hot asset” under section 751 (mentioned above). If the distributed property is subject to indebtedness, any net change (typically an increase) in the partner’s share of liability is treated as a contribution (in most cases) or a distribution of cash by the partner, and the distributed property is distributed without recognizing any gain.<sup>746</sup>

(2) The basis of the distributed property in the hands of the partner is based on the tax basis that the partnership had in the property prior to the distribution (the “inside basis”).<sup>747</sup> The basis of the distributed property will, however, be limited to the outside basis of the partner’s partnership interest, as adjusted for cash distributions (reduction) and changes in liabilities because the distributed property is encumbered with debt.<sup>748</sup> This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. When multiple properties are distributed and the outside basis limitation is triggered, the outside basis is allocated first to section 752 property and any excess to other property.<sup>749</sup> All other distributed property once all outside basis has been exhausted will have a zero basis.

(3) Generally speaking, the character of the distributed property in the hands of the partner will be determined at the partner level, with the exception of unrealized receivables and inventory items, as defined in section 751.<sup>750</sup> This provision prevents a partner from converting an ordinary income item, like inventory in the partnership’s hands, into a capital asset. The holding period of the distributed property includes the holding period of the partnership.<sup>751</sup>

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<sup>744</sup> § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). Although the “mixing bowl” rules may apply to trigger gain to a partner who contributed the distributed property. §§ 704(c)(2)(B) and 737.

<sup>745</sup> § 731(c) and Treas. Reg. § 1.731-2.

<sup>746</sup> Treas. Reg. § 1.752-1(e) and (g).

<sup>747</sup> § 732(a)(1) and Treas. Reg. § 1.732-1(a). Note, that if a Section 754 election is in place or if the partnership had a substantial built-in loss under Section 743(d), the inside basis includes any basis adjustment allocable to the partner under Section 743(b) but only as they relate to the partner. If the distributed property is not the property that was the subject of the basis adjustment under Section 743(b), the adjustment is transferred to the distributed property in the same class (capital gain or ordinary property). Treas. Reg. § 1.755-1(a).

<sup>748</sup> See Treas. Reg. §§ 1.732-1, 1.736-1(b)(1), and 1.743-1(d)(1).

<sup>749</sup> § 732(c)(1)(A)(i) and Treas. Reg. § 1.732-1(c)(1)(i).

<sup>750</sup> § 735(a).

<sup>751</sup> § 735(b). Note, the holding period of the partner’s interest in the partnership is generally irrelevant when determining the holding period of distributed property.

c. Partnership Inside Basis

(1) When gain is recognized on a distribution (cash in excess of outside basis) or when the basis of the distributed property is reduced because outside basis is less than the basis of the property prior to the distribution, absent a section 754 election, there is no adjustment to the partnership's inside basis. This gives may give rise to a temporary duplication of gain or to a loss of basis to the partnership (and to the partners).

(2) If a section 754 election is made, an adjustment of basis under section 734(b) occurs when a partner recognizes gain due to a distribution (or deemed distribution) of cash in excess of outside basis, or property is distributed that results in a reduction of basis on the distributed property.<sup>752</sup> The adjustment results in an increase to the inside basis of the partnership assets. The basis increase is allocated among two different classes of assets: (i) capital and section 1231 assets, and (ii) ordinary income property.<sup>753</sup> Any basis adjustment due to gain from a distribution of cash must be allocated to capital assets.<sup>754</sup> As discussed in more detail in these materials, under section 755 of the Code, any increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class in proportion to fair market values.<sup>755</sup> Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. Adjustments under section 734(b) are discussed in more detail later in this outline.

2. Liquidating Distributions Can Result in Gain and Loss

a. Liquidating distributions (whether in one distribution or a series of distributions) terminate the liquidated partner's entire interest in a partnership.<sup>756</sup> Liquidating distributions are treated the same as current distributions except a loss may be recognized,<sup>757</sup> and the basis of property distributed to a partner may be increased (discussed below).<sup>758</sup> The only way to recognize a loss upon a liquidating transfer is if the distribution consists only of cash (but not including marketable securities<sup>759</sup>) and section 751 assets (hot assets).<sup>760</sup>

b. In the estate planning context, most partnerships are structured as “pro rata” or single class share partnerships because of the “same class” exception under section 2701(a)(2)(B). With respect to this exception, the Treasury Regulations provides, “[a] class is the

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<sup>752</sup> § 734(b)(1).

<sup>753</sup> Treas. Reg. §§ 1.755-1(a)(1) and 1.755-1(c)(1).

<sup>754</sup> Treas. Reg. § 1.755-1(c)(1)(ii).

<sup>755</sup> Treas. Reg. § 1.755-1(c)(1)(i).

<sup>756</sup> § 761(d).

<sup>757</sup> § 731(a)(2) and Treas. Reg. § 1.731-1(a)(2).

<sup>758</sup> § 732(b), 732(c), and Treas. Reg. § 1.732-1(b).

<sup>759</sup> § 731(c)(1) refers to § 731(a)(1), the gain provision, not § 731(a)(2), the loss provision.

<sup>760</sup> § 731(a)(2). Treas. Reg. §§ 1.731-1(a)(2) and 1.732-1(c)(3).

same class as is (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).”<sup>761</sup> In order to qualify for this exception, it generally requires that distributions must be made proportionately and at the same time (and perhaps with the same assets). In order to effectuate a disproportionate distribution of property to, for example, an older partner with limited outside basis (trying to maximize the benefit of the “step-up”), one would need to redeem a portion of the partner’s interest (lower the percentage ownership), which would be considered a current distribution, or liquidate the partner.

c. When property is distributed in liquidation of a partner’s interest, for purposes of determining the basis in the hands of the former partner, the Code provides the basis in section 751 assets cannot exceed the transferred basis.<sup>762</sup> However, basis of other property distributed can be increased if the liquidated partner’s outside basis (reduced by cash distributed and adjusted for any change in the partner’s share of liabilities as a result of the distribution) is greater than the inside basis of the assets distributed.<sup>763</sup> If the transferred basis is in excess of the fair market value of the distributed asset, then a loss can be recognized on a subsequent sale or, if the property is depreciable, depletable or amortizable, the added basis can provide tax benefits in the form of ongoing deductions.

d. The basis adjustments to the partnership are the same as discussed with current distributions, in particular, if there is a section 754 election in place. With respect to liquidating distributions, the inside basis adjustments may be increased or decreased (rather than only increased in a current distribution). This is because a liquidating distribution may result in a loss to the withdrawing partner,<sup>764</sup> and a property distribution may result an increased tax basis.<sup>765</sup> Another difference with liquidating distributions exists when there is a substantial basis reduction. Under section 734(a), an inside basis adjustment is not required upon a distribution of property to a partner, unless a section 754 election is in place or unless “there is a substantial basis reduction with respect to such distribution,”<sup>766</sup> which will exist if the amount exceeds \$250,000.<sup>767</sup> There will be a substantial basis reduction when the sum of: (i) any loss recognized by the liquidating partner, and (ii) the excess of the basis of distributed property to the liquidated partner over the partnership's transferred inside basis, exceeds \$250,000. For example, if a partner with an outside basis of \$2 million is distributed an asset with an inside basis of \$1 million in full liquidation of his or her interest, then under section 732(b) of the Code, the partner’s basis in the distributed asset is now \$2 million. Because the partner’s basis in the asset

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<sup>761</sup> Treas. Reg. § 25.2701-1(c)(3).

<sup>762</sup> § 732(c)(1)(A) and Treas. Reg. § 1.732-1(c)(1)(i).

<sup>763</sup> § 732(b) and Treas. Reg. § 1.732-1(b).

<sup>764</sup> § 734(b)(2)(A) and Treas. Reg. § 1.734-1(b).

<sup>765</sup> § 734(b)(2)(B) and Treas. Reg. § 1.734-1(b).

<sup>766</sup> § 734(a).

<sup>767</sup> § 734(d). The subsection refers to § 734(b)(2)(A), which in turn refers to § 731(a)(2) relating to liquidating distributions, and § 734(b)(2)(B), which refers to § 732(b) also relating to liquidating distribution.

now exceeds the partnership's basis in the asset by more than \$250,000, there is a substantial basis reduction. Consequently, the partnership must reduce the basis of its remaining assets by \$1 million as if a section 754 election were in effect.<sup>768</sup>

e. Adjustments for the gain or loss on the partnership interest, or for distributed capital or section 1231 assets may be made only to the inside basis of capital or section 1231 assets, while adjustments to reflect a limitation on the basis of ordinary income property are allocated only to partnership ordinary income property. There may be a positive adjustment for ordinary income assets, and a negative adjustment for capital assets, or the reverse, but no positive adjustment for one capital or ordinary income asset, and negative adjustment for another.<sup>769</sup> Like the adjustments for current distributions, positive adjustments for a class are allocated to appreciated properties, first, in proportion to unrealized gain, and then to all properties in proportion to fair market value.<sup>770</sup> Similarly, reductions in partnership assets are allocated first to property that has declined in value in proportion to the unrealized loss, then to all properties in proportion to their adjusted basis.<sup>771</sup>

f. As discussed earlier, the unitary basis rule means that a grantor and his or her IDGT would share a the combined basis of each of their respective interests. The Tax Court has held that for purposes of determining the amount of gain or loss recognized upon a distribution under section 731 of the Code a partner having multiple classes or types of interests is treated as owning a single partnership interest with a unitary basis. In *Chase v. Commissioner*,<sup>772</sup> the Tax Court confirmed that section 731(a)(2) of the Code requires that all the taxpayer's direct ownership interest in the partnership be liquidated to recognize a loss on the liquidation. Consequently, the liquidation of a limited partnership interest at a time that the same person holds a general partnership interest in the partnership prevents the recognition of the loss incurred with respect to the liquidation of the investment in the limited partnership interest.<sup>773</sup>

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<sup>768</sup> See IRS Notice 2005-32, 2005-1 C.B. 895.

<sup>769</sup> Treas. Reg. § 1.755-1(c)(2).

<sup>770</sup> Treas. Reg. § 1.755-1(c)(2)(i).

<sup>771</sup> Treas. Reg. § 1.755-1(c)(2)(ii).

<sup>772</sup> *Chase v. Commissioner*, 92 T.C. 874 (1989).

<sup>773</sup> It is significant to note that the court allowed the wife of the general partner to recognize a loss upon a distribution of cash to her in liquidation of her interest.

3. Exception: Distributions and “Hot Assets”

a. Section 751 was enacted to prevent partners from converting ordinary income to capital gain through sales or exchanges of their partnership interests or through distributions of partnership property. Generally, the Code provides that any consideration received by a partnership in exchange for his or her partnership interest that is attributable to unrealized receivables or inventory items (“hot assets”) shall be treated as an amount realized in exchange for property other than a capital asset.<sup>774</sup> In other words, to the extent applicable, it converts what otherwise would be considered capital gain (sale of a partnership interest) to ordinary income.

b. Section 751(b) provides that if a partner receives a distribution of hot assets (sometimes referred to as “section 751(b) property”) in exchange for all or part of his or her partnership interest,<sup>775</sup> or receives other partnership property (not hot assets) in exchange for all or part of his or her interest in such hot assets,<sup>776</sup> then the transaction will be considered a sale or exchange between the distributee partner and the partnership (as constituted after the distribution). Section 751(b) applies to both non-liquidating distributions as well as liquidating distributions.<sup>777</sup> In effect, section 751(b) only applies to distributions involving an exchange of interests in one class of property for another class of property (ordinary for capital/capital for ordinary). As such, section 751(b) does not apply to distributions of one partner’s share of both section 751(b) property and other property.<sup>778</sup> Furthermore, if a partnership has only one class of property (e.g., no hot assets), then section 751(b) will never apply. Thus, any disproportionate distribution of partnership property that results in any partner receiving more or less than his or her proportionate share of the hot assets will trigger section 751(b).

c. If section 751(b) applies to a distribution, then income inclusion is required. If, by way of example, a partner receives a disproportionate distribution of section 751(b) (hot assets), then the partner will realize capital gain. If, on the other hand, the partner a disproportionate distribution of other property, then the partner will realize ordinary income.

d. In determining whether there has been a disproportionate shift of hot assets or other property, the Treasury Regulations provide for a hypothetical transaction involving:

(1) Current distribution of partnership property relinquished by the distributee partner (the partner’s decreased interest in section 751(b) property or other property) in order to determine the partner’s tax basis in the relinquished property;<sup>779</sup> and

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<sup>774</sup> § 751(a).

<sup>775</sup> § 751(b)(1)(A).

<sup>776</sup> § 751(b)(1)(B).

<sup>777</sup> See Treas. Reg. § 1.751-1(b)(1).

<sup>778</sup> See Rev. Rul. 57-68, 1957-1 C.B. 207.

<sup>779</sup> See Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(iii), and 3(iii).

(2) Partnership sale of the increased share in the other section 751(b) property in exchange for the property relinquished by the partner.<sup>780</sup>

e. The Code provides two specific exceptions to section 751(b). It does not apply to distributions of property to a partner who contributed the property to the partnership.<sup>781</sup> Section 751(b) also does not apply to section 736(a) payments made to a retiring partner or a successor in interest of a deceased partner.<sup>782</sup>

f. Originally, the definition of “unrealized receivables” under section 751(c) only included rights to payments for services and rights to payments for goods. Since its enactment, 751(c) property has been expanded to include many additional types of property, the sale of which would result in the realization of ordinary income.<sup>783</sup> In particular, the following types of assets have been added as “unrealized receivables” for purposes of section 751:

(1) Section 1245 property, but only to the extent that ordinary income would be recognized under section 1245(a) if a partnership were to sell the property at its fair market value.<sup>784</sup> The amount is treated as an unrealized receivable with a zero basis. Section 1245 property includes property which allows for depreciation other than buildings or their structural components.<sup>785</sup>

(2) Section 1250 property but only to the extent that ordinary income would be recognized under section 1240(a) if a partnership were to sell the property at its fair market value.<sup>786</sup> Section 1250 property is any depreciable property other than section 1245 property.<sup>787</sup> Generally, gain which is treated as ordinary income under section 1250(a) is the lower of: (a) “additional depreciation” taken after 1975, and (b) the gain realized on the disposition of the property.<sup>788</sup> “Additional depreciation” generally refers to section 1250 property held for one year or less, all depreciation taken (in that one year or less), and for section 1250 property held for more than one year, the excess of the depreciation taken over the amount of depreciation which would have been taken if the straight-line method of depreciation had been used. Since TRA 1986, the “applicable recovery period” for most commercial real property assets are placed in 27.5 or 39-year recovery periods, while land improvements fall within 15 or

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<sup>780</sup> See Treas. Reg. §§ 1.751-1(b)(1)(iii), 2(ii), and 3(ii).

<sup>781</sup> § 751(b)(2)(A).

<sup>782</sup> § 751(b)(2)(B).

<sup>783</sup> One court ruled that section 751(c) “invites a liberal construction by stating that the phrase ‘unrealized receivables’ includes certain specified rights, thereby implying that the statutory definition of term is not necessarily self-limiting.” *Logan v. Commissioner*, 51 T.C. 482, 486 (1968).

<sup>784</sup> § 704(c) and Treas. Reg. §§ 1.751-1(c)(4)(iii), -1(c)(5).

<sup>785</sup> § 1245(a)(3).

<sup>786</sup> Treas. Reg. §§ 1.751-1(c)(4)(v), -1(c)(5), -1(a)(1)(i) and -1(a)(2)(ii).

<sup>787</sup> § 1250(c).

<sup>788</sup> § 1250(a)(1)(A).

20-year recovery periods.<sup>789</sup> Most importantly, the depreciation method for nonresidential and residential real property is straight line.<sup>790</sup> Thus, most commercial real property assets would fall out of the definition of “unrealized receivables” and would not be considered a “hot” section 751(b) asset.

(3) Amortizable section 197 intangibles (patents, copyrights, goodwill, going concern value, etc.), which by definition are held in connection with a trade or business or an activity described in section 212.<sup>791</sup> Amortizable section 197 intangibles are treated as property which is of the character subject to the allowance for depreciation,<sup>792</sup> and these assets are subject to section 1245 recapture.<sup>793</sup> Generally, this does not include self-created intangibles,<sup>794</sup> so intangible assets in the hands of the creator (or held by a donee of such intangible) would fall out of the definition of “unrealized receivables” and would not be considered a “hot” section 751(b) asset.

(4) Section 1248 stock of a controlled foreign corporation (CFC) to the extent that ordinary income would be recognized under section 1248(a) if a partnership were to sell the CFC stock at its fair market value.<sup>795</sup> The amount is treated as an unrealized receivable with a zero basis. The ordinary income under these circumstances is generally the “dividend,” which is determined, in part, by the additional corporate income tax that would have been paid by the CFC if it had been taxed as a domestic corporation plus the tax which would have been paid by the taxpayer by including in gross income (as long-term capital gain).<sup>796</sup>

(5) Section 1254 property, which includes oil, gas, geothermal, or other mineral property, to the extent that ordinary income would be recognized under section 1254(a) if a partnership were to sell the property at its fair market value.<sup>797</sup> The amount is treated as an unrealized receivable with a zero basis. Section 1254 recaptures certain previously expensed amounts as ordinary income to the extent of gain realized on the disposition of section 1254 property. Amounts deducted under sections 263 (capital expenditures), 616 (development expenditures with respect to a mine or other natural deposit other than an oil or gas well), and 617 (mining exploration expenditures), which otherwise would have been included in the property's adjusted tax basis, must be recaptured as ordinary income.<sup>798</sup> In addition, any amount deducted under section 611 (deduction for depletion) must be recaptured to the extent it reduced

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<sup>789</sup> § 168(c).

<sup>790</sup> § 168(b).

<sup>791</sup> See §§ 197(c) and (d)(1).

<sup>792</sup> § 197(f)(7) and Treas. Reg. § 1.197-2(g)(8).

<sup>793</sup> See Treas. Reg. § 1.197-2(g)(8).

<sup>794</sup> § 197(c)(2).

<sup>795</sup> See § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(iv), -1(c)(5).

<sup>796</sup> § 1248(b) and Treas. Reg. § 1.1248-4.

<sup>797</sup> § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(ix), -1(c)(5).

<sup>798</sup> See § 1254(a)(1)(A)(i) and Treas. Reg. § 1.1254-1(b)(1)(i)(A).

the tax basis (e.g., cost depletion) of the section 1254 property.<sup>799</sup> The calculation for section 1254 property is determined at the partner level, not at the partnership.<sup>800</sup>

(6) Section 617(f)(2) mining property to the extent of the amount that would be treated as ordinary income under section 617(d)(1) if a partnership were to sell the mining property at its fair market value.<sup>801</sup> The amount is treated as an unrealized receivable with a zero basis. Pursuant to section 617(a), a taxpayer can elect to deduct, as ordinary and necessary business expenses, expenditures paid or incurred during the taxable year and prior to the beginning of the development stage of the mine, for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral. In general, under section 617(d)(1), a portion of the gain recognized on the sale or other disposition of mining property is treated as ordinary income (the deducted exploration expenditures).

(7) Section 1252(a)(2) farm land to the extent that ordinary income would be recognized under section 1252(a)(1) if a partnership were to sell the property at its fair market value.<sup>802</sup> The amount is treated as an unrealized receivable with a zero basis. Section 1252 generally provides that, if a taxpayer has held farm land for less than 10 years and has elected to deduct soil and water conservation expenditures under section 175, then upon disposition of the land, the taxpayer is required to treat a portion of the gain as ordinary income.<sup>803</sup>

(8) Section 1253 property, to the extent that ordinary income would be recognized under section 1253(a) if the partnership were to sell the property at its fair market value. The amount is treated as an unrealized receivable with a zero basis. Under §1253(a), the transfer of a franchise, trademark, or trade name is not treated as a sale or exchange of a capital asset if the transferor retains any “significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark or trade name.”<sup>804</sup>

(9) Partnership property subject to basis reduction under section 1017, relating to income from discharge of indebtedness that is excluded from income under section 108(a). These are reductions are treated as depreciation subject to section 1245 or section 1250 recapture.

(10) Market discount bonds to the extent that ordinary income would be recognized under section 1276(a) if a partnership were to sell the bonds at fair market value.<sup>805</sup> The amount is treated as an unrealized receivable with a zero basis. Section 1276(a) provides

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<sup>799</sup> See § 1254(a)(1)(A)(ii) and Treas. Reg. § 1.1254-1(b)(1)(i)(B).

<sup>800</sup> See Treas. Reg. § 1.1254-5(b)(1).

<sup>801</sup> See Treas. Reg. §§ 1.751-1(c)(4)(i) and -1(c)(5).

<sup>802</sup> See Treas. Reg. §§ 1.1252-1(a), 1.751-1(c)(4)(vii), and -1(c)(5).

<sup>803</sup> § 1252(a).

<sup>804</sup> § 751(c) and Treas. Reg. §§ 1.751-1(c)(4)(viii), -1(c)(5).

<sup>805</sup> § 751(c) and Treas. Reg. § 1.751-1(c)(5).

that gain recognized upon the disposition of any market discount bond<sup>806</sup> is treated as ordinary income to the extent of “accrued market discount” on the bond. The term “market discount bond” means any bond having “market discount.”<sup>807</sup> The term “market discount” means the excess of the stated redemption price of the bond over the basis of the bond immediately after its acquisition by the taxpayer.<sup>808</sup>

4. Exception: Distributions in “Mixing Bowl” Transactions

a. Generally

(1) Because both property contributions to and distributions from a partnership are generally nonrecognition events, partnerships could be used to exchange property without recognizing income despite the fact that the properties would not have qualified as a like-kind exchange under section 1031. The partnership would be treated as a “mixing bowl” where assets are commingled and then the partnership is dissolved, each partner walking away with a different mixture of assets. As a result of this perceived abuse, Congress enacted the “mixing bowl transaction” provisions of sections 704(c)(1)(B) and 737. These provisions can be triggered when contributed property is distributed to another partner or if other property is distributed to a contributing partner.

(2) Some of the techniques discussed in these materials require a distribution of partnership property to one partner (or less than all of the partners). If such property had been contributed by a partner (rather than purchased by the partnership), then these “mixing bowl” rules could be implicated, possibly triggering gain to one or more of the partners. As discussed, if seven years have elapsed from contribution to distribution, then that gain can be avoided.

b. Contributed Property to Another Partner-Section 704(c)(1)(B)

(1) If contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution.<sup>809</sup>

(2) The amount of such gain or loss will generally equal the lesser of (a) the difference between the fair market value of the contributed at the time the property was contributed and the contributing partner’s basis in the contributed property, or (b) the difference between the fair market value of the contributed property and the inside basis of the partnership at the time of the distribution.<sup>810</sup> The reason for the latter limitation is the gain or loss is meant to

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<sup>806</sup> See § 1278(a)(1).

<sup>807</sup> § 1278(a)(1)(A).

<sup>808</sup> § 1278(a)(2).

<sup>809</sup> § 704(c)(1)(B).

<sup>810</sup> § 704(c)(2)(B)(i) and Treas. Reg. § 1.704-4(a).

be limited to the amount that would have been allocated to the contributing partner under section 704(c) had the partnership sold the asset.

(3) The character of any such gain or loss is determined by the character of the contributed property in the hands of the partnership.<sup>811</sup>

(4) If the contributed property is exchanged for other property in a tax free exchange, the property received will be treated as the contributed property for the application of section 704(c)(1)(B).<sup>812</sup>

(5) The outside basis of the contributing partner and the inside basis of the contributed property and the “non-contributing” partner (distributee) are adjusted for any gain or loss without the need for a section 754 election.<sup>813</sup>

(6) With respect to transfers of partnership interests, the Treasury Regulations provide, for section 704(c) purposes, “If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built-in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.”<sup>814</sup> Specifically to contributed property distributions to another partner, the Treasury Regulations provide, “The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner.”<sup>815</sup>

(7) Similar to the general anti-abuse provisions mentioned above, the Treasury Regulations provides that “if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 704(c)(1)(B),”<sup>816</sup> based on all the facts and circumstances, the IRS can recast the transaction appropriately. One example given in the Treasury Regulations deals with a partnership having a nominal outside partner for a number of years, and then prior to the expiration of the (now seven years) section 704(c)(1)(B) period, adding a partner to whom it is intended the contributed property will be distributed. When the contributed property is distributed after the “mixing bowl” period has expired, the example provides that a taxable transfer is deemed to have occurred because the “mixing bowl” period is deemed to have been tolled until the admission of the intended recipient partner of the contributed property.<sup>817</sup>

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<sup>811</sup> Treas. Reg. § 1.704-4(b).

<sup>812</sup> Treas. Reg. § 1.704-4(d)(1)(i).

<sup>813</sup> § 704(c)(1)(B)(iii) and Treas. Reg. § 1.704-4(e).

<sup>814</sup> Treas. Reg. § 1.704-3(a)(7).

<sup>815</sup> Treas. Reg. § 1.704-4(d)(2).

<sup>816</sup> Treas. Reg. § 1.704-4(f)(1).

<sup>817</sup> Treas. Reg. § 1.704-4(f)(2), Ex. 2.

c. Other Property Distributed to Contributing Partner- Section 737

(1) If a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.<sup>818</sup> The reason for this provision is to avoid deferral of the gain that would have been allocated to the contributing partner under section 704(c) because such gain would not be triggered unless the partnership actually sold the property in a taxable transaction. If section 737 is triggered, to avoid a doubling of the gain, the subsequent distribution of the property previously contributed by the same partner does not trigger gain.<sup>819</sup>

(2) Unlike section 704(c)(1)(B), this provision only applies to gain, not loss. As a result, in order to recognize any loss under section 704(c), the partnership would need to sell the asset in a taxable transaction.

(3) Under section 737(a), a partner who has contributed section 704(c) property and who receives a distribution of property within seven years thereafter is required to recognize gain in an amount equal to the *lesser* of:

(a) The excess (if any) of the fair market value (other than money) received in the distribution over the adjusted basis of such partner's outside basis immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution (sometimes referred herein as the "excess distribution");<sup>820</sup> or

(b) The "net precontribution gain,"<sup>821</sup> which is the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if, at the time of the distribution, all section 704(c) property contributed by the distributee partner within seven years of the distribution that is still held by the partnership were distributed to another partner.<sup>822</sup>

(4) For purposes of calculating the excess distribution, the fair market value of the distributed property is calculated according to the willing buyer, willing seller standard.<sup>823</sup> The value determined by the partnership will control, provided the value is reasonably agreed to by the partners in an arm's-length negotiation and the partners have

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<sup>818</sup> §§ 704(c)(1)(B) and 737.

<sup>819</sup> § 737(d)(1) and Treas. Reg. § 1.737-3(d).

<sup>820</sup> § 737(a)(1).

<sup>821</sup> § 737(a)(2).

<sup>822</sup> § 737(b). Other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. *See* Treas. Reg. § 1.737-1(c)(1). Further, any losses inherent in section 704(c) property contributed by the distributee partner within the preceding 7-year period are netted against gains in determining net precontribution gain. *See* Treas. Reg. § 1.737-1(e), Ex. 4(iv).

<sup>823</sup> Treas. Reg. § 1.737-1(b)(2).

sufficiently adverse interests.<sup>824</sup> If the distributed property is subject to a liability, it is the gross value of the property that is used in the calculation.<sup>825</sup>

(5) Any portion of the property that consists of property previously contributed by the distributee partner is not taken into account in determine the amount of the partner's "net precontribution gain" or the "excess distribution."<sup>826</sup> In such case, the basis of the previously contributed property is computed as if such property had been distributed in a "separate and independent distribution prior to the distribution that is subject to section 737."<sup>827</sup>

(6) The Treasury Regulations provide, "The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to the interest transferred."<sup>828</sup> The Treasury Regulation then provides, "See Section 1.704-3(a)(7) and Section 1.704-4(d)(2) for similar provisions in the context of section 704(c)(1)(A) and section 704(c)(1)(B)." As mentioned above, the Treasury Regulations provide for purposes of section 704(c)(1)(B) purposes, the transferee of a partnership interest is treated as a contributing partner. There is some debate as to whether a transferee under section 737 is treated as a contributing partner as specifically provided for section 704(c)(1)(B).<sup>829</sup> It seems, however, the consensus view is that a transferee steps in the shoes of the transferor as the contributing partner. One partnership treatise provides, "Any transferee of all or part of a contributing partner's partnership interest steps into the shoes of the contributing partner under § 737 to the extent of a proportionate part of the net precontribution gain."<sup>830</sup> The same authors go on to assert, "The step-in-the-shoes rule should apply for all aspects of § 737 (e.g., the exception for distributions of previously contributed property provided by Regulations § 1.737-2(d)), although the Regulation by its terms is more limited."<sup>831</sup> Another leading treatise provides, "... if the contributing partner transfers his

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<sup>824</sup> *Id.*

<sup>825</sup> Treas. Reg. § 1.737-1(e), Ex. 2.

<sup>826</sup> § 737(d)(1) and Treas. Reg. § 1.737-2(d)(1).

<sup>827</sup> Treas. Reg. § 1.737-3(b)(2).

<sup>828</sup> Treas. Reg. § 1.737-1(c)(2)(iii).

<sup>829</sup> See Richard B. Robinson, "Don't Nothing Last Forever"—Unwinding the FLP to the Haunting Melodies of Subchapter K, 28 ACTECJ. 302 (2003), Ellen K. Harrison and Brian M. Blum, *Another View: A Response to Richard Robinson's "Don't Nothing Last Forever"—Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTECJ. 313 (2003), and Richard B. Robinson, *Comments on Blum's and Harrison's "Another View"*, 28 ACTECJ. 318 (2003). See also Paul Carman, *Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Pre-Seven Year Itch*, 96 J. Tax'n 163 (Mar. 2002) and *Shop Talk: When Is a Transferee Partner a Contributing Partner?*, 98 J. Tax'n 317 (May 2003).

<sup>830</sup> McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, Fourth Edition (Thompson Reuters, 2017), ¶ 19.08[2][e]. The treatise goes on to assert, "The step-in-the-shoes rule should apply for all aspects of § 737 (e.g., the exception for distribution

<sup>831</sup> *Id.* at ¶ 19.08[2][e], fn. 167.

interest in a transaction in which gain or loss is not recognized, the transferee should step into his shoes in order to preserve the taxation of the built-in gain.”<sup>832</sup>

(7) The character of the gain is determined by reference to the “proportionate character of the net precontribution gain,”<sup>833</sup> which is to say, it is generally determined by its character in the hands of the partnership.

(8) The partner’s outside basis and the partnership’s inside basis in the contributed property are automatically adjusted without the need for a section 754 election.<sup>834</sup> Further, the basis of the distributed property is adjusted to reflect the recognized gain on the partner’s outside basis.<sup>835</sup>

(9) Marketable securities are generally treated as money for purposes of section 737.<sup>836</sup> In determining “net precontribution gain” under section 737, however, marketable securities contributed to the partnership are treated as contributed property.<sup>837</sup>

(10) Similar to the anti-abuse guidelines under section 704(c)(1)(B), the Treasury Regulations provide that transactions can be recast if, based on all the facts and circumstances, they are “inconsistent with the purposes of section 737.”<sup>838</sup> The deemed abusive example provided in the Treasury Regulations involves a transaction, in an intentional plan to avoid section 737, where there is a contribution of property to a partnership (under section 721) immediately before a distribution of other property to the contributing partner (who also made a previous contribution of appreciated property). Gain under section 737 would be avoided because the contribution increased the outside basis of the contributing partner. Then the partnership liquidates the contributing partner’s interest in a nontaxable distribution, returning the contributed property (temporarily parked in the partnership to avoid gain on the distribution of other property prior to the liquidation of the partner’s interest).<sup>839</sup>

## 5. Exception: Distributions and the “Disguised Sale” Rules

a. If a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash within two years of the contribution, based

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<sup>832</sup> Willis, Pennell, Postlewaite & Lipton, *Partnership Taxation*, Sixth Edition (Thompson Reuters, 2017), ¶ 13.02[1][a][v].

<sup>833</sup> § 737(a) [flush language] and Treas. Reg. § 1.737-1(d).

<sup>834</sup> § 737(c) and Treas. Reg. § 1.737-3. The increase in inside basis is allocated to property with unrealized gain of the same character as the gain recognized. See Treas. Reg. §§ 1.737-3(c)(3) and 1.737-3(e), Ex. 3.

<sup>835</sup> § 737(c)(1) and Treas. Reg. § 1.737-3(b)(1).

<sup>836</sup> §§ 737(c)(1), 737(e), and Treas. Reg. § 1.731-2(a).

<sup>837</sup> Treas. Reg. § 1.731-2(g)(i)-(iii).

<sup>838</sup> Treas. Reg. § 1.731-4(a).

<sup>839</sup> Treas. Reg. § 1.731-4(b), Ex. 1.

on the applicable facts and circumstances, the distribution will likely cause the partner to recognize gain with respect to his or her contributed property under the "disguised sale" rules.<sup>840</sup> In such case, the contributing partner is treated as having engaged in a transaction with the partnership "other than in his capacity as a member of the partnership" and "the transaction shall ... be considered as occurring between the partnership and one who is not a partner."<sup>841</sup> Thus, in this instance, the partner will recognize gain on the deemed sale of the appreciated property to the partnership, and the partnership holds the property with a cost basis and new holding period.

b. The Treasury Regulations recognize two different types of disguised sales that occur between a partner and a partnership: (i) sales of property by a partner to the partnership (the foregoing example),<sup>842</sup> and sales of property by the partnership to a partner.<sup>843</sup> The latter can occur if, for example, the partnership distributes appreciated property to a partner who, within two years of such transfer, contributes or had contributed cash to the partnership. If this is treated as a disguised sale, the partnership recognizes gain on the distributed property, which is allocated to all of the partners under section 704(b), and the purchasing partner's contribution (cash) is consideration for the property, not a contribution to the partnership. The disguised purchasing partner has a cost basis in the property, and a new holding period, instead of transferred basis and tacked holding period had it been considered a partnership distribution. As discussed later, a disguised sale transaction can occur between two partners when it is determined that a purported contribution and distribution by two partners is treated as a taxable sale of a partnership interest by one partner to the other.<sup>844</sup>

c. As illustrated above, if it is determined that a transfer of property by a partner to a partnership and a transfer of consideration by a partnership to the partner is a sale exchange of that property (disguised sale), then such transfers are not treated as a contribution and distribution under section 721 and 731 of the Code.<sup>845</sup> In such instant, purported distributions in a disguised sale are treated as payments by the partnership to the disguised seller-partner, acting in an independent capacity, and not as a partner.<sup>846</sup> The sale is considered to take place on that date the partnership is considered the owner of the property.<sup>847</sup> If the transfer of the consideration from the partnership to the partner occurs after the transfer of property to the partnership, the partner and the partnership are treated as if, on the date of the sale, the partnership transferred to the partner an obligation to transfer to the partner money or other consideration at a later date.<sup>848</sup> If there is a difference in the amount between the contribution

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<sup>840</sup> § 707(a)(2)(B).

<sup>841</sup> §§ 707(a)(1) and 707(a)(3).

<sup>842</sup> See Treas. Reg. § 1.707-3.

<sup>843</sup> See Treas. Reg. § 1.707-6(a).

<sup>844</sup> § 707(a)(2)(B), flush language ("such transfers shall be treated... as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.").

<sup>845</sup> Treas. Reg. § 1.707-3(a)(2).

<sup>846</sup> § 707(a)(2) and Treas. Reg. § 1.707-3.

<sup>847</sup> Treas. Reg. § 1.707-3(a)(2).

<sup>848</sup> *Id.*

and the value of the property distributed that is attributable to the time between the two events, the difference is considered imputed interest.<sup>849</sup> If a purported contribution to a partnership is determined to be a property transferred in a disguised sale, it may result in the transferor not being considered a partner at all, and it may result in a determination that no partnership exists.<sup>850</sup>

d. Specifically, section 707(a)(2)(B) of the Code provides for disguised sale treatment if:

(1) “there is a direct or indirect transfer of money or other property by a partner to a partnership,”<sup>851</sup>

(2) “there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner),”<sup>852</sup> and

(3) The two transfers, “when viewed together, are properly characterized as a sale or exchange of property.”<sup>853</sup>

e. The Code and the Treasury Regulations take a facts-and-circumstances approach to determine whether a disguised sale has occurred. The Treasury Regulations provide that simultaneous distributions are disguised sales if “the transferor money or other consideration would have been made but for the transfer of property.”<sup>854</sup> For non-simultaneous transfers and distributions, a disguised sale occurs if the “subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.”<sup>855</sup> The Treasury Regulations provide two rebuttable presumptions in determining whether a disguised sale has occurred:

(1) If the contribution and distribution occur within a 2-year period (regardless of the order), a disguised sale is presumed to have occurred, unless the facts and circumstances “clearly establish that the transfers do not constitute a sale;”<sup>856</sup> and

(2) If the contribution and distribution occur more than two years apart (regardless of the order), a disguised sale is presumed not to have occurred, unless the facts and circumstances “clearly establish that the transfers constitute a sale.”<sup>857</sup>

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<sup>849</sup> See Treas. Reg. § 1.707-6(d), Ex. 1.

<sup>850</sup> See Treas. Reg. § 1.707-3(a)(3).

<sup>851</sup> § 707(a)(2)(B)(i).

<sup>852</sup> § 707(a)(2)(B)(ii).

<sup>853</sup> § 707(a)(2)(B)(iii).

<sup>854</sup> Treas. Reg. § 1.707-3(b)(1)(i).

<sup>855</sup> Treas. Reg. § 1.707-3(b)(1)(ii).

<sup>856</sup> Treas. Reg. § 1.707-3(c)(1).

<sup>857</sup> Treas. Reg. § 1.707-3(d).

f. The Treasury Regulations provide a list of 10 factors that would tend to prove the existence of a disguised sale. Notably, the Treasury Regulations provide, “Generally, the facts and circumstances existing on the date of the earliest of such transfers are the ones considered in determining whether a sale exists.”<sup>858</sup> The factors are:

(1) The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

(2) The transferor has a legally enforceable right to the subsequent transfer;

(3) The partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;

(4) Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration

(5) Any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations

(6) The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

(7) The partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

(8) Partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property;

(9) The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

(10) The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

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<sup>858</sup> Treas. Reg. § 1.707-3(b)(2).

g. The definition of a disguised sale is written broadly enough to include transactions that would include a deemed sale of property by the partnership to one or more partners. To that end, the Treasury Regulations provide, “Rules similar to those provided in section 1.707-3 apply in determining whether a transfer of property by a partnership to a partner and one or more transfers of money or other consideration by that partner to the partnership are treated as a sale of property, in whole or in part, to the partner.”<sup>859</sup> If a contribution and distribution is thus treated as a disguised sale, the partnership recognizes gain (or loss) on the property distributed that is shared by all partners, and the contribution is consideration for the property, not a contribution to the partnership. As a result, the disguised purchaser is entitled to a purchase price cost basis in the property, and a new holding period, instead of the transferred basis and tacked holding period of a partnership distribution. Furthermore, a disguised sale will not affect capital accounts, since it is not considered a partnership distribution. The Treasury Regulations also provide, “Rules similar to those provided in section 1.707-5 apply to determine the extent to which an assumption of or taking subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale.”<sup>860</sup>

h. As mentioned, the two-year presumption of a disguised sale is a facts and circumstances test based upon the factors listed above. These factors point toward circumstances where the distribution and contribution are related or tied in such a way that disguised sale treatment is warranted. However, if the contribution and distribution have independent significance in the context of the business purpose of the partnership, then the rebuttable presumption is likely to be overcome. That being said, if practitioners proceed with any of the planning ideas discussed in these materials and if they require a distribution of property to a partner (e.g., basis strip), then practitioners should inquire whether the distributee partner contributed any money or property to the partnership within two years of the distribution and if not the case, caution against such partner making any contributions within two years of the distribution (unless necessitated for business reasons).

i. The partnership is required to disclose transfers of property that are not treated as disguised sales to a partner if they are made within two years before or after transfers of consideration by the distributee or the partnership's incurring liabilities transferred to the distributee with property.<sup>861</sup>

j. When a contribution by one partner, usually a new partner, is followed, or preceded, by a distribution to another partner, the transaction can be recharacterized as a disguised sale of all (but often a portion) of a partnership interest.<sup>862</sup> Treating a transfer of property to another partner as a distribution, rather than a sale of a partnership, is advantageous because the distributee partner can apply the entire outside basis of the partnership interest

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<sup>859</sup> Treas. Reg. § 1.707-6(a).

<sup>860</sup> Treas. Reg. § 1.707-6(b)(1).

<sup>861</sup> Treas. Reg. §§ 1.707-3(c) and 1.707-8 (requiring the filing of Form 8275).

<sup>862</sup> § 707(a)(2)(B), flush language (“such transfers shall be treated... as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.”).

against what could be characterized as consideration for only a portion of the interest.<sup>863</sup> Unlike the disguised sales discussed above, a disguised sale of a partnership interest will be deemed a taxable transaction between the selling and purchasing partner, notwithstanding the involvement of the partnership.

Example: AB Partnership has two partners, A and B. A has a 2/3 partnership interest in AB Partnership with an outside basis of \$120x and capital account of \$200x. B has a 1/3 interest in AB Partnership with an outside basis of \$60x and capital account of 100x. C would like to be admitted as a partner, and C is willing to pay \$100x of cash to become a partner of AB Partnership. A would like to reduce his or her partnership interest by one-half (a 1/3 interest). If C purchased one-half of A's interest for \$100x of cash, then A would recognize \$40x of gain (adjusted basis of the sold partnership interest is \$60x—50% of A's outside basis of \$120x). C would have a 1/3 partnership interest with an outside basis of \$100x, capital account of \$100x, and a new holding period on the partnership interest.

Alternatively, the foregoing could be accomplished in the following steps: (i) AB Partnership distributes Asset A with an inside basis of \$100x and fair market value of \$100x to A; and (ii) C contributes \$100x of cash to AB Partnership in exchange for an equal 1/3 interest in the partnership (A, B, and C would be equal 1/3 partners in the partnership). If the latter transaction is not recast as a disguised sale, then under sections 731 and 732: (i) A would not recognize any gain on the transaction; (ii) A would own Asset A with a basis and fair market value of \$100x with a tacked holding period; and (iii) A would still have a 1/3 partnership interest with an outside basis of \$20x and capital account of \$100x. If the transaction is deemed to be a disguised sale, then it would be treated as a sale by A of one-half of A's partnership interest, resulting in gain to A of \$40x.

k. Proposed Treasury Regulations dealing with disguised sales of partnership interests were issued in 2004<sup>864</sup> but were withdrawn in 2009.<sup>865</sup> Notwithstanding the withdrawal of the proposed Treasury Regulations, some mention should be made about their content. In a disguised sale of a partnership interest, unlike a disguised sale between a partner and a partnership, there are three parties involved: the partnership, the disguised selling partner, and the disguised purchasing partner. Generally, under the withdrawn proposed regulations,

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<sup>863</sup> See Treas. Reg. § 1.731-1(c)(3) (“Section 731 does not apply to a distribution of property, if, in fact, the distribution was made in order to effect an exchange of property between two or more of the partners... Such a transaction shall be treated as an exchange of property.”). See also *Communications Satellite Corp. v. United States*, 625 F.2d 997 (Ct. Cl. 1980) (no disguised sale by members who received distributions of part of their contributions when new members joined and made contributions that were under formula designed to put new members in same position as if they were original members) and *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983) (no disguised sale when capital contributed by new limited partners was distributed to general partner because different types of interests made it difficult to see how there was “sale” of partnership interest that withdrawing partner did not own).

<sup>864</sup> REG-149519-03, 69 Fed. Reg. 68,838 (Nov. 26, 2004).

<sup>865</sup> REG-1458512-03, 74 Fed. Reg. 3008 (Jan. 21, 2009).

there is a disguised sale when there is a distribution to a partner coupled with a contribution by an existing or new partner that would not have been made without the shift in partnership interests (the transfer of consideration by the partnership to the selling partner would not have been made without the transfer to the partnership by the purchasing partner).<sup>866</sup> The withdrawn proposed regulations state that when the transaction is a disguised sale of the partnership interest, it should be treated as a sale for all income tax purposes.<sup>867</sup> The timing of such disguised sale of a partnership interest is deemed to take place on the earlier of the purported contribution or distribution, if the two transfers are not simultaneous, with appropriate adjustments for the time value of money.<sup>868</sup>

## 6. Leveraged Distributions and Disguised Sales

a. The Treasury Regulations provide that if a partnership incurs a liability and distributes the loan proceeds to a partner, the distribution will be treated as part of a disguised sale only to the extent that the amount of the distribution exceeds the distributee partner's allocable share of the partnership liability.<sup>869</sup> This "leveraged partnership distribution" exception allows a partnership to borrow money and distribute the entire amount to a single partner, even if the partner just contributed property to the partnership, provided that the entire liability is properly allocated to the distributee partner under section 752 of the Code (as discussed later in these materials).

b. Generally, the assumption of liabilities encumbering transferred property is not alone considered indicative of a disguised sale unless the liabilities are incurred or in contemplation of the transfer. The Treasury Regulations generally presume liabilities incurred within two years of the contribution of the property are incurred in contemplation of the transfer.<sup>870</sup> Under section 1.707-5(a)(5) of the Treasury Regulations, a partnership's assumption of a "qualified liability," or a partnership's taking property subject to a "qualified liability," in connection with a transfer of property by a partner to the partnership is not treated as part of a disguised sale. Prior to 2014, the Treasury Regulations defined four types of qualified liabilities, which were liabilities that encumber the property<sup>871</sup> and those that are:

- (1) Incurred more than two years prior to the transfer;<sup>872</sup>
- (2) Not incurred in anticipation of the transfer;<sup>873</sup>

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<sup>866</sup> See withdrawn Prop. Reg. § 1.707-7(b)(1).

<sup>867</sup> See withdrawn Prop. Reg. § 1.707-7(a)(2)(i).

<sup>868</sup> See withdrawn Prop. Reg. § 1.707-7(a)(2)(ii).

<sup>869</sup> Treas. Reg. § 1.707-5(b)(1).

<sup>870</sup> See Treas. Reg. §§ 1.707-5(a)(7) (disguised sale to partnership) and 1.707-6(b)(1) (disguised sale by partnership).

<sup>871</sup> The disguised sale by partnership rules treat all partnership liabilities incurred by the partnership more than two years before the transfer as qualified, even if they do not encumber partnership property. Treas. Reg. § 1.707-6(b)(2)(iii)(B).

<sup>872</sup> Treas. Reg. § 1.707-5(a)(6)(i)(A).

(3) Incurred to finance capital expenditures (allocable under the rules of section 1.163-8T of the Treasury Regulations) on the property;<sup>874</sup> or

(4) Incurred in the ordinary course of a trade or business transferred, but only if all of the assets that are material to that trade or business are transferred to the partnership.<sup>875</sup>

c. In 2016, the IRS issued proposed, temporary, and final Treasury Regulations<sup>876</sup> addressing the use of leverage to circumvent the disguised sale rules and the allocation of liabilities. This multi-faceted issuance was in response to the public comments to proposed Treasury Regulations published in 2014 (the “2014 Proposed Regulations”).<sup>877</sup> The 2014 Proposed Regulations were, in part, issued to address certain leveraged (debt-financed) partnership distributions and bottom end (bottom dollar) guarantees. Whether liabilities have been properly allocated to a partner under these types of transactions has been the subject of a number of court and IRS rulings that are instructive to review.

(1) The disguised sale rules generally provide that a contribution of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the partner will be treated as a sale of property by the partner to the partnership if, based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of the property (and, for non-simultaneous contributions, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership).<sup>878</sup> Notwithstanding the foregoing rule, the Treasury Regulations provide an exception for distributions of money to a partner if the distribution is traceable to a partnership borrowing and if the amount of the distribution does not exceed the partner’s allocable share of the liability incurred to fund the distribution.<sup>879</sup>

(2) A bottom end (bottom dollar) guarantee is a type of arrangement pursuant to which debt is allocated to a partner, but the risk of loss to the partner is very remote and the liability represents the last dollars to be paid to the lender. For example, a developer holds real estate with a fair market value of \$10 million, an adjusted basis of zero, and subject to a recourse debt of \$3 million. If the developer contributes the property to a partnership (e.g., UPREIT), then there would be a \$3 million deemed distribution under sections 731(a) and 752(b) of the Code, unless the partnership allocated \$3 million of the partnership’s liabilities. The partnership refinances the contributing partner’s \$3 million liability into the partnership’s pre-

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<sup>873</sup> Treas. Reg. § 1.707-5(a)(6)(i)(B).

<sup>874</sup> Treas. Reg. § 1.707-5(a)(6)(i)(C).

<sup>875</sup> Treas. Reg. § 1.707-5(a)(6)(i)(D).

<sup>876</sup> T.D. 9787, T.D. 9788, and REG-122855-15 (Oct. 5, 2016).

<sup>877</sup> REG-119305-11 (January 30, 2014).

<sup>878</sup> See Treas. Reg. § 1.707-3.

<sup>879</sup> Treas. Reg. § 1.707-5(b).

existing \$1 billion line-of-credit, and the contributing partner guarantees the “bottom” \$3 million of the line-of-credit. At the time of the guarantee, the partnership owns \$5 billion of assets. Under the Treasury Regulations under section 752 prior to the issuance of the 2014 Proposed Regulations, the contributing partner would have been allocated \$3 million of liability. Thus, the contributing partner can contribute the real estate without recognizing gain and diversify the single real property holding with minimal economic exposure.

(3) The Tax Court in *Canal Corp v. Commissioner*<sup>880</sup> held that an indemnity provided by a contributing partner would not be respected under the anti-abuse rule of section 752 of the Code.<sup>881</sup> Thus, the court concluded that the contribution of property followed by a cash distribution triggered the disguised sale rules. The facts of the case are:

(a) WISCO (a subsidiary of Canal Corp) and GP formed an LLC, to which WISCO contributed a business valued at \$775 million, and GP contributed a business valued at \$376 million. On the same day as the contributions, the LLC borrowed \$755 million from a bank. The loan was guaranteed by GP, but WISCO agreed to indemnify GP for any principal payments (not interest) GP might have to pay under the guaranty. Under the indemnity agreement, the parties agreed that GP had to proceed first against the LLC assets before seeking indemnification from WISCO, and if WISCO made any payments under the indemnity, WISCO would receive a proportionately increased interest in the LLC. On the day the loan proceeds were received, the LLC distributed \$755 million to WISCO.

(b) WISCO paid \$604 million of the loan proceeds to Canal in the form of repayment of intercompany loans and a dividend. WISCO then loaned the remaining \$151 million to Canal. After all of the foregoing transactions, WISCO’s assets consisted of its interest in the LLC, the \$151 million Canal note, and a corporate jet valued at \$6 million.

(c) After the distribution of the loan proceeds, the LLC had net equity value of \$400 million (contributed businesses minus the loan). GP had a 95% interest in the LLC with a capital account of \$376 million, and WISCO had a 5% interest in the LLC with a capital account of \$20 million.

(d) Within a month after closing, the LLC borrowed \$491 million from GP Finance (a subsidiary of GP) to refinance a portion of the original loan. The following year, the LLC borrowed \$264 million from GP Finance to repay the balance of the original loan. The terms of the GP Finance loans were similar to the original loan terms, and the parties executed similar guaranty and indemnity agreements with respect to the GP Finance loans.

(e) The LLC operated with this structure for a year. GP desired to acquire another corporation and, for antitrust purposes, had to sell its LLC interest before making the new acquisition. GP found a buyer for the LLC, but the buyer insisted only on buying 100% of the LLC interests. As a result, GP purchased WISCO’s 5% interest for \$41

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<sup>880</sup> *Canal Corp v. Commissioner*, 135 T.C. 199 (2010).

<sup>881</sup> Treas. Reg. § 1.752-2(j).

million. GP also paid Canal \$196 million to compensate Canal for the loss of the tax deferral Canal believed it had achieved under the leveraged partnership structure. WISCO then cancelled the \$151 million note receivable from Canal.

(4) In ILM 201324013, the IRS relied on the anti-abuse provision to disregard a partner's indemnity of a partnership liability. The IRS concluded that the leveraged distribution exception did not apply to a distribution to the indemnifying partner because the liability was not properly allocable to the distribute partner. In the ruling, the IRS offered 3 arguments for disregarding the indemnity:

(a) The indemnity lacked important features that were typically used in a commercially-driven transaction. According to the IRS, a typical indemnity includes such features such as a net worth maintenance requirement, an arms-length fee, an obligation to provide annual financial statements, and evidence that the parties engaged in a genuine negotiation over the indemnity. In the ruling request, the IRS noted the indemnity allowed the partner to sell off assets, make distributions to shareholder, or shift assets to related entities to insulate its assets if the partner expected the indemnity to be enforced.

(b) The indemnity provided no practical or commercial risk of being enforced. The partnership liability was guaranteed by affiliates of the non-distributee partner. The distribute partner agreed to indemnify those guarantors, but only to the extent the guarantors actually made payments on the guarantees. The distribute partner had no direct or indirect obligation to the lender under the indemnity. If the guarantors defaulted on their guarantees, the indemnifying partner had no obligation under the indemnity to pay the lender, even if the underlying partnership liability had not been paid.

(c) The non-distributee partner, in the opinion of the IRS, merely used the partnership as a conduit to borrow from the bank to accommodate the distributee partner's structure.

(5) In TAM 200436011,<sup>882</sup> a partner contributed assets to the partnership. The partnership borrowed against the contributed assets and made a simultaneous distribution to the contributing partner. The partnership had three classes of ownership interests: Senior Preferred Interests, Junior Preferred Interests, and Junior Common Interests. The contributing partner owned 100% of the Senior Preferred Interests. The contributing partner, along with other partners, owned the other two junior interests. The partnership allocated 100% of the gross income every quarter to the contributing partner up to the amount of the preferred return on the Senior Preferred Interests. The partnership agreement also specified that the contributing partner's share of excess nonrecourse liabilities would be determined under the "significant item" method,<sup>883</sup> the result being that 100% of the nonrecourse liabilities would be allocated to the contributing partner in respect of the preferred return on the Senior Preferred Interests treated as the significant partnership item. The IRS ruled that a preferred return (gross income allocation) is not a "significant item" for purposes of allocating partnership liabilities.

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<sup>882</sup> See also ILM 200513022.

<sup>883</sup> Treas. Reg. § 1.752-3(a)(3).

Therefore, all of the liability could not be allocated to the distributee partner, and the distribution did not qualify for the leveraged partnership exception. The IRS explained, a “significant item of partnership income or gain” does not refer to a tranche of bottom-line gross or net income, but instead refers to partnership income of a certain character or type, such as gain from the sale of property or tax-exempt income.

d. The 2014 Proposed Regulations sought to amend not only the disguised sale rules under section 707 but also made significant changes to the sharing of partnership recourse and nonrecourse liabilities under section 752 (this is discussed in more detail later in the “Partnership Liabilities and Basis” section of these materials). In response to commentary, in 2016, the IRS issued temporary regulations under section 707 (the “707 Temporary Regulations”) for disguised sale rule purposes and under section 752 (the “752 Temporary Regulations”) directly relating to bottom dollar payment obligations.<sup>884</sup> At the same time, the IRS issued final regulations Treasury Regulations under section 707 of the Code (the “707 Final Regulations”) and section 752 of the Code, relating to allocations of excess nonrecourse liabilities for disguised sale rule purposes (the “752 Final Regulations”).<sup>885</sup> The 752 Temporary Regulations, with some changes, were adopted in final form in 2019 and are discussed later in the “Partnership Liabilities Are Reflected in Outside Basis” section of these materials).

e. As discussed below, on October 9, 2019, the 707 Temporary Regulations were withdrawn and replaced with Treasury Regulations that were in effect prior to their issuance. However, a discussion of the 707 Temporary Regulations may still be relevant because the IRS and the Treasury Department believe the approach set out therein has merit. The 707 Temporary Regulations require a partner to apply the same percentage used to determine the partner’s share of excess nonrecourse liabilities under section 1.752-3(a)(3) (with certain limits) in determining the partner’s share of partnership liabilities for disguised sale rule purposes only.

(1) The rationale stated in the preamble to the 707 Temporary Regulations is that this more accurately reflects the economic arrangement of the partners. The preamble states, “In most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon. This is true whether: (1) a partner's liability is assumed by a partnership in connection with a transfer of property to the partnership or by a partner in connection with a transfer of property by the partnership to the partner; (2) a partnership takes property subject to a liability in connection with a transfer of property to the partnership or a partner takes property subject to a liability in connection with a transfer of property by the partnership to the partner; or (3) a liability is incurred by the partnership to make a distribution to a partner under the debt-financed distribution exception in §1.707-5(b).”

(2) As such, the 707 Temporary Regulations provide, “For purposes of § 1.707- 5, a partner's share of a liability of a partnership, as defined in § 1.752-1(a) (whether a recourse liability or a nonrecourse liability) is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability under § 1.752-3(a)(3)... but

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<sup>884</sup> T.D. 9788 (including two correcting amendments, 81 Fed. Reg. 80993 and 81 Fed. Reg. 80994).

<sup>885</sup> T.D. 9787 (including a correction, 81 Fed. Reg. 80587).

shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations.”<sup>886</sup>

(3) Thus, the 707 Temporary Regulations treat all partnership liabilities, whether recourse or nonrecourse, as nonrecourse liabilities solely for disguised sale purposes under section 707 of the Code. The 707 Final Regulations, however, provide limitations on the available allocation methods under section 1.752-3(a)(3) of the Treasury Regulations, applicable solely for disguised sale purposes under section 707, for determining a partner's share of excess nonrecourse liabilities. Under section 1.752-3(a)(3) of the 2014 Proposed Regulations, the “significant item method” and the “alternative method” (as discussed later in these materials) were removed and were replaced by a new approach based on a partner’s liquidation value percentage.<sup>887</sup> In response to commentary, the 752 Final Regulations retain the significant item method and alternative method, but do not adopt the liquidation value percentage approach for determining a partner’s interest in profits. That being said, the IRS concluded that the allocation of excess nonrecourse liabilities in accordance with the significant item method and the alternative method has been abused by partnerships and their partners for disguised sale purposes. The pre-existing Treasury Regulations already provided that the “additional method” does not apply for disguised sale rule purposes. The 752 Final Regulations now provide, “The significant item method, alternative method, and additional method do not apply for purposes of § 1.707-5(a)(2).”<sup>888</sup>

(4) Therefore, under the 707 Temporary Regulations, a partner's share of any partnership liability for disguised sale purposes is determined using the same percentage used to determine the partner's share of the partnership's excess nonrecourse liabilities under section 1.752-3(a)(3) of the Regulations based on the partner's share of partnership profits.

f. The 707 Temporary Regulations were incorporated by cross reference in a notice of proposed rulemaking published on October 5, 2016 (the “707 Proposed Regulations”).<sup>889</sup> That notice also incorporated by cross reference the 752 Temporary Regulations and included new proposed regulations under sections 704 and 752 (the “752 Proposed Regulations”).

g. The 707 Final Regulations formally add a new type of “qualified liability” to the pre-existing four types. This new qualified liability is one that is not incurred in anticipation of a transfer of the property to a partnership but that was incurred in connection with a trade or business in which property transferred to the partnership was used or held, provided that all assets related to that trade or business are transferred other than assets not material to a continuation of the trade or business.<sup>890</sup> The 707 Final Regulations also provide guidance on the

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<sup>886</sup> Treas. Reg. § 1.707-5T(a)(2).

<sup>887</sup> See § 1.752-3(a)(3) of the 2014 Proposed Regulations.

<sup>888</sup> Treas. Reg. § 1.752-3(a)(3).

<sup>889</sup> REG-12855-15.

<sup>890</sup> Treas. Reg. § 1.707-5(a)(6)(i)(E).

treatment of preformation capital expenditures,<sup>891</sup> tiered partnerships, and liabilities in assets-over mergers. These subjects are beyond the scope of these materials.

h. 2019 Withdrawal and Reinstatement of Regulations

(1) On October 9, 2019, the IRS formally withdrew the 707 Temporary Regulations and reinstated section 1.707-5(a)(2) of the Treasury Regulations (the “Prior 707 Regulations”) in effect, prior to the 707 Temporary Regulations, as of April 1, 2016 (the “2019 Withdrawal and Reinstatement”).<sup>892</sup> This 2019 Treasury decision adopted the approach set out in a 2018 notice of proposed notice of rulemaking (the “2018 Proposed Regulations”),<sup>893</sup> essentially with no change other than the applicability date.

(2) Under section 1.707-5(a)(2) of the Prior 707 Regulations, a partner's share of a partnership's recourse liability equals the partner's share of the liability under section 752 and the Treasury Regulations thereunder. A partnership liability is a recourse liability to the extent that the obligation is a recourse liability.<sup>894</sup>

(3) Under section 1.707-5(a)(2)(ii) of the Prior 707 Regulations, a partner's share of a partnership's nonrecourse liability is determined by applying the same percentage used to determine the partner's share of the excess nonrecourse liability.<sup>895</sup> A partnership liability is a nonrecourse liability of the partnership to the extent that the obligation is a nonrecourse liability.<sup>896</sup>

(4) As mentioned above, the 707 Final Regulations limited the available methods for determining a partner's share of an excess nonrecourse liability for disguised sale purposes. Under the 707 Final Regulations, a partner's share of excess nonrecourse liability for disguised sale purposes is determined only in accordance with the partner's share of partnership profits and by taking into account all facts and circumstances relating to the economic arrangement of the partners. Therefore, the significant item method, the alternative method, and the additional method<sup>897</sup> do not apply for purposes of determining a partner's share of a partnership's nonrecourse liability for disguised sale purposes.

(5) Section 1.707-5(a)(2)(i) and (ii) of the Prior 707 Regulations provided that a partnership liability is a recourse or nonrecourse liability if the liability was treated as a partnership liability for purposes of section 752, specifically dealing with contingent

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<sup>891</sup> See Treas. Reg. § 1.707-4(d).

<sup>892</sup> T.D. 9876, 84 Fed. Reg. 54027 (Oct. 9, 2019).

<sup>893</sup> REG-131186-17, 83 Fed. Reg. 28397 (Jun. 19, 2018).

<sup>894</sup> As determined under Treas. Reg. § 1.752-1(a)(1).

<sup>895</sup> As determined under Treas. Reg. § 1.752-3(a)(3).

<sup>896</sup> As determined under Treas. Reg. § 1.752-1(a)(2).

<sup>897</sup> See Treas. Reg. § 1.752-3(a)(3).

liabilities under section 1.752-7 of the Treasury Regulations. In the 2018 Proposed Regulations, the IRS requested additional guidance on this issue.

(6) Examples 2, 3, 7, and 8 under section 1.707-5(f) of the Prior 707 Regulations are reinstated with the exception of added language to Example 3 to reflect an amendment made by the 707 Final Regulations regarding an anticipated reduction in a partner's share of a liability that is not subject to the entrepreneurial risks of partnership operations.

(7) The Prior 707 Regulations apply to any transaction with respect to which all transfers occur on or after October 4, 2019.

(8) The 2019 Withdrawal and Reinstatement came about, ostensibly, as a result of the 2017 Executive Order 13789 (E.O. 13789), titled “Reducing Regulation and Controlling Regulatory Costs,” pursuant to which the President Trump ordered the Treasury to identify significant tax regulations issued on or after January 1, 2016, that (i) impose an undue financial burden on U.S. taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the IRS. The 707 Temporary Regulations were identified as meeting the regulatory burdens specified by E.O. 13789 and thus were withdrawn.<sup>898</sup> Notwithstanding the withdrawal, 2019 Withdrawal and Reinstatement provides “The Treasury Department and the IRS continue to study the merits of the approach in the 707 Temporary Regulations and other approaches, including these final regulations, to determine which results in the most appropriate treatment of liabilities in the context of disguised sales.”

#### 7. Exception: Distributions of Marketable Securities

a. A distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property) but only for purposes of determining whether gain is recognized as a result of the distribution.<sup>899</sup> For these purposes, marketable securities includes financial instruments (stocks, equity interests, debt, options, forward or futures contracts, notional principal contracts and other derivatives) and foreign currencies which are actively traded.<sup>900</sup> In addition, the Code provides that a marketable security includes “any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities.”<sup>901</sup> Further, the Code provides that a marketable security includes “any financial instrument the value of which is determined substantially by reference to marketable securities.”<sup>902</sup>

b. There are a number of applicable exceptions to the foregoing treatment of distributions of marketable securities, including: (1) distributions of contributed securities to

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<sup>898</sup> See Notice 2017-18, 2017-31 I.R.B. 147 (Jul 24, 2017) and Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, 82 Fed. Reg. 48013 (Oct. 16, 2017).

<sup>899</sup> § 731(c).

<sup>900</sup> § 731(c)(2)(A) and (C).

<sup>901</sup> § 731(c)(2)(B)(ii).

<sup>902</sup> § 731(c)(2)(B)(iii).

the partner who contributed them;<sup>903</sup> (2) distributions of securities that were not marketable when acquired by the partnership and are distributed within five years of becoming marketable;<sup>904</sup> and (3) distributions of securities from an “investment partnership” to an “eligible partner.”<sup>905</sup>

c. An “investment partnership” is defined as a partnership substantially all of whose assets consist of specified investment-type assets and has never been engaged in a trade or business.<sup>906</sup> Specified investment-type assets include (1) money, (2) stock in a corporation, (3) notes, bonds, debentures, or other evidences of indebtedness, (4) interest rate, currency, or equity notional principal contracts, (5) foreign currencies, and (6) derivative financial instruments (including options, forward or futures contracts and short positions).<sup>907</sup> A partnership will not be considered engaged in a trade or business by reason of any activity undertaken as an investor, trader, or dealer in such specified investments.<sup>908</sup>

d. An “eligible partner” is one who, before the date of distribution, did not contribute to the partnership any property other than specified investment-type assets permitted to be held by an investment partnership.<sup>909</sup>

e. If one of these exceptions does not apply and a distribution of marketable securities results in gain to the distributee partner, the gain is the excess of the value of the marketable securities over the partner’s outside basis.<sup>910</sup> The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by, according to the section 731(c)(3)(B) of the Code:

(i) such partner's distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over

(ii) such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed

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<sup>903</sup> § 731(c)(3)(A) and Treas. Reg. § 1.731-2(d)(1).

<sup>904</sup> § 731(c)(3)(A)(ii) and Treas. Reg. § 1.731-2(d)(1)(iii). To qualify for this exception, the security must not have been marketable on the date acquired and the entity to which the security relates must not have had any outstanding marketable securities on that date. Further, the partnership must have held the security for at least 6 months prior to the security becoming marketable, and the partnership must distribute the security within 5 years from the date the security became marketable.

<sup>905</sup> §§ 731(c)(3)(C)(i) and 731(c)(3)(A)(iii).

<sup>906</sup> § 731(c)(3)(C)(i).

<sup>907</sup> § 731(c)(3)(C)(i)(I) through (VIII).

<sup>908</sup> § 731(c)(3)(C)(ii)(I) and Treas. Reg. § 1.731-2(e)(3)(i).

<sup>909</sup> § 731(c)(3)(C)(iii)(I).

<sup>910</sup> § 731(c)(3)(B) and Treas. Reg. § 1.731-2(a) and (j), Ex. 1.

securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under clause (i).<sup>911</sup>

f. Notwithstanding the fact that the Code speaks in terms of the “same class and issuer as the distributed securities,” the flush language of section 731(c)(3)(B) gives permission for the Treasury Regulations to aggregate securities. As such section 1.731-2(b)(2) of the Treasury Regulations provides that the foregoing reduction is:

(i) The distributee partner's distributive share of the net gain, if any, which would be recognized if all the marketable securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value; over

(ii) The distributee partner's distributive share of the net gain, if any, which is attributable to the marketable securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under paragraph (b)(2)(i) of this section.

g. Thus the reduction applies to “all marketable securities held by the partnership” and the reduction reflects not only the marketable security distributed but also any reduction in the distributee partner’s gain in all of the marketable securities. According to the preamble to when the Treasury Regulations were proposed, “This provision allows a partner to withdraw the partner's portion of appreciation in the partnership's marketable securities without recognizing gain on the transaction. As a result, section 731(c) generally applies only when a partner receives a distribution of marketable securities in exchange for the partner’s share of appreciated assets other than marketable securities.”<sup>912</sup>

h. As to aggregating all marketable securities, the preamble explains:

Under authority of section 731(c)(3)(B), the proposed regulations provide that all marketable securities held by a partnership are treated as marketable securities of the same class and issuer as the distributed securities. Treating all marketable securities as a single class asset for this purpose is consistent with the basic rationale of section 731(c) that marketable securities are the economic equivalent of money. As a result, the amount of the distribution that is not treated as money will depend on the partner’s share of the net appreciation in all partnership securities, not on the partner’s share of the appreciation in the type of securities distributed.

i. Any unrealized loss in the marketable securities is not recognized, either by the partnership or the partner.<sup>913</sup>

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<sup>911</sup> § 731(c)(3)(B)(i) and (ii).

<sup>912</sup> PS-2-95, 61 Fed. Reg. 28 (Jan. 2, 1996).

<sup>913</sup> § 731(b).

j. The basis of distributed marketable securities when gain is recognized under section 731(c) is the basis as determined under section 732 but increased by the amount of gain recognized as a result of the distribution.<sup>914</sup> The basis of distributed securities when no gain is recognized will be based on the general rule of section 732 for distributions. The outside basis of the distributee partner is determined as if no gain is recognized and no adjustments to it is made to the basis of the marketable security attributable to the distribution itself.<sup>915</sup> As a result, the distributee-partner's outside basis is reduced only by the basis of the distributed securities determined under section 732 without regard to any basis increase under section 731(c)(4) (which is reflected in the securities). The foregoing rules and resulting outside basis of the distributee-partner and in the security can be complicated:

Example 1: Partnership distributes a marketable security with an inside basis of \$10x and a fair market value of \$50x to P, a partner, who has an outside basis of \$30x and a capital account of \$200x. Under section 731(c) of the Code, P is treated receiving a distribution of \$50x cash, which is more than P's outside basis, and P recognizes \$20x of gain. P's outside basis is not affected by the gain. The distribution of the marketable security reduces P's outside basis by \$10x (inside basis of the partnership), so after the distribution, P's outside basis is \$20x, and P's capital account is \$150x (reduced by the fair market value of the security). The marketable security in P's hands has a resulting basis of \$30x (gain is added to the basis of the security).

Example 2: Same facts as example 1, except the marketable security has an inside basis of \$40x. P recognizes \$20x of gain. The inside basis of the security is higher than P's outside basis. As a result, P's resulting outside basis is \$0x, and capital account is \$150x. The distribution of the marketable security results in an initial reduction of basis to \$30 (limited by P's outside basis) but then the resulting gain is added to the security. The marketable security in P's hands has a resulting basis of \$50x.

k. For inside basis purposes, section 734 (adjustment to inside basis when there is a section 754 election or substantial basis reduction) is applied as if no gain were recognized and no basis increase was made to the distributed securities.<sup>916</sup> Even if a section 754 election is in place, any gain triggered from a distribution of marketable securities will not be reflected in the inside basis of any other partnership property. However, if a section 754 election is in place, the inside basis of partnership can be adjusted for any lost basis resulting from the limitation of the basis of the marketable securities in the partner's hands to the partner's outside basis (because outside basis is not adjusted to reflect the gain, as mentioned above).<sup>917</sup> Therefore, for purposes of sections 733 and section 734 of the Code, a distribution of marketable securities is treated as a property distribution.

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<sup>914</sup> § 731(c)(4)(A) and Treas. Reg. § 1.731-2(f)(1)(i).

<sup>915</sup> § 731(c)(5) and Treas. Reg. § 1.731-2(f)(1)(ii).

<sup>916</sup> § 731(c)(5) and Treas. Reg. § 1.731-2(f)(2).

<sup>917</sup> Treas. Reg. § 1.731-2(j), Ex. 6(iv).

l. If the partner receives other property in addition to marketable securities in the same distribution, the reduction in outside basis due to the marketable securities (cash) is taken into account first, with any remaining basis applied against the other property distributed.<sup>918</sup>

m. The Treasury Regulations under section 731(c) of the Code contain an anti-abuse provision which provides generally, “The provisions of section 731 (c) and this section must be applied in a manner consistent with the purpose of section 731(c) and the substance of the transaction. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 731(c) and this section, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 731(c) and this section.”<sup>919</sup> The provision goes on to provide three examples:<sup>920</sup>

(1) A change in partnership allocations or distribution rights with respect to marketable securities may be treated as a distribution of the marketable securities subject to section 731(c) if the change in allocations or distribution rights is, in substance, a distribution of the securities;

(2) A distribution of substantially all of the assets of the partnership other than marketable securities and money to some partners may also be treated as a distribution of marketable securities to the remaining partners if the distribution of the other property and the withdrawal of the other partners is, in substance, equivalent to a distribution of the securities to the remaining partners; and

(3) The distribution of multiple properties to one or more partners at different times may also be treated as part of a single distribution if the distributions are part of a single plan of distribution.

## G. Partnership Liabilities and Outside Basis

### 1. Introduction

a. Generally, as discussed in more detail below, a partner’s basis in his or her partnership interest (outside basis) includes the partner’s share of the partnership’s liabilities. As such, any increase in a partner’s share of partnership liabilities will increase the partner’s outside basis. Conversely, any decrease in a partner’s share of partnership liabilities will decrease the partner’s outside basis and could also cause the partner to recognize income.

b. Outside basis determines, among other things, the amount of money a partnership can distribute to a partner without triggering gain. Section 731(a) of the Code

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<sup>918</sup> § 731(a)(1) and Treas. Reg. § 1.731-2(f)(1)(ii), (j), Ex. 5.

<sup>919</sup> Treas. Reg. § 1.731-2(h).

<sup>920</sup> *Id.*

provides that a partnership does not recognize gain on a distribution of money except to the extent that the amount of money distributed exceeds the partner's basis in his or her interest.

c. In addition, section 704(d) of the Code provides that a partner's distributive share of partnership losses is allowed only to the extent of the partner's outside basis at the end of the partnership taxable year in which the loss occurred. Any loss in excess of the partner's outside basis is disallowed. The excess loss is allowed as a deduction at the end of the first succeeding partnership taxable year (and any subsequent years) but only to the extent, if any, of the partner's outside basis at the end of that year.

d. Importantly, in the context of tax basis management, outside basis determines (in whole or in part) the adjusted basis of property distributed to a partner. As discussed in more detail above, the basis of distributed property to a partner in a current distribution is the *lesser* of the inside basis of the property and the outside basis of the distributee partner.<sup>921</sup> With respect to liquidating distributions of property, the basis of the distributed property is simply the outside basis of the distributee partner (as reduced by any money distributed in the same transaction).<sup>922</sup>

e. An extension of the unitary basis rule is that a partner (i.e., grantor and a grantor trust) will have one unitary liability allocation amount under section 752 of the Code. In a technical advice memorandum,<sup>923</sup> the IRS concluded that the deemed distribution under section 752(b) of the Code from a reduction in a partner's share of nonrecourse liabilities should be applied against the partner's entire basis in both its limited and general partnership interests. The limited partnership interests of two partners, A and B, each having both a general partner and a limited partnership interest, were liquidated. As a result of the liquidation of the limited partnership interests, the nonrecourse liability allocation of A and B decreased. The IRS agent argued that A and B each had a separate basis as a limited partner and as a general partner and that to the extent the decrease in liability allocation exceeded their basis in the limited partnership interests, they would recognize gain under section 731 of the Code. The IRS National Office disagreed with the agent, specifically stating that A and B had a single adjusted basis with respect to their interests in the partnership. Because each of A and B had a basis in the partnership exceeding the amount of money deemed to be distributed under section 752(b) of the Code, the liquidation of their limited partnership interests did not result in gain recognition to either A or B under section 731 of the Code.

## 2. Treasury Regulations on Economic Risk of Loss

a. The partnership rules make an important distinction between recourse and nonrecourse liabilities. In this context, generally, recourse liabilities increase basis only as to the partner who bears economic risk of loss, whereas nonrecourse liabilities increase basis proportionately among all of the partners. A partnership liability is considered recourse if any

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<sup>921</sup> § 732(a).

<sup>922</sup> § 732(b).

<sup>923</sup> TAM 8350006.

partner or “related person” bear the economic risk of loss for the liability.<sup>924</sup> Conversely, a liability is considered nonrecourse to the extent no person or “related person” bears such risk of loss.<sup>925</sup>

b. Under the Treasury Regulations, a partner is deemed to have the economic risk of loss if the partner would be required to pay the liability in the event all of the partnership assets are worthless,<sup>926</sup> even if the economic reality is that the chance the partner will be required to pay or have the ability to pay the liability is very small. Under section 1.752-2(b)(1) of the Treasury Regulations, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated:

(1) The partner or related person would be obligated to make a payment to any person or a contribution to the partnership because that liability becomes due and payable; and

(2) The partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.

c. Whether the partner’s or related person’s payment or contribution obligation exists (and the extent of such obligation) depends on all the facts and circumstances, like the existence of the following:

(1) Contractual obligations like “guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership;”<sup>927</sup>

(2) Partnership obligations including “obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership;”<sup>928</sup>

(3) Payment obligations “imposed by state law, including the governing state partnership statute;”<sup>929</sup> and

(4) Reimbursement rights a partner or related person may have from another partner or a person who is related to such other partner.<sup>930</sup>

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<sup>924</sup> Treas. Reg. § 1.752-1(a)(1).

<sup>925</sup> Treas. Reg. § 1.752-1(a)(2).

<sup>926</sup> Treas. Reg. § 1.752-2(b).

<sup>927</sup> Treas. Reg. § 1.752-2(b)(3)(i).

<sup>928</sup> Treas. Reg. § 1.752-2(b)(3)(ii).

<sup>929</sup> Treas. Reg. § 1.752-2(b)(3)(iii).

<sup>930</sup> Treas. Reg. § 1.752-2(b)(5).

d. In making a determination of whether a partner or related person has a payment obligation on a partnership liability and bears the economic risk of loss, it is assumed the partner or related person will be able to pay the obligations “irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.”<sup>931</sup> This presumption is sometimes referred to as the “deemed satisfaction rule.” Notwithstanding the deemed satisfaction rule, a payment obligation is disregarded if, taking into account all of the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will be discharged. If a payment would arise in the future after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored, but only until the triggering event occurs.<sup>932</sup> In addition, the satisfaction presumption is subject to an anti-abuse rule in section 1.752-2(j) of the Treasury Regulations pursuant to which a payment obligation of a partner or related person may be disregarded or treated as an obligation of another person if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's economic risk of loss with respect to that obligation (or create the appearance of the partner or related person bearing the economic risk of loss when the substance is otherwise).

e. Any increase in a partner's share of liabilities (including any assumption by a partner of any partnership liabilities) is treated as contribution of cash by the partner in the partnership, thereby increasing basis.<sup>933</sup> Any decrease is treated as a distribution of cash to the partner, thereby reducing basis and possibly resulting in the recognition of gain if the amount of the deemed distribution exceeds available outside basis.<sup>934</sup> If property that is subject to a liability is contributed to or distributed from a partnership, the transferee is deemed to assume the liability but only to the extent the liability is not in excess of the fair market value.<sup>935</sup>

f. The Treasury Regulations state that a person will be a “related person” to a partner if they have a relationship that is specified in sections 267(b) and 707(b)(1) but with a few modifications.<sup>936</sup> Including those modifications, a person is related to a partner if they are (in part):

- (1) Members of the same family (spouse, ancestors and lineal descendants);
- (2) An individual and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for such individual;
- (3) A grantor and a fiduciary of any trust;

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<sup>931</sup> Treas. Reg. § 1.752-2(b)(6).

<sup>932</sup> Treas. Reg. § 1.752-2(b)(4).

<sup>933</sup> § 722 and Treas. Reg. § 1.752-1(b).

<sup>934</sup> §§ 733, 731(a), 751 and Treas. Reg. § 1.752-1(c).

<sup>935</sup> Treas. Reg. § 1.752-1(e).

<sup>936</sup> Treas. Reg. § 1.752-4(b)(1).

(4) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(5) A fiduciary of a trust and a beneficiary of such trust;

(6) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(7) A fiduciary of a trust and a corporation if more than 80% of the value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(8) A person and a charitable organization if the organization is controlled directly or indirectly by such person or, if the person is an individual, by members of the individual's family;

(9) A corporation and a partnership if the same persons own more than 80% in value of the outstanding stock of the corporation and more than 80% of the capital interest or the profits interest in the partnership;

(10) An S corporation and another S corporation (or C corporation) if the same persons own more than 80% in value of the outstanding stock of each corporation;

(11) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of that estate;

(12) A partnership and a person owning, directly or indirectly, more than 80% of the capital interest, or the profits interest, in such partnership; or

(13) Two partnerships in which the same persons own, directly or indirectly, more than 80% of the capital interests or profits interests.

g. To avoid double counting, the Treasury Regulations provide that persons owning interests (directly or indirectly) in the same partnership are not treated as related persons for purposes of determining their share of partnership loss.<sup>937</sup>

h. The Treasury Regulations further provide that if (i) a partnership liability is held or guaranteed by another entity that is a partnership, S corporation, C corporation, or trust; (ii) a partner or related person (directly or indirectly) owns 20% or more in such other entity, and (iii) a principal purpose of having such other entity act as a lender or guarantor is to avoid having the partner bears the risk of loss for all or part of the liability, then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of that partner's or related person's ownership interest in such other entity.<sup>938</sup> The ownership interest of the partner and related person are determined according to each entity in the following manner:

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<sup>937</sup> Treas. Reg. § 1.752-4(b)(2)(iii).

<sup>938</sup> Treas. Reg. § 1.752-4(b)(2)(iv)(A).

(1) Partnership: highest percentage interest in any partnership loss or deduction for any taxable year;<sup>939</sup>

(2) S corporation: percentage of outstanding stock owned by the shareholder;<sup>940</sup>

(3) C corporation: percentage of the issued and outstanding stock owned by the shareholder based upon fair market value;<sup>941</sup> and

(4) Trust: actuarial percentage interest owned beneficially.<sup>942</sup>

i. An otherwise nonrecourse partnership liability is treated as a recourse liability to the extent that a partner or a related person holds an interest in the liability, referred to as “partner nonrecourse debt” in the Treasury Regulations.<sup>943</sup> In such case, the economic risk of loss is allocated to such partner (or related person) to the extent not otherwise allocated to another partner.<sup>944</sup>

j. If a partner (or related person) pledges property outside the partnership (a direct pledge) as security for a partnership liability, the partner is deemed to bear the risk of loss to the extent of the “net fair market value” of the pledged property.<sup>945</sup> If a partner contributes property to a partnership solely for the purpose of securing a partnership liability (an indirect pledge), the partner is deemed to bear the risk of loss to the extent of the “net fair market value” of the pledged property.<sup>946</sup> Contributed property will not be deemed indirectly pledged unless “substantially all of the items of income, gain, loss, and deduction attributable to the contributed property are allocated to the contributing partner, and this allocation is generally greater than the partner's share of other significant items of partnership income, gain, loss, or deduction.”<sup>947</sup>

k. As with other partnership provisions, the Treasury Regulations contain anti-abuse rules that would disregard the form of the situation “if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner's economic risk of loss with respect to that obligation or create the appearance of the

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<sup>939</sup> Treas. Reg. § 1.752-4(b)(2)(iv)(B)(1)

<sup>940</sup> Treas. Reg. § 1.752-4(b)(2)(iv)(B)(2).

<sup>941</sup> Treas. Reg. § 1.752-4(b)(2)(iv)(B)(3).

<sup>942</sup> Treas. Reg. § 1.752-4(b)(2)(iv)(B)(4).

<sup>943</sup> See Treas. Reg. § 1.704-2(b)(4).

<sup>944</sup> Treas. Reg. § 1.752-2(c)(1).

<sup>945</sup> Treas. Reg. § 1.752-2(h)(1).

<sup>946</sup> Treas. Reg. § 1.752-2(h)(2).

<sup>947</sup> *Id.*

partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise.”<sup>948</sup> The Treasury Regulations discuss 2 situations:

(1) Arrangements tantamount to a guarantee:<sup>949</sup>

(a) Partner or related person undertakes one or more contractual obligations so the partnership may obtain a loan;

(b) Contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and

(c) One of the principal purposes is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests.

(2) A plan to circumvent or avoid the obligation, based on the facts and circumstances, of a partner (or related person).<sup>950</sup>

1. A complete discussion of how nonrecourse liabilities are shared by partners is beyond the scope of this outline, but the Treasury Regulations generally provide that a partner’s share of such liabilities are the sum of:<sup>951</sup>

(1) The partner’s share of “partnership minimum gain”<sup>952</sup> (gain that would be realized if all property subject to nonrecourse liability is sold in full satisfaction of the liabilities and for no other consideration);<sup>953</sup>

(2) Amount of taxable gain that would be allocated to the partner under section 704(c) (arising because the partner contributed property to the partnership and the partnership still holds the property) if the partnership disposed of all partnership property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of the liabilities and for no other consideration;<sup>954</sup> and

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<sup>948</sup> Treas. Reg. § 1.752-2(j)(1).

<sup>949</sup> Treas. Reg. § 1.752-2(j)(2). *See* CCA 200246014 (a guarantee was disregarded due to a number of facts including severe undercapitalization and the provisions of the guarantee set forth many waivers and defenses for the benefit of the purported guarantor).

<sup>950</sup> Treas. Reg. § 1.752-2(j)(3). An example is provided that involved a general partnership, minimally capitalized corporation as a partner and a deficit capital account restoration obligation. The obligations of the corporate partner and the capital account restoration obligation are ignored for purposes of Section 752.

<sup>951</sup> Sometimes referred to as the sum of tier one, tier two, and tier three allocations.

<sup>952</sup> Treas. Reg. § 1.752-2(d)(1).

<sup>953</sup> Treas. Reg. § 1.752-3(a)(1).

<sup>954</sup> Treas. Reg. § 1.752-3(a)(2).

(3) The partner's share of "excess nonrecourse liabilities" (liabilities not allocated above).<sup>955</sup>

m. Section 1.752-3(a)(3) of the Treasury Regulations provides a number of methods to determine a partner's share of "excess nonrecourse liabilities." Under one method, a partner's share of "excess nonrecourse liabilities" is generally "determined in accordance with the partner's share of partnership profits" under all of the "facts and circumstances relating to the economic arrangement of the partners."<sup>956</sup> As a result, if an FLP has pro rata shares (as is common), and no partner has made a contribution of property to the partnership, then nonrecourse debt will also be shared pro rata. The partnership agreement may specify the partners' interests in partnership profits so long as the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain (often referred to as the "significant item" method). Alternatively, excess nonrecourse liabilities may be allocated among partners in a manner that deductions attributable to those liabilities are reasonably expected to be allocated (often referred to as the "alternative" method). Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property<sup>957</sup> or property for which reverse section 704(c) allocations are applicable<sup>958</sup> where such property is subject to the nonrecourse liability, to the extent that such built-in gain exceeds the gain described in section 1.752-3(a)(2) of the Treasury Regulations with respect to such property (often referred to as the "additional" method).

n. As discussed earlier in these materials, for disguised sale rule purposes only, a partner's share of partnership liabilities, whether recourse as to that partner or nonrecourse,<sup>959</sup> is determined solely under the profit share provision.<sup>960</sup> The significant item method, alternative method, and additional method are unavailable for this purpose.<sup>961</sup>

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<sup>955</sup> Treas. Reg. § 1.752-3(a)(3).

<sup>956</sup> *Id.*

<sup>957</sup> As defined under section 1.704-3(a)(3)(ii) of the Treasury Regulations.

<sup>958</sup> As described in section 1.704-3(a)(6)(i) of the Treasury Regulations.

<sup>959</sup> Treas. Reg. § 1.707-5T(a)(2)(i) and (f), *Ex. 2*, and T.D. 9788.

<sup>960</sup> Treas. Reg. § 1.707-5T(a)(2)(ii) and T.D. 9788.

<sup>961</sup> Treas. Reg. § 1.752-3(a)(3) and T.D. 9787.

3. Withdrawal and Replacement of 2014 Proposed Regulations

a. As mentioned in the “Leveraged Distributions and Disguised Sales” portion of these materials, the 2014 Proposed Regulations sought to amend not only the disguised sale rules under section 707 but also made significant changes to the sharing of partnership recourse and nonrecourse liabilities under section 752. The 2014 Proposed Regulations took a much more fact-specific approach providing that a partner will be treated as having the economic risk of loss only if there is a significant possibility that the partner will have to pay a partnership liability and that the partner will have enough net worth to pay the liability with his or her own assets. If both of those conditions do not exist, then the partnership liability will be allocated to all of the partners as a nonrecourse liability. As with the previous regulations, the determination of the extent to which a partner or related person has an obligation to make a payment is based on the facts and circumstances, except that under the 2014 Proposed Regulations, the obligation will not be recognized if it fails any of the “recognition requirements.”<sup>962</sup>

b. The recognition requirements were:<sup>963</sup>

(1) The partner or related person is:

(a) Required to maintain a commercially reasonable net worth throughout the term of the payment obligation; or

(b) Subject to commercially reasonable contractual restrictions on transfers of assets for inadequate consideration.

(2) The partner or related person is required periodically to provide commercially reasonable documentation regarding the partner’s or related person’s financial condition.

(3) The term of the payment obligation does not end prior to the term of the partnership liability.

(4) The payment obligation does not require that the primary obligor or any other obligor with respect to the partnership liability directly or indirectly hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor.

(5) The partner or related person received arm’s length consideration for assuming the payment obligation.

(6) In the case of a guarantee or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner’s or related person’s payment obligation if, and to the extent that, any amount of the partnership liability is not otherwise satisfied.

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<sup>962</sup> § 1.752-2(b)(3) of the 2014 Proposed Regulations.

<sup>963</sup> Prop. Treas. Reg. § 1.752-2(b)(3)(ii)(A)-(G) of the 2014 Proposed Regulations.

(7) In the case of an indemnity, reimbursement agreement, or similar arrangement, the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that, any amount of the indemnitee's or other benefitted party's payment obligation is satisfied.

c. In addition to the recognition factors, the 2014 Proposed Regulations would have effectively eliminated the deemed satisfaction rule for partners (other than individuals and estates of decedents). While it is still assumed that all partners and related persons who have obligations to make payments actually preform those obligations, a payment obligation is recognized only to the extent of the net value of the partner or related person.<sup>964</sup> A partner or related person's net value is determined under section 1.752-2(k) of the Treasury Regulations that determine the net value of disregarded entities.

d. In response to comments to the 2014 Proposed Regulations, the IRS withdrew the proposed regulations under section 1.752-2 in 2016 and propose to move the recognition factors (other than those concerning bottom end/bottom dollar arrangements) to an anti-abuse rule under section 1.752-2(j) of the Treasury Regulations (the "752 Proposed Regulations").<sup>965</sup> On October 9, 2019, the IRS adopted in final form, with certain changes, the 752 Temporary Regulations (dealing with: (i) bottom dollar payment obligations, and (ii) capital contributions and deficit restoration obligations) and the 752 Proposed Regulations (rules regarding when certain liabilities will be treated as recourse obligations under the anti-abuse rule of section 1.72-2(j) of the Treasury Regulations).<sup>966</sup>

#### 4. Bottom Dollar Payment Obligations

a. The Treasury Regulations provide generally that the extent to which a partner (or related party) has an obligation to make a payment is based on the facts and circumstances, taking into account obligations inside and outside the partnership agreement and imposed by law, and if the obligation is not recognized, then section 752 will be applied as if the obligation did not exist.<sup>967</sup> Specifically, "bottom dollar payment obligation" will not be recognized as a payment obligation under of the Treasury Regulations.<sup>968</sup>

(1) The Treasury Regulations broadly define a "bottom dollar payment obligation" as:<sup>969</sup>

(a) With respect to a guarantee (or similar arrangement), any obligation other than one in which the partner (or related person) is or would be liable up to the

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<sup>964</sup> § 1.752-2(b)(3)(iii) of the 2014 Proposed Regulations.

<sup>965</sup> REG-122855-15 (October 5, 2016).

<sup>966</sup> T.D. 9877, 85 Fed. Reg. 54014 (Oct. 9, 2019).

<sup>967</sup> Treas. Reg. § 1.752-2(b)(3)(i).

<sup>968</sup> Treas. Reg. § 1.752-2(b)(3)(ii)(A).

<sup>969</sup> Treas. Reg. § 1.752-2(b)(3)(ii)(C)(1).

full amount of such partner's (or related person's) payment obligation if any amount of the partnership liability is not otherwise satisfied;

(b) With respect to an indemnity (or similar arrangement), any obligation other than one in which the partner (or related person) is or would be liable up to the full amount of such partner's (or related person's) payment obligation if any amount of the indemnitee's or benefited party's payment obligation is satisfied;

(c) With respect to an obligation to make a capital contribution or to restore a deficit capital account upon liquidation of the partnership,<sup>970</sup> as any payment obligation other than one in which the partner is or would be required to make the full amount of the partner's capital contribution or to restore the full amount of the partner's deficit capital account; and

(d) An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, and with a principal purpose of avoiding having at least one of such liabilities or payment obligations being treated as a bottom dollar payment obligation (as described above).

(2) An obligation will not be considered a bottom dollar payment obligation merely because:<sup>971</sup>

(a) A maximum amount is placed on the partner's (or related) person's payment obligation;

(b) A partner's (or related person's) payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates (a vertical slice obligation); or

(c) There exists a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable.

(3) The Treasury Regulations include a simple, but instructive, example, pursuant to which ABC limited liability company (taxed as a partnership for tax purposes) borrows \$1,000 from a bank. The LLC has 3 equal members. A guarantees up to \$300 of the ABC liability if any amount of full liability is not recovered. B guarantees up to \$200, but only if the bank recovers less than \$200. A and B waive their rights of contribution from each other. Based on these facts, the Treasury Regulations conclude:<sup>972</sup>

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<sup>970</sup> As described in, and taking into account, Treas. Reg. §§ 1.704-1(b)(2)(ii)(b)(3) and 1.704-1(b)(2)(ii)(c).

<sup>971</sup> Treas. Reg. § 1.752-2(b)(3)(ii)(C)(2).

<sup>972</sup> Treas. Reg. § 1.752-2(f)(10), Ex. 10.

(a) A's \$300 guarantee obligation is not a bottom dollar payment obligation. As a result, A's payment obligation is recognized under section 1.752-2(b)(3) of the Treasury Regulations, and A's economic risk of loss under section 1.752-2(b)(1) of the Treasury Regulations is \$300.

(b) B's guarantee is a bottom dollar payment obligation. As a result, B's payment obligation is not recognized under section 1.752-2(b)(3)(ii)(A) of the Treasury Regulations, and B bears no economic risk of loss under section 1.752-2(b)(1) of the Treasury Regulations for ABC's liability.

(c) The result is that \$300 of ABC's liability is allocated to A under section 1.752-2(a) of the Treasury Regulations (relating to a partner's share of recourse liabilities), and \$700 is allocated to A, B, and C under section 1.752-3 of the Treasury Regulations (relating to a partner's share of nonrecourse liabilities).

(4) The Treasury Regulations further provide if a partner (or related person) has a payment obligation that would be recognized section 1.752-2(b)(3) of the Treasury Regulations (referred to as the "initial payment obligation") but for a right of indemnification or reimbursement, then such bottom dollar payment obligation will nevertheless be recognized provided the partner (or related person) is liable for at least 90% of the initial payment obligation.<sup>973</sup>

(5) The Treasury Regulations impose a requirement that a partnership must disclose a bottom dollar payment obligation (including those obligations that would be recognized under the 90% threshold exception described above) on Form 8275, Disclosure Statement, attached to the return of the partnership for the taxable year in which the bottom dollar payment obligation is undertaken or modified.<sup>974</sup>

## 5. New Anti-Abuse Treasury Regulations

a. Pursuant to the Treasury Regulations, an obligation of a partner (or related person) to make a payment will not be recognized if "the facts and circumstances evidence a plan to circumvent or avoid the obligation."<sup>975</sup> The list of non-exclusive list of factors that may indicate a plan to circumvent or avoid the payment obligation (other than an obligation to restore a deficit capital account upon liquidation of a partnership) include:<sup>976</sup>

(1) The partner (or related person) is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment, including restrictions on transfers for inadequate consideration or on distributions by the partner (or related person) to equity owners in the partner (or related person).

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<sup>973</sup>Treas. Reg. § 1.752-2(b)(3)(ii)(B).

<sup>974</sup> Treas. Reg. § 1.752-2(b)(3)(ii)(D).

<sup>975</sup> Treas. Reg. § 1.752-2(j)(3)(i).

<sup>976</sup> Treas. Reg. § 1.752-2(j)(3)(ii).

(2) The partner or related person is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's (or related person's) financial condition.

(3) The term of the payment obligation ends prior to the term of the partnership liability, or the partner (or related person) has a right to terminate its payment obligation, if the purpose of limiting the duration of the payment obligation is to terminate such payment obligation prior to the occurrence of an event or events that increase the risk of economic loss to the guarantor or benefited party.<sup>977</sup>

(4) There exists a plan or arrangement in which the primary obligor or any other obligor (or a person related to the obligor) with respect to the partnership liability directly or indirectly holds money or other liquid assets in an amount that exceeds the reasonable foreseeable needs of such obligor.

(5) The payment obligation does not permit the creditor to promptly pursue payment following a payment default on the partnership liability, or other arrangements with respect to the partnership liability or payment obligation otherwise indicate a plan to delay collection.

(6) In the case of a guarantee or similar arrangement, the terms of the partnership liability would be substantially the same had the partner or related person not agreed to provide the guarantee.

(7) The creditor or other party benefiting from the obligation did not receive executed documents with respect to the payment obligation from the partner or related person before, or within a commercially reasonable period of time after, the creation of the obligation.

b. The Treasury Regulations include an example of a gratuitous guarantee by a partner that would be disregarded, thereby causing the partnership liability to be nonrecourse debt (not recourse as to the guarantor partner):<sup>978</sup>

In 2020, A, B, and C form a domestic limited liability company (LLC) that is classified as a partnership for federal tax purposes. Also in 2020, LLC receives a loan from a bank. A, B, and C do not bear the economic risk of loss with respect to that partnership liability, and, as a result, the liability is treated as nonrecourse under § 1.752-1(a)(2) in 2020. In 2022, A guarantees the entire amount of the liability. The bank did not request the guarantee and the terms of the loan did not change as a result of the guarantee. A did not provide any executed documents with respect to A's guarantee to the bank. The bank also did not require any restrictions on asset transfers by A and no such restrictions exist.

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<sup>977</sup> For example, termination prior to the due date of a balloon payment or a right to terminate that can be exercised because the value of loan collateral decreases. Treas. Reg. § 1.752-2(j)(3)(ii)(C).

<sup>978</sup> Treas. Reg. § 1.752-2(j)(4).

The example concludes the facts and circumstances evidence a plan to circumvent or avoid the payment obligation pointing to the following factors: (i) the partner is not subject to commercially reasonable contractual restrictions that protect the likelihood of payment; (ii) the partner is not required to provide (either at the time the payment obligation is made or periodically) commercially reasonable documentation regarding the partner's or related person's financial condition to the benefited party; (iii) in the case of the guarantee, the terms of the liability are the same as they would have been without the guarantee; and (iv) the creditor did not receive executed documents with respect to the payment obligation from the partner at the time the obligation was created.

c. In addition to the foregoing, the Treasury Regulations provide an “obligation of any partner or related person to make a payment is not recognized ... if the facts and circumstances indicate that at the time the partnership must determine a partner's share of partnership liabilities ... there is not a commercially reasonable expectation that the payment obligor will have the ability to make the required payments under the terms of the obligation if the obligation becomes due and payable.”<sup>979</sup> “Commercially reasonable expectation” facts and circumstances include factors that a third party creditor would take into account when determining to grant the loan.<sup>980</sup> For this purpose, payment obligors include grantor trusts and disregarded entities (including wholly-owned limited liability companies, qualified subchapter S subsidiaries, and qualified REIT subsidiaries).<sup>981</sup>

d. The Treasury Regulations provide an example of an undercapitalized limited liability company (LLC) that is a disregarded entity for Federal income tax purposes and owned by A. In the example, LLC has no assets and is the general partner of a limited partnership (LP) that has two other partners (B and C) and that has \$300,000 of debt. The partnership agreement provides that only the LLC is required to restore its any deficit in its capital account. The example concludes that A is treated as the partner in the limited partnership but only the LLC has an obligation with respect to the debt of the LP. As such the “commercially reasonable expectation” test is applied to the LLC, not A. As a result, because LLC has no assets, its deficit capital account restoration obligation is not recognized and, the \$300,000 debt is characterized as nonrecourse, allocated among all three partners under section 1.752-3 of the Treasury Regulations.

#### H. Termination of Grantor Trust Status May Cause Gain Due to Partnership Debt

1. Because grantor trust status will be terminated on the death of the grantor or “turned off” by the release of the power causing grantor trust status,<sup>982</sup> changing trustees,<sup>983</sup> or

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<sup>979</sup> Treas. Reg. § 1.752-2(k)(1).

<sup>980</sup> *Id.*

<sup>981</sup> *Id.*

<sup>982</sup> *E.g.*, § 675(4)(C) power.

<sup>983</sup> *E.g.*, § 674(c) power.

repayment of borrowed trust assets,<sup>984</sup> taxpayers must deal with having a trust that will ultimately be considered a separate taxable entity, a non-grantor trust. In the context of partnerships, this normally does not cause adverse tax consequences, but if there is partnership debt, it can, under certain circumstances, trigger gain.

2. As mentioned above, if grantor trust status is terminated during the lifetime of the grantor, a transfer is deemed to occur, and the grantor may recognize gain to the extent the amount the IDGT may owe to the grantor (installment obligation) exceeds the grantor's basis in the assets. For this reason, practitioners advise against terminating grantor trust status while the debt is still outstanding and advise clients to pay off the debt prior to the death of the grantor if at all possible.

3. Gain can also result if grantor trust status is renounced and, due to the creation of a new taxpayer (the trust), it results in a reduction of partnership liabilities of the grantor or the IDGT. Outside basis of the partnership would no longer be calculated across all of the partnership interests and would thus be determined separately. If all of the partnership liabilities are nonrecourse, then no net reduction should occur to either the grantor or the trust. However, if the grantor had guaranteed some partnership debt thereby making such debt recourse as to the grantor, then the loss of grantor trust status would result in a net reduction of partnership liabilities with respect to the trust partner and a deemed distribution on the partnership shares owned by the trust. If there is insufficient outside basis in the trust shares, capital gain would be recognized by the trust.

4. The IRS has ruled that when the grantor of a grantor trust that holds a partnership interest that is subject to liabilities renounces grantor trust status, the grantor is treated as transferring the partnership interest to the trust. When the interest transferred is a partnership interest and the grantor's share of the partnership liabilities is reduced, the grantor is treated as having sold the partnership interest for an amount equal to the grantor's share of the reduced liabilities.<sup>985</sup>

5. The Treasury Regulations also provide that if a taxpayer creates a grantor trust which purchases a partnership interest and the grantor later renounces grantor trust status, then the taxpayer is considered to have transferred the partnership interest to the trust. The taxpayer's share of liabilities that are eliminated as a result of the transfer are considered part of the amount realized for income tax purposes.<sup>986</sup>

6. The loss of grantor trust status due to the death of the grantor should not result in a reduction of partnership liabilities with respect to the IDGT. If anything, it may result in an increase of such liabilities and an increase in basis if the partnership had recourse debt as to the grantor.

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<sup>984</sup> See § 675(c).

<sup>985</sup> Rev. Rul. 77-401, 1977-2 C.B. 215.

<sup>986</sup> Treas. Reg. § 1.1001-2(c), Ex. 5. See also TAM 200011005.

I. Outside Basis Issues with Transfers of Partnership Interests

1. Generally

a. When a donor makes a gratuitous transfer of a partnership interest to a donee, even if the donee is not deemed to be the donor for income tax purposes (e.g., a grantor trust of the donee), generally no gain or loss is recognized on the transfer.<sup>987</sup> The donee has the donor's basis in the interest received, increased by any gift tax paid.<sup>988</sup> The transferred basis is, however, limited to fair market value of the partnership interest, for purposes of determining a loss.<sup>989</sup> Given the foregoing limitation with respect to losses, valuation discounts could, in fact, limit the ability of the donee to recognize a portion of a subsequent loss. In such cases, the partner might be better off having received distributions of partnership assets in-kind and selling such assets, rather than selling the partnership interest itself. The tax difference between selling a partnership interest and selling distributed assets is discussed in more detail later in this outline.

b. If the donor transfers only a portion of his or her partnership interest, only a portion of the donor's unitary outside basis is transferred. One would assume that a pro rata portion of the donor's outside basis would also be transferred to the donee. In other words, if a donor owns a partnership interest having an outside basis of \$100 and the donor gifts 55% to a donee (who is not a grantor trust), then the donee will now own a partnership interest with an outside basis of \$55. Surprisingly, that may not be the case.

c. As mentioned above, Revenue Ruling 84-53,<sup>990</sup> the IRS ruled in the context of calculating outside basis of a transferred partnership interest, "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest."<sup>991</sup> Under this calculation, if the gift of the 55% partnership interest carries a valuation discount (which it should since that reflects fair market value), then the 55% interest would actually transfer less than \$55 of basis.

d. For example, assume a donor has a partnership interest that has a fair market value of \$200 (the value represents a controlling interest in the partnership but reflects

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<sup>987</sup> This assumes that the transfer is not considered a part sale/part gift transfer. Gain, possibly ordinary income under section 751(a) of the Code, but not loss, may be recognized with a part sale/part gift, but only when the sale price exceeds the outside basis of the partnership interest. See § 751(a) and Rev. Rul. 60-351, 1960-2 C.B. 169 (gift accelerated gain on an installment obligation). The sale price would be deemed to include any partnership liabilities deemed to have been transferred. See § 752(d), Rev. Rul. 77-402, 1977-2 C.B. 222 (grantor trust converting to a taxable trust), and *Madorin v. Commissioner*, 84 T.C. 667 (1985).

<sup>988</sup> § 1015(d).

<sup>989</sup> § 1015(a).

<sup>990</sup> Rev. Rul. 84-53, 1984-1 C.B. 159.

<sup>991</sup> *Id.* The ruling relies on Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

some discounts for lack of marketability) and an outside basis of \$100. The donor gifts 45% of his or her partnership interest to a donee. Assume further that 45% transfer carries a valuation discount of 30%. As a result the gift tax value (fair market value) of the transfer is \$63 (reflecting a 30% discount on an interest which has a value before the discount of \$90). Under the formula of Revenue Ruling 84-53, the transferred interest has a fair market value of \$63, and the fair market value of the entire interest is \$200, resulting in only 31.5% of the donor's original basis having been transferred (\$63/\$200). After the transfer, the donee owns 45% of the partnership interest with an outside basis of \$31.50, and the donor retains 55% of the partnership interest but has an outside basis of \$68.50.

$$\begin{array}{rcccl}
 \text{Transferor's} & & \text{Fair Market Value (Discounted)} & & \\
 \text{Adjusted Basis} & & \text{Transferred Portion} & & \\
 \$100 & \times & \underline{\$63} & = & \text{Transferee's} \\
 & & \text{Fair Market Value} & & \text{Adjusted Basis} \\
 & & \text{Transferor's Entire Portion} & & \$31.50 \\
 & & \underline{\$200} & & 
 \end{array}$$

It should be noted, that had the valuation of the donor's interests prior to the transfer included the same valuation discount (30%), then the foregoing formula would have resulted in \$45 of basis apportioned to the transferred interests (a proportionate percentage). It's the fact that the value of the transferor's entire portion has no (or less) valuation discount that causes the "distortion."

e. Many practitioners are surprised by this result, and some have contended that Revenue Ruling 84-53 is not applicable to gratuitous transfers.<sup>992</sup> It is true that Revenue Ruling 84-53 dealt exclusively with the taxable sale of a partnership interests. The ruling also assumed that there was no discount in value of limited versus general partnership interests.<sup>993</sup> This fact may have been the reason why an "equitable apportionment" of basis was done on the basis of the fair market value of the interest conveyed to the transferor's entire uniform basis. To the extent a discount is involved, transferring a lower amount of basis increases gain. In addition, in the case of gifts, allowing discounts to affect the amount of basis conveyed allows manipulation, as later described in this outline. There are some reasons why

<sup>992</sup> See Ellen K. Harrison and Brian M. Blum, *Another View: A Response to Richard Robinson's "'Don't Nothing Last Forever'—Unwinding the FLP to the Haunting Melodies of Subchapter K*," 28 ACTEC J. 313 (2003). In support of their assertion, the authors cite Treasury Regulation section 1.743-1(f) that states, "in the case of the gift of an interest in a partnership, the donor is treated as transferring and the donee is treated as receiving, that portion of the [section 743] basis adjustment attributable to the gifted partnership interest." *But see* Richard B. Robinson, *Comments on Blum's and Harrison's "Another View"*, 28 ACTEC J. 318 (2003).

<sup>993</sup> Situation 2 in the ruling involved a transfer by A of one half of A's general partnership interest and Situation 3 in the ruling involved a transfer by A of A's limited partner interest. Both transfers involved a sale of 1/3 of A's economic interest in the partnership and both were valued at \$10x. Moreover, the ruling misquotes Treas. Reg. § 1.61-6(a) on which it relies. The regulation does not provide that "the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market of the entire interest." The regulation says that "when a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts..."

the basis apportionment rule may be different for gratuitous transfers, including sales to grantor trusts that can be interpreted as gifts for income tax purposes.

f. On the other hand, sales to grantor trusts are structured to be bona fide sale transactions that are nonetheless ignored for income tax purposes. The Code defines the amount of gain as “the excess of the amount realized therefrom over the adjusted basis.”<sup>994</sup> The amount realized is “the sum of any money received plus the fair market value of the property (other than money) received.”<sup>995</sup> Since the amount realized is based on fair market value, it makes perfect sense that the basis of the transferred property (the partnership interest) would also be apportioned based on the fair market value of the property. Similarly, estate, gift, and generation-skipping transfer taxes are based on the “value” of the property transferred, sometimes defining the same in terms of “money or money’s worth.”<sup>996</sup> Value, for these purposes, is 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. Most would agree that this valuation standard for transfer tax purposes is the same as it would be in determining the amount realized for income tax purposes. Thus, there may be some basis for apportioning tax basis of gifted property by referencing the fair market value (including applicable valuation discounts) of the property.

g. Some commentators argue that Revenue Ruling 84-53 specifically refers to section 1.61-6(a) of the Treasury Regulations which provides, “When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts.” They argue that “equitably apportioned” should be interpreted to mean that when a partner transfers 45% of his or her partnership interest, then 45% of the partner’s outside basis should “equitably” pass to the transferee.<sup>997</sup> This produces the same result as in Rev. Rul. 84-53 where it was assumed that general and limited partnership interests had the same value regardless of any differences in right to vote and right to liquidate the partnership. A question arises as to the correct result if (i) all of the partnership interests do not have identical voting rights and economic rights to profits, distributions, and partnership capital, and (ii) if there are limitations or restrictions on a partner’s ability to immediately receive his or her proportionate share of the fair market value of the partnership’s business and assets. What apportionment is equitable where there are differences in partners’ rights?

h. To illustrate why fair market value may be an appropriate way of apportioning outside basis, consider a partnership that holds assets and other underlying business interests having a value of \$10 million.

(1) Scenario 1: The partnership agreement provides for 2 classes of interests: 50 units of Class A-Voting and 50 units of Class B-Non-Voting. The partnership

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<sup>994</sup> § 1001(a).

<sup>995</sup> § 1001(b).

<sup>996</sup> See §§ 2031, 2512 and 2642

<sup>997</sup> See Richard B. Robinson, *Comments on Blum’s and Harrison’s “Another View,”* 28 ACTEC J. 318 (2003) where he correctly points out that “The term ‘equitably apportioned’ has been consistently interpreted to mean ‘divided according to the fair market value of the separate parts.’”

agreement provides that each unit, whether voting or non-voting, is entitled to a pro rata allocation of all profits and partnership distributions, and the partnership will be liquidated according to capital accounts upon the unanimous vote of all of the Class A holders. Donor owns 50 units of Class A, and 50 units of Class B. Assume, Donor’s spouse owns a small interest of Class B, but such interest and its share of partnership capital is ignored for purposes of simplicity (thus, the entity is a partnership for tax purposes, not a disregarded entity). Donor’s unitary capital account is \$10 million, and the outside basis of the of the Donor’s units is \$8.0 million. Assume that the Class B units are entitled to a 30% valuation discount. If Donor gifts 50 units of Class B (50% of Donor’s units, having a fair market value of \$3.5 million), then the transferee will receive \$5 million of capital account.

(a) With regard to basis, if one follows Revenue Ruling 84-53, the transferee will succeed to \$2.65 of basis (with donor retaining \$5.35 million of basis), as follows:

$$\begin{array}{r}
 \text{Transferor's} \\
 \text{Adjusted Basis} \\
 \underline{\$8,000,000}
 \end{array}
 \times
 \frac{\begin{array}{c} \text{Fair Market Value (30\% Discount)} \\ \text{Transferred Portion} \\ \underline{\$3,500,000} \end{array}}{\begin{array}{c} \text{Fair Market Value} \\ \text{Transferor's Entire Portion} \\ \underline{\$10,000,000} \end{array}}
 =
 \begin{array}{r}
 \text{Transferee's} \\
 \text{Adjusted Basis} \\
 \underline{\$2,650,000}
 \end{array}$$

(b) If one ignores the ruling and apportions basis proportionately (the same way capital account is apportioned), then the transferee would succeed to \$4.0 million of basis (50% of the Donor’s total basis):

$$\begin{array}{r}
 \text{Transferor's} \\
 \text{Adjusted Basis} \\
 \underline{\$8,000,000}
 \end{array}
 \times
 \begin{array}{c}
 \text{Percentage} \\
 \text{Transferred} \\
 \underline{50\%}
 \end{array}
 =
 \begin{array}{r}
 \text{Transferee's} \\
 \text{Adjusted Basis} \\
 \underline{\$4,000,000}
 \end{array}$$

(c) If an independent third party purchased the 50 Class B-Non-Voting units from the transferee for cash, the purchaser would not pay \$5.0 million (because the units have no voting rights and are unmarketable). It would presumably pay \$3.5 million for the Class B units. Under Revenue Ruling 84-53, the seller would recognize \$850,000 of gain. On the other hand, if the proportionate rule for basis is used then the seller would actually recognize a \$500,000 of loss, which does not seem reasonable since the transferor held appreciated partnership interest before the gift.<sup>998</sup> However, as shown in the example below discussing the possible use of incomplete gift non-grantor trusts, if the sequence of transfers is changed, the same artificial loss is possible. Similarly, there could be an “artificial” loss if basis was allocated based on relative fair market values and shortly thereafter the partnership was liquidated and distributions were made in accordance with capital accounts. The transferee who had a basis in her interest that was higher than her share of capital accounts might realize a loss,

<sup>998</sup> While not applicable under these facts, if the purchaser had to make a purchase price allocation under section 1060 of the Code (to determine tax liability of the seller and to determine the new basis of the purchased business assets), the Code mandates that the price allocated to an asset may not be more than the fair market value (willing buyer/willing seller) of such asset.

assuming that cash or assets treated as cash were distributed so that the substituted basis rules did not apply to the liquidation.

(2) Scenario 2: The partnership agreement provides for 2 classes of interests: 100 units of Class A Preferred-Voting and 100 units of Class B Common-Non-Voting. The partnership agreement provides the Class A Preferred units have a liquidation preference of \$4.0 million and an annual cumulative preferred yield of 12%, and the Class B Common units are entitled to any excess profits or return on the partnership assets after taking into account the economic rights of Class A. Donor owns 100 units of Class A, and 100 units of Class B. Assume, Donor’s spouse owns a small interest of Class B, but such interest and its share of partnership capital is ignored for purposes of simplicity (thus, the entity is a partnership for tax purposes, not a disregarded entity). Donor’s unitary capital account is \$10 million, and the outside basis of the of the Donor’s units is \$8.0 million. Assume that the Class B units are entitled to a 40% valuation discount. If Donor gifts 100 units of Class B (fair market value of \$3.6 million), then the transferee will receive \$6.0 million of capital account (because a liquidation of the partnership at the time of the transfer would limit the Class A units to \$4.0 million of partnership property). How should the outside basis be “equitably” apportioned to the transferred Class B units? The Class A and Class B do not have identical economic rights to partnership property, profits, and distributions (not to mention Class A has voting rights and Class B does not).

(a) One option is to apportion the basis according to capital accounts, so \$4.8 million (60% of the \$8 million of outside basis) will pass to the transferee of the Class B units. However, that again presumes that Class A and Class B have identical economic rights under the partnership agreement. They do not. While the holders of Class B may have \$6.0 million of capital account, they do not have the right to liquidate the partnership. Further, consider that the 12% cumulative preferential distribution might have been gifted when preferred rates are much lower. Said another way, given how high the Class A preferential rate is, there is a chance that all partnership profits (and perhaps partnership property) will be needed to satisfy the 10% preferred distribution. Based on these facts, apportioning according to capital account balances does not seem reasonable.

$$\begin{array}{r}
 \text{Transferor's} \\
 \text{Adjusted Basis} \\
 \underline{\$8,000,000}
 \end{array}
 \times
 \frac{
 \begin{array}{r}
 \text{Fair Market Value (Discounted)} \\
 \text{Transferred Portion} \\
 \underline{\$3,600,000} \\
 \text{Fair Market Value} \\
 \text{Transferor's Entire Portion} \\
 \underline{\$10,000,000}
 \end{array}
 }{
 }
 =
 \begin{array}{r}
 \text{Transferee's} \\
 \text{Adjusted Basis} \\
 \underline{\$2,880,000}
 \end{array}$$

2. Estate Planning Implications

a. The income and estate planning implications are significant. In the example above, the result is the donor retains a disproportionate amount of the basis, and the donee receives less. If the donee is in a lower income tax bracket or resides in a state (or is a resident non-grantor trust of such state) that has no state income tax and if the donor is in a higher income tax situation, a taxable event like the sale of the partnership interests (or the sale of the assets of the partnership followed by a distribution of the assets) would generally result in less taxes to be paid when compared to having the donor be the sole taxpayer. In addition, if the donee is near death, then holding a lower basis asset provides more potential for a “step-up” in basis.

b. Often, however, the donor is in the senior generation and is wealthier than the donee. Under those circumstances, how can this distortion in basis be used, assuming it would be preferred that the donor retain less basis (for a potential “step-up” in basis) and the donee receive more basis. Consider the following:

(1) As in the first example in the previous section, donor owns a partnership interest that has a fair market value of \$200 and an outside basis of \$100. Transfers of minority interest in the partnership are entitled to a 30% valuation discount.

(2) The donor transfers a 45% interest to a DING, NING, or other incomplete gift non-grantor trust.<sup>999</sup> A properly structured incomplete gift non-grantor trust has the following features:

(a) The trust not a grantor trust (although the grantor is a permissible beneficiary of the trust);

(b) Contributions to the trust by the grantor are not completed gifts for Federal gift tax purposes; and

(c) The assets of the trust are includible in the grantor’s gross estate upon the grantor’s death, although the corpus is subject to a testamentary special power of appointment held by the grantor.

(3) After the initial transfer to the incomplete gift non-grantor trust, the donor gifts the remainder of his or her partnership interests (55% interest) to an IDGT.

(4) For basis purposes, based on Revenue Ruling 84-53, the non-grantor trust (the assets of which will be includible in the estate of the donor at death) has a partnership interest with an outside basis of \$31.50 (although representing 45% of the donor’s interest). The IDGT (the assets of which are not includible in the donor’s estate), on the other hand, has a partnership interest with an outside basis of \$68.50 (representing 55% of the donor’s

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<sup>999</sup> The same result could be achieved if the donor transfers the interest to the donor’s spouse although in that case the basis adjustment would occur, of course, on the spouse’s death rather than the death of the grantor. *See* § 1041(b).

interest). Thus, a disproportionate amount of basis ends up passing with the partnership interest that is out of the donor's estate, while the partnership interest that remains in the estate is poised to get a disproportionately large "step-up" in basis (particularly, if as discussed above, certain measures are taken to reduce or eliminate the valuation discounts attributable to the partnership interest in the non-grantor trust).

J. Allocation of Tax Items and the Varying Interest Rule

1. Pass-Through Taxation

a. The pass-through nature of partnerships is established by section 701 of the Code which provides, "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."<sup>1000</sup> The allocated income (or loss) is credited to the individual partner's capital account (discussed in more detail later), and is taxed to the partner without regard to when or whether the income is ever distributed to the partner.<sup>1001</sup>

b. Section 702 of the Code establishes the concept of distributive share, mandating, "In determining his income tax, each partner shall take into account separately his distributive share of the partnership's"<sup>1002</sup> tax items including capital gains and losses, gains and losses from section 1231 property, taxes, and other taxable income. While section 702(a) of the Code specifically lists specific tax items that must be separately stated and reported the partners, the Code permits the Treasury Regulations to require the separate statement of other tax items,<sup>1003</sup> and there is a long list of such items.<sup>1004</sup> The partnership provides each partner with a Schedule K-1 listing the share of each separately stated item and the share of partnership profits and losses that are not separately stated.

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<sup>1000</sup> § 701. *See also* Treas. Reg. § 1.701-1.

<sup>1001</sup> *See U.S. v. Basye*, 410 U.S. 441 (1973).

<sup>1002</sup> § 702(a).

<sup>1003</sup> § 702(a)(7).

<sup>1004</sup> *See* Treas. Reg. 1.702-1(a)(8).

2. Allocation of Tax Items among Partners

a. Section 704(a) of the Code provides that a “partner’s distributive share of income, gain, loss, deduction, or credit shall ... be determined by the partnership agreement.”<sup>1005</sup> Section 704(b) of the Code then provides that the allocation is determined by the “interest in the partnership,”<sup>1006</sup> under all the facts and circumstances, if the partnership agreement does not provide for the allocation,<sup>1007</sup> or if the allocation does not have “substantial economic effect.”<sup>1008</sup>

b. In order to ensure the validity of a partnership’s allocation of tax items, many family partnership agreements are written to satisfy the “substantial economic effect” test,<sup>1009</sup> which requires (i) that the allocations must have economic effect, and (ii) the economic effect must be substantial. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. According to the Treasury Regulations, this means “in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.”<sup>1010</sup> The economic effect of an allocation will be deemed substantial if there is a reasonable probability that the allocation will affect substantially the dollar amount to be received by the partners from the partnership, independent of the tax consequences.<sup>1011</sup>

c. The “safe harbor” Treasury Regulations provide that allocations will have economic effect if:<sup>1012</sup>

(1) The partnership maintains capital accounts (discussed in more detail below) under section 1.704-1(b)(2)(iv) of the Treasury Regulations;

(2) Upon liquidation of the partnership (or any partner’s interest in the partnership), liquidating distributions are required to be made in accordance with the positive capital account balances of the partners; and

(3) Either:

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<sup>1005</sup> § 704(a).

<sup>1006</sup> § 704(b).

<sup>1007</sup> § 704(b)(1).

<sup>1008</sup> § 704(b)(2).

<sup>1009</sup> Treas. Reg. § 1.704-1(b)(2)(i).

<sup>1010</sup> Treas. Reg. § 1.704-1(b)(2)(ii)(a).

<sup>1011</sup> Treas. Reg. § 1.704-1(b)(2)(iii).

<sup>1012</sup> Treas. Reg. § 1.704-1(b)(2)(ii)(b). In addition, allocations that are attributable to property secured by nonrecourse debt required to comply with additional requirements.

(a) Each partner is unconditionally obligated to restore any deficit in such partner's capital account on liquidation of the partnership; or

(b) The partnership agreement has a "qualified income offset" provision.<sup>1013</sup>

d. If allocations do not fall under the foregoing safe harbor provisions, they will be deemed to have economic effect provided that as of the end of each partnership taxable year, a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if the foregoing requirements above had been satisfied. This is referred to as the economic effect equivalence.<sup>1014</sup> This would be similar to an approach that some partnerships employ called "targeted allocations." Targeted allocations assume a hypothetical liquidation at the end of each accounting period where it is determined what each partner would receive if all of the partnership assets are sold for cash as each asset is valued under section 704(b) of the Code. The hypothetical cash proceeds are distributed in liquidation of the partnership under the distribution provisions of the partnership agreement. Once that amount is determined, each partner is allocated section 704(b) profits and losses so that the partner's capital account balance at the end of the period is equal to the amount of cash the partner would have received in the hypothetical liquidation. The IRS has not formally blessed targeted capital account allocations as qualifying under the economic effect equivalence rule.<sup>1015</sup>

e. If the partnership agreement does not address allocations or the allocations do not have substantial economic effect, allocations will be made according to each partner's economic interest in the item of income or deduction, based on the facts and circumstances (referred to as the "partner's interest in the partnership" or "PIP").<sup>1016</sup> In determining the PIP, the Treasury Regulations point to the partner's capital contributions to the partnership and the partner's interest in the economic profits and losses (if different from his or her interest in the taxable income and losses), cash flow, non-liquidating distributions, and liquidating distributions of capital.<sup>1017</sup> Generally, a PIP (and thus allocations hereunder) will be based on the amount the partner would receive if the partnership liquidated and distributed all of its assets.

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<sup>1013</sup> See Treas. Reg. § 1.704-1(b)(2)(ii)(d). Generally, if a partner unexpectedly receives certain adjustments, allocations, or distributions (relating to depletion allowances, changes in the partner's interest in the partnership, a partnership loss related to section 751(b) property, or adjustments under the family partnership rules of section 704(e)(2) of the Code) and it causes a deficit capital account balance for the partnership, a qualified income offset provision will allocate as quickly as possible items of income and gain in an amount and manner sufficient to eliminate that deficit capital account balance.

<sup>1014</sup> See Treas. Reg. § 1.704-1(b)(2)(ii)(i).

<sup>1015</sup> See Treas. Reg. § 1.704-1(b)(2)(ii)(h)(i) and Proposed Treasury Regulations under section 707(a)(2)(A) of the Code, REG-11452-14, 80 Fed. Reg. 43,652 (July 23, 2015). The preamble requests comments on the impact of targeted allocations on certain allocations but then provides "[n]o inference is intended as to whether and when targeted capital account agreements could satisfy the economic effect equivalence rule."

<sup>1016</sup> Treas. Reg. § 1.704-1(b)(3)(i).

<sup>1017</sup> Treas. Reg. § 1.704-1(b)(3)(ii).

f. For a variety of reasons, very few family partnership agreements provide for allocations based on targeted allocations or allocations based on PIP. Further, while there are some instances (i.e., preferred partnership structures) pursuant to which family partnerships can allocate profits disproportionately to some partners than others or allocate losses differently than profits, in the estate planning context, most partnerships are structured as “pro rata” or single class share partnerships because of the “same class” exception under section 2701(a)(2)(B) of the Code. With respect to this exception, the Treasury Regulations provides, “[a] class is the same class as is (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).”<sup>1018</sup> As such, most family partnerships will provide for allocations of profit and loss based upon each partner’s capital account balance, which is essentially each partner’s net equity in the partnership. The capital account rules are discussed in the next section of these materials.

### 3. Sales of Partnership Interests, Gifts, and the Varying Interest Rule

#### a. Varying Interest Rule

(1) Section 706(d)(1) of the Code provides, “if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.”<sup>1019</sup> This is commonly referred to as the “varying interest rule.” This rule prohibits a partnership from making retroactive allocations of a full share of partnership items for a tax year to persons who were partners in the partnership for only a portion of the tax year.

(2) Notwithstanding the prohibition against making retroactive allocations if partnership interests vary during the year, the Treasury Regulations permit amendments to the partnership agreement after the close of the tax year to make changes among contemporaneous partners for the entire taxable year (or among contemporaneous partners for a segment if the item is entirely attributable to a segment).<sup>1020</sup> That being said, if the partnership agreement is amended to reflect a non-pro rata contribution of additional capital to the partnership by one or more existing partners, the interests of noncontributing partners are considered “otherwise” reduced within the meaning of section 706(c)(2)(B) of the Code, and the varying interest rule applies.

(3) The varying interest rule does not apply to gifts of partnership interests and sales of partnership interests to certain family members (or trusts for the same).

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<sup>1018</sup> Treas. Reg. § 25.2701-1(c)(3).

<sup>1019</sup> § 706(d)(1).

<sup>1020</sup> Treas. Reg. 1.706-4(b)(1). See § 761(c) allowing amendments to a partnership agreement after the close of the taxable year.

Allocations of partnership income, in those instances, are governed by the family partnership rules (discussed below).

(4) Section 706(c)(2)(A) of the Code provides that if a partner sells its entire interest in its partnership, the taxable year of the partnership closes with respect to the partner. On the other hand, section 706(c)(2)(B) of the Code provides if a partner sells less than his entire interest, the taxable year of the partnership does not close.

(5) For tax years in which there is a variation in a partner's interest (either because the partner has disposed of a partial or entire interest in the partnership or because the partner's interest has been reduced), the regulations provide the following ten-step process for determining the partners' distributive shares of items subject to allocation under the varying interest rule.<sup>1021</sup> A complete discussion of the steps is beyond the scope of these materials, but some discussion about the methodology is warranted:

(a) The partnership can apply either an interim closing method or proration method with respect to each variation in interest. The interim closing method is the default method, but proration can be applied if there is an agreement of the partners.<sup>1022</sup>

(b) "Extraordinary items" cannot be prorated, but must be allocated among the partners in proportion to their interests in the partnership item at the time of day on which the extraordinary item occurred. Extraordinary items include, in pertinent part:<sup>1023</sup> (i) any item from the disposition or abandonment (other than in the ordinary course of business) of a capital asset; (ii) any item from the disposition or abandonment (other than in the ordinary course of business) of section 1231(b) property; (iii) any item from the discharge or retirement of debt, except certain instances that are subject to special allocation rules as provided in sections 108(e)(8) or 108(i) of the Code; and (iv) any other item if there is an "agreement of the partners" to treat the item as an extraordinary item for the tax year, provided it does not result in a substantial distortion of income in any partner's return.<sup>1024</sup>

(c) Absent an agreement of the partners to perform regular monthly or semi-monthly interim closings, the only interim closings during the partnership's tax year will be at the deemed time of the occurrence of variations for which the partnership uses the interim closing method. If there is an interim closing during the year, the partnership tax year is delineated into "segments" of the tax year. The partnership tax items are allocated among the segments and in which the items can be further prorated.

(d) A special rule applies to allocable cash items. Under section 706(d)(2) of the Code, allocable cash basis items (interest, taxes, rents, payments for services, and other items specified Treasury Regulations)<sup>1025</sup> are allocated among the partners on

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<sup>1021</sup> See Treas. Reg. §§ 1.706-4(a)(3) and (a)(4).

<sup>1022</sup> See Treas. Reg. § 1.706-4(f).

<sup>1023</sup> Treas. Reg. § 1.706-4(e)(2).

<sup>1024</sup> See Treas. Reg. § 1.706-4(e)(2)(ix).

<sup>1025</sup> See REG-109370-10, 80 Fed. Reg. 45,905 (Aug. 3, 2015)

essentially an accrual basis. Section 706(d)(2)(A) of the Code provides these cash basis items are allocated to each day in the tax period in which the item was accrued.

b. Gifts, Sales, and Allocations under the Family Partnership Rules

(1) The Treasury Regulations provide that a transfer of a partnership interest by gift does not close the partnership year with respect to the donor, and that income up to the date of the gift attributable to the donor's interest should be allocated to the donor in accordance with section 704(e)(1) of the Code.<sup>1026</sup> Section 704(e) of the Code, in turn, provides that the donee will include in gross income his or her distributive share under the partnership agreement, “except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital.”<sup>1027</sup>

(2) Pursuant to the foregoing, if capital income is a material income-producing factor and the donee's ownership is real, the partnership's income may be allocated among the partners by first, providing reasonable compensation for services rendered by the donor and ensuring that the donee's income attributable to capital is proportionate to the donor's capital. To the extent the distributive share of the donee is not so allocated, the Treasury Regulations provide, “the distributive shares of the partnership income of the donor and donee shall be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of such income (other than a reasonable allowance for the services, if any, rendered by the donee) to the partnership capital of the donor and donee. The portion of income, if any, thus attributable to partnership capital for the taxable year shall be allocated between the donor and donee in accordance with their respective interests in partnership capital.”<sup>1028</sup> As such, pro rata allocations according to capital account balances (equal to the amount of capital that would be distributed to the partner upon liquidation of the partnership) should be respected. It is unknown how this provision might be applied to preferred partnership structure, which generally provide that a preferred return must be matched by a corresponding allocation of income or gain. The Treasury Regulations provide, in the context of the disguised sale rules, that a preferred return means “a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.”<sup>1029</sup>

(3) In addition, the Code goes on to provide that an interest purchased by a family member will, for this rule, be considered transferred by gift from the seller, and “the fair market value of the purchased interest shall be considered to be donated capital.”<sup>1030</sup> Family of an individual includes his or her “spouse, ancestors, and lineal

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<sup>1026</sup> Treas. Reg. § 1.706-1(c)(5).

<sup>1027</sup> § 704(e)(1).

<sup>1028</sup> Treas. Reg. § 1.704-1(e)(3)(i)(b).

<sup>1029</sup> Treas. Reg. § 1.707-4(a)(2).

<sup>1030</sup> § 704(e)(2).

descendants, and any trusts for the primary benefit of such persons.”<sup>1031</sup> Thus, a taxable purchase of a partnership interest by a family member (or trust for the benefit of such family member) will be treated as a gift for purposes of section 704(e) of the Code. This would include, in all circumstances, a transfer due to the termination of grantor trust status which would likely be considered a transfer by gift or a taxable sale to the extent there is debt in excess of basis.

(4) The Treasury Regulation provide, “Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and whether the donee has dominion and control over such interest, must be ascertained from all the facts and circumstances of the particular case.”<sup>1032</sup> Control by the donee has been held to mean the donee’s participation in the partnership activities and with respect to the partnership interest as a property right.<sup>1033</sup> Further, actual distribution to a donee partner of the “entire amount or a major portion of his distributive share of the business income... is substantial evidence of the reality of donee’s interest.” The Treasury Regulations provide that when a donor has retained certain controls over the gifted interest and the donee has little control over the gifted interest, then for distributive share purposes, the donor will be treated as remaining the owner of the interest.<sup>1034</sup> These retained powers include the control over distributions, liquidations, assets outside the partnership that are essential to the business of the partnership, and management inconsistent with normal relationships among partners.<sup>1035</sup>

(5) Notwithstanding the foregoing, the vast majority of family partnerships are limited partnership or limited liability companies. Non-managing members and limited partners generally do not have unlimited rights and powers. To that end, the Treasury Regulations provide:

To be recognized for Federal income tax purposes, a limited partnership must be organized and conducted in accordance with the requirements of the applicable State limited-partnership law. The absence of services and participation in management by a donee in a limited partnership is immaterial if the limited partnership meets all the other requirements prescribed in this paragraph. If the limited partner's right to transfer or liquidate his interest is subject to substantial restrictions (for example, where the interest of the limited partner is not assignable in a real sense or where such interest may be required to be left in the business for a long term of years), or if the general partner retains any other control which substantially limits any of the rights which would ordinarily be exercisable by unrelated limited partners in normal business relationships, such restrictions on the right to transfer or liquidate, or retention of other control, will be considered strong evidence as to the lack of reality of ownership by the donee.

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<sup>1031</sup> *Id.*

<sup>1032</sup> Treas. Reg. § 1.704-1(e)(2)(i).

<sup>1033</sup> *Pflugradt v. U.S.*, 310 F.2d 412 (7th Cir. 1962).

<sup>1034</sup> Treas. Reg. § 1.704-1(e)(2)(ii).

<sup>1035</sup> Treas. Reg. § 1.704-1(e)(2)(ii)(a) through (d).

(6) Section 761(b) of the Code provides, “In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person.”<sup>1036</sup> The Treasury Regulations provide:<sup>1037</sup>

Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.

(7) For purposes of section 704(e), a “capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.”<sup>1038</sup>

(8) If the partnership interest is gifted to a trust (or sold to a trust for the benefit of a family member) and if the trustee is unrelated to and independent of the grantor, then the trust will likely be recognized as the legal owner of the partnership interest, “unless the grantor has retained controls inconsistent with such ownership.”<sup>1039</sup> If the grantor (or a person amenable to the grantor’s will) is the trustee, “the trust may be recognized as a partner only if the grantor (or such other person) in his participation in the affairs of the partnership actively represents and protects the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate such interests to the interests of the grantor.”<sup>1040</sup> In addition, other factors will be considered including whether the trust is recognized as a partner in business dealings with customers and creditors, and whether the trust’s share of the partnership income not retained for the businesses’ reasonable needs is distributed to the trust annually and used or reinvested solely for the beneficiaries’ interests.<sup>1041</sup> In one case,<sup>1042</sup> the court held when a donor conveyed a partnership interest to a trust for which he served as trustee, the trust did not become a partner for federal tax purposes because there was no evidence that: (i) the donor actively represented the trust as an independent factor in the management and operation of the business (metal parts manufacturer), and (ii) the trust was held out as a partner to customers or creditors.

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<sup>1036</sup> § 761(b).

<sup>1037</sup> Treas. Reg. 1.704-1(e)(1)(iv). *See also* Ketter v. Commissioner, 70 T.C. 637 (1978).

<sup>1038</sup> Treas. Reg. 1.704-1(e)(1)(v).

<sup>1039</sup> Treas. Reg. 1.704-1(e)(2)(vii).

<sup>1040</sup> *Id.*

<sup>1041</sup> *Id.*

<sup>1042</sup> *Ginsberg v. Commissioner*, 502 F.2d 965, 966 (6th Cir. 1974).

In addition the partnership agreement did not provide any right to sell its partnership, and although trust could withdraw from the partnership, it could do so without allowance for goodwill, trade names, patents or other tangible assets.

K. Capital Accounts and Estate Planning

1. Generally

a. As noted above, one of the central concepts in partnership taxation is each partner's "capital account." The capital account maintenance rules are not based on generally accepted account principles but are based on the Treasury Regulations under section 704(b) of the Code, relating to allocations of partnership tax items.

b. In effect, the Treasury Regulations use a partner's capital account as a yardstick to measure the partner's economic interest in the partnership property at any given point and time. Stated simplistically, a partner's capital account reflects the amount of equity invested in the partners and is adjusted to reflect the ongoing profits and losses of the partnership. Thus, if the partnership is liquidated at some point, it reflects the amount the partner would receive upon liquidation of the partnership, assuming all partnership assets were disposed of at their book value.

c. A full discussion of the capital account maintenance rules is beyond the scope of this outline, but some discussion is warranted.

(1) Each partner's capital account is increased by:<sup>1043</sup>

(a) The amount of money contributed to the partnership by the partner;

(b) The fair market value of property contributed to the partnership by the partner, net of any liabilities that the partnership assumes or takes subject to; and

(c) Allocations to the partner of items of partnership income and gain, including tax-exempt income.

(2) Each partner's capital account is decreased by:<sup>1044</sup>

(a) the amount of money distributed by the partnership to the partner;

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<sup>1043</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(b).

<sup>1044</sup> *Id.*

(b) the fair market value of property distributed by the partnership to the partner, net of any liabilities that the distributee partner assumes or takes the distributed property subject to; and

(c) allocations to the partner of items of partnership loss and deduction and partnership expenditures that are neither deductible by the partnership in computing its taxable income nor properly chargeable to capital account.

(3) Partnership agreements may provide that the partner's capital accounts will be adjusted to reflect a revaluation of partnership property, but such adjustments must be based on the fair market value of the partnership's properties (assuming for these purposes that the value of the property is not less than any indebtedness on the property) and must reflect the manner in which gain or loss (not previously reflected in capital account balances) would be allocated to the partnership if each partnership property were sold at its fair market value in a taxable transaction.<sup>1045</sup> The adjustments are deemed to be made principally for a substantial non-tax business purpose under the following circumstances:<sup>1046</sup>

(a) in connection with a contribution of money or property to the partnership by a new or existing partner in exchange for an interest in the partnership;

(b) in connection with the liquidation of the partnership or a distribution of money or other property by the partnership to a retiring or continuing partner as consideration for an interest in the partnership;

(c) in connection with the grant of an interest in the partnership, 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;

(d) in connection with the issuance by the partnership of a non-compensatory option; or

(e) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

d. The Treasury Regulations provide, "a partner who has more than one interest in a partnership shall have a single capital account that reflects all such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired."<sup>1047</sup> This one capital account rule presumably would apply if the partner held preferred and common interests in a partnership and

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<sup>1045</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(f)(1) and (2).

<sup>1046</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5).

<sup>1047</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(b).

would apply if the partner is deemed to own interests held by an IDGT pursuant to Revenue Ruling 85-13.<sup>1048</sup>

## 2. Capital Accounts and Transfers of Partnership Interests

a. The Treasury Regulations provide that “upon the transfer of all or a part of an interest in the partnership, the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner.”<sup>1049</sup> The Treasury Regulations contain a simple example<sup>1050</sup> pursuant to which a partner sells half of the partner’s interest in a general partnership (representing a 25% interest in the partnership) for \$10,000. At the time of the transfer, the general partnership held \$40,000 in cash and securities, and the transferring partner’s capital account prior to the transfer was \$11,000. The example provides, in accordance with the Treasury Regulations “the partnership agreement provides” the transferee “inherits 50 percent of”<sup>1051</sup> the transferor’s capital account balance. Thus, the transferee inherits a capital account of \$5,500. In other words, the Treasury Regulations seem to take the position that the portion of the transferor’s capital account that carries over to the transferee equals the percentage of the transferor’s total interest that is sold. In other words, when only a portion of a partner’s interest is transferred and the partnership is a pro rata partnership, then the amount of capital account carried over to the transferee is in direct proportion to the amount transferred and retained. Thus, for example, if the transferor’s capital account was \$200 prior to the transfer and the transferor transferred (by gift or sale) 45% of his or her interest, then \$90 of capital account carries over to the transferee:

$$\begin{array}{rcccl} \text{Transferor's} & & \text{Percentage} & & \text{Transferee's} \\ \text{Capital Account} & & \text{Transferred} & & \text{Capital Account} \\ \hline \$200 & \times & 45\% & = & \$90 \end{array}$$

b. As mentioned in the above, however, this is not how the calculation of transferred outside basis is calculated under Revenue Ruling 84-53.<sup>1052</sup> In this example, assume the donor’s partnership interest has a fair market value of \$200 (for simplicity’s sake, assume the fair market value is equal to the transferor’s capital account) and an outside basis of \$100. When the transferor transfers 45% of his or her partnership interest and if the transfer carries a valuation discount of 30% (discounted value of \$63.00), then only \$31.50 of outside basis is deemed to have been transferred (not \$45.00), as follows:

<sup>1048</sup> See Rev. Rul. 85-13, 1985-1 C.B. 184.

<sup>1049</sup> Treas. Reg. §§ 1.704-1(b)(2)(iv)(I) and 1.704-1(b)(5), ex. 13.

<sup>1050</sup> Treas. Reg. § 1.704-1(b)(5), Ex. 13.

<sup>1051</sup> *Id.*

<sup>1052</sup> Rev. Rul. 84-53, 1984-1 C.B. 159.

$$\begin{array}{rcccl}
 & & \text{Fair Market Value (Discounted)} & & \\
 & & \text{Transferred Portion} & & \\
 \text{Transferor's} & & \$63 & & \text{Transferee's} \\
 \text{Adjusted Basis} & \times & \hline & = & \text{Adjusted Basis} \\
 \$100 & & \text{Fair Market Value} & & \$31.50 \\
 & & \text{Transferor's Entire Portion} & & \\
 & & \$200 & & 
 \end{array}$$

Clearly, this will have a direct impact on the gain recognized by the transferor if the transfer is a taxable sale and if the transfer is a gift, the amount of basis carried over to the donee.

c. The calculation of transferred capital account is straightforward when dealing with a partnership that has only one class of partnership interest (each partner holds a static percentage of the profits, losses, and capital of the partnership). However, it becomes more complicated when dealing with partnerships that have multiple classes of interests (e.g., preferred and common interests or profits and capital interests). For example, if a partner contributes \$100 to a partnership, in exchange for 10% of the future profits of the partnership and 10% of the capital of the partnership, how much capital account would be transferred if the partner then made a gift of the profits interest but retained the right to receive a return of the capital upon liquidation of the partnership. It would seem in this situation that no capital account should pass to the donee and the donor would retain \$100 of the capital account, notwithstanding the profits interest transferred might have significant value for gift tax purposes.<sup>1053</sup> As the Treasury Regulations provide in the context of the family partnership provisions of section 704(e) of the Code, “a capital interest in a partnership means an interest in the assets of the partnership, which is distributable to the owner of the capital interest upon his withdrawal from the partnership or upon liquidation of the partnership. The mere right to participate in the earnings and profits of a partnership is not a capital interest in the partnership.”<sup>1054</sup> If no capital account is allocated to a transferred profits interest, should outside basis be allocated to it under Revenue Ruling 84-53 because it has some value?<sup>1055</sup>

### 3. Capital Accounts, Liquidations, and Redemptions

a. It’s clear that capital accounts, when properly maintained, determine how much partnership property will be received by the partner upon liquidation of the partnership. However, it’s not as clear how much property a partner should receive upon a complete or partial redemption of such partner’s interest, particularly in the family and estate planning context.

b. If a partnership completely redeems a partner’s interest, must the partner receive property equal in value to the partner’s entire capital account balance or must the partnership distribute property equal in value to the fair market value of the interest, which might

<sup>1053</sup> See CCA 201442053. See also, Richard Dees, *Is Chief Counsel Resurrecting the Chapter 14 “Monster,”* 145 TaxNotes 1279 (Dec. 15, 2014).

<sup>1054</sup> Treas. Reg. § 1.704-1(e)(1)(v).

<sup>1055</sup> For an excellent discussion of the complexities of identifying a partner’s interest in profits and capital, see Sheldon I. Banoff, *Identifying Partners’ Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, 85 Taxes-The Tax Magazine 197 (March 2007).

include significant discounts in value? What value should be distributed if it is a partial redemption, fair market value (including valuation discounts) or capital account balance (not including discounts)? The answer significantly affects the economics of many estate planning transfers. For example, assume a partnership owns property with a fair market value of \$1,000,000. After a series of estate planning transfers, the partnership is owned 40% by the grantor and 60% by non-grantor trusts for the benefit of the grantor's children. If the partnership makes a full redemption of the grantor's interest at a discounted value (assume a 45% discount), then the grantor will receive \$220,000, rather than \$400,000. This redemption at discounted value creates a shift in value of \$180,000 for the benefit of the non-grantor trusts.

c. Is this a taxable gift? How are the capital accounts of the remaining partners affected? If capital accounts are properly maintained, does a "capital shift" occur and what are the tax ramifications of that shift? As Sheldon Banoff writes, "a 'capital shift' occurs when one or more partners directly or indirectly give up their right to a portion of their capital interest to one or more other existing partners. As a result, the transferor partner's right to repayment of capital is reduced, while the transferee partner's right to capital increases. The meaning, relevance and impact of 'capital shifts' in the analysis of partnership ownership realignments is far from clear."<sup>1056</sup>

d. On the gift tax issue, the Treasury Regulations provide that a bona fide sale, exchange, or other transfer of property, in the ordinary course of business will not constitute a gift:

Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefor. However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth.<sup>1057</sup>

The courts have, however, held that if the transaction is between family members, special scrutiny is required, and the presumption is that the transfer is a gift.<sup>1058</sup> The Treasury Regulations provide that if a corporation makes a transfer to shareholder B for less than full and adequate consideration, the other shareholders are deemed to have made a gift to B (but only to the extent it exceeds B's own interest in such amount as a shareholder). Further, a transfer by B

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<sup>1056</sup> Sheldon I. Banoff, *Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalization and Conversions: What Are the Tax Consequences?*, 83 Taxes-The Tax Magazine 105 (March 2005).

<sup>1057</sup> Treas. Reg. § 25.2512-8.

<sup>1058</sup> See *Cavallaro v. Commissioner*, T.C. Memo 2014-189, *Harwood v. Commissioner*, 82 T.C. 238 (1984), *aff'd*, 786 F.2d 1174 (9<sup>th</sup> Cir. 1986) and *Estate of Reynolds v. Commissioner*, 55 T.C. 172 (1970).

to a corporation for less than full and adequate consideration will be treated as a gift by B to the other shareholders to the extent of their proportionate interests in the corporation.<sup>1059</sup>

e. In this context, the courts have consistently held that fair market value is based on the willing buyer/willing seller standard, which necessarily requires consideration of valuation discounts and premiums when warranted by the facts and circumstances. For example, in *Estate of Mary D. Maggos v. Commissioner*,<sup>1060</sup> the Tax Court held that a complete redemption of one of the shareholders of a closely held corporation for less than the fair market value of the stock was a gift by the redeemed shareholder to the sole remaining shareholder (the son of the redeemed shareholder). The Tax Court determined that the fair market value, after taking into account a control premium and a discount for lack of marketability (which were deemed to offset each other), of the redeemed stock was \$4.9 million. Because the redeemed shareholder only received \$3.0 million (in the form of a promissory note), the Tax Court held that the redeemed shareholder made a gift of \$1.9 million to her son at the time of the redemption.

f. As noted above, the “safe harbor” rule for economic effect provides that all distributions must be made according to positive capital account balances upon a “liquidation of the partnership (or any partner’s interest in the partnership).”<sup>1061</sup> This would seem to imply that a complete redemption of a partner’s interests requires a distribution of partnership property equal in value to the partner’s capital account. However, the Treasury Regulations explain that the foregoing requirement is “not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners ... pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of”<sup>1062</sup> the economic benefit principles (allocations must correspond with economic benefit or burden). The Treasury Regulations do not elaborate on what would be considered “materially adverse interests,” though the phrase “sufficiently adverse interests” is used in the context of distributions of section 704(c) property, which requires valuation at “the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution” but which will be deemed correct if the “value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.”<sup>1063</sup>

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<sup>1059</sup> Treas. Reg. § 25.2511-1(h)(1). Also, if a shareholder makes a transfer to a corporation for less than full and a adequate consideration, then the contributing shareholder is treated as having made a gift to the other shareholders.

<sup>1060</sup> *Estate of Mary D. Maggos v. Commissioner*, T.C. Memo 2000-129. See also, *Kincaid v. U.S.*, 682 F.2d 1220 (1982) (deemed gift upon contribution of ranchland to a corporation for less valuable non-voting stock when there was no business reason for such contribution), *Senda v. Commissioner*, T.C. Memo 2004-160 (contribution of stock to family limited partnership and transfers of the interests were deemed gifts of the underlying stock), and *Trenchard v. Commissioner*, T.C. Memo 1995-121 (taxpayer’s excess contributions to a corporation, not in the ordinary course of business, deemed a gift).

<sup>1061</sup> Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

<sup>1062</sup> Treas. Reg. § 1.704-1(b)(2)(ii)(b) [last paragraph].

<sup>1063</sup> “The fair market value of the distributed section 704(c) property is the price at which the property would change hands between a willing buyer and a willing seller at the time of the distribution, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The

g. Taken together, the foregoing would seem to imply that as long as the value distributed upon full (or partial) redemption is appropriately determined under the willing buyer/willing seller standard (which necessarily might include valuation discounts and premiums), then “arm’s-length negotiation” and “materially adverse interests” can be deemed to exist. Thus, the value paid upon full redemption would necessarily be fair market value, not capital account value. If the value is greater or less than fair market value, the courts have consistently held that a taxable gift will result.

4. Example

a. The following example will provide an illustration of how tax basis and capital account would be calculated if a taxpayer gifted interests in a FLP and then later had his or her interest in the FLP fully redeemed (liquidated).

b. D formed Family, LLC by contributing \$3 million of cash and an asset worth \$7 million with zero basis. Assume for purpose of this example, Family, LLC is taxed as a partnership because a non-grantor trust contributed a nominal amount of property to the Family, LLC, but for purposes of this example the trust’s ownership interest (and any interest it may have in any partnership property and any allocations relating to the same) is ignored. A qualified business appraiser has determined that D’s interest has a fair market value of \$10 million because it represents a controlling interest in the LLC and the resulting control premium negates any valuation discount due to lack of marketability. The adjusted tax bases and capital accounts are:

Partnership	Inside Basis	Book Value
Cash	\$3,000,000	\$3,000,000
Appreciated Asset	\$0	\$7,000,000
<b>TOTAL</b>	<b>\$3,000,000</b>	<b>\$10,000,000</b>
Partners (Ownership %)	Outside Basis	Book Capital Account
D (100%)	\$3,000,000	\$10,000,000
<b>TOTAL</b>	<b>\$3,000,000</b>	<b>\$10,000,000</b>

c. D subsequently gifts 60% of the units to his two children, C1 and C2, in equal shares. At the time of the gift, the LLC owns the same \$10 million in assets. A qualified business appraiser has determined that D’s interest, after the transfer, has a fair market value of \$2.2 million, and each child’s interest is worth \$1.65 million (45% valuation discount). The resulting tax bases and capital accounts are:

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fair market value that a partnership assigns to distributed section 704(c) property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm's-length negotiation and the partners have sufficiently adverse interests.” Treas. Reg. § 1.704-4(a)(3).

Partnership Assets	Inside Basis	Book Value
Cash	\$3,000,000	\$3,000,000
Appreciated Asset	\$0	\$7,000,000
<b>TOTAL</b>	<b>\$3,000,000</b>	<b>\$10,000,000</b>
Partners (Ownership %)	Outside Basis	Book Capital Account
D (40%)	\$2,010,000	\$4,000,000
C1 (30%)	\$495,000	\$3,000,000
C2 (30%)	\$495,000	\$3,000,000
<b>TOTAL</b>	<b>\$3,000,000</b>	<b>\$10,000,000</b>

Note how, after the gift, capital accounts are in proportion to the ownership interests of the partners, but the outside bases are not. D's ownership interest retains 67% of the \$3,000,000 of tax basis, and C1 and C2 each hold 16.5% of the original basis (33% in the aggregate). This is because the value of D's interest prior to the transfer was \$10 million and the gift to the children was valued, in aggregate, at \$3.3 million due to valuation discounts.

d. Assuming the same values, Family, LLC distributes \$2.2 million (fair market value) to D in complete redemption of D's interest. Assuming this is the only transaction affecting basis and capital accounts since formation and gift, and also assuming the LLC has a section 754 election in place, the result of the redemption is as follows:

Partnership Assets	Inside Basis	Book Value
Cash	\$800,000	\$800,000
Appreciated Asset	\$190,000	\$7,000,000
<b>TOTAL</b>	<b>\$990,000</b>	<b>\$7,800,000</b>
Partners (Ownership %)	Outside Basis	Book Capital Account
C1 (50%)	\$495,000	\$3,900,000
C2 (50%)	\$495,000	\$3,900,000
<b>TOTAL</b>	<b>\$990,000</b>	<b>\$7,800,000</b>

e. D recognizes \$190,000 of gain on the redemption because the cash distributed is in excess of D's outside basis of \$2,010,000 prior to the distribution.<sup>1064</sup> As discussed later in these materials, the section 754 election provides an increase in the inside basis of partnership property in an amount equal to the amount of gain recognized to D under section 734(b)(1) of the Code. The basis increase is allocated under section 755 of the Code to the zero basis partnership asset (the only asset capable of receiving the basis increase since cash always has a basis equal to face value). Had there been no section 754 election in place, the basis of the appreciated asset would have remained at zero and the inside basis of all of the partnership property would be \$800,000 but the outside bases of the partners would have been \$990,000. The inside basis adjustment eliminates this discrepancy. Importantly, note how the capital account balances of C1 and C2 have been increased by \$900,000 each. The cumulative effect of

<sup>1064</sup> § 731(a)(1).

the redemption at fair market value creates an aggregate “capital shift” of \$1.8 million in favor of the children.

L. Section 704(c), “Reverse” Section 704(c), Book-Ups, and Revaluations

1. Generally

a. The Treasury Regulations under section 704(b) point out that when appreciated (or depreciated) property is contributed to a partnership, the book value (fair market value at the time of contribution) reflected in the capital account of the contributing partner will be different from the adjusted tax basis of the property as reflected on the partnership’s balance sheet. In such case, depreciation, depletion, amortization, and gain or loss with respect to such property “as computed for book purposes” will be “greater or less” than they would be “as computed for tax purposes.”<sup>1065</sup> This is often referred to as a “book/tax disparity.” Pursuant to section 704(c)(1)(A), items of income, gain, loss, and deduction determined for tax purposes with respect to property contributed must be shared among partners in a manner that takes into account the variation between the partnership's adjusted tax basis in the property and the fair market value of the property at the time of contribution. Said another way, section 704(c)(1)(A) seeks to ensure that the historical tax characteristics at contribution associated with such difference will ultimately be allocated to the contributing partner. Thus, for example, when the contributed property is sold by the partnership, any inherent gain or loss (as calculated at the time of contribution) will be allocated to the contributing partner.<sup>1066</sup> In that manner, section 704(c) ensures that the inherent gain or loss is not allocated to the non-contributing partners. As the Treasury Regulations provide, “The purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss. Under section 704(c), a partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value at the time of contribution.”<sup>1067</sup>

b. Because the fair market value of the contributed property is reflected in the contributing partner’s capital account, if the partnership subsequently sells the property at the same value (e.g., at a gain), then the gain must be allocated to the contributing partner but capital account must remain unaffected by the realization of that gain. Capital accounts already reflect the unrealized appreciation. Because of this, the Treasury Regulations provide, “In these cases the capital accounts of the partners are required to be adjusted solely for allocations of the book items to such partners..., and the partners' shares of the corresponding tax items are not independently reflected by further adjustments to the partners' capital accounts.”<sup>1068</sup>

Example: A and B create a newly-formed AB Partnership as equal partners. A contributes Asset A with an adjusted basis of \$40x and fair market value of \$100x, and B contributes cash of \$100x to AB Partnership. Both A and B’s

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<sup>1065</sup> Treas. Reg. § 1.704-1(b)(4)(i).

<sup>1066</sup> See Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

<sup>1067</sup> Treas. Reg. § 1.704-3(a)(1).

<sup>1068</sup> Treas. Reg. § 1.704-1(b)(4)(i).

capital accounts reflect a “book” value of \$100x each. A’s “tax” account is \$40x, and B’s “tax” account is \$100x. AB Partnership sells Asset A for \$110x. Pursuant to section 704(c)(1)(A), \$60x of gain will be allocated to Partner A, and the remaining \$10 of gain will be allocated equally to A and B under section 704(b) of the Code. The \$60x of gain allocated to A under section 704(c)(1)(A) will increase A’s outside basis (“tax” account) to \$100x but there will be no corresponding increase to A’s capital account (“book” account). The remaining \$10x of gain allocated equally under section 704(b) to A and B will increase both partners’ tax and book account by \$5x each. The result is both A and B will each have a tax account (outside basis) of \$105x and book account (capital account) of \$105x

c. A related issue occurs when a partner is admitted into (or withdraws from) an existing partnership and the partnership has property with a value (book value) that is greater (or less than) the partnership’s inside basis (tax value) in the property. This is illustrated in the following example:

Example: A and B create a newly-formed AB Partnership as equal partners. Both A and B contribute cash of \$100x each to AB Partnership. In year 1, AB Partnership purchases Asset AB for \$200x. Both A and B’s tax (outside basis) and book (capital) accounts are \$100x each. In year 2, AB Asset appreciates to \$300x in value, and AB Partnership admits C, who contributes Asset C that has an adjusted basis of \$50x and a fair market value of \$150x, as an equal one-third partner. At the time of C’s contribution, A and B’s book capital accounts are \$100x each, but C’s book capital account is \$150x. Assuming that the partnership follows the “safe harbor” allocation method for substantial economic effect (i. e., liquidation distributions will be made according to the partners’ positive book capital account balances), if the AB partnership liquidated at this point, A and B’s capital account would not accurately reflect the unrealized (pre-entry) appreciation in Asset AB that accrued prior to C’s admission to the partnership.

d. To solve the foregoing issue, the Treasury Regulations allows a partnership to revalue (“book-up”) its assets (including intangible assets like goodwill) at their current fair market value and correspondingly adjust all of the partner’s book capital accounts. The book-up adjustments to capital account are determined as if the partnership had sold all of its assets for their fair market value, and the resulting gain and loss with respect to each asset is allocated to the pre-existing partners under the terms of the partnership agreement.<sup>1069</sup> The result is the pre-existing partners’ book capital accounts will reflect the “booked-up” fair market value of the assets on the partnership at the time of the admission of the new partner. So, in the foregoing example, A and B’s book capital accounts would be adjusted upward from \$100x to \$150x each, and the partnership’s book value for AB Asset on the balance sheet would be adjusted upward from \$200x to \$300x.

e. Under the foregoing example, after the book-up of partnership assets and the admission of C to the partnership, each of the partners has a book capital account of

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<sup>1069</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(f).

\$150x. C has a tax (outside basis) account of \$50x. The unrealized \$100x inherent in Asset C will ultimately allocated to C under section 704(c)(1)(A) because, as discussed above, it applies to appreciation that occurred *before* C became a partner. In contrast, A and B each has a tax account of \$100x, and the unrealized appreciation reflected in the “book-tax disparity” is due to unrealized appreciation that occurred *after* A and B became partners. It is because of this distinction that the allocations with respect to the AB Asset are referred to as “reverse” section 704(c) allocations.<sup>1070</sup> Although the resulting allocations to resolve the book-tax disparity created upon contribution of property to a partnership or the admission of a new partner are all sourced under section 704(c), the Treasury Regulation provide, “Partnerships are not required to use the same allocation method for reverse section 704(c) allocations as for contributed property, even if at the time of revaluation the property is already subject to section 704(c).”<sup>1071</sup>

f. Book-up revaluations of partnership property are allowable, under the Treasury Regulations, as long as five criteria are met:

(1) The adjustments must be based on the fair market value of partnership property on the date of the adjustment;<sup>1072</sup>

(2) The adjustments to book capital accounts must reflect the manner in which unrealized income, gain, loss, or deduction inherent in partnership property will be allocated among the partners if the property had be sold for fair market value.<sup>1073</sup>

(3) The partnership agreement requires that capital accounts will be maintained according to rules set out in the Treasury Regulations with respect to allocations of depreciation, depletion, amortization, and gain or loss;<sup>1074</sup>

(4) The partnership agreement requires that the partners’ distributive share 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 under section 704(c);<sup>1075</sup> and

(5) The revaluation adjustments must be made principally for a substantial non-tax business purpose.<sup>1076</sup>

g. Book-up revaluations are appropriate for a myriad of partnership transactions, not just contributions of property and admissions of partners, as discussed up this

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<sup>1070</sup> See Treas. Reg. § 1.704-3(a)(6)(i).

<sup>1071</sup> *Id.*

<sup>1072</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(f)(1).

<sup>1073</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(f)(2).

<sup>1074</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(f)(3).

<sup>1075</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4).

<sup>1076</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5).

point. The list of these types of transactions contained in the Treasury Regulations include the following:<sup>1077</sup>

(1) Contribution of money or property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership;

(2) Liquidation of the partnership;

(3) Distribution of money or property (other than a de minimis amount) by the partnership to a retiring partner or continuing partner as consideration for an interest in the partnership;

(4) Grant of a partnership interest as consideration for the provision of services to or for the benefit of the partnership;

(5) Partnership's issuance of a non-compensatory option for a partnership interest (other than for a de minimis interest); and

(6) If substantially all of the partnership's property (excluding money) consists of stocks, securities, commodities, options, warrants, future or similar instruments that are readily tradable on an established market, those transactions as set forth under generally accounting practices.

h. Generally, property may not be aggregated for purposes of making allocations under section 704(c). The Treasury Regulations generally provide that section 704(c) allocations apply on a property-by-property basis.<sup>1078</sup> That being said, the following types of property may be aggregated, as long as they are contributed by one partner in a single tax year: (i) depreciable property, other than real property, included in the same general asset account of the contributing partner and the partnership under section 168; (ii) property, other than real property, with a zero adjusted basis; and (iii) inventory, other than "qualified financial assets,"<sup>1079</sup> that does not use a specific identification method of accounting.<sup>1080</sup>

i. The Treasury Regulations permit a securities partnership<sup>1081</sup> to aggregate built-in gains and losses from qualified financial assets using any reasonable approach when making "reverse" section 704(c) allocations.<sup>1082</sup> This aggregation approach is generally not available for purposes of "forward" section 704(c) allocations for any built-in gain or loss from

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<sup>1077</sup> See Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(i) through (v).

<sup>1078</sup> Treas. Reg. § 1.704-3(a)(2).

<sup>1079</sup> Generally includes any personal property (including stocks and securities) that is actively traded. Treas. Reg. § 1.704-3(e)(3)(ii)(A).

<sup>1080</sup> Treas. Reg. § 1.704-3(e)(2).

<sup>1081</sup> See Treas. Reg. § 1.704-3(e)(3)(iii)(A).

<sup>1082</sup> Treas. Reg. § 1.704-3(e)(3).

contributed property. However, the Treasury Regulations allow the IRS, by published guidance or by private letter ruling to permit aggregation of financial assets for purposes of making “forward” section 704(c) allocations.<sup>1083</sup>

2. Methods of Resolving Book-Tax Disparities

a. Generally

(1) As noted above, the Treasury Regulations provide that a partnership must allocate items of income, gain, loss, or deduction with respect to contributed property so as to prevent the shifting of tax consequences among partners with respect to built-in gain or built-in loss. The allocations must be made using a reasonable method that is consistent with the purpose of section 704(c).<sup>1084</sup> Property contributed with built-in gain (or loss) is referred to as “section 704(c) property” (contributed property with a section 704(b) book value [capital account] that is different than the contributing partner’s adjusted tax basis in the property).<sup>1085</sup>

(2) In the context of contributions of property, the Treasury Regulations describe three methods that are deemed reasonable for taking book-tax differences into account: (1) the traditional method; (2) the traditional method with curative allocations; and (3) the remedial allocation method. Other reasonable methods are permissible.<sup>1086</sup> Although the Treasury Regulations discuss the application of section 704(c) allocations with respect to contributions of property, the same principles apply to reverse section 704(c) allocations when there is a partnership revaluation or book-up, as mentioned above.<sup>1087</sup>

(3) The Treasury Regulations do not require a particular election to apply curative or remedial allocations. However, the partnership agreement needs to reflect the allocation chosen by the partnership.

b. Traditional Method

(1) The traditional method is described in section 1.704-3(b) of the Treasury Regulations. Under this method, if the partnership sells all or a portion of section 704(c) property and recognizes gain or loss, then any built-in gain (or loss) that existed at the time of the contribution must be allocated to the contributing partner.<sup>1088</sup> When only a portion of the property is sold, a proportionate part of the built-in gain (or loss) at the time of the contribution is allocated to the contributing partner.<sup>1089</sup>

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<sup>1083</sup> Treas. Reg. § 1.704-3(e)(4)(iii).

<sup>1084</sup> See Treas. Reg. § 1.704-3(a)(1).

<sup>1085</sup> Treas. Reg. § 1.704-3(a)(3).

<sup>1086</sup> Treas. Reg. § 1.704-3(a)(1).

<sup>1087</sup> Treas. Reg. § 1.704-1(b)(3)(iv)(f).

<sup>1088</sup> Treas. Reg. § 1.704-3(b)(1).

<sup>1089</sup> *Id.*

(2) The traditional method is subject to the “ceiling rule,” which can limit the amount of the section 704(c) allocations. The Treasury Regulations provide, “the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule).”<sup>1090</sup> This can be illustrated by the following:

Example: A and B create a newly-formed AB Partnership as equal partners. A contributes Asset A with an adjusted basis of \$40x and fair market value of \$100x, and B contributes cash of \$100x to AB Partnership. Both A and B’s capital accounts reflect a “book” value of \$100x each. A’s “tax” account is \$40x, and B’s “tax” account is \$100x. AB Partnership sells Asset A for \$90x, recognizing gain of \$50x. Under the traditional method, \$50x of gain will be allocated to A under section 704(c), leaving A with a tax account of \$90x and a book capital account of \$100x. B’s tax account and book capital account are \$100x.

(3) In the foregoing example, AB Partnership has effectively suffered a book loss of \$10x (the partnership’s assets have depreciated in value by \$10x since the contribution of Asset A) even though the partnership has recognized tax gain of \$50x. The result is A still has a book-tax disparity equal to \$10x. Due to the ceiling rule, with Asset A no longer owned by the partnership, there is no other gain that can be allocated to A to resolve the remaining book-tax disparity. Furthermore, there is no tax loss to be allocated to B, although B could eventually recognize that loss, if the AB Partnership sold all of its assets and then liquidated.

c. Traditional Method with Curative Allocations

(1) The Treasury Regulations allow partnerships to elect to cure the deficiencies to the noncontributing partner that are created by the ceiling rule by making reasonable “curative” allocations with the traditional method.<sup>1091</sup> As described in section 1.704-3(c) of the Treasury Regulations, “To correct distortions created by the ceiling rule, a partnership using the traditional method . . . may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners. A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership’s allocation of the corresponding book item.”<sup>1092</sup> A partnership may limit its curative allocations to a particular tax item even if allocation of those available items does not fully offset the effect of

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<sup>1090</sup> *Id.*

<sup>1091</sup> For an excellent article on using section 704(c) allocation in the family partnership context, see Thomas N. Lawson, *Using Curative and Remedial Allocations to Enhance the Tax Benefits of FLPs*, 9 Est. Plan. No. 8, pg. 12 (Aug. 2009).

<sup>1092</sup> Treas. Reg. § 1.704-3(c)(1).

the ceiling rule.<sup>1093</sup> A partnership must be consistent with its application of curative allocations with respect to each item of property from year to year.<sup>1094</sup>

(2) A curative allocation will be reasonable: (i) only up to the amount necessary to offset the effect of the ceiling rule (i.e., only up to the amount necessary to make the tax allocation to the noncontributing partner equal to its corresponding book allocation) for the current tax year (or, in the case of a curative allocation upon disposition of the property, for prior tax years);<sup>1095</sup> and (ii) only if it is made using a tax item that must be expected to have substantially the same effect on each partner's tax liability as the tax item affected by the ceiling rule.<sup>1096</sup> The period of time over which curative allocations are made must be taken into account in determining whether the allocations are reasonable.<sup>1097</sup> However, a partnership may make a curative tax allocation that offsets the effect of the ceiling rule for a prior tax year, if they are made over a reasonable period of time.<sup>1098</sup>

Example: A and B create a newly-formed AB Partnership as equal partners. A contributes Asset A, a capital asset, with an adjusted basis of \$40x and fair market value of \$100x, and B contributes cash of \$100x to AB Partnership which the partnership uses to purchase Asset B, also a capital asset. Both A and B's capital accounts reflect a "book" value of \$100x each. A's "tax" account is \$40x, and B's "tax" account is \$100x. A few years later, AB Partnership sells Asset A for \$90x, recognizing gain of \$50x capital gain, and Asset B for \$130x, recognizing gain of \$30x of capital gain. Under the traditional method, \$50x of capital gain (but a -\$10x book loss) from the sale of Asset A will be allocated to A under section 704(c), and, absent curative allocations, the \$30x of gain from the sale of Asset B will be allocated equally to A and B, as follows:

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<sup>1093</sup> *Id.*

<sup>1094</sup> Treas. Reg. § 1.704-3(c)(2).

<sup>1095</sup> Treas. Reg. § 1.704-3(c)(3)(i).

<sup>1096</sup> Treas. Reg. § 1.704-3(c)(3)(iii).

<sup>1097</sup> Treas. Reg. § 1.704-3(c)(3)(ii)

<sup>1098</sup> *Id.*

	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$40x	\$100x	\$100x	\$100x
704(c) Gain-Asset A	\$50x	(-\$5x)	0	(-\$5x)
704(b) Gain-Asset B	\$15x	\$15x	\$15x	\$15x
Ending Balance	\$105x	\$110x	\$115x	\$110x

Due to the ceiling rule, the end result is that AB Partnership has \$220x in cash, A and B have book-tax disparities, and total book capital account balances are \$220x.

If AB Partnership, on the other hand, elects to make a curative allocation by allocating \$10x of gain from the sale of Asset B to A, and the remaining \$20x of gain from the sale of Asset B to each of the partners under section 704(b), then the result is as follows:

	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$40x	\$100x	\$100x	\$100x
704(c) Gain-Asset A	\$50x	(-\$5x)	0	(-\$5x)
Curative Allocation of \$10x-Asset B	\$10x	0	0	0
704(b) Gain of \$20x-Asset B	\$10x	\$15x	\$10x	\$15x
Ending Balance	\$110x	\$110x	\$110x	\$110x

Note that the book capital accounts attributable to the sale of Asset B are increased by the \$30x of appreciation, shared equally by A and B. A and B's book and tax accounts have a balance of \$110x, reflecting B's 50% share of the partnership's book loss in Asset A (-\$10x) and book gain in Asset B (\$30x). The partnership has a net book gain of \$20x, which was shared equally among A and B. Hence, book and tax capital accounts are \$110 each, which in turn equals the amount of cash in the partnership.

#### d. The Remedial Allocation Method

(1) Section 1.704-3(d) provides a third allocation method, the remedial allocation method, which involves the partnership creating notional (hypothetical) tax

items that are not dependent upon actual tax items recognized by the partnership.<sup>1099</sup> In this manner, the partnership can create offsetting tax items that do not actually exist to eliminate book-tax disparities created by the ceiling rule. The Treasury Regulations provide that in the absence of other published guidance, the remedial allocation method is the only reasonable section 704(c) method permitting the creation of notional tax items.<sup>1100</sup>

(2) Under the remedial allocation method, the partnership allocates tax items on 704(c) property under the traditional method, and then, the Treasury Regulations instruct:<sup>1101</sup>

If the ceiling rule...causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss, or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner.

In other words, remedial allocations to noncontributing partners and offsetting remedial allocations to the contributing partner net to zero at the partnership level. Thus, remedial allocations, in the aggregate, do not affect the partnership's taxable income, as determined under section 703.<sup>1102</sup> In addition, unlike curative allocations, remedial allocations must fully offset the disparity created by the ceiling rule.<sup>1103</sup>

(3) In contrast, at the partner level, the remedial allocations are actual tax items that must be recognized.<sup>1104</sup> As such, remedial allocations will affect the partner's tax liability and will be reflected in the outside basis of the partner's interest in the partnership.

Example: A and B form AB Partnership as equal partners. The partnership agreement provides that AB Partnership will make section 704(c) allocations using the remedial allocation method. A contributes Asset A, a capital asset, with an adjusted basis of \$40x and a fair market value of \$100x. B contributes Asset B, a capital asset, with an adjusted basis and a fair market value of \$100x. The following year, AB Partnership sells Asset A for \$90x, recognizing \$50x of capital gain for tax purposes (but a \$10x loss for book purposes). The partnership has no other tax items. Under the traditional method, subject to the ceiling rule, the tax and book capital accounts would be as follows:

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<sup>1099</sup> See Treas. Reg. § 1.704-3(d)(4) and the preamble to T.D. 8585, 59 Fed. Reg. 66,725 (Dec. 29, 1994).

<sup>1100</sup> Treas. Reg. § 1.704-3(d)(5)(i).

<sup>1101</sup> Treas. Reg. § 1.704-3(d)(1).

<sup>1102</sup> Treas. Reg. § 1.704-3(d)(4)(i).

<sup>1103</sup> Treas. Reg. § 1.704-3(d).

<sup>1104</sup> Treas. Reg. § 1.704-3(d)(4)(ii).

	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$40x	\$100x	\$100x	\$100x
704(c) Gain-Asset A	\$50x	(-\$5x)	0	(-\$5x)
Ending Balance	\$90x	\$95x	\$100x	\$95x

The ceiling rule causes B to have a \$50x book-tax disparity between B's allocation of book and tax loss. AB must make a remedial allocation of a -\$50x loss to B and an offsetting remedial allocation of \$50x of capital gain to Y. The result of these remedial allocations are as follows:

	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$40x	\$100x	\$100x	\$100x
704(c) Gain-Asset A	\$50x	(-\$5x)	0	(-\$5x)
Remedial Allocations	\$5x		(-\$5x)	
Ending Balance	\$95x	\$95x	\$95x	\$95x

(4) A remedial allocation is reasonable only to the extent it equals the amount necessary to offset the disparity created by the ceiling rule for that tax year and only if it has the same tax attributes as the tax item limited by the ceiling rule.<sup>1105</sup> As a result, if the item limited by the ceiling rule is loss from the sale of contributed property, then the offsetting allocation under the remedial allocation method must be gain from the sale of that property. Further, if the item limited by the ceiling rule is gain from the sale of contributed property, then the offsetting allocation must be a loss from the sale of that property.<sup>1106</sup>

### 3. Depreciable Property

a. When 704(c) property is subject to amortization, depletion, depreciation, or other cost recovery, the "allocation of deductions attributable to these items takes into account built-in gain or loss on the property"<sup>1107</sup> at the time of contribution. To that end, the Treasury Regulations instruct, "tax allocations to the noncontributing partners of cost recovery deductions with respect to section 704(c) property generally must, to the extent possible, equal

<sup>1105</sup> Treas. Reg. §§ 1.704-3(d)(1) and 1.704-3(d)(3). *See also* preamble to T.D. 8585, 59 Fed. Reg. 66,724 (Dec. 28, 1994).

<sup>1106</sup> Treas. Reg. 1.704-3(d)(3).

<sup>1107</sup> Treas. Reg. § 1.704-3(b)(1).

book allocations to those partners.”<sup>1108</sup> Said another way, the Treasury Regulations provide that section 704(c) allocations should follow a “tax follows book” methodology, and in this instance, book depreciation will exceed tax depreciation. Section 704(c) attempts to put the non-contributing partners in the same position they would be if the depreciable property had been contributed when the tax basis was equal to the fair market value.

Example: A and B form AB Partnership as equal partners. The partnership agreement provides that the partnership will make allocations under section 704(c) using the traditional method. A contributes Asset A, depreciable property with an adjusted basis of \$400x and a fair market value of \$1,000x. Assume, Asset A has a remaining (straight-line) depreciable life of 5 years. B contributes \$1,000x of cash.

Absent section 704(c), A and B would each be allocated \$40x of tax depreciation per year ( $\$400x/5 \text{ years} = \$80x$  total tax depreciation), and at the end of the first taxable years, tax and book capital accounts would be as follows:

	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$400x	\$1,000x	\$1,000x	\$1,000x
Asset A-Depreciation No § 704(c)	(-\$40x)	(-\$100x)	(-\$40x)	(-\$100x)
Ending Balance	\$360x	\$900x	\$960x	\$900x

As the table shows, B, the contributing partner, is allocated \$60x less depreciation than B should be receiving based on book value. Said another way, for the same equal contribution to become an equal partner, B will have \$60x more taxable income per year. In theory, A is effectively shifting taxable income to B because A has already enjoyed more of the depreciation prior to the contribution.

Under the “tax follows book” methodology, tax depreciation should follow, to the extent possible, book depreciation. Under the traditional method, all of the tax depreciation of the partnership (\$80x) will be allocated to B.<sup>1109</sup> The result at the end of the first taxable year are as follows:

<sup>1108</sup> *Id.*

<sup>1109</sup> See Treas. Reg. § 1.704-3(b)(2), Ex. 1.

	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$400x	\$1,000x	\$1,000x	\$1,000x
Asset A-Depreciation § 704(c)	0	(-\$100x)	(-\$80x)	(-\$100x)
Ending Balance	\$400x	\$900x	\$920x	\$900x

The net result for B, is that B's book-tax disparity is reduced from \$60x in the previous hypothetical to \$20x, and A's book-tax disparity is not increased.

b. In the family partnership context, when dealing with depreciable property, section 704(c) serves to disproportionately allocate depreciation deductions to the noncontributing partner. Thus, families could form a partnership and use the traditional method of allocations under section 704(c) to their advantage particularly if the non-contributing partner is: (i) a high income taxpayer (including a non-grantor taxable trust); (ii) holding property that has basis and that is not depreciable (e.g., cash or marketable securities); or (iii) has an investment that generates significant passive income each year.

c. In the previous example, B will be allocated \$80x of tax depreciation per year, not the \$100x that B would have received if the depreciable property had a tax basis equal to its book value on contribution (\$1,000x). Over the remaining 5 years, B will be allocated, in aggregate, \$400x of depreciation deductions (which is \$100x less than the \$500x B would have received if the property had \$1,000 of tax basis). As discussed earlier, this result is due to the ceiling rule.<sup>1110</sup> Without any curative or remedial allocations, over the 5-year expected life of Asset A, the projected tax and book capital accounts would look as follows:

Years 1-5	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$400x	\$1,000x	\$1,000x	\$1,000x
Asset A-Depreciation § 704(c)	0	(-\$500x)	(-\$400x)	(-\$500x)
Ending Balance	\$400x	\$500x	\$600x	\$500x

d. You will note in the previous example, the ceiling rule prevents B, the noncontributing partner, from being allocated B's full share of depreciation deductions (as measured by reductions in book value). To resolve this, the partnership can make curative allocations, as illustrated by the following example:

<sup>1110</sup> Treas. Reg. § 1.704-3(a)(1). "The total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule)."

Example: A and B form AB Partnership as equal partners. The partnership agreement provides that the partnership will make allocations under section 704(c) using the traditional method with curative allocations. A contributes Asset A, depreciable property with an adjusted basis of \$400x and a fair market value of \$1,000x. Assume, Asset A has a remaining (straight-line) depreciable life of 5 years. B contributes \$1,000x of cash that AB Partnership uses to purchase, Asset B. Asset B is depreciable property with a depreciable life of 5 years. In the first year, AB Partnership elects to make a special \$20x curative allocation of depreciation attributable to Asset B to Partner B, with any excess depreciation \$100x to B and remaining \$80x to A, as follows:

Year 1	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$400x	\$1,000x	\$1,000x	\$1,000x
Asset A-Depreciation § 704(c)	0	(-\$100x)	(-\$80x)	(-\$100x)
Asset B-Depreciation Curative Allocation			(-\$20x)	
Asset B-Depreciation § 704(b)	(-\$80x)	(-\$100x)	(-\$100x)	(-\$100x)
Ending Balance	\$320x	\$800x	\$800x	\$800x

If AB Partnership continues to make this curative allocation over the 5-year depreciable life of Asset B, the result over that period would be as follows:

Years 1-5	A		B	
	Tax	Book	Tax	Book
Initial Contributions	\$400x	\$1,000x	\$1,000x	\$1,000x
Asset A-Depreciation § 704(c)	0	(-\$500x)	(-\$400x)	(-\$500x)
Asset B-Depreciation Curative Allocation			(-\$100x)	
Asset B-Depreciation § 704(b)	(-\$400x)	(-\$500x)	(-\$500x)	(-\$500x)
Ending Balance	\$0x	\$0x	\$0x	\$0x

e. Alternatively, if the partnership does not have other depreciable property, it could allocate \$20x of ordinary income to A, which has the same effect as an allocation of depreciation to B.<sup>1111</sup> There is no requirement that curative allocations must offset

<sup>1111</sup> *Id.*

the entire distortion created by the ceiling rule, and curative allocations can be limited to taking depreciation from a specific set of assets or to specific items of income.<sup>1112</sup>

f. Generally, curative allocations must be made over the remaining depreciation life of the asset,<sup>1113</sup> but if the remaining depreciation life is very short in comparison to its actual economic life, under certain circumstances, the IRS could invoke the anti-abuse rule and invalidate the curative allocation.

g. As noted above, a disparity created by the ceiling rule can also be cured under the remedial allocation method. The amount of 704(b) book depreciation allowed is determined differently under the remedial allocation method than under the traditional method or the traditional method with curative allocations (which must use the rules under section 1.704-1(b)(2)(iv)(g)(3) to determine book cost recovery).<sup>1114</sup> Under the remedial allocation method, a partnership must bifurcate its section 704(b) book basis in the contributed property for purposes of calculating depreciation. The portion of book basis in the property equal to the tax basis in the property at the time of contribution is recovered generally over the property's remaining depreciable life of the property (under section 168(i)(7) or other applicable part of the Code).<sup>1115</sup> With respect to the portion of the book value (fair market value at the time of contribution) in excess of the tax basis (the partnership's remaining book basis in the property), it is recovered using any applicable recovery period and depreciation (or other cost recovery) method, including first-year conventions, available to the partnership as if newly purchased property of the same type as the contributed property that is placed in service at the time of contribution.<sup>1116</sup>

h. As mentioned above, a remedial allocation is reasonable only if it has the same tax attributes as the tax item limited by the ceiling rule. To that end, the Treasury Regulations provide that if the item limited by the ceiling rule consists of depreciation or other cost recovery allowance from contributed property, the offsetting remedial allocation must be income of the type produced (directly or indirectly) by that property.<sup>1117</sup>

i. Generally, curative allocations will be more desirable than remedial allocations for families because curative allocations will be taken over the life of the remaining depreciable life of the contributed property. Furthermore, curative allocations do not have to fully negate the disparity in the ceiling rule. As such, families have the flexibility to tailor the use of curative allocations to the tax situation of the partners.

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<sup>1112</sup> *Id.*

<sup>1113</sup> *See* Treas. Reg. § 1.704-3(c)(4), Ex. 2.

<sup>1114</sup> *See* Treas. Reg. § 1.704-3(d)(2).

<sup>1115</sup> *Id.*

<sup>1116</sup> *Id.*

<sup>1117</sup> Treas. Reg. § 1.704-3(d)(3).

4. Built-In Loss Property

a. Section 704(c)(1)(C) provides that if contributed property has a built-in loss, the built-in loss is only taken into account in determining the amount of items allocated to the contributing partner. For purposes of determining tax items allocated to the other partners, the partnership's adjusted basis in the contributed property is equal to the fair market value of the property at the time of contribution. As a result, if the contributing partner's interest in the partnership is transferred or liquidated, the built-in loss is eliminated.<sup>1118</sup> This rule prevents a partnership from allocating a loss to other partners in situations in which the partner contributes built-in loss property to the partnership and then sells his or her partnership interest (at a loss) before the partnership recognizes the loss.

Example: A, B, and C form ABC Partnership as equal partners. A contributes Asset A that is built-in loss property with an adjusted basis of \$200x and a fair market value of \$100x. B and C each contribute \$100x of cash. Under section 722, A has an outside basis in A's partnership interest of \$200x and a book capital account of \$100x. In year 1, A sells A's partnership interest for \$100x to D, recognizing a loss of -\$100x. Assume ABC Partnership does not have a section 754 election in place. In year 2, ABC Partnership sells Asset A for \$100x. Pursuant to section 704(c)(1)(C), ABC Partnership recognizes no gain or loss on the sale of Asset A.

b. All tax attributes arising from the inherent loss in the contributed property must be allocated to the contributing partner. Thus, if a partner contributes depreciable property with an adjusted basis of \$150x and a fair market value of \$100x, the depreciation deductions attributable to the inherent loss (\$50x) must be allocated entirely to the contributing partner.<sup>1119</sup>

c. In 2014, the IRS published proposed Treasury Regulations on the application of section 704(c)(1)(C).<sup>1120</sup> These proposed Treasury Regulations would be generally be applicable to contributions and transactions after the regulations are finalized. They have not yet been finalized. The proposed Treasury Regulations introduce the term “§ 704(c)(1)(C) partner” (the partner contributing built-in loss property) and the concept of a “§ 704(c)(1)(C) basis adjustment,” which would be taken into account only with respect to the § 704(c)(1)(C) partner.<sup>1121</sup> For example, if partner A contributes property with an adjusted basis of \$900x and a fair market value of \$500x, the partnership's basis in the property is \$500x, but there would be a special adjustment basis of the property that applies only to partner A.

d. The § 704(c)(1)(C) basis adjustment would initially equal the amount of inherent built-in loss on the date of contribution but it would be adjusted to reflect the §

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<sup>1118</sup> See H.R. Conf. Rep. No. 108-755, at 610(2004).

<sup>1119</sup> See Prop. Treas. Reg. § 1.704-3(f).

<sup>1120</sup> REG-144468-05, 79 Fed. Reg. 3,042 (Jan. 16, 2014).

<sup>1121</sup> See Prop. Treas. Reg. § 1.704-3(f)(3)(ii)(A).

704(c)(1)(C) partner's share of partnership items with respect to the built-in loss property.<sup>1122</sup> The amount of gain or loss allocated to the § 704(c)(1)(C) partner on the sale of the property is equal to such partner's share of the partnership gain or loss minus the partner's § 704(c)(1)(C) basis adjustment for the partnership property.<sup>1123</sup>

Example: A, B, and C form ABC Partnership as equal partners. A contributes Asset A with an adjusted basis of \$900x and a fair market value of \$500x. B and C each contribute \$500x in cash. ABC Partnership's basis in Asset A is \$500x. A's outside basis in his or her partnership interest is \$900x and A's § 704(c)(1)(C) basis adjustment is \$400x. The following year, A sells 50% of A's partnership interest to D for \$250x in cash. Assume the partnership does not have a section 754 election in place. A recognizes a loss of \$200x (\$250 minus 50% of \$900x outside basis). A's § 704(c)(1)(C) basis adjustment will be reduced by \$200x (equal to the recognized loss).

e. If built-in loss property is subject to amortization under sections 197 or 168 of the Code, the partner's § 704(c)(1)(C) basis adjusted associated with the property would be recovered in accordance with sections 197(f)(2) and 168(i)(7), and the amount of the basis adjustment with the property would be recovered by a § 704(c)(1)(C) partner in any tax year would be added to the partner's distributive share of the partnership's depreciation or amortizations deductions for the same year.<sup>1124</sup>

Example: A, B, and C form ABC Partnership as equal partners. A contributes Asset A with an adjusted basis of \$900x and a fair market value of \$500x. B and C each contribute \$500x in cash. Asset A is depreciable property and on the date of contribution under section 168 the property has 5 years remaining in recovery period. A's § 704(c)(1)(C) basis adjustment is \$400x. ABC Partnership's inside basis for Asset A is \$500x. Under section 168, the partnership's depreciation is \$100x (\$500 divided by 5 years) is shared equally among A, B, and C. A's § 704(c)(1)(C) basis adjustment is subject to additional depreciation equal to \$80x (\$400x divided by 5 years) which is allocated to only to A.

## 5. Anti-Abuse Rule for Allocation Methods

a. Echoing the general anti-abuse provisions discussed above, the Treasury Regulations provide that any "allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in "reverse" section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability."<sup>1125</sup> It also provides that any reference to partners above includes both "direct and indirect" partners,

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<sup>1122</sup> Prop. Treas. Reg. § 1.704-3(f)(3)(ii)(B).

<sup>1123</sup> Prop. Treas. Reg. § 1.704-3(f)(3)(ii)(C).

<sup>1124</sup> Prop. Treas. Reg. § 1.704-3(f)(3)(ii)(D)(1).

<sup>1125</sup> Treas. Reg. § 1.704-3(a)(10)(i).

and an “indirect partner” is “any direct or indirect owner of a partnership, S corporation, or controlled foreign corporation ... or direct or indirect beneficiary of a trust or estate, that is a partner in the partnership.”<sup>1126</sup>

b. Example 3 in the Treasury Regulations describes a situation where the contributed property only has one year remaining in its depreciable life (although the economic life is 10 years) and the contributing partner has an expiring net operating loss.<sup>1127</sup> The proposed curative allocation is to offset the entire disparity between book value and tax basis in the first year. The example concludes that the curative allocation is unreasonable because income would be allocated to a partner with a low marginal tax rate from a partner with a high marginal tax rate “within a period of time significantly shorter than the economic life of the property.” However, the example goes on, if the partnership makes curative allocations over the economic life of the property (10 years) then the allocation would be deemed reasonable.<sup>1128</sup>

c. It should be noted that the anti-abuse rules do not necessarily apply for state income tax purposes (although most state income tax regimes are tied to the Federal tax liability). When the anti-abuse rules refer to the present value of aggregate tax liability, it refers only to the Federal income tax. Therefore, there are likely allocations that would not result in any Federal income tax savings that would be deemed reasonable, but could result in significant state income tax savings (e.g., partners in high and low income tax states).

#### M. Section 754 Election and Inside Basis Adjustments

##### 1. Generally

a. As discussed above, whether a partnership has a section 754 election in place has a direct bearing on the inside basis of the assets held by a partnership. Those adjustments to basis are made pursuant to section 743, when there is a sale or exchange of a partnership interest or a death of a partner occurs, and section 734, when there is a distribution to a partner.

b. Generally, the inside bases of partnership assets are not adjusted when a partnership interest is sold or exchanged, when a partner dies or when there is a distribution of property to a partners. These transactions can create discrepancies between inside and outside basis, which in turn can create distortions in the amount of income recognized and the timing of the income. For example, if a partner dies or a partner sells his or her partnership interest, the transferee partner will have a basis in the partnership interest equal to fair market value or the cost of the sale. If that basis is greater than the inside basis of the assets, when the partnership sells those assets, additional gain will be allocated to the transferee partner. Similarly, if a partnership makes a liquidating distribution to a partner for cash, and the partner recognizes gain as a result of that distribution because the partner’s outside basis is less than the cash distributed,

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<sup>1126</sup> Treas. Reg. § 1.704-3(a)(10)(ii).

<sup>1127</sup> Treas. Reg. § 1.704-3(c)(4), Ex. 3.

<sup>1128</sup> *See also* Treas. Reg. § 1.704-3(b)(2), Ex. 2 for an example of an unreasonable use of the traditional method involving the contribution of property having on year of remaining depreciable life.

that gain essentially represents the liquidated partner's share of appreciation in the partnership. Absent an adjustment to inside basis, a subsequent sale of the partnership assets will result in that gain being allocated to the remaining partners. The adjustments under sections 743 and 734 attempt to adjust for those types of discrepancies. Adjustments can increase or decrease the inside basis of partnership property.

c. A section 754 election is generally made by the partnership in a written statement filed with the partnership return for the taxable year during which the transfer in question (sale, exchange, death or distribution) occurs.<sup>1129</sup> Once the election is made, it applies to the year for which it is filed as well as all subsequent taxable years until and unless it is formally revoked.<sup>1130</sup>

## 2. Basis Adjustments under Section 743(b) Are Hypothetical

a. Essentially, the inside basis adjustment under section 743(b) is the difference between the outside basis that the transferee partner receives against the transferee's share of inside basis. As such, adjustments under section 743(b) result in either:

(1) An increase in the transferee's share of partnership inside basis "by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property"<sup>1131</sup> or

(2) A decrease in the transferee's share of partnership inside basis "by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership."<sup>1132</sup>

b. A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities.<sup>1133</sup> The partner's previously taxed capital is:<sup>1134</sup>

(1) The amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the

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<sup>1129</sup> Treas. Reg. § 1.754-1(b)(1). Under certain circumstances, there is a 12-month extension past the original deadline. Treas. Reg. § 301.9100-2.

<sup>1130</sup> § 754 and Treas. Reg. § 1.754-1(a). An election may be revoked if there exists: (i) a change in the nature of the partnership business; (ii) a substantial increase in or a change in the character of the partnership's assets; and (iii) an increase in the frequency of partner retirements or shifts in partnership interests (resulting in increased administrative costs attributable to the § 754 election). Treas. Reg. § 1.754-1(c)(1).

<sup>1131</sup> § 734(b)(1).

<sup>1132</sup> § 734(b)(2).

<sup>1133</sup> Treas. Reg. § 1.743-1(d)(1).

<sup>1134</sup> Treas. Reg. § 1.743-1(d)(1)(i)-(iii).

case may be) in a fully taxable transaction for cash equal to the fair market value of the assets;<sup>1135</sup> increased by

(2) The amount of tax loss that would be allocated to the partner on the hypothetical transaction; and decreased by

(3) The amount of tax gain that would be allocated to the partner on the hypothetical transaction.

c. Inside basis adjustments under section 743(b) do not change or affect capital accounts,<sup>1136</sup> and because the adjustments only apply to the transferee, they are not made to the common basis of the partnership.<sup>1137</sup> The partnership will compute its taxable income, gain, loss, and deduction without regard to the inside basis adjustments under section 743(b), and then allocate these amounts among all the partners under the principles of section 704(b) of the Code. At this point, the inside basis adjustments then come into consideration. The partnership will adjust the transferee partner's distributive share of income, gain, loss, and deduction to reflect the adjustments. For example, if the partnership sells an asset that has a basis adjustment, the amount of the adjustment will reduce or increase the transferee's distributive share of the gain or loss from the sale of the asset.<sup>1138</sup> Also, if a positive adjustment is made to depreciable (or amortizable) property, then the adjustment will increase the transferee's share of depreciation (or amortization) from that property. In effect, the transferee is treated as if he or she purchased new property for a price equal to the adjustment.<sup>1139</sup>

### 3. Basis Adjustments under Section 734(b) Are Actual

a. Despite their similarities, there are a number of important distinctions between the inside basis adjustments upon a transfer of a partnership interest under section 743(b) and the adjustments upon a distribution of partnership property under section 734(b). Generally, a distribution triggers a *possible* (depending upon whether the partnership has a section 754 election in effect or if there is a substantial basis adjustment requiring a mandatory inside basis adjustment) section 734(b) adjustment whenever the distributee recognizes gain or loss, or takes a basis in the distributed property different from that which the partnership had in the property.

b. Unlike adjustments under section 743(b), adjustments under section 734(b) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee). Section 734(b)(1) and (2) provides that increases or decreases are made to “partnership

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<sup>1135</sup> Treas. Reg. § 1.743-1(d)(2).

<sup>1136</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(m).

<sup>1137</sup> Treas. Reg. § 1.743-1(j)(1). There is a limited exception in the case of certain distributions to a transferee partner. See Treas. Reg. § 1.734-2(b)(1).

<sup>1138</sup> Treas. Reg. § 1.743-1(j)(3).

<sup>1139</sup> Treas. Reg. § 1.743-1(j)(4).

property.”<sup>1140</sup> In contrast, adjustments under section 743(b) “shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only.”<sup>1141</sup>

c. As mentioned above, adjustments under section 743(b) are not reflected in the capital accounts of the transferee partner or on the books of the partnerships.<sup>1142</sup> On the other hand, adjustments under section 734(b) result in corresponding adjustments to capital accounts.<sup>1143</sup>

d. When evaluating inside basis adjustments under section 734(b) of the Code, one must make a distinction between current and liquidating distributions.

(1) With a current distribution, only gain (not loss) can be recognized to a distributee partner. As such, an adjustment under section 734(b) is triggered when a distributee partner recognizes a gain on distribution of money in excess of outside basis. The amount of gain results in a corresponding increase in the inside basis of partnership property.<sup>1144</sup>

(2) With a current distribution, when partnership property (other than money) is distributed, the basis of the property in the hands of the partner is the *lesser* of the inside basis of the property or the distributee partner’s outside basis (after reducing outside basis by any money distributed).<sup>1145</sup> When the distributee partner’s outside basis is less than the inside basis of the distributed property, then the basis of the property is reduced. The amount of “lost” basis results in a corresponding increase in the remaining inside basis of partnership property.<sup>1146</sup>

(3) Unlike current distributions, a distributee partner can recognize a loss on a liquidating distribution. Thus, on a liquidating distribution, the inside basis adjustment can increase the basis of partnership (for a gain) or decrease the basis of partnership property (for a loss).<sup>1147</sup>

(4) Further, unlike a current distribution, when partnership property (other than money) is distributed in a liquidating distribution, the basis of the property can be increased if the liquidated partner’s outside (after reducing outside basis by any money distributed) is greater than the inside basis of the asset distributed.<sup>1148</sup> The inside basis of the

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<sup>1140</sup> § 734(b)(1) and (2).

<sup>1141</sup> § 743(b) (flush language).

<sup>1142</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(m)(2).

<sup>1143</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4) and (5).

<sup>1144</sup> § 734(b)(1)(A).

<sup>1145</sup> § 732(a)(1) and (2).

<sup>1146</sup> § 734(b)(1)(B).

<sup>1147</sup> § 734(b)(1)(A) and (2)(A).

<sup>1148</sup> § 732(b) and Treas. Reg. § 1.732-1(b).

property has its basis replaced by the outside basis of the liquidated partnership interest.<sup>1149</sup> If liquidated property has its basis increased, then the inside basis adjustment would correspond to a reduction of inside basis of remaining partnership property under section 734(b)(2)(B) of the Code.

(5) For liquidating distributions, unlike current distributions, there is a mandatory inside basis adjustment when there is a substantial basis reduction with respect to a distribution of partnership property.<sup>1150</sup> This would occur if the partner recognized a loss of more than \$250,000 upon liquidation, or the basis of liquidated property is increased by more than \$250,000. Either of these events would require the partnership to reduce the basis of its remaining assets under section 734(b) of the Code by the total amount of the loss or basis increase even if a section 754 election was not in place.

#### 4. Allocating Inside Basis Adjustments under Section 755

a. The Treasury Regulations provide that the inside basis adjustment is divided between two classes of partnership assets: (i) “ordinary income property,” and (ii) “capital gain property.”<sup>1151</sup> For these purposes, capital gain property includes capital assets and section 1231(b) property, and all other property (including unrealized receivables and recapture items under section 751(c) of the Code) is considered ordinary income property.<sup>1152</sup> Next the portion of the adjustment allocated to each class of assets is then further divided among the assets in each class. The mechanism for making the allocation in this second step is different depending on whether the inside basis adjustment is under section 734(b) (e.g., distributions) or section 743(b) (e.g., transfers or death of a partner) of the Code.

b. As mentioned above, inside basis adjustments under section 743(b) of the Code only apply to the transferee. The Treasury Regulations treat the total amount of these adjustments as a net amount, which means that positive adjustments can be made with respect to some assets (or one class of assets), and negative adjustments can be made with respect to other assets (or class). For purposes of calculating the amount to be allocated to each class and to each asset within a class, the Treasury Regulations employ a hypothetical transaction pursuant to which you can calculate the transferee’s allocable share of gain or loss from each asset if immediately after the transfer the partnership made a cash sale of all of the partnership assets for fair market value.<sup>1153</sup>

c. If the purchaser of a partnership interest or the fair market value of the asset upon the death of a partner is equal to the selling partner’s or deceased partner’s share of the partnership assets, then the general result will be that the inside basis adjustments under section 743(b) will exactly offset the buyer’s gain or loss inherent in each asset. However, that is not

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<sup>1149</sup> Certain limitations apply to section 751 assets. See § 732(c)(1)(A) and § Treas. Reg. 1.732(c)(1)(i).

<sup>1150</sup> § 734(a), (b), and (d).

<sup>1151</sup> Treas. Reg. § 1.755-1(a).

<sup>1152</sup> *Id.*

<sup>1153</sup> Treas. Reg. § 1.755-1(b)(1)(ii).

always the case. If the buyer pays a premium over asset value, then under the residual method utilized under section 1060 of the Code, the excess will be allocated to goodwill or other section 197 intangibles. If the buyer purchases at a discount below fair market value (or more likely in the estate planning context, the deceased partner's partnership interest is valued at a discount for purposes of section 1014 of the Code), the Treasury Regulations first allocate the adjustment to ordinary income property to the extent possible, and then provide a mechanism to allocate the shortfall based upon two factors: (i) unrealized appreciation in each asset, and (ii) each asset's relative fair market value.<sup>1154</sup>

d. In contrast with the hypothetical sale approach used for section 743(b) adjustments, the Treasury Regulations under section 755 allocate the section 734(b) adjustments on the transaction that triggers the adjustment (e.g., gain or loss upon a distribution of cash or change in the basis of an asset upon distribution to a partner). If the adjustment is caused by the recognition of gain or loss to the distributee, the section 734(b) adjustment can only be applied to capital gain property.<sup>1155</sup> If, on the other hand, the adjustment is caused by a change in the basis of any asset within a particular class (ordinary income property or capital gain property), then the adjustment must be assigned only to assets in the same class.<sup>1156</sup> If the partnership has no assets in the appropriate class, the adjustment is deferred until the partnership acquires an asset in that class.<sup>1157</sup>

e. Once the adjustment is assigned to the appropriate class, positive adjustments (increases to the basis of partnership property) are first allocated to assets with unrealized appreciation in proportion to their relative appreciation. Once all of the unrealized appreciation has been eliminated, then the remaining amount is divided among the properties of the class in proportion to their relative fair market values.<sup>1158</sup> Negative basis adjustments are allocated first to assets within the relevant class which have unrealized depreciation in proportion to their relative unrealized depreciation. Once all of the unrealized depreciation has been eliminated, then the adjustment is allocated among all assets in the class in proportion to their adjusted basis (not fair market value).<sup>1159</sup> The inside basis of property cannot be reduced below zero.<sup>1160</sup>

Example: ABC Partnership has three equal partners, A, B, and C. The partnership does not have any liabilities. The balance sheet of the partnership is as follows:

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<sup>1154</sup> See Treas. Reg. § 1.755-1(b)(3)(ii).

<sup>1155</sup> Treas. Reg. § 1.755-1(c)(1)(ii).

<sup>1156</sup> Treas. Reg. § 1.755-1(c)(1)(i).

<sup>1157</sup> Treas. Reg. § 1.755-1(c)(4).

<sup>1158</sup> Treas. Reg. § 1.755-1(c)(2)(i).

<sup>1159</sup> Treas. Reg. § 1.755-1(c)(2)(ii).

<sup>1160</sup> Treas. Reg. § 1.755-1(c)(3).

ABC Partnership Balance Sheet					
Assets			Capital Accounts		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	\$40x	\$100x	Partner A	\$40x	\$100x
Asset B	\$60x	\$100x	Partner B	\$60x	\$100x
Asset C	\$20x	\$100x	Partner C	\$20x	\$100x
<b>Total</b>	<b>\$120x</b>	<b>\$300x</b>	<b>Total</b>	<b>\$120x</b>	<b>\$300x</b>

The partnership liquidates C's interest by distributing Asset B to C. Because C's outside basis is \$20x, Asset B has its basis reduced by \$40x to \$20x. This causes the partnership to have \$40x less in basis than it had before the liquidation. If Asset A, B, and C are all capital assets, the section 734(b) adjustment would be as follows:

ABC Partnership Balance Sheet					
Assets			Capital Accounts		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	\$57x	\$100x	Partner A	\$40x	\$100x
Asset C	\$43x	\$100x	Partner B	\$60x	\$100x
<b>Total</b>	<b>\$100x</b>	<b>\$200x</b>	<b>Total</b>	<b>\$100x</b>	<b>\$200x</b>

If Assets A and B are capital assets but Asset C is an ordinary asset, then the section 734(b) basis adjustment is allocated only to Asset A, as follows:

ABC Partnership Balance Sheet					
Assets			Capital Accounts		
	Tax Basis	Book Value		Outside Basis	Capital Account
Asset A	\$80x	\$100x	Partner A	\$40x	\$100x
Asset C	\$20x	\$100x	Partner B	\$60x	\$100x
<b>Total</b>	<b>\$100x</b>	<b>\$200x</b>	<b>Total</b>	<b>\$100x</b>	<b>\$200x</b>

If Asset B is an ordinary asset and Assets A and C are capital assets, the basis adjustment would be suspended until ABC Partnership acquires an ordinary asset to which the section 734(b) adjustment can be applied.

#### 5. Mandatory Inside Basis Adjustments

a. Even in the absence of a section 754, the Code provides that a partnership must make mandatory inside basis adjustments under the following circumstances:

(1) There is a distribution of property that results in a “substantial basis reduction” with respect to the distribution (requiring a mandatory basis adjustment under section 734(b) of the Code).<sup>1161</sup>

(2) There is a transfer of a partnership interest when the partnership has a “substantial built-in loss” immediately after the transfer (requiring a mandatory basis adjustment under section 743(b) of the Code).

b. A “substantial basis reduction” is deemed to occur when upon a distribution of property there is any loss to the distributee partner or an increase in the basis of the distributed property to the distributee partner (or a combination of the two) that exceeds \$250,000.<sup>1162</sup> In other words, if there had been a section 754 election in place, a distribution under these circumstances would have resulted in a negative inside basis adjustment that exceeds \$250,000. As discussed above, losses to the partner and increases to the basis of distributed property only occur on liquidating distributions (not current distributions).

c. Since the enactment of TCJA, a partnership is deemed to have “substantial built-in loss” if:

(1) The partnership’s adjusted basis in the partnership property exceeds the fair market value of such property by more than \$250,000.<sup>1163</sup>

(2) Effective for transfers of partnership interests after December 31, 2017, “the transferee partner would be allocated a loss of more than \$250,000 if the partnership assets were sold for cash equal to their fair market value immediately after such transfer.”<sup>1164</sup>

## N. Partnership Divisions Are an Important Tool in Estate Planning

### 1. Generally

a. Divisions of partnerships are generally not specifically defined in the Code or under state law. A partnership division is any transaction that converts a single partnership into two or more resulting partnerships. A division of a partnership can be accomplished in a number of different ways, sometimes referred to as, “assets-over, assets-up, and interests-over.”<sup>1165</sup>

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<sup>1161</sup> § 734(a)(1).

<sup>1162</sup> §§ 734(d) and 734(b)(2).

<sup>1163</sup> § 743(d)(1)(A).

<sup>1164</sup> § 743(d)(1)(B).

<sup>1165</sup> Cassady V. Brewer, *Coming Together and Breaking Apart: Planning and Pitfalls in Partnership Mergers and Divisions*, 43<sup>rd</sup> Annual Southern Federal Tax Institute (2008), Outline F, F-13.

(1) Assets-Over: Divided partnership contributes some of its assets (and perhaps liabilities) to a recipient partnership in exchange for an interest in the recipient partnership, followed by a distribution of the interests in the recipient partnership to the partners.

(2) Assets-Up: Divided partnership contributes some of its assets (and perhaps liabilities) to some or all of its partners, and the partners then contribute those assets (and liabilities, if any) to the recipient partnership for interests in the recipient partnership.

(3) Interests-Over: Some or all of the partners in the divided partnership contribute a portion of their interest in the divided partnership to the recipient partnership in exchange for interests in the recipient partnership, followed by a liquidating distribution of assets (and perhaps liabilities) into the recipient partnership.

b. To avoid unintended transfer tax consequences, tax planners must be wary of the special valuation rules of Chapter 14, in particular, section 2701.

(1) Section 2701 includes a “transfer” of an interest in a family-controlled partnership to a member of the transferor’s family, pursuant to which the transferor keeps an applicable retained interest.<sup>1166</sup> “Transfer” is broadly defined and is deemed to include “a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership.”<sup>1167</sup>

(2) Importantly in this context, section 2701 does not apply to a transfer “to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer.”<sup>1168</sup> The Treasury Regulations provide the following example: “Section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P’s child in a manner that reduces each interest held by P and any applicable family members, in the aggregate by 10 percent even if the transfer does not proportionately reduce P’s interest in each class.”<sup>1169</sup> This exception is often referred to as the “vertical slice exception.”

(3) In addition, section 2701 does not apply to any right with respect to an applicable retained interest if such interest is the same class as the transferred interest,<sup>1170</sup> or the same as the transferred interest, without regard to non-lapsing differences in voting power (or, for a partnership, non-lapsing differences with respect to management and limitations on liability).<sup>1171</sup>

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<sup>1166</sup> § 2701.

<sup>1167</sup> § 2701(e)(5).

<sup>1168</sup> Treas. Reg. § 25.2701-1(c)(4).

<sup>1169</sup> *Id.*

<sup>1170</sup> § 2701(a)(2)(B).

<sup>1171</sup> § 2701(a)(2)(C). Non-lapsing provisions that are necessary to comply with the partnership allocation requirements will be treated as non-lapsing differences with respect to limitations on liability. Treas. Reg. § 25.2701-1(c)(3).

(4) Consequently, most divisions of partnerships for estate planning purposes (assuming no gifts are intended as a result of the division) will result in the partners in the divided partnership being the same partners in the recipient partners and retaining the same pro rata interest in both the divided and the recipient partnership.

## 2. Tax Treatment of Partnership Divisions

a. Partnership divisions are governed by section 708(b)(2)(B). The Treasury Regulations issued in 2001,<sup>1172</sup> provide that the IRS will not respect the “interests-over” form of partnership division described above. In addition, while both an assets-over and assets-up method will be respected under the Treasury Regulations, there is a preference to treat the transaction as an assets-over transaction.<sup>1173</sup>

b. In the assets-over form, the divided partnership transfers assets to the recipient partnership in exchange for interest in the recipient partnership, followed by a distribution of the recipient partnership interests to the partners.<sup>1174</sup> Parity of ownership interests will likely exist between the divided partnership and the recipient partnership because of the Chapter 14 considerations mentioned above. As such, the distribution of the recipient partnership interest to the partners will be current distributions rather than liquidating distribution because no partner is terminating his or her interest in the divided partnership. Because of this parity of ownership, it is unlikely that the “mixing bowl” transaction (as discussed above) will trigger any gain or loss.<sup>1175</sup> In particular, the preamble to the final Treasury Regulations on partnership mergers and divisions, the IRS and Treasury clearly asserted the following:<sup>1176</sup>

In the preamble to the proposed regulations, the IRS and Treasury requested comments as to whether expanded exceptions under sections 704(c)(1)(B) and 737 would be appropriate in the context of partnership divisions. Most commentators agreed that it would not be wise to expand the current exceptions. In a related point, some commentators stated that the contribution of assets in a division should not create new section 704(c) property or section 737 net precontribution gain.

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<sup>1172</sup> T.D. 8925, 66 Fed. Reg. 715 (Jan. 4, 2001).

<sup>1173</sup> See Treas. Reg. § 1.708-1(d)(3).

<sup>1174</sup> Treas. Reg. § 1.708-1(d)(3)(i)(A). The transitory ownership by the divided partnership of all the interests in the recipient partnership is ignored. Treas. Reg. § 1.708-1(d)(5) Ex. 3-6.

<sup>1175</sup> §§ 704(c)(1)(B), 737 and Treas. Reg. §§ 1.704-4(c)(4), 1.737-2(b)(2).

<sup>1176</sup> T.D. 8925, 66 Fed. Reg. 715 (1/4/01). See also IRS Notice 2009-70, 2009-34 I.R.B. 255 (IRS inviting comments on multiple layers of forward and reverse 704(c) gain and loss to partnerships and tiered partnerships, including in the context of mergers and divisions. On issue 18 for comment, the IRS asks, “Assuming a partnership division should not create new section 704(c) property (or section 737 precontribution gain) when each partner’s overall interest in each partnership property does not change, how should section 704(c) layers be created and maintained when a division is not pro rata or other changes in partners or property interests occur at the time of the division?”).

To the extent that a partnership division merely affects a restructuring of the form in which the partners hold property (that is, each partner's overall interest in each partnership property does not change), the IRS and Treasury agree that a partnership division should not create new section 704(c) property or section 737 net precontribution gain. However, it is not clear that this result is necessarily appropriate where a division is non-pro rata as to the partners, where some property is extracted from or added to the partnerships in connection with the division, or where new partners are added to the ownership group in connection with the division. The IRS and Treasury intend to study this issue and request comments in this regard.

Similarly, given the parity of ownership before and after the division, there should be no gain resulting from a deemed distribution of cash under section 752 because the division will not result in a change in the share of the liabilities of the partners.

c. The resulting basis that the partners have in their respective interests in the divided partnership and the recipient partnership depend on what assets and liabilities are contributed and distributed as a result of the division.

d. In a division, the Treasury Regulations provide that a “resulting partnership”<sup>1177</sup> (a partnership that has at least 2 partners from the prior partnership) will be considered a continuation of the prior partnership if the partners in the resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership.<sup>1178</sup> All resulting partnerships that are considered a continuation of the prior partnership are subject to all preexisting tax elections (for example, a section 754 election) that were made by the prior partnership.<sup>1179</sup> Thus, in pro rata divisions where all of the partners retain the same ownership in the resulting partnerships, all of the resulting partnerships will be considered continuing partnerships, retaining all prior tax elections of the divided partnership.<sup>1180</sup>

e. There is a narrow anti-abuse provision in the Treasury Regulations with respect to partnership divisions. It provides that if a partnership division is “part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent”<sup>1181</sup> with the form, the IRS may recast the larger series of transactions in accordance with their substance.

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<sup>1177</sup> Treas. Reg. § 1.708-1(d)(4)(iv)

<sup>1178</sup> Treas. Reg. § 1.708-1(d)(1).

<sup>1179</sup> Treas. Reg. § 1.708-1(d)(2)(ii).

<sup>1180</sup> See PLR 9015016 (seven continuing partnerships with same owners in the same proportions).

<sup>1181</sup> Treas. Reg. § 1.708-1(d)(6). See also Treas. Reg. § 1.708-1(c)(6)(ii) for an example of a abusive series of transactions that involved a partnership division and merger.

3. Partnership Divisions in Tax Basis Management

a. The importance of tax-free partnership divisions in the new paradigm of estate planning cannot be overstated. The unitary basis rules applicable to partnership interests do not allow taxpayers to differentiate between low or high basis lots of partnership interests. The partnership division rules effectively allow taxpayers to segregate particular assets within a partnership into a new partnership and provide a separate outside basis in those assets through the new partnership. Because the basis of partnership property distributed in-kind to a partner is determined by the outside basis of the partner's interest, careful partnership divisions allow taxpayers to determine what the tax basis of the in-kind property will be upon distribution (rather than determined by an aggregate basis under the unitary basis rule).

b. Furthermore, divisions allow taxpayers to isolate the particular assets that they wish to benefit from an inside basis adjustment under sections 743 and 734, as the case may be. As mentioned above, the inside basis adjustments under section 755 are made at an entity level and apply across all of the assets within the partnership. Careful partnership divisions would allow taxpayers to determine what assets would be the subject of the inside basis adjustment and perhaps separately choose to make a section 754 election for the new partnership, rather than the original partnership.

O. Death of a Partner

1. Generally

a. The transfer of a deceased partner's interest in a partnership will not result in gain or loss, even if the deceased partner's share of liabilities exceeds outside basis.<sup>1182</sup>

b. The estate's outside basis in the partnership will equal the fair market value of the partnership interest for estate tax purposes (which is net of partnership liabilities), plus the estate's share of partnership liabilities, minus any value attributed to items of IRD owned by the partnership. The Treasury Regulations provide, "The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691."<sup>1183</sup>

c. Because only the net equity value (after taking into account partnership liabilities) is included in the gross estate for estate tax purpose but the "step-up" in basis is grossed up to include the estate's share of partnership liabilities, one of the ways to leverage the "step-up" in basis prior to the death of a partner is to borrow at the partnership level and distribute the proceeds of the loan to the partners (often referred to as a "refinancing" in the

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<sup>1182</sup> See Elliott Manning and Jerome M. Hesch, *Sale or Exchange of Business Assets: Economic Performance, Contingent Liabilities and Nonrecourse Liabilities (Part Four)*, 11 Tax Mgmt. Real Est. J. 263, 272 (1995).

<sup>1183</sup> Treas. Reg. § 1.742-1.

commercial real property business). The procurement of the loan and the subsequent distribution of the proceeds should (assuming the partnership liability is nonrecourse and the distributions are made proportionately to the partners) be a tax free distribution. As mentioned above in the upside of debt portion of these materials, in order to take advantage of this “step-up” in basis on the partnership interest, the partner must engage in another step to transfer the loan proceeds out of the gross estate. This second step would not necessarily be needed in the context of nonresident alien partners because, as discussed earlier in these materials, often a basis adjustment under section 1014 is available without any U.S. estate tax inclusion.

d. Unless a section 754 election applies, no adjustment is made to the tax basis of the partnership property as a result of the partner’s death. The lack of an inside basis adjustment puts the estate (or the successor in interest) at risk of being taxed on unrealized gain in the partnership at the time of the decedent’s death.

## 2. Inside Basis Adjustments at Death

a. If a section 754 election is timely made or in place at the time of a partner’s death, the estate or successor to the partnership interest gets the benefit of an inside basis adjustment over the partnership’s assets under section 743.

(1) The inside basis adjustment will not, however, “step-up” the basis of partnership assets that would be considered IRD if held by the deceased partner individually and unrealized receivables of the partnership.<sup>1184</sup>

(2) The IRS has affirmatively ruled that the inside basis adjustment applies to the entire partnership interest that is considered community property upon the death of the deceased spouse/partner (even if the estate of the deceased partner is admitted as a partner and the surviving spouse is not admitted as a partner).<sup>1185</sup> The rule applies regardless of which spouse predeceases the other.

(3) The inside basis adjustment is limited by the fair market value of the deceased partner’s interest in the partnership. As such, to the extent that valuation discounts are applicable to the partnership interest, the inside basis adjustment will be limited to the extent of such discounts. To the extent little or no transfer taxes would be payable upon the death of a partner, practitioners may want to reduce or eliminate such valuation discounts, thereby maximizing the inside basis adjustment with a section 754 election. Further, because the inside basis adjustment under section 743 is applied to all of the assets in the partnership at the time of the death of the partner, the adjustment does not allow tax practitioner to proactively choose which asset will get the benefit of the “step-up” in basis. For this reason, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner’s death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner’s outside basis is very low, the distributed property

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<sup>1184</sup> §§ 1014(c), 691(a)(1), Treas. Reg. § 1.691(a)(1)-1(b), and *Woodhall v. Commissioner*, 454 F.2d 226 (9<sup>th</sup> Cir. 1972).

<sup>1185</sup> Rev. Rul. 79-124, 1979-1 C.B. 224.

will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the “step-up” in basis and also choose the asset that they wish to receive the basis adjustment at death.

(4) As mentioned above, the adjustment under section 743(b) is the difference between the successor partner’s tax basis in partnership interest (generally, fair market value at the date of death under section 1014(a), increased by the partner’s share of partnership liabilities and reduced by items of IRD) and the successor partner’s proportionate share of the basis of the partnership property. In calculating the partner’s proportionate share of the partnership’s tax basis, the Treasury Regulations assume a fully taxable hypothetical sale of the partnership’s assets. This taxable sale is deemed to occur immediately after the transfer that triggers the inside basis adjustment. The IRS has ruled that the transfer in question, for purposes of section 743(b), is the date of the decedent partner’s death.<sup>1186</sup> As such, practitioners should consider what effect the death of the partner might have on the value of the partnership assets in determining the inside basis adjustment.

b. Even in the absence of a section 754 election, there is a mandatory downward inside basis adjustment if, at the time of death, the partnership has a substantial built-in loss (more than \$250,000).<sup>1187</sup> For example, if A owns 90% of a partnership. At the time of A’s death, if the partnership owns property worth \$9 million but with a tax basis of \$10 million, then the partnership will be required to make a mandatory downward basis adjustment of \$900,000 (assuming A’s share the partnership’s basis is 90% of the total basis).<sup>1188</sup>

### 3. Section 732(d) Election: Avoiding the Section 754 Election

a. As mentioned above, even with no section 754 election, the estate or successor in interest can achieve the same benefits of an inside basis adjustment if the partnership makes a liquidating distribution of property within two years of the date of death and if the successor partner makes an election under section 732(d).<sup>1189</sup> The election must be made in the year of the distribution if the distribution includes property that is depreciable, depletable, or amortizable. If it does not include such property, the election can wait until the first year basis has tax significance.<sup>1190</sup>

b. The basis adjustment is computed under section 743(b), which relates the basis adjustments due to sales or transfer of partnership interest (during lifetime, or more notably for this discussion, at death). The inside basis adjustment is made artificially to all of the partnership property owned on the date of death (for purposes of determining the transferred inside basis to the distributee with respect to the property distributed). In other words, it is

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<sup>1186</sup> Rev. Rul. 79-84, 1979-1 C.B. 223 (partnership interest owned by grantor trust).

<sup>1187</sup> § 743(b).

<sup>1188</sup> See IRS Notice 2005-32, 2005-1 C.B. 895.

<sup>1189</sup> Treas. Reg. § 1.732-1(d)(1)(iii).

<sup>1190</sup> Treas. Reg. § 1.732-1(d)(2).

allocated to all of the partnership property whether actually distributed or not.<sup>1191</sup> If any property for which the distributee/transferee would have had an inside basis adjustment is distributed to another partner, the adjustment for such distributed property is reallocated to remaining partnership property.<sup>1192</sup>

c. The election under section 732(d) can be a significant planning opportunity especially when planners would like to avoid having a section 754 election in place. As mentioned above, once the section 754 election is made, it is irrevocable unless the IRS gives permission to revoke the election. Because the inside basis adjustments under section 743(b) only apply to the transferees of the partnership interests (not to the partnership as a whole), having a section 754 election in place requires having a different set of basis calculations for the transferees of the interest. The book keeping requirements become quite onerous as partnership interests are often distributed at death to multiple trusts or beneficiaries and become even more so as additional partners pass away.

d. If the distribution of property is made pursuant to provision in the partnership agreement that requires a mandatory in-kind liquidation of the deceased partner's interest based on the partner's positive capital account balance, then the estate would have a good argument to say that the value of the partner's interest for purposes of section 1014(a) should not entail valuation discounts. This would, in turn, increase the inside basis adjustment on the assets claimed with the section 732(d) election. Giving the manager of the LLC or general partner of the partnership the discretion to determine what assets to distribute in liquidation of the partnership interest could give considerable planning opportunities to pick and choose which assets to receive the inside basis adjustment based on the needs of the distributee partner. While the assets received would likely not receive full fair market value (because, as mentioned above, the inside basis adjustment is artificially allocated across all of the partnership assets whether distributed or not), some planning opportunities could exist by distributing assets to other partners prior to the liquidation because the nominal inside basis adjustment that would have been allocated to those assets would be adjusted to the remaining partnership property.

## P. Partnership Terminations

1. Prior to the enactment of TCJA, a partnership was treated as terminated for tax purposes if:

a. No part of any “business, financial operation, or venture of the partnership continues to be carried on by any of its partners,”<sup>1193</sup> or

b. Within a twelve month period there is a “sale or exchange of 50 percent or more of the “total interest in partnership capital and profits.”<sup>1194</sup>

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<sup>1191</sup> Treas. Reg. §§ 1.732-1(d)(1)(vi), 1.743-1(g)(1) and (5), Ex. (ii).

<sup>1192</sup> Treas. Reg. §§ 1.743-1(g)(2) and (5), Ex. (iv).

<sup>1193</sup> § 708(b)(1)(A).

<sup>1194</sup> § 708(b)(1)(B).

2. The latter termination event is often referred to as a “technical termination” because the termination often did not necessarily end the partnership’s existence. However, a technical termination closes the partnership’s taxable year, terminates certain partnership elections, and can restart the depreciation recovery periods for certain types of property.<sup>1195</sup>

3. With the enactment of TCJA, effective for partnership taxable years beginning after December 31, 2017, the technical termination rule under section 708(b)(1)(B) of the Code is repealed.<sup>1196</sup> As a result, a partnership is considered terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners.

4. Any partnership activity will suffice to continue a partnership and keep it from terminating.<sup>1197</sup> For example, it’s been held that the mere collection of promissory notes is sufficient to keep a partnership from terminating.<sup>1198</sup>

#### Q. Maximizing the “Step-Up” and Shifting Basis

1. Given the limitations of the basis adjustment at death, practitioners may want to consider distributing certain property in-kind to the partner prior to the partner’s death and allowing the partner to own the property outside the partnership at the time of death. Valuation discounts will not apply, and if the partner’s outside basis is very low, the distributed property will have a very low basis in the hands of the partner. In this manner, practitioners can maximize the size of the “step-up” in basis and also choose the asset that they wish to receive the basis adjustment at death.

2. Consider the following scenario: FLP owns 2 assets, one with very high basis and one with very low basis, neither of which is a marketable security. The assets have been in the FLP for more than seven years. The partners consist of younger family members and a parent. Assume that the parent’s outside basis in the FLP is zero. As discussed above, the traditional advice of allowing the parent to die with the FLP interest and making a section 754 election after death will likely create an inside basis adjustment that is limited by a significant valuation discount under section 743. Assume further that the partnership intends on selling the very low basis asset relatively soon. What might be a way to maximize the “step-up” in basis that will occur at the parent’s death and also create tax basis for the low basis asset that will be sold? The partnership should make a section 754 election and distribute the high basis asset, in-kind, to the parent in full or partial liquidation/redemption of the parent’s interest in the partnership. What is the result of this distribution?

3. Because the distribution is not cash or marketable securities, neither the partner nor the partnership will recognize any gain or loss upon a distribution of the property.<sup>1199</sup>

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<sup>1195</sup> See e.g., §§ 708(a), 706(c)(1), 168(i)(7), and Treas. Reg. § 1.708-1(b)(3).

<sup>1196</sup> § 13504 of TCJA.

<sup>1197</sup> See § 708(a).

<sup>1198</sup> See *Baker Commodities v. Commissioner*, 415 F.2d 519 (9th Cir. 1969), and *Foxman v. Commissioner*, 41 T.C. 535 (1964), *aff’d*, 392 F.2d 466 (3rd Cir. 1965).

In addition, because the assets have been in the partnership for more than seven years, there are no concerns about triggering any gain to another partner under the “mixing bowl” or the “disguised sale” rules. The basis of the distributed property in the hands of the parent is based on the tax basis that the partnership had in the property prior to the distribution. The basis of the distributed property will, however, be limited to the outside basis of the partner’s partnership interest, as adjusted for cash distributions (reduction in basis) and changes in liabilities because the distributed property is encumbered with debt. This limitation, effectively, transfers the inherent gain in the partnership interest (outside basis) to the distributed property. In other words, the basis of the asset now held by the parent is zero. Because the parent now owns the property individually and outside of the partnership, upon the parent’s death, the property will get a full “step-up” in basis to fair market value, free of any valuation discounts.

4. Because a section 754 election was made, an adjustment of inside basis under section 734(b) occurs. The adjustment results in an increase to the inside basis of the partnership assets. The increased basis adjustment is allocated first to appreciated property in proportion to the amount of unrealized appreciation, with any remaining increase allocated to all of the properties within the same class (capital gain or ordinary) in proportion to fair market values. Thus, there is a possibility of allocating basis to an asset above its fair market value, creating the possibility of a recognizable loss to the partners. The result, in this case, is the tax basis that was “stripped” from the high basis asset when it was distributed to the parent (and became a zero basis asset) is allocated to the only other remaining asset in the partnership (the low basis asset that will be sold). Thus, the low basis asset becomes a high basis asset, reducing or eliminating the gain to be recognized when it is sold. Unlike adjustments under section 743(b), adjustments under section 734(b) (upon a distribution of partnership property to a partner) are made to the common inside basis of the partnership assets, so the basis adjustment is made in favor of all of the partners in the partnership (not just for the benefit of a transferee). This is commonly referred to as “basis shifting.”

5. Boiled down to its purest form, partnership basis shifting requires the following elements: (i) a partnership that owns a low basis asset (or group of assets) and a high basis asset (or group of assets); (ii) the low and high basis asset must have either been purchased by the partnership or if they were contributed, they were contributed more than 7 years ago; and (iii) a partner (or group of partners) who has little or no outside basis in its partnership interest. Assuming all of these elements are present, basis stripping and shifting occurs when the partnership makes a distribution of the high basis asset to the low outside basis partner when the partnership has a section 754 election in place.

Example: ABC Partnership owns two assets and has a section 754 election in place. Asset A has an inside basis of \$0x and a fair market value of \$100x. Asset B has an inside basis of \$100x and a fair market value of \$100x. ABC Partnership has three partners, A, B, and C. The outside basis of C’s partnership interest is \$0x and a capital account of \$100x. ABC Partnership distributes Asset B (the high basis asset) to C in liquidation of C’s partnership interest.

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<sup>1199</sup> § 731(a)-(b) and Treas. Reg. § 1.731-1(a)-(b). This assumes the property distributed is not a “hot asset” under section 751 of the Code.

As discussed in these materials, Asset B will have its basis reduced to the outside basis of C's partnership interest, which is \$0x. This is sometimes referred to as the "basis strip." C owns Asset B outside of the partnership with an outside basis of \$0x and a fair market value of \$100x. It should be noted that if this was a non-liquidating "current" distribution (e.g., C's capital account was \$150x), you would have the same result and C would still be a partner.

Because ABC Partnership has a section 754 election in place, under section 734(b), the adjusted basis of partnership property (the only asset in the ABC Partnership is Asset A) is increased by the amount of basis what was stripped from Asset B upon the distribution to C.<sup>1200</sup> As a result, Asset A (as the only asset remaining in the partnership) will have its inside basis increased to \$100x. This is sometimes referred to as the "basis shift." The end result is the tax basis that was on Asset B has been "shifted" to Asset A.

6. Although the elements of a basis strip and shift are straightforward, the path to creating an efficient structure to accomplish the shift is quite complex. If the assets used in this technique were contributed to the partnership, the 7-year holding period to avoid triggering gain under the mixing bowl rules is often the most difficult factual hurdle for many clients. It is just simply too long for many clients. In addition, in order to have an efficient basis shift (i.e., tax basis is added to a specific asset in an amount equal to or close to the fair market value of that asset), then the asset (or group of assets) receiving the basis must be the only asset left in the partnership. Otherwise, the basis increase created from the strip will be allocated across a number of partnership assets, none of which will likely get a full basis increase to fair market value. Furthermore, as noted above, both assets in the basis strip and shift must be of the same class (i.e., both capital assets or both ordinary income assets). Practitioners should also remember that if the partnership has "hot" (ordinary income) assets, a disproportionate distribution of a capital asset (or vice versa) may trigger gain under section 751. Thus, it is recommended that partnerships only hold one class of property (i.e., only capital assets). This is why, as noted, partnership divisions are a critical step in basis shifting, in particular, vertical slice divisions. A vertical slice division is a tax free method of segregating classes of assets and, more importantly, isolating the low and high basis assets that will be the subject of the basis strip and shift into its own partnership. Lastly, the partner (or partners) receiving the distributed asset must have a low outside basis. To that end, the unitary basis rule will generally increase the basis of the recipient partner, so turning off grantor trust status may be one of the preliminary steps toward the goal of the recipient partner having a low outside basis. As one can see, creating an efficient basis shift environment is much more difficult to create, than the actual mechanics of it. However, it is possible.

7. Practitioners should consider setting up a partnership that is funded with all manner of assets that might be used in this type of planning (high and low basis assets, depreciable and non-depreciable assets, closely held company interests, cash, etc.). The more

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<sup>1200</sup> The basis increase is "in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution... over the basis of the distributed property to the distributee, as determined under section 732." § 734(b)(1)(B).

assets the taxpayers contribute, the more options will be available in the future. The only type of asset planners should consider avoiding is marketable securities. This is because, generally, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property) when assets other than marketable securities are held by the partnership.<sup>1201</sup> Thus, regardless of the basis in the marketable securities, a distribution may cause the distributee partner to recognize gain because of insufficient outside basis. However, as discussed above, there is an important exception to this rule that might allow practitioners to create a separate partnership holding only marketable securities and still allow the types of tax basis management discussed herein. Once the assets have been contributed, it is critical that the assets remain in the partnership for at least seven years to avoid the “mixing bowl” and “disguised sale rule” problems.

8. During the seven year period, if at all possible, the partnership should avoid making a section 754 election because of the limitations of the inside basis adjustment at death and the onerous record keeping requirements. Once the seven year period has expired, then the assets of the partnership (that is hopefully free of a section 754 election) are ripe for proactive tax basis management. Once an opportunity arises for the type of planning discussed above (e.g., a potential sale of a low basis asset or the failing health of a partner), then the partnership can then proceed to isolate the appropriate assets in tax free “vertical slice” division. The assets to be carved out of the larger partnership into a smaller partnership would be those assets selected to receive the basis and those that would have their basis reduced upon distribution. Careful consideration should be given to reducing the outside basis of the distributee partner through disproportionate distributions of cash, shifting basis to other partners by changing the allocable share of partnership debt under section 752 (e.g., by converting nonrecourse debt to recourse debt through a guarantee by the other partners),<sup>1202</sup> or as noted, turning off grantor trust status.

9. Upon distribution of the higher basis assets to the distributee partner, the inside basis adjustment would be applied across all of the remaining assets in the partnership, but only those assets that have been spun off the larger partnership are in this partnership. Thus, allowing for a larger basis increase to those assets (rather than having the basis increase apply to all of the assets of the larger partnership and never creating an asset fully flush with tax basis). A section 754 election is required to effectuate the inside basis shift under section 734, but the election would only apply to the smaller, isolated partnership. As such, the record keeping requirements are kept to a minimum and are totally eliminated when and if the smaller partnership is dissolved and liquidated. Remember, in a vertical slice division, the isolated partnership is considered a continuation of the larger partnership, and the elections of the previous partnership follow to the new partnership. By keeping the larger partnership free of a section 754 election, it allows practitioners to selectively choose when and over what assets it would apply to in the future.

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<sup>1201</sup> § 731(c).

<sup>1202</sup> See Treas. Reg. § 1.752-2(b).

R. Basis Shifts to Diversify a Concentrated Stock Position

1. Introduction

a. Investors with a low-basis “single stock” or concentrated stock position often look for strategies that allow them to diversify (or hedge) the concentrated position and that either defer the recognition of or eliminate the recognition of capital gain. For example, prepaid variable forward strategies allow investors to hedge the underlying stock position and provide funds to invest in a diversified portfolio, and exchange funds allow investors to contribute their concentrated stock positions to a partnership and after at least seven years, leave the partnership with a “diversified” portfolio consisting of the stocks contributed by the other partners. The prepaid variable forward strategy only defers the recognition of capital gain, and although the exchange fund allows for a tax free method of getting a portfolio of stocks different from the concentrated position, there is no guarantee that the portfolio of stocks received is of high quality or appropriately diversified. In addition, all of these strategies come at a cost that might include investment management fees, relinquishment of upside appreciation, or less than 100% of value invested in a diversified portfolio. Carefully utilizing the basis rules in a family limited partnership may be a superior alternative to the foregoing.

b. All of the strategies discussed in this section assume that (i) the partnership entity is an “investment partnership” under section 731(c)(3)(C) of the Code, and (ii) all of the assets in the partnership have been contributed more than seven years ago or have been purchased by the partnership. As such, distributions of marketable securities are not treated as distributions of cash under section 731(c) of the Code, and the “mixing bowl” rules do not apply. Further, assume the disguised sale rules do not apply, and the relevant anti-abuse rules would not apply to recharacterize the partnership transactions.

2. Shifting Basis from a Diversified Position to a Concentrated Position

a. Assume a FLP owns \$100 million of assets comprised of: (i) \$50 million of Stock A, a publicly-traded security, with zero basis, and (ii) \$50 million of a diversified portfolio of marketable securities (or shares in a diversified stock exchange-traded fund, ETF) with \$50 million of basis. The FLP is owned equally by family members of the first generation (G1 Partners) and of the second generation (G2 Partners), each generation holding a 50% interest in the FLP. To simplify the example, the two generational groups of partners will be referred to collectively (and separately) as the G1 and G2 Partners. Each of the G1 and G2 Partners has \$25 million of outside basis, and each of the partner groups have a capital account balance of \$50 million. The FLP was formed more than seven years ago when the G1 and G2 Partners each contributed an equal amount of Stock A,<sup>1203</sup> and recently one-half of the Stock A position was sold for cash and a diversified portfolio of marketable securities. The G1 and G2 Partners each recognized \$25 million of capital gain. As a result, the adjusted tax bases and capital accounts are:

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<sup>1203</sup> The contribution would have been a non-taxable event under section 721(a) of the Code even though the FLP would have constituted an investment company under sections 721(b) and 351(e) of the Code. The contributions of Stock A did not result in any diversification. Treas. Reg. §§ 1.351-1(c)(1)(i) and 1.351-1(c)(5).

Partnership Holding Stock A & Diversified Portfolio				
	<i>Partnership</i>	<i>Inside Basis</i>	<i>§ 704(b) Book Value</i>	<i>Gain</i>
	Stock A	\$0	\$50,000,000	
	Diversified Portfolio	\$50,000,000	\$50,000,000	
	<b>TOTAL</b>	<b>\$50,000,000</b>	<b>\$100,000,000</b>	
(%)	<i>Partners</i>	<i>Outside Basis</i>	<i>Book Capital Account</i>	<i>Gain</i>
50%	G1 Partners	\$25,000,000	\$50,000,000	
50%	G2 Partners	\$25,000,000	\$50,000,000	
	<b>TOTAL</b>	<b>\$50,000,000</b>	<b>\$100,000,000</b>	

b. The FLP wishes to sell the remaining position in Stock A for cash in an effort to diversify the concentrated position in Stock A. If the FLP sells the Stock A position, the results are straightforward. The FLP recognizes \$50 million of capital gain, and G1 and G2 are each allocated 50% of the gain (\$25 million each), as follows:

Partnership Sells Stock A for Cash				
	<i>Partnership</i>	<i>Inside Basis</i>	<i>§ 704(b) Book Value</i>	<i>Gain</i>
	Cash	\$50,000,000	\$50,000,000	\$50,000,000
	Diversified Portfolio	\$50,000,000	\$50,000,000	
	<b>TOTAL</b>	<b>\$100,000,000</b>	<b>\$100,000,000</b>	<b>\$50,000,000</b>
(%)	<i>Partners</i>	<i>Outside Basis</i>	<i>Book Capital Account</i>	<i>Gain</i>
50%	G1 Partners	\$50,000,000	\$50,000,000	\$25,000,000
50%	G2 Partners	\$50,000,000	\$50,000,000	\$25,000,000
	<b>TOTAL</b>	<b>\$100,000,000</b>	<b>\$100,000,000</b>	<b>\$50,000,000</b>

c. Instead of selling Stock A, assume the FLP makes a 754 election or has one in effect at such time, and the FLP could make an in-kind distribution of the diversified portfolio to the G1 Partners in a liquidating distribution (G1's capital account balance and the diversified portfolio each have a value of \$50 million). Under section 732(b) of the Code, the diversified portfolio in the hands of the G1 partners has a basis of \$25 million (having been reduced from \$50 million). Under section 734(b) of the Code, the partnership's assets (Stock A) are increased by "the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution... over the basis of the distributed property to the distributee."<sup>1204</sup> In other words, the FLP basis in Stock A is increased by \$25 million. The resulting adjusted tax bases, capital accounts of the remaining G2 Partners, and assets held by the former G1 Partners are:

<sup>1204</sup> § 734(b)(1)(B).

Partnership Distributes Diversified Portfolio to G1 Partners (754 Election/734(b) Adjustment)				
	<i>Partnership</i>	<i>Inside Basis</i>	<i>§ 704(b) Book Value</i>	<i>Gain</i>
	Stock A	\$25,000,000	\$50,000,000	
	<b>TOTAL</b>	<b>\$25,000,000</b>	<b>\$50,000,000</b>	
(%)	<i>Partners</i>	<i>Outside Basis</i>	<i>Book Capital Account</i>	<i>Gain</i>
100%	G2 Partners	\$25,000,000	\$50,000,000	
	<b>TOTAL</b>	<b>\$25,000,000</b>	<b>\$50,000,000</b>	
	<i>Diversified Portfolio</i>	<i>Tax Basis</i>	<i>Fair Market Value</i>	
	Former G1 Partners	\$25,000,000	\$50,000,000	

d. If the FLP subsequently sells the Stock A position for its fair market value and then purchases a diversified portfolio, then only \$25 million of gain will be recognized. The overall result is that all of Stock A will have been diversified, but only \$25 million (rather than \$50 million) was recognized, as illustrated below:

Partnership Sells Stock A and Reinvests in a New Diversified Portfolio				
	<i>Partnership</i>	<i>Inside Basis</i>	<i>§ 704(b) Book Value</i>	<i>Gain</i>
	New Diversified Portfolio	\$50,000,000	\$50,000,000	\$25,000,000
	<b>TOTAL</b>	<b>\$50,000,000</b>	<b>\$50,000,000</b>	<b>\$25,000,000</b>
(%)	<i>Partners</i>	<i>Outside Basis</i>	<i>Book Capital Account</i>	<i>Gain</i>
100%	G2 Partners	\$50,000,000	\$50,000,000	\$25,000,000
	<b>TOTAL</b>	<b>\$50,000,000</b>	<b>\$50,000,000</b>	<b>\$25,000,000</b>
	<i>Diversified Portfolio</i>	<i>Tax Basis</i>	<i>Fair Market Value</i>	
	Former G1 Partners	\$25,000,000	\$50,000,000	

Of course, the G1 Partners continue to have an unrealized \$25 million capital gain, but that gain can be deferred indefinitely and possibly eliminated with a “step-up” in basis upon the death of the G2 Partners.

### 3. Using Debt to Exchange a Concentrated Position for a Diversified One

a. Assume a FLP that has one asset, \$100 million of a publicly traded security, Stock A, that has zero basis. The FLP is owned by family members, 10% by first generation (G1 Partners) and 90% by the younger generations (G2 Partners). The two generational groups of partners will be referred to collectively (and separately) as the G1 and G2 Partners. The adjusted tax bases and capital accounts are:

PARTNERSHIP HOLDING STOCK A				
	<i>Partnership</i>	<i>Inside Basis</i>	<i>§ 704(b) Book Value</i>	<i>Gain</i>
	Stock A	\$0	\$100,000,000	
	Cash	\$0	\$0	
	Debt		\$0	
	<b>TOTAL</b>	<b>\$0</b>	<b>\$100,000,000</b>	
PARTNERSHIP HOLDING STOCK A				
(%)	<i>Partners</i>	<i>Outside Basis</i>	<i>Book Capital Account</i>	<i>Gain</i>
10.0%	G1 Partners	\$0	\$10,000,000	
90.0%	G2 Partners	\$0	\$90,000,000	
	<b>TOTAL</b>	<b>\$0</b>	<b>\$100,000,000</b>	

b. The family is considering winding up the affairs of the FLP and liquidating the partnership. They are also looking for ways to tax efficiently diversify the concentrated position in Stock A. Instead of selling Stock A and recognizing \$100 million of gain, the FLP borrows \$90 million from a third party lender. The third party lender, as a condition for the loan, requires a pledge of the \$100 million of the Stock A held by the partnership, and (given the size of the loan against a concentrated stock position) it also requires the G1 Partners (who have significantly more net worth than the G2 Partners) to personally guarantee the loan and post additional personal assets as collateral for the loan, in case the FLP is unable to pay any portion of the loan. The G1 Partners agree with the G2 Partners to be solely responsible for the repayment of any partnership liabilities with respect to this loan and give up any right of reimbursement from the G2 Partners. Assume, under the current and proposed Treasury Regulations, the partnership liabilities under section 752 of the Code are properly allocated to the G1 Partners because they bear the economic risk of loss. When the \$90 million loan is procured, the adjusted tax bases, capital accounts, and books of the partnership are:

PARTNERSHIP BORROWS \$90 MILLION, G1 PARTNERS BEAR ECONOMIC RISK OF LOSS				
	<i>Partnership</i>	<i>Inside Basis</i>	<i>§ 704(b) Book Value</i>	<i>Gain</i>
	Stock A	\$0	\$100,000,000	
	Cash	\$90,000,000	\$90,000,000	
	Debt		(\$90,000,000)	
	<b>TOTAL</b>	<b>\$90,000,000</b>	<b>\$100,000,000</b>	
PARTNERSHIP BORROWS \$90 MILLION, G1 PARTNERS BEAR ECONOMIC RISK OF LOSS				
(%)	<i>Partners</i>	<i>Outside Basis</i>	<i>Book Capital Account</i>	<i>Gain</i>
10.0%	G1 Partners	\$90,000,000	\$10,000,000	
90.0%	G2 Partners	\$0	\$90,000,000	
	<b>TOTAL</b>	<b>\$90,000,000</b>	<b>\$100,000,000</b>	

c. The FLP then purchases a diversified marketable securities portfolio in the form of shares in an exchange traded fund (ETF). After the purchase, the partnerships books are:

PARTNERSHIP BUYS ETF WITH LOAN PROCEEDS				
	Partnership	Inside Basis	§ 704(b) Book Value	Gain
	Stock A	\$0	\$100,000,000	
	ETF	\$90,000,000	\$90,000,000	
	Debt		(\$90,000,000)	
	<b>TOTAL</b>	<b>\$90,000,000</b>	<b>\$100,000,000</b>	
(%)	Partners	Outside Basis	Book Capital Account	Gain
10.0%	G1 Partners	\$90,000,000	\$10,000,000	
90.0%	G2 Partners	\$0	\$90,000,000	
	<b>TOTAL</b>	<b>\$90,000,000</b>	<b>\$100,000,000</b>	

d. Later, assuming the FLP makes a 754 election or has one in effect, the FLP distributes the ETF to the G2 Partners in liquidation of their interest in the FLP. The capital account balance of the G2 Partners and the fair market value of the ETF are \$90 million. Under section 732(b) of the Code, the ETF in the hands of the G2 partners has a basis of zero.<sup>1205</sup> Under section 734(b) of the Code, the partnership’s assets (Stock A) are increased by the \$90 million of excess basis that was stripped from the ETF. The results are:

§ 754 ELECTION AND INSIDE BASIS ADJUSTMENT UNDER § 734				
	Partnership	Inside Basis	§ 704(b) Book Value	Gain
	Stock A	\$90,000,000	\$100,000,000	
	Cash	\$0	\$0	
	Debt		(\$90,000,000)	
	<b>TOTAL</b>	<b>\$90,000,000</b>	<b>\$10,000,000</b>	
(%)	Partners	Outside Basis	Book Capital Account	Gain
100%	G1 Partners	\$90,000,000	\$10,000,000	
	<b>TOTAL</b>	<b>\$90,000,000</b>	<b>\$10,000,000</b>	
	ETF	Adjusted Basis	Fair Market Value	
	Former G2 Partners	\$0	\$90,000,000	

e. Assuming no changes in value and ignoring interest and other costs, when the FLP then sells \$90 million of Stock A (90% of the partnership’s holdings) to repay the

<sup>1205</sup> In this example, the G1 partners bear the economic risk of loss and the partnership liability is recourse to the G1 partners. As a result, the outside bases of the G1 partners are increased by the total liability under section 752(a) of the Code. If, in contrast, the partnership liabilities were considered nonrecourse liabilities and all of the partners had their outside bases increased by a proportionate amount of the liability, you would get the same result (the ETF in the hands of the G2 partners has a basis of zero) because the interests of the partners are fully liquidated. As a result, when the G2 partners exit the partnership and they are no longer share any of the partnership liabilities, there is a deemed distribution of money under section 752(b) of the Code, reducing their outside bases to zero, which is then followed by a distribution of the ETF with an inside basis of \$90 million.

loan, the FLP will recognize \$9 million of gain. The gain will be reflected in the outside basis of the G1 Partners, as follows:

PARTNERSHIP SELLS ENOUGH STOCK A TO REPAY LOAN				
	Partnership	Inside Basis	§ 704(b) Book Value	Gain
	Stock A	\$0	\$10,000,000	
	Cash	\$90,000,000	\$90,000,000	\$9,000,000
	Debt		(\$90,000,000)	
	<b>TOTAL</b>	<b>\$90,000,000</b>	<b>\$10,000,000</b>	
PARTNERSHIP SELLS ENOUGH STOCK A TO REPAY LOAN				
(%)	Partners	Outside Basis	Book Capital Account	Gain
100%	G1 Partners	\$99,000,000	\$10,000,000	\$9,000,000
	<b>TOTAL</b>	<b>\$99,000,000</b>	<b>\$10,000,000</b>	

f. The subsequent repayment of the loan to the third party lender will decrease the outside basis of the G1 Partners under section 752(b) of the Code:

PARTNERSHIP PAYS OFF THIRD PARTY LOAN				
	Partnership	Inside Basis	§ 704(b) Book Value	
	Stock A	\$9,000,000	\$10,000,000	
	Cash	\$0	\$0	
	Debt		\$0	
	<b>TOTAL</b>	<b>\$9,000,000</b>	<b>\$10,000,000</b>	
PARTNERSHIP PAYS OFF THIRD PARTY LOAN				
(%)	Partners	Outside Basis	Book Capital Account	
100%	G1 Partners	\$9,000,000	\$10,000,000	
	<b>TOTAL</b>	<b>\$9,000,000</b>	<b>\$10,000,000</b>	

g. If the FLP subsequently liquidates and winds up its affairs, assuming no changes in values, the end result is exactly the same as it would have been if G2 had contributed its allocable share of Stock A to a third party exchange fund and then liquidated its share of the fund seven years later. In this strategy, however, there is no need to wait seven years (the “mixing bowl” period was tolled in the FLP), the diversified portfolio is chosen by the family (rather than what may be held by the exchange fund including non-equity assets [e.g., real estate investments] that are typically held by exchange funds to avoid investment company status), and there is minimal gain:

LIQUIDATION OF PARTNERSHIP AND END RESULT			
Former Partner	Adjusted Basis	Fair Market Value	Gain
G1 (STOCK A)	\$9,000,000	\$10,000,000	\$9,000,000
G2 (ETF)	\$0	\$90,000,000	\$0

S. Basis Shifts with Grantors and Grantor Trusts

1. Generally

a. When reduced down to its simplest form, basis shifting transactions involve a partnership holding a low and a high basis asset, a partner having a low outside basis in

his or her partnership interest, and a distribution of the high basis asset to the low outside basis partner. Often, however, a partnership may not have any assets with sufficient basis in order to effectuate the basis shift.

b. In the previous example dealing with marketable securities, the partnership used leverage to purchase an asset, thereby acquiring a high basis asset. If, however, partnership debt is not an option, a contribution of a high basis asset to the partnership should be considered. The difficulty with using contributed property in this type of planning is that the distribution of the high basis asset may trigger a taxable gain under the disguised sale and mixing bowl transaction rules.

c. Contributions by a grantor to a partnership that has a grantor trust (IDGT) as a partner may be a way to reduce the risk of triggering gain because of the unitary basis rules. As mentioned earlier in these materials, the unitary basis rules require that a grantor and an IDGT will share outside basis (and capital account), and as a result, contributions of high basis assets by one or the other will result in a proportional increase in the outside basis that is shared by both partners.

## 2. Basis Shift Example

a. A limited partnership (LP) has an S corporation as general partner, with 100% of the limited partnership interests owned by an IDGT. Assume that the S corporation owns a sufficient interest in the LP to be recognized as partner for tax and state law purposes (e.g., 1%), but for purposes of this illustration, its interest in the partnership will be ignored. The LP owns Asset A with an inside basis of zero and a fair market value of \$100x. The IDGT owns 100% of the limited partnership interests which have an outside basis of zero and a capital account of \$100x. For tax reasons, the partnership would like Asset A to have tax basis.

b. Grantor contributes Asset B, which has an adjusted basis of \$100x and a fair market value of \$100x, to the LP in exchange for 50% of the limited partnership interests. After the contribution, grantor and IDGT are equal partners, each owning an equal share of all of the limited partnership interests. Due to unitary basis and capital account rules, grantor and IDGT share an outside basis of \$100x and a capital account of \$200x. LP owns Asset A (\$0 basis/\$100x in value) and Asset B (\$100x basis/\$100x in value).

c. So long as grantor and IDGT are considered the same taxpayer, they will continue to share an outside basis of \$100x such that if Asset B (high basis asset) is distributed to either of them, it's unlikely that a basis reduction would occur because the basis that is shared by both of them is equal to the tax basis of Asset B. However, what if grantor trust status is relinquished with respect to the IDGT?

d. When grantor trust status is lost, the grantor is deemed to make a transfer of the partnership interest held by the trust, which is now a separate taxpayer, as a non-grantor trust. In this example, grantor is deemed to make a transfer of 50% of the limited partnership interests to the trust, which requires an allocation of outside basis and capital account to the transfer. Prior to the transfer, the unitary basis of all of the limited partnership interests was \$100x and the capital account was \$200x. 50% of the capital account or \$100x will go to the trust upon the deemed transfer. As discussed above, according to Revenue Ruling 84-53, the amount of basis that is allocated to the transfer depends on the relative fair market values of the transferred interest and the entire interest prior to the transfer.

e. Let's assume in "Version 1" of this example, the fair market value of 100% of the limited partnership is equal to the capital account balance of \$200x (liquidation value) because the sole shareholder of the S corporation is the grantor who is the transferor in this deemed transfer. The grantor has the power to compel liquidation of the LP. If the deemed transfer of the 50% limited partnership interest to the trust carries a 30% valuation discount, then \$35x of basis will pass to the trust (\$65x will remain with the grantor), as follows:

$$\begin{array}{r}
 \text{Transferor's} \\
 \text{Adjusted Basis} \\
 \underline{\$100x}
 \end{array}
 \times
 \frac{
 \begin{array}{c}
 \text{Fair Market Value (Discounted)} \\
 \text{Transferred Portion} \\
 \underline{\$70x} \\
 \text{Fair Market Value} \\
 \text{Transferor's Entire Portion} \\
 \underline{\$200x}
 \end{array}
 }{
 }
 =
 \begin{array}{r}
 \text{Transferee's} \\
 \text{Adjusted Basis} \\
 \underline{\$35x}
 \end{array}$$

f. The resulting partnership books after the deemed transfer are as follows:

LP: Version 1 (After Deemed Transfer)			
	Partnership	Inside Basis	§ 704(b) Book Value
	Asset A	\$0	\$100
	Asset B	\$100	\$100
	<b>TOTAL</b>	<b>\$100</b>	<b>\$200</b>
(%)	Partners	Outside Basis	Book Capital Account
50%	Grantor	\$65	\$100
50%	Trust (Former IDGT)	\$35	\$100
	<b>TOTAL</b>	<b>\$100</b>	<b>\$200</b>

g. Assuming a section 754 election is in place, if Asset B is distributed to the trust in liquidation of its interest in the LP, the resulting partnership books and position of the trust are as follows:

LP: Version 1 (After Liquidating Distribution to Trust)			
	Partnership	Inside Basis	§ 704(b) Book Value
	Asset A	\$65	\$100
	<b>TOTAL</b>	<b>\$65</b>	<b>\$100</b>
(%)	Partners	Outside Basis	Book Capital Account
100%	Grantor	\$65	\$100
	<b>TOTAL</b>	<b>\$65</b>	<b>\$100</b>
	<i>Asset B</i>	<i>Tax Basis</i>	<i>Fair Market Value</i>
	Trust (Former IDGT)	\$35	\$100

h. Version 1 of this example results in a shift of \$65x of basis to Asset A with \$35x remaining with Asset B now owned by the trust outside of the partnership.

i. In “Version 2” of this example, everything is the same except the fair market value of 100% of the limited partnership is not equal to a liquidation value of \$200x. Rather, the fair market value of the limited partnership interests held by the grantor have a 30% valuation discount associated with them (because in Version 2, perhaps, the grantor is not have control of the S corporation general partner of LP). The value of the grantor’s interests prior to the deemed transfer is \$140x. If the deemed transfer of the 50% limited partnership interest to the trust carries a 30% valuation discount, then \$50x of basis will pass to the trust (\$50x will remain with the grantor), as follows:

$$\begin{array}{r}
 \text{Transferor's} \\
 \text{Adjusted Basis} \\
 \underline{\$100x}
 \end{array}
 \times
 \frac{
 \begin{array}{c}
 \text{Fair Market Value (Discounted)} \\
 \text{Transferred Portion} \\
 \underline{\$70x}
 \end{array}
 }{
 \begin{array}{c}
 \text{Fair Market Value} \\
 \text{Transferor's Entire Portion} \\
 \underline{\$140x}
 \end{array}
 }
 =
 \begin{array}{r}
 \text{Transferee's} \\
 \text{Adjusted Basis} \\
 \underline{\$50x}
 \end{array}$$

j. The resulting partnership books after the deemed transfer are as follows:

LP: Version 2 (After Deemed Transfer)			
	Partnership	Inside Basis	§ 704(b) Book Value
	Asset A	\$0	\$100
	Asset B	\$100	\$100
	<b>TOTAL</b>	<b>\$100</b>	<b>\$200</b>
(%)	Partners	Outside Basis	Book Capital Account
50%	Grantor	\$50	\$100
50%	Trust (Former IDGT)	\$50	\$100
	<b>TOTAL</b>	<b>\$100</b>	<b>\$200</b>

k. Assuming a section 754 election is in place, if Asset B is distributed to the trust in liquidation of its interest in the LP, the resulting partnership books and position of the trust are as follows:

LP: Version 2 (After Liquidating Distribution to Trust)			
	<i>Partnership</i>	<i>Inside Basis</i>	<i>§ 704(b) Book Value</i>
	Asset A	\$50	\$100
	<b>TOTAL</b>	<b>\$50</b>	<b>\$100</b>
(%)	<i>Partners</i>	<i>Outside Basis</i>	<i>Book Capital Account</i>
100%	Grantor	\$50	\$100
	<b>TOTAL</b>	<b>\$50</b>	<b>\$100</b>
	<i>Asset B</i>	<i>Tax Basis</i>	<i>Fair Market Value</i>
	Trust (Former IDGT)	\$50	\$100

1. Version 2 of this example results in a shift of \$50x of basis to Asset A with \$50x remaining with Asset B now owned by the trust outside of the partnership, which may seem less effective, but as discussed below, it may solve a taxable gain issue under the mixing bowls transaction rules.

### 3. Possible Income Tax Implications of the Basis Shifts

#### a. Generally

(1) As mentioned above, whenever property is contributed to a partnership and, within a certain period of time, partnership property is distributed to a partner, there is the potential to trigger gain under the disguised sale and mixing bowl transaction rules.

(2) In the example above, the LP held Asset A that had an inside basis of zero and a fair market value of \$100x. Assume that the LP was formed by contribution of Asset A to LP in exchange for 100% of the limited partnership interests, and assume that there has been no change in the value of Asset A since contribution.

(3) The tax implication of Version 1 and Version 2 in the example above depend, in large part, on how long the asset has been held by the partnership.

#### b. Disguised Sale

(1) As discussed above, if a partner who has contributed appreciated property to a partnership receives a distribution of any other property or cash generally within two years of the contribution, based on the applicable facts and circumstances, the distribution may cause the partner to recognize gain as of the original date of contribution with respect to his or her contributed property under the "disguised sale" rules. Thus, assuming no facts or circumstances that would properly characterize the transaction as a sale, the operating holding period for Asset A is two years.

(2) If Asset A has been held by the partnership for less than two years at the time of the distribution of Asset B, then the disguised sale will be presumed to have occurred. Interestingly, it likely would have not have made a difference whether the grantor

originally contributed Asset A to LP (and subsequently transferred 100% of the limited partnership interests to the IDGT) or if the IDGT originally contributed Asset A to the LP because they would be considered the same taxpayer under the grantor trust rules. As such, both the grantor trust and the IDGT would be considered the contributing partner. Also note that the Code provides that the elements of a disguised sale can occur if (i) there is a contribution to the partnership by a partner, (ii) there is a “transfer of money or other property by the partnership to such partner (or another partner),”<sup>1206</sup> and (iii) the transfers “when viewed together, are properly characterized as a sale or exchange of property.”<sup>1207</sup>

(3) In either Version 1 or Version 2 in the example above, if Asset A has been held by the partnership for two years or less, a disguised sale is deemed to occur, resulting in a deemed sale of Asset A for \$100x and resulting in \$100x of gain. The basis that could have been shifted to Asset A in the basis shifts above would not reduce the amount of gain because a disguised sale is calculated as of the original date of contribution.

c. Mixing Bowl Transaction

(1) As discussed above, the mixing bowls transaction provisions of sections 704(c)(1)(B) and 737 of the Code have a seven year time limit. Both operative sections of the mixing bowl transaction rules are operative in this example. If Asset A has been in the partnership for more than two years but seven years or less at the time of the distribution of Asset B, then the mixing bowl transaction rules will be triggered and a taxable event will be deemed to have occurred, but the gain differs in Version 1 and Version 2.

(2) Section 704(c)(1)(B) provides if contributed property is distributed within seven years of the date of contribution to any partner other than the partner who contributed such property, the contributing partner must generally recognize a taxable gain or loss in the year of distribution.<sup>1208</sup> Further, with respect transfers of partnership interests, the Treasury Regulations provide, for section 704(c) purposes, “If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of the partnership interest, the share of built- in gain or loss proportionate to the interest transferred must be allocated to the transferee partner.”<sup>1209</sup> Specifically to contributed property distributions to another partner, the Treasury Regulations provide, “The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner.”<sup>1210</sup>

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<sup>1206</sup> § 707(a)(2)(B)(ii).

<sup>1207</sup> § 707(a)(2)(B)(iii).

<sup>1208</sup> § 704(c)(1)(B).

<sup>1209</sup> Treas. Reg. § 1.704-3(a)(7).

<sup>1210</sup> Treas. Reg. § 1.704-4(d)(2).

(3) Section 737 provides if a partner contributes appreciated property to the partnership and, within seven years of the date of contribution, that partner receives a distribution of any property other than the contributed property, such partner generally will be required to recognize gain upon the receipt of such other property.<sup>1211</sup> Thus, section 737 only applies to property received that was not otherwise contributed by such partner.

(4) Under section 737(a), a partner who has contributed section 704(c) property and who receives a distribution of property within seven years thereafter is required to recognize gain in an amount equal to the *lesser* of:

(a) The excess (if any) of the fair market value (other than money) received in the distribution over the adjusted basis of such partner's outside basis immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution (the "excess distribution");<sup>1212</sup> or

(b) The "net precontribution gain,"<sup>1213</sup> which is the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if, at the time of the distribution, all section 704(c) property contributed by the distributee partner within 7 years of the distribution that is still held by the partnership were distributed to another partner.<sup>1214</sup>

(5) As discussed in more detail in the mixing bowl transaction section in these materials, although there is some debate as to whether a transferee under section 737 is treated as a contributing partner, the consensus view is that a transferee steps into the shoes of the transferor as the contributing partner.

(6) In the example above, grantor and IDGT are essentially both contributors of the appreciated Asset A (section 704(c) property) and of the high basis asset, Asset B (as far as the unitary basis rules are concerned). When the IDGT converts to a non-grantor trust, there is a deemed transfer of 50% of the limited partnership interests to the trust. Prior to the deemed transfer, grantor (as the taxpayer) was the contributor of both assets. After the transfer, the trust, as transferee (now a separate taxpayer), steps into the grantor's shoes but only with respect to ½ of each of Asset A and Asset B. It is similar to how they would be treated under the mixing bowl transaction rules if grantor and the trust had formed LP by each contributing an undivided ½ interest in Asset A and Asset B in exchange for 50% each of the limited partnership interests.

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<sup>1211</sup> §§ 704(c)(1)(B) and 737.

<sup>1212</sup> § 737(a)(1).

<sup>1213</sup> § 737(a)(2).

<sup>1214</sup> § 737(b). Other than a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership. *See* Treas. Reg. § 1.737-1(c)(1). Further, any losses inherent in section 704(c) property contributed by the distributee partner within the preceding 7-year period are netted against gains in determining net precontribution gain. *See* Treas. Reg. § 1.737-1(e), Ex. 4(iv).

(7) When Asset B is distributed to the trust in both versions of the example above, one-half of Asset B is being returned to the trust. That portion that is being “returned” to the trust does not trigger section 704(c)(1)(B) because that one-half portion of Asset B was deemed to have been contributed by the trust (transferee steps into the shoes of the grantor as contributor). Section 737 applies to other property distributed to the contributing partner. The trust is deemed to be the contributor of one-half of Asset A. In the example, the distribution of the *other* one-half of Asset B (the one-half that was contributed by the grantor and retained by the grantor because only 50% is transferred to the trust) to the trust will trigger section 737.

(8) The amount of gain under section 737 is a lesser of the excess distribution, and the net precontribution gain.

(a) In Version 1, the outside basis of the trust is \$35x, and the inside basis of Asset A is \$65 after the distribution but zero at the time of the distribution. The excess distribution is \$15x (fair market value of the *other* one-half of Asset B [\$50x] over the trust’s outside basis [\$35x]). The net precontribution gain under section 704(c)(1)(B) is \$50x. It is limited to 50x because the trust is the deemed contributor of one-half of Asset A. The *other* one-half of Asset A has \$50x of gain. In all, because section 737 uses a lesser of rule, Version 1 would result in \$15x of gain.

(b) In Version 2, the outside basis of the trust is \$50x, and the inside basis of Asset A is \$50 after the distribution but zero at the time of the distribution. The excess distribution is zero (fair market value of the *other* one-half of Asset B [\$50x] over the trust’s outside basis [\$50x]). The net precontribution gain under section 704(c)(1)(B) is \$50x, as explained above. Version 2 would result in *no gain*.

(9) As illustrated, in this type of basis shift, when the appreciated contributed asset has been in the partnership for more than two years but for seven years or less, the amount of gain that might result is a function of how much outside basis is allocated to the distributee partner, the trust. That, in turn, is often a function of the valuation discounts that might be applicable to the partnership interests at the time of the deemed transfer when the grantor trust converts to a non-grantor trust.

(10) If, in the example above, Asset A has been held by LP for more than seven years, the mixing bowl transactions rules would not be applicable, and both Version 1 and Version 2 would result in *no gain*.

#### 4. Section 678, BDOTs, and Basis

a. Section 678(a) of the Code provides a person (other than the grantor) will be treated as the owner of any portion of a trust if (i) the person has a “power exercisable solely by himself to vest the corpus or the income therefrom in himself,”<sup>1215</sup> or (ii) the person “previously partially released or otherwise modified such a power and after the release or

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<sup>1215</sup> § 678(a)(1).

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.”<sup>1216</sup>

b. A trust where a person other than the grantor is conferred “grantor trust” by a “power exercisable solely by himself to vest the corpus or the income therefrom in himself” under section 678(a)(1) of the Code is more commonly referred to as a beneficiary deemed owner trust or BDOT.<sup>1217</sup> Common examples of this type of situation include section 2056(b)(5) marital trusts pursuant to which the spouse has a general power of appointment over the entire trust or trusts that permit withdrawal by a beneficiary as an alternative to mandatory termination or distribution when the beneficiary reaches a certain age. The foregoing examples involve the power to vest corpus.

c. An example of a power to vest “the income therefrom” is described in Private Letter Ruling 201633021.<sup>1218</sup> The ruling involved Trust 1 and Trust 2 which were non-grantor trusts because the grantor had died. The assets of Trust 1 and Trust 2 are held for the benefit of the same beneficiaries. The governing document of Trust 2 provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year. Trust 2 further provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under section 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months. The ruling provides that the trustee “proposes to transfer funds from Trust 1 to Trust 2.”<sup>1219</sup> The IRS concluded, “Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2.”<sup>1220</sup>

d. The ruling unfortunately does not provide any insight on what the income tax consequences would be when Trust 1 “transfers funds” to Trust 2. The language of the ruling implies the Trust 1 will be treated as a beneficiary of Trust 2 but also “as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a).” The language doesn’t necessarily (but it could) mean that Trust 1 is the deemed owner entirely of Trust 2 and all of its assets. If Trust 1 is treated as the owner entirely of Trust 2, then theoretically Trust 1 could engage in a sale of the assets of Trust 1 to Trust 2 in exchange for an installment note, and the transaction would be disregarded for income tax purposes under

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<sup>1216</sup> § 678(a)(2).

<sup>1217</sup> For an in-depth discussion of the BDOT, see Edwin P. Morrow, *IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)* (2020) available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3165592](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3165592) and a large portion of which was published previously as LISI Estate Planning Newsletter #2587 (Sept 5, 2017).

<sup>1218</sup> PLR 201633021.

<sup>1219</sup> *Id.*

<sup>1220</sup> *Id.*

Revenue Ruling 85-13. This would be the result if Trust one could withdraw all the assets of Trust 2 at any time. If, however, Trust 1 is merely an entity that must report the income, capital gain, expenses, and other items used to compute DNI, then such a transaction could, in part, be considered a taxable event. Even if the latter interpretation is correct, if Trust 1 is a non-GST exempt trust and Trust 2 is a GST exempt trust, the tax liability borne by Trust 1 from all of Trust 2's income and capital gain could significantly increase Trust 2's trust assets over time and decrease the assets in Trust 1.

e. In a more recent ruling,<sup>1221</sup> the trust agreement of a Trust 1 prohibited the distribution of Shares (perhaps of a closely-held company) to the beneficiaries, but allowed for the distribution of the proceeds from the sale of Shares. Trust 1 contributed all of its Shares to LLC, a newly formed entity classified as partnership for Federal tax purposes, in exchange for membership interest in LLC. The same restrictions on the Shares were placed on the membership interests of LLC. Trust 1 then transferred a portion of its LLC interest to a Subtrust for the sole benefit of A. After A reached the age of 40, A exercised a withdrawal right to take all of the Subtrust's assets, except the LLC interests. The Subtrust agreed to sell a portion of its LLC interests to Trust 2 in exchange for cash and a promissory note. Trust 2 is a grantor trust with respect to A. A also has the authority to withdraw the cash and promissory note from Subtrust after the sale. The IRS concluded, "because A has a power exercisable by herself to vest the proceeds of Subtrust's LLC interest in herself and that those proceeds are Subtrust's only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A."<sup>1222</sup> In this ruling, it is clear that the beneficiary is deemed to be the owner of trust assets for all income tax purposes.

f. In the situation involved in the previous ruling, even if the power holder would not be deemed to be the owner of the entire trust, the power holder would be required to "take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary."<sup>1223</sup> It seems that if the power holder has that requirement, then for unitary basis and capital account purposes, the power holder (beneficiary or other trust) would be considered the same taxpayer. In that case, then, the types of basis shifting transactions between a grantor and a grantor trust discussed above might be available to the power holder and the trust.

## T. Planning with Charitable Entities

### 1. Generally

a. One of the tax benefits of having a partner that is a charitable entity is its tax-exempt status. When a charitable entity holds a partnership interest, however, due regard should be given to unrelated business taxable income<sup>1224</sup> and excess benefit transactions.<sup>1225</sup>

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<sup>1221</sup> PLR 202022002.

<sup>1222</sup> *Id.*

<sup>1223</sup> PLR 201633021.

<sup>1224</sup> § 511.

Further, if the charitable entity is a private foundation, planners should consider the rules relating to self-dealing transactions<sup>1226</sup> and excess business holdings.<sup>1227</sup> A full discussion of these and other related rules is beyond the scope of these materials. For purposes of these materials, it is assumed that the charitable partner is a public charity, and the assets in the partnership do not give rise to unrelated business taxable income, excess benefit transactions, or private inurement issues.

b. If a donor makes a charitable contribution of a partnership interest to charity, the donor may be entitled to a charitable deduction (for income and transfer tax purposes). If the partnership interest is appreciated (outside basis is less than the fair market value), then the amount of the charitable deduction may be reduced under section 170(e) of the Code. If a partnership interest is sold in a taxable transaction, the character of the gain recognized by the selling partner is capital subject to recharacterization as ordinary income under section 751(a) of the Code for gain attributable to “hot assets” (ordinary income items like unrealized receivables, inventory items, etc.) held by the partnership.<sup>1228</sup>

c. The Code provides that all contributions of “ordinary income property,” regardless of the type of charitable done, must be reduced by the amount of ordinary income that would have resulted if the donor had sold the contributed property at its fair market value at the time of the contribution.<sup>1229</sup> For these purposes, ordinary income includes any gain attributable to “hot assets” of the partnership, and any short-term capital gain attributable with respect to the partnership interest. The capital gain attributable to a partnership interest will be short-term or long-term depending on the transferor partner’s holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.<sup>1230</sup>

d. The Code further provides that a donor’s contribution of capital gain property will be further reduced by “the amount of gain which would have been long-term capital gain”<sup>1231</sup> if the donor contributes the property to a private foundation (other than private operating foundations, distributing foundations, and foundations with a common fund).<sup>1232</sup> If the donor contributes the partnership interest to a public charity, the donor will be entitled to a charitable deduction equal to the fair market value of the interest (assuming there is no reduction for ordinary income due to “hot assets” in the partnership). However, the income tax deduction will be limited to 30%<sup>1233</sup> (not 50%<sup>1234</sup>) of the donor’s contribution base for the taxable year.<sup>1235</sup>

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<sup>1225</sup> § 4958.

<sup>1226</sup> § 4941

<sup>1227</sup> § 4943.

<sup>1228</sup> § 741.

<sup>1229</sup> § 170(e)(1)(A).

<sup>1230</sup> Treas. Reg. § 1.1223-3.

<sup>1231</sup> § 170(e)(1)(B).

<sup>1232</sup> § 170(e)(1)(B)(ii)

<sup>1233</sup> See § 170(b)(1)(C).

A donor may avoid limiting the deduction to 30% if the donor elects to be subject to section 170(e)(1)(B) of the Code.<sup>1236</sup> Pursuant to the election, the amount of the contribution is reduced by the amount that would have been long-term capital gain (if the contributed property had been sold for its fair market value at the time of contribution). If the election is made, then the contribution is subject to the 50% limitation, rather than the 30% limitation.

e. A charitable contribution of a partnership interest generally will not cause the donor to recognize gain or loss. However, there may be gain if, as a result of the transfer, there is a deemed reduction in partnership liabilities under section 752(d) of the Code or if the partnership interest is subject to a liability in excess of outside basis, so that the transfer is considered a part sale/part gift. In such circumstances, the donor will recognize gain (but not loss) for the excess of any liability over the outside basis in the partnership interest.<sup>1237</sup> In addition, ordinary income may be triggered under section 751(a) of the Code if the partnership owns hot assets if there is a deemed transfer of partnership liabilities,<sup>1238</sup> and the contribution may also accelerate inherent gain in an installment obligation owned by the partnership.<sup>1239</sup>

## 2. Basis Shifting with Charitable Entities

a. As discussed above, Revenue Ruling 84-53 provides that when a partner transfers (gratuitous or taxable) a partnership interest and the interest carries a valuation discount, a disproportionately smaller amount of basis is transferred to the transferee. Further, as discussed in these materials, a tax basis “shift” is predicated upon the partnership distributing a higher inside basis asset (in-kind) to a partner whose outside basis in the partnership is lower than the distributed asset. With these rules in mind, a gift of a non-controlling partnership interest to a charitable entity may provide significant tax basis planning opportunities.

b. Consider the following highly simplified hypothetical:

(1) Taxpayer creates a limited partnership and contributes to the partnership the following assets:

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<sup>1234</sup> See § 170(b)(1)(A).

<sup>1235</sup> § 170(b)(1)(C)(i).

<sup>1236</sup> § 170(b)(1)(C)(iii).

<sup>1237</sup> Treas. Reg. § 1.1001-1(e), *Diedrich v. Commissioner*, 457 U.S. 191 (1982), *aff'd* 643 F.2d 499 (8<sup>th</sup> Cir. 1981), *rev'g* T.C. Memo 1979-441, 29 T.C.M433 (gain recognized with a net gift where gift tax paid by the donees exceeded the basis of property transferred), *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980) (gain realized on net gift of encumbered property).

<sup>1238</sup> See Rev. Rul. 64-102, 1984-2 C.B. 119 (shift of liability upon the admission of a new partner resulting in income to the partners under Section 751(b) of the Code).

<sup>1239</sup> See *Tennyson v. United States*, 76-1 USTC ¶9264 (W.D. Ark. 1976) and Rev. Rul. 60-352, 1960-2 C.B. 208 (gift of interest in partnership holding an installment receivable is a disposition of the receivable accelerating the gain).

and (a) Asset A with a zero basis and fair market value of \$100;

(b) Asset B with \$100 basis and fair market value of \$100.

(2) As a result of the contribution, the taxpayer takes back a 1% general partnership interest and 99% limited partnership interest. Assume another person contributes and owns a nominal interest in the partnership to ensure that the entity is a partnership for income tax purposes, rather than a disregarded entity (see the discussion later in these materials). For purposes of this hypothetical, ignore the existence of this nominal partner. Outside basis in the taxpayer’s partnership interest is \$100 and his capital account is \$200. Assume for purposes of this example that the taxpayer’s interest (prior to any transfer) in the partnership remains at \$200 (no valuation discounts).

(3) Taxpayer donates 50% of the limited partnership interest to charity (retaining the 1% general partnership interest and a 49% limited partnership interest). Assume the value of the limited partnership interest carries a 50% valuation discount. In other words, the value for income and gift tax purposes is \$50.<sup>1240</sup>

(4) Under Revenue Ruling 84-53, the basis of charity’s partnership interest is only \$25, and taxpayer’s outside basis is \$75:

$$\begin{array}{r}
 \text{Transferor's} \\
 \text{Adjusted Basis} \\
 \underline{\$100}
 \end{array}
 \times
 \frac{\begin{array}{c} \text{Fair Market Value (Discounted)} \\ \text{Transferred Portion} \\ \underline{\$50} \end{array}}{\begin{array}{c} \text{Fair Market Value} \\ \text{Transferor's Entire Portion} \\ \underline{\$200} \end{array}}
 =
 \begin{array}{r}
 \text{Transferee's} \\
 \text{Adjusted Basis} \\
 \underline{\$25}
 \end{array}$$

(5) Notwithstanding the foregoing, charity’s capital account, under the Treasury Regulations,<sup>1241</sup> is \$100.

$$\begin{array}{r}
 \text{Transferor's} \\
 \text{Capital Account} \\
 \underline{\$200}
 \end{array}
 \times
 \frac{\begin{array}{c} \text{Percentage} \\ \text{Transferred} \\ \underline{50\%} \end{array}}{\begin{array}{c} \text{Fair Market Value} \\ \text{Transferor's Entire Portion} \\ \underline{\$200} \end{array}}
 =
 \begin{array}{r}
 \text{Transferee's} \\
 \text{Capital Account} \\
 \underline{\$100}
 \end{array}$$

(6) At least seven years after the contribution of the assets, assuming the assets remain in the partnership and there has been no change in the values, the partnership liquidates charity’s interest (according to its capital account balance) and distributes Asset B (\$100 basis and fair market value of \$100) to charity. Assume the LLC has a section 754 election in place at the time of the distribution of Asset B.

<sup>1240</sup> Assuming the charitable entity is a public charity and the partnership does not have a ny “hot a sset” under section 751 of the Code, the taxpayer will receive a \$50 income tax deduction. See § 170(e)(1)(A).

<sup>1241</sup> Treas. Reg. §§ 1.704-1(b)(2)(iv)(l) and 1.704-1(b)(5), Ex. 13.

(7) The basis of Asset B owned by charity has its basis replaced by charity's outside basis in the partnership. As a result, Asset B's basis is \$25. Charity can then sell the Asset B and recognize the gain in a tax-exempt environment.

(8) With the section 754 election, the \$75 of basis reduction (basis strip) results in an increase in the basis to Asset A under section 734(b) of the Code. Asset A's basis goes from zero to \$75. As discussed in more detail above, the basis adjustment under section 734(b) is to partnership property, so if the partnership sells Asset A, the basis increase will benefit all of the remaining partners (the taxpayer and any transferees of the taxpayer's retained interest).

### 3. Charitable Family Limited Partnership

#### a. Purpose and Mechanics

(1) The purpose of a charitable partnership is to enable a donor to:

(a) Make a larger charitable gift than the donor would feel comfortable making otherwise;

(b) Make a charitable gift when the donor is making substantial gifts to the donor's descendants; and

(c) Sell appreciated assets without incurring gain. In the discussion below a transaction with the donor's children is generally assumed. However, the transaction may also be undertaken with grandchildren or other descendants, or with trusts for the benefit of descendants.

(2) The donor creates a limited partnership. The other initial partner may be the donor's spouse or children. Generally, forming a limited partnership between a donor and spouse is better than involving children because it reduces the opportunity for the IRS to claim that the donor made a gift upon the formation of the partnership. The partnership may have 10,000 units of which 100 would be general partnership units and 9900 would be limited partnership units. Thus, 99% of the "equity" in the partnership is represented by the limited partnership units while 1% of the partnership controls it.

(3) The partnership can be funded with whatever assets the donor desires. Ideally appreciated assets would be used and care must be taken to avoid the investment company rules.<sup>1242</sup> The effects on valuation of funding options should be considered as well. For example, if real property is contributed, more different parcels usually create lower values, e. g. a

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<sup>1242</sup> § 721(b) provides gain is realized on the contribution of property to a partnership if the partnership would be treated as an "investment company" under § 351(e). Section 351(e) of the Code and the Treasury Regulations provide that any contributions will be deemed to be a transfer to an investment company if the transfer results, directly or indirectly, in diversification of the transferor's interests, and the transferee is, in pertinent part, a corporation more than 80 percent of the value of whose assets are held for investment and are stocks or securities, or interests in regulated investment companies, or real estate investment trusts.

partnership that contains some undeveloped land and rental properties of various types may be discounted more than a partnership that owns only one kind of real estate.

(4) The donor would contribute the 9900 limited partnership units to a charity. A community foundation is often a good choice because through the foundation the donor is able to benefit multiple charitable beneficiaries. Private foundations are not a good choice because of the self-dealing limitations nor are public charities that are controlled or substantially influenced by the donor.

(5) Section 170 of the Code allows the donor to receive an income tax deduction for the contribution of limited partnership units so long as the contribution is not viewed as being of a partial interest. That is, in order for an income tax deduction to be available the partnership must be respected so that the charity is viewed as receiving partnership units rather than a partial interest in the assets of the partnership. For that reason, the charity should receive the full benefits of the units it receives including income distributions, and the partnership formalities should be followed completely. In general, the same considerations as a donor would follow to minimize or avoid the application of section 2036(a)(1) of the Code (transfers with retained enjoyment or control) in the FLP context are applicable here. The amount of the donor's income tax deduction depends on the fair market value of the units which must be determined by appraisal.<sup>1243</sup>

(6) Most charities do not desire to retain limited partnership interests and thus will want to sell the units. Experience suggests that the most likely purchasers will be one or more members of the donor's family. That may be the children, grandchildren, or trusts for their benefit. The charity should be willing to sell the units for their fair market value which is appraised value. The net effect is that the charity receives appraised value and the children, or other purchasers of the units, receive the value of the partnership above the appraised value.

b. Economics of the Basic Transaction

(1) With Children

(a) Is the transaction beneficial to the family and to the charity? Stated differently, is it a good deal? To illustrate, let us begin with a donor with \$1,000,000 in cash. The donor, who has used her gift tax exemption, intends to give \$700,000 of that to charity and \$300,000 to her children. Of the \$300,000 for the donor's children, gift tax of about \$86,000 will be owed netting to the children about \$214,000.

(b) The \$700,000 given to charity will remove \$700,000 from the donor's estate but will save the donor about \$280,000 in income tax (assuming a combined 40% federal and state rate). If the donor took that \$280,000 and paid gift tax of \$80,000 (assuming a 40% tax rate) the donor's children would receive about \$200,000. So, the donor's children would receive \$214,000 plus \$200,000 for about \$414,000 in this transaction. Charity would have \$700,000.

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<sup>1243</sup> See Treas. Reg. § 1.170A-13.

(c) The same transaction with the partnership would have the following results. First, assume that the partnership is funded with \$1,000,000 and that the 9900 limited partnership units are valued at \$700,000 (approximately a 30% discount). The donor receives a \$700,000 income tax deduction upon making the gift to charity which is same as above. If the donor takes the income tax savings and gives them to the children, they will net \$200,000.

(d) If the children purchase the partnership units from the charity for \$700,000, the units would have \$990,000 of underlying value. If (when) the donor transfers the 100 general partnership units to the children that value may be unlocked. If it is unlocked, the children will have paid \$700,000 for something worth \$990,000.

(e) The total benefit to the children is, therefore, \$200,000 from the charitable deduction and \$290,000 from the unlocking of partnership value for a total of \$490,000. The children are ahead by \$76,000. Of course, consideration should be given to the children's adjusted basis.

## (2) With Grandchildren or Trusts for Descendants

(a) The transaction becomes more favorable when assets are moved down more than one generation. To illustrate, a donor with \$300,000 of cash will pay \$86,000 in gift tax and \$61,000 in generation-skipping tax (at the 40% rate, tax exclusive because a direct skip), leaving the children with \$153,000. Similarly, the donor who makes a charitable gift of \$700,000 and receives an income tax deduction of \$280,000 may give only \$143,000 to the grandchildren after payment of gift and generation-skipping transfer tax. Thus the grandchildren would receive \$153,000 plus \$143,000, which is \$296,000.

(b) Recall that the yield of the charitable partnership transaction does not vary regardless of the purchaser of the limited units; if grandchildren or a trust for descendants is the purchaser, the benefit remains at \$217,500 net of capital gains tax. The value of income tax deduction to the grandchildren remains \$143,000. So the grandchildren receive if the partnership is used a total of \$360,500. The increase to the grandchildren from using the partnership is \$360,500 minus \$296,000, which is \$64,500. If the donor must sell assets to pay gift tax and generation-skipping transfer tax, the benefits are likewise substantially increased.

## (3) Enhancement of the Transaction

(a) If appreciated assets are used to fund the partnership, the transaction may be enhanced. If the assets are sold while the charity owns the limited units, the 99% of the gain realized by the partnership would be allocated to the charity and thus escape income tax. Under the disguised sale rules, a partner who contributes assets to a partnership must recognize gain from the sale of the assets within two-years; however, that rule causes the owner of the limited units to be taxed, in effect, rather than the donor/contributor.

(b) In almost every situation the assets inside the partnership should be sold while the charity is the substantial partner. Otherwise, the donee's lack of basis tends to reduce the overall tax benefits.

(4) Role of the Charity

(a) The charity's role is that of an independent charity looking out for its own best interest. To that end, it will require an appraisal, at a minimum, before selling the limited partnership units. The appraisal may be the same as the donor's appraisal, although the better practice would be to have an independent review. In addition, the charity may have other procedures it follows, such as review of acceptance and disposition of partnership units by special committees; requirements that it be indemnified against liability and unrelated business income tax before it accepts the units; and "shopping" the units to potentially interested purchasers (e.g. "advertising" the availability of units to the financial community through private communications, notification to the charity's board, etc.).

(b) Charities are required to disclose the disposition of contributed nonmarketable assets sold within three years of receipt by filing a Form 8282 (Donee Information Return) within 125 days after the disposition. In many instances charities have as policy the retention of nonmarketable assets during the three-year period. If the partnership units are to be retained, then another appraisal will be required at the time of the sale and should be procured by the charity.

(c) An independent charity is best to ensure that the IRS does not conclude that the sale of the units was conducted in other than an arms-length manner. Although private foundations should not be used for this purpose – because of concerns about self-dealing arising not only from the sale of the units but also from the acquisition and retention of the units – supporting organizations may be. Special care should be taken to ensure that all decisions about the retention and sale of the units are made by persons other than the donor or the donor's family.

(5) Poor Children

(a) A common concern about the charitable partnership is that the children do not have sufficient assets to purchase the limited partnership units. Generally, it is a concern raised by the charity. Experience suggests that it is not a concern in most family situations. The reason would appear to be that most persons who are ready to contribute significant amounts to charity have already given significant amounts to their descendants or at least in trust for their descendants. However, if that is not the case, or if the costs of generating the funds is prohibitive (e.g., the basis of the purchaser in the assets to be sold to raise cash to purchase the units is zero or very low), then a variation may be used.

(b) The partnership may sell the assets it owns and generate cash. With that cash it may redeem partnership units from the charity, at the appropriately discounted value, thereby, indirectly, increasing the value of the remaining units. To illustrate, suppose donor creates a partnership with 100 general partnership units and 9900 limited partnership units and gives the 100 general partnership units to a trust for the benefit of the donor's descendants (value is 1% of the amount in the partnership; a \$1,000,000 partnership produces a \$10,000 gift). The trustee, as general partner, orders all of the assets of the partnership to be sold and then negotiates to redeem the charity's units at appraised value. If the charity's 9900 limited units are redeemed for \$700,000 the partnership has only 100 general partnership units remaining and owns \$300,000 in assets. As before, gain will be triggered if the partnership is liquidated. In many instances it may be desirable to retain the form of a general partnership interest in which case a few limited units may be given to the trust or to the donor's descendants.

(c) Transactions structured in this manner have been advocated across the country by a number of different entities and planners. In certain versions the redemption occurs at deeply discounted values, supported, in some instances, by giving the charity the rights to put the units to the partnership for specified amounts. To illustrate, the partnership might provide for a 50-year term during the first year of which the charity would have the right to put the units for 2% of the partnership's book value, during the second year for 4%, and so forth. Planners will need to evaluate such arrangements carefully, particularly given the IRS position with respect to such transactions, discussed below.

c. IRS Position

(1) As might be expected, the IRS has identified some potential areas of abuse with charitable family limited partnerships. In 2001, the IRS Exempt Organizations Continuing Professional Education (hereinafter, 2001 EO CPE) identified the "CHAR-FLIP" (an extreme version of the charitable family limited partnership transaction described above) as the "years favorite charity scam."<sup>1244</sup> As provided in 2001 EO CPE, "The charitable family limited partnership technique is touted as avoiding the capital gain tax on the sale of the donor's appreciated assets, allowing the donor to continue to control the assets until some subsequent sale date, often many years in the future, and still provide the donor with a current charitable deduction on his or her income tax return. Another 'benefit' is reducing estate taxes."

(2) 2001 EO CPE describes the CHAR-FLIP as follows:<sup>1245</sup>

A typical charitable family limited partnership works as follows: Donor "D", having substantially appreciated assets, which are often not readily marketable, such as real estate or proprietary interest in a closely held business, sets up a donor family limited partnership ("DFLP"). D transfers highly appreciated assets to DFLP in exchange for both a general and limited partnership interest with the general partnership interest comprising a very modest 1 or 2 percent of the total partnership interests. The DFLP agreement usually provides for a term of 40 to 50 years.

D contributes a large percentage of the DFLP interest to charity "Z", usually as much as 95 to 98 percent, in the form of a limited partnership interest. D will usually retain the general partnership interest. D may also retain a modest limited partnership interest or transfer such an interest to D's children. D obtains an independent appraisal of the value of the partnership interests in order to establish the fair market value of the IRC 170(c) charitable contribution deduction. Z receives whatever assets are held by DFLP at the end of the

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<sup>1244</sup> 2001 Exempt Organizations Continuing Professional Education, Chapter G: Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds and Disqualified Person Financial Institutions, p. 128 (hereinafter, 2001 EO CPE).

<sup>1245</sup> 2001 EO CPE, p. 128.

partnership term, assuming the partnership interest was not sold prior to the expiration of the partnership term.

D claims an IRC 170(c) tax deduction based on the value of the gift of the partnership interest to Z. The value likely has been discounted to take into account the lack of Z control and management of partnership operations as well as the lack of marketability of the limited partnership interest in the context of a closely held business.

The key point is control. Control remains with D as the general partner. Z holds a limited partnership interest with no voice in the day to day management or operations of the partnership.

If appreciated property held by DFLP is sold by DFLP, most of the gain escapes taxation by virtue of the IRC 501(c)(3) exempt status of Z. Only the modest limited or general partnership interests held by D and his family are subject to capital gain taxation.

D generally receives a management fee as compensation for operating and managing the partnership.

Z holds a DFLP interest that may produce current income (although many charitable family limited partnerships produce little or no income) as well as an interest in a (hopefully) appreciating asset which will be sold or exchanged no later than the expiration of the partnership term, usually 40 years or even 50 years.

One of the aspects of the “CHAR-FLIP” is a feature which gives a DFLP the right to sell the property to D or his family at a price specified in the partnership agreement. This right is essentially a put option. While such option may serve to benefit Z, the option is often viewed by critics of this technique as working more for the benefit of D or his family than for Z.

(3) Among the identified issues with the foregoing described transaction were private inurement and benefit, unrelated business income under section 511 of the Code, and excess benefit transaction under section 4958 of the Code. If the charity is a private foundation, then some additional issues were self-dealing under section 4941 of the Code and excess business holdings under section 4943 of the Code.

d. Given the issues identified by the IRS, practitioners should consider one or all of the following with charitable family limited partnership planning:

- (1) Transfer the GP interest to a family trust contemporaneously or soon after contribution to charity in order to avoid the argument of donor control;
- (2) Distribute the net income of the partnership annually;
- (3) Allow charity to sell its limited partnership units, if the charity can find a buyer;
- (4) Do not grant an option;

(5) Do not sell the partnership property to donor or donor's family (or trust); and

(6) Do not provide any compensation to or for the benefit of the general partner.

U. Sale of a Partnership Interests Is Likely Worse Than a Distribution

1. Taxable Sale of Partnership Interests

a. If a partner sells his or her partnership interest in a taxable transaction, the transferor recognizes gain or loss in accordance with the rules of section 1001.<sup>1246</sup> The transferee takes a cost basis in the acquired partnership interest,<sup>1247</sup> but the transferee's capital account is not based on the consideration tendered. The capital account of the transferee carries over from the transferor partner.<sup>1248</sup> The purchased partnership interest carries with it the transferor's share of section 704(c) gain (both forward and reverse) in the partnership's assets.<sup>1249</sup>

b. The character of the gain recognized by the selling partner is capital subject to recharacterization under section 751(a) for "hot assets," as discussed in more detail above.<sup>1250</sup> Capital gain or loss is recognized as it would be under section 1001 less the amount of ordinary income (or plus the amount of ordinary loss) recharacterized under section 751(a).<sup>1251</sup>

c. Section 1(h) provides that the tax rate on the capital gain portion of the sale is determined by looking through to the partnership assets at the time of the sale.<sup>1252</sup> As a result, the transferor partner may recognize capital gain at a 20%, 25%, and 28% rate (along with the 3.8% Net Investment Income Tax, if applicable to the taxpayer) depending on the nature of the assets in the partnership. The capital gain will be short-term or long-term depending on the transferor partner's holding period in the partnership interest. Notwithstanding the unitary basis requirement for partnership interests, as discussed above, the Treasury Regulations provide that a partner can have multiple holding periods for a single partnership interest.<sup>1253</sup> As a result, the sale of a partnership interest can result in ordinary income, short-term capital gain, and long-term capital gain at a multitude of different rates.

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<sup>1246</sup> § 741.

<sup>1247</sup> § 742.

<sup>1248</sup> Treas. Reg. § 1.704-1(b)(2)(iv).

<sup>1249</sup> Treas. Reg. § 1.704-3(a)(7).

<sup>1250</sup> § 741.

<sup>1251</sup> Treas. Reg. § 1.751-1(a)(2).

<sup>1252</sup> § 1(h)(5)(B), (h)(9), (h)(10) and Treas. Reg. § 1.1(h)-1(a).

<sup>1253</sup> Treas. Reg. § 1.1223-3.

d. As discussed below, a distribution of assets, rather than a sale of the partnership interest (particularly when the partner is exiting the partnership) may result in much better results for the exiting partner. The distribution is not subject to the look-through rule of section 1(h).

e. As discussed above, if the partnership has a section 754 election in place, the inside basis of the partnership's assets will be adjusted based upon the value of the consideration furnished by the purchasing partner. This will essentially give the income purchasing partner a fair market value basis in each of the partnership assets (assuming no valuation discount), so that if the partnership were to sell the assets at that time, no additional gain or loss would be borne by the incoming partner.<sup>1254</sup>

## 2. Liquidating Distributions

a. As mentioned above, if the liquidating distribution includes cash, then gain or loss is recognized based on the amount of outside basis on the partnership interest prior to the distribution. Ordinary income will be generated under section 751(b) to the extent that certain "hot assets" are in the partnership.<sup>1255</sup> To the extent the distributee partner recognizes capital gain, the gain will be taxed at 20% (never 25% or 28%) because there is no look-through rule under section 1(h).<sup>1256</sup> As one author points out, "While there is no obvious reason why the higher capital gain rates can apply to dispositions of partnership interests but not to distributions, that is the way the statute is written."<sup>1257</sup> If a section 754 election is in place, any gain recognized by a distributee will not be also be allocated to the remaining partners (thereby avoiding the higher capital gain tax rates in the future for the remaining partners). If the liquidating distribution does not include cash in excess of outside basis, no gain will be recognized but ordinary income may be generated under section 751(b).

b. If property in-kind is distributed, the outside basis of the partnership interest replaces the basis of the distributed assets.<sup>1258</sup> Ordinary income assets take a carryover basis, with any outside basis remaining going to the capital gain and section 1231 assets distributed.<sup>1259</sup> Assuming a section 754 election, if the distributed capital assets receive additional

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<sup>1254</sup> In fact, in this instance, the gain or loss would be allocated to the purchasing partner in an amount equal to the gain or loss that would have been allocated to the transferor partner had there been no taxable sale of the interest, and then the inside basis adjustment under section 743(b) then offsets the gain or loss allocated. The effect is the same. *See* Treas. Reg. § 1.743-1(j)(3)(ii), Ex. 2.

<sup>1255</sup> One thing to note, however, section 751(b) only applies to "substantially appreciated" inventory. *See* §§ 751(b)(1)(A)(ii) and 751(a)(2). To the extent that inventory exists but is not substantially appreciated, a distribution of cash in liquidation of a partnership interest will be considered capital gain, but a taxable sale of such interest would generate ordinary income under section 751(a). "Substantial appreciation" is defined in section 751(b)(3).

<sup>1256</sup> The rule only applies to the sale or exchange of an interest. *See* § 1(h)(9) and Treas. Reg. § 1.1(h)-1(a).

<sup>1257</sup> Howard E. Abrams, *Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear*, 50 Tax Mgmt. Mem. No. 4 (Feb. 16, 2009).

<sup>1258</sup> § 732(b).

<sup>1259</sup> § 732(c).

basis after the distribution (or if there is a substantial basis reduction with respect to such distribution exceeding \$250,000), then the partnership must adjust the inside basis of the remaining assets downward by that amount.<sup>1260</sup> If the distributed capital asset results in a basis reduction, the partnership will receive an upward inside basis adjustment if a section 754 election is in place.<sup>1261</sup> All of these adjustments are made pursuant to section 734(b) and are therefore for the benefit of the partnership and the remaining partners. If the distribution in-kind is not in liquidation of the distributee partner's interest, the inside basis adjustment shifts results in a basis shift from the distributee partner to the non-distributee partners.<sup>1262</sup>

### 3. Planning for FLPs: Sales vs. Distributions

a. Given the disparate treatment of taxable sales of partnership interests and distributions of partnership property, families in FLPs will often find distributions of assets in-kind more advantageous than a taxable sale of a partnership interest.

b. A number of strategies can be devised to take advantage of lower income tax bracket partners (including individuals or non-grantor trusts residing in no income tax states or private foundations). By way of example, one strategy might be distributing appreciated property to the lower income tax rate partner (not in liquidation of the partnership) prior to a taxable sale of the assets. This puts the appreciated property in hands of the lower income tax bracket partner

c. Another strategy might include a non-liquidating distribution of cash<sup>1263</sup> in partial redemption of most of the departing partner's interest in the partnership (triggering gain), followed then by a taxable sale of the remaining partnership interest to another family taxpayer. This takes advantage of the no look-through feature of distributions, and with a section 754 election in place, a common inside basis adjustment in favor of the partnership under section 734(b) for the cash distribution, and then an inside basis adjustment in favor of the purchasing partner under section 743.

## VIII. PREFERRED PARTNERSHIP STRUCTURES

### A. Generally

1. Unlike S corporations which require that they only have one economic class of stock, partnerships can be structured to provide different classes of ownership and economic interests. In the family-owned entity context, if different ownership interests are utilized, careful consideration must be given to section 2701 of the Code because, as discussed in detail below,

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<sup>1260</sup> § 734(b)(2)(B).

<sup>1261</sup> § 734(b)(1)(B).

<sup>1262</sup> See Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 Tax Law. 343 (2004).

<sup>1263</sup> The partnership could borrow the proceeds to effectuate the cash distribution. Care should be given to ensure that undesirable partnership liability shifts do not occur in the transaction. Thus, taxpayers should consider borrowing on a nonrecourse basis but having certain remaining partners guarantee the debt.

the “same class”<sup>1264</sup> exception will not be available. Notwithstanding the foregoing, “preferred” partnership interests can be created that avoid the punitive effects of section 2701, namely the “zero valuation” rule.<sup>1265</sup>

2. The ability to segregate the economic interest of a pool of partnership assets into preferred and common interests has profound practical implications and provides a flexible structure to maximize the benefits of certain planning structures that seek to maximize the income and transfer tax savings for families. By way of example, consider a client who is interested in transferring assets to the client’s children, but not at the expense of the client’s cash flow needs. In a traditional FLP structure, all partnership interests in the FLP are a single class share, with all allocations of income and distributions shared pro rata according to capital account balances. Thus, with a traditional FLP structure, if a client transfers a 40% of the partnership interest to the client’s children, then the client also relinquishes the right to receive 40% of the cash flow from the partnership. Many clients would be reluctant to make that transfer if they felt that such a drop in cash flow would jeopardize their lifestyle in the future. A preferred partnership structure would allow a client to maintain a fixed priority to cash flow (perhaps all of the current cash flow), freeze the value for estate tax purposes, but still transfer the future appreciation in the partnership’s assets. This type of transaction, often called a forward freeze where the client retains the preferred and transfers the common, is often quite appealing to clients.

3. Preferred partnership structures allow for at least 2 classes of interest, one which provides for a preferred return to the holder. The remaining class or classes of interest (the common shares) will receive any economic benefit from the partnership property above the preferred return. Commonly, a preferred partnership structure will provide the preferred shares with the following rights:

a. Preferred right to cash flow of the partnership. This is commonly stated as a fixed dollar amount, fixed percentage of a liquidation preference amount or a variable percentage of a liquidation preference amount.

b. One critical issue is whether the preferred payment is paid regardless of whether profits are made by the partnership or whether the amount payable is contingent upon the partnership being profitable. As discussed below, guaranteed payment preferred interests are payable regardless of partnership profits whereas qualified payment interest right preferred interests are contingent upon the partnership being profitable.

c. Upon dissolution of the partnership, the preferred holders will receive liquidating distributions of a certain amount (liquidation preference amount) or certain percentage of the partnership assets.

4. By consequence, the common interest holders will have a residual interest in any cash flow, liquidation proceeds and earnings of the partnership after the preferred interest

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<sup>1264</sup> § 2701(a)(2)(B).

<sup>1265</sup> § 2701(a)(3)(A).

holders have been paid. As such, from an economic standpoint, the preferred holder's return is capped at the preferred rate or payment, and the common holder's return is any excess return above the preferred interest.

5. Preferred partnership structures come in two general forms. A "forward freeze" (sometimes referred as a traditional freeze) involves the transferor retaining the preferred interest and transferring (gifting or selling to an IDGT for an installment note) a common interest. A "reverse freeze" involves the transferor retaining common and transferring the preferred interest. Preferred interests can be created in many different forms, but for estate planning purposes, most practitioners will likely limit the preferred interest to those that would be a "qualified payment right" or a guaranteed payment (as discussed herein). At this point, it is unclear how a "profits interest" is characterized under section 2701 of the Code, and as such, these materials do not discuss profits only interests.<sup>1266</sup>

B. Chapter 14 Considerations (Section 2701)

1. Generally

a. Section 2701 of the Code provides that in determining whether a gift has been made and the value of such gift, when a person transfers interest in a corporation or partnership (or LLC) to a "member of the transferor's family"<sup>1267</sup> the value of any of the following rights shall be treated as zero<sup>1268</sup> (broadly defined as an "applicable retained interest"):

(1) A "distribution right,"<sup>1269</sup> if immediately before the transfer, the transferor and "applicable family members"<sup>1270</sup> have "control"<sup>1271</sup> of the entity;<sup>1272</sup> or

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<sup>1266</sup> See e.g., CCA 201442053 (transferor's sons were granted the right to future profits) and Richard L. Dees, *Is Chief Counsel Resurrecting the Chapter 14 "Monster"?*, 145 Tax Notes 1279 (Dec. 15, 2014).

<sup>1267</sup> § 2701(a). A "member of the transferor's family" means: (a) the transferor's spouse, (b) a lineal descendant of the transferor or the transferor's spouse, or (c) the spouse of any such lineal descendant. § 2701(e)(1).

<sup>1268</sup> § 2701(a)(3)(A).

<sup>1269</sup> A "distribution right is a right to receive distributions with respect to an equity interest" but does not include: (i) any rights to receive distributions "with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest;" (ii) any extraordinary payment right; and (iii) any rights that are specifically excepted in section 25.2701-2(b)(4) of the Treasury Regulations. Treas. Reg. § 25.2701-2(b)(3).

<sup>1270</sup> For purposes of determining control, this includes the transferor's spouse, an ancestor of the transferor or the transferor's spouse, or the spouse of any such ancestor and any lineal descendant of any parent of the transferor or the transferor's spouse. §§ 2701(e)(2) and 2701(b)(2)(C). In other words, it expands the definition to capture siblings of the transferor and the transferor's spouse and their descendants.

<sup>1271</sup> If the entity is partnership (which would be the most likely choice of entity for a family investment entity), control means: (a) holding at least 50% of the capital or profits interests in the partnership, or (b) in the case of a limited partnership, the holding of any interest as a general partner. § 2701(b)(2)(B).

<sup>1272</sup> § 2701(b)(1)(A).

(2) A liquidation, put, call, or conversion right<sup>1273</sup> (sometimes referred to as an “extraordinary payment right,”<sup>1274</sup> which is defined differently in the Treasury Regulations as a “put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest.”).

b. For these purposes, a “transfer” is broadly defined and is deemed to include “a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership.”<sup>1275</sup> However, these would not be considered a transfer if “the interests in the entity held by the transferor, applicable family members, and members of the transferor’s family before and after the transaction are substantially identical.”<sup>1276</sup>

c. For purposes of these materials, it is assumed that a transfer is being made to an applicable family member, the partnership in question is a control entity, and the retained interest includes a distribution right. As such, in this portion of the materials dealing with preferred partnership structures, it is assumed that section 2701 technically applies to the transactions proposed herein. However, the transfer tax results will differ based upon whether certain exceptions to the broad rule (notably, the zero valuation rule) are applicable.

## 2. Important Exceptions

### a. Generally

(1) There are a number of notable exceptions under section 2701 to consider in preferred partnership planning. Some exceptions represent transfers or other transactions that are wholly exempt from section 2701. These types of transactions will be valued under normal gift tax rules.

(2) Other types of exceptions include interests or rights that are neither considered extraordinary payment rights nor distributions rights. As such, they are not considered applicable retained interests. Depending on the type of transaction, normal gift tax rules may or may not apply to the transfer.

### b. Market Quotation Exception

(1) Section 2701 does not apply to the “transfer of any interest for which market quotations are readily available (as of the date of transfer) on an established market.”<sup>1277</sup>

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<sup>1273</sup> § 2701(b)(1)(B).

<sup>1274</sup> See Treas. Reg. § 25.2707-2(b)(2).

<sup>1275</sup> § 2701(e)(5).

<sup>1276</sup> § 2701(e)(5).

<sup>1277</sup> § 2701(a)(1).

(2) In addition, the general rule of section 2701 does not apply to any right with respect to an applicable retained interest if market quotations are readily available (as of the date of transfer) on an established market.<sup>1278</sup>

(3) In other words, the Code and the Treasury Regulations provide a broad exception to both the retained and transferred interest so long as market quotations are readily available.

c. Same Class Exception

(1) Section 2701 does not apply to any right with respect to an applicable retained interest if such interest is:

(a) The same class as the transferred interest,<sup>1279</sup> or

(b) Such interest is proportionally the same as the transferred interest, without regard to nonlapsing differences in voting power (or, for a partnership, nonlapsing differences with respect to management and limitations on liability).<sup>1280</sup>

(2) With respect to this exceptions, the Treasury Regulations provides, “[a] class is the same class as is (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).”<sup>1281</sup>

(3) The Treasury Regulations provide that non-lapsing provisions that are necessary to comply with the partnership allocation requirements of the Code will be treated as non-lapsing differences with respect to limitations on liability.<sup>1282</sup> Further, a right that lapses by reason of Federal or State law will be treated as a non-lapsing differences unless the Treasury determines that it is necessary to treat such right as a lapsing right in order to accomplish the purposes of Section 2701.<sup>1283</sup>

(4) This same class exception is the one most relied upon in estate planning and is the primary reason that most FLPs have a single class share structure (all profits, losses, tax items, and distributions are shared proportionately according to capital accounts, for example). Furthermore, if an existing partnership is recapitalized from a single class share partnership to a preferred and common structure, then as long as the original owners receive a

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<sup>1278</sup> § 2701(a)(2)(A).

<sup>1279</sup> § 2701(a)(2)(B).

<sup>1280</sup> § 2701(a)(2)(C).

<sup>1281</sup> Treas. Reg. § 25.2701-1(c)(3).

<sup>1282</sup> *Id.*

<sup>1283</sup> § 2701(a)(2) and Treas. Reg. § 25.2701-1(c)(3).

proportional amount of both the preferred and common shares, then the “same class” exception applies to such recapitalization.

d. Vertical Slice Exception

(1) Section 2701 does not apply to a transfer “to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer.”<sup>1284</sup>

(2) The Treasury Regulations provide the following example: “Section 2701 does not apply if P owns 50 percent of each class of equity interest in a corporation and transfers a portion of each class to P’s child in a manner that reduces each interest held by P and any applicable family members, in the aggregate by 10 percent even if the transfer does not proportionately reduce P’s interest in each class.”<sup>1285</sup>

e. Guaranteed Payment Exception

(1) Excluded from the definition of “distribution right” is “any right to receive any guaranteed payment described in section 707(c) of a fixed amount.”<sup>1286</sup> As such, guaranteed payment interests are not considered applicable retained interests

(2) The Treasury Regulations provide that a fixed amount under this exception is the right to receive a payment “the amount of which is determined at a fixed rate (including a rate that bears a fixed relationship to a specified market interest rate).”<sup>1287</sup> Specifically, it does not include a payment that is contingent as to time or amount.

f. Mandatory Payment Right Exception

(1) A “mandatory payment right” is a right to a required payment at a specified time. For purposes of Section 2701 it is considered neither an extraordinary payment right nor a distribution right.<sup>1288</sup>

(2) It includes a right in preferred stock requiring that the stock be redeemed at its par value on a date certain and it also includes a right to receive specific amount on the death of the holder.<sup>1289</sup>

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<sup>1284</sup> Treas. Reg. § 25.2701-1(c)(4).

<sup>1285</sup> *Id.*

<sup>1286</sup> § 2701(c)(1)(B)(iii).

<sup>1287</sup> Treas. Reg. § 25.2701-2(b)(4)(iii). *See* § 707(c).

<sup>1288</sup> Treas. Reg. § 25.2701-2(b)(4)(i).

<sup>1289</sup> *Id.*

(3) The Service has also ruled that a mandatory payment right includes the right to redeem preferred stock at a stated value plus any accrued and unpaid dividends on the earlier to occur of a certain date or change in control of the company.<sup>1290</sup>

g. Junior Equity Interest Exception

(1) A distribution right does not include a right to distributions with respect to any interest which is junior to the rights of the transferred interest.<sup>1291</sup>

(2) The Treasury Regulations also exempt an interest that is of the same class, or a class that is subordinate to, the transferred interest.<sup>1292</sup>

(3) This is one of the most significant exceptions under section 2701 from an estate planning standpoint. Essentially, it is an exception relied upon with a reverse freeze, the transfer of the preferred or senior equity interest (with the retention of the junior equity or common interest by the transferor). As an exception, normal gift tax rules apply to such transfer of the preferred interest, along with any applicable valuation discounts for lack of marketability and minority interest discount. This is particularly beneficial because a transfer of a preferred interest with a “guaranteed” return of, for example, 8% annually (if that is the preferred rate) can be contributed at a discount to a grantor retained annuity trust<sup>1293</sup> or charitable lead annuity trust<sup>1294</sup> when the section 7520 (the assumed internal rate of return) is significantly lower than that, for example 2.4% (the rate currently in effect at the time of this article). In that instance, an automatic arbitrage between the 8% return on the preferred (not even taking into account the effective rate of return due to any applicable valuation discount) against the 2.4% is created, thus guaranteeing wealth transfer of 5.6% annually.

h. Other Exceptions of Note

(1) A non-lapsing right to convert an interest into an interest of the same class as the transferred interest that is subject to proportionate adjustment changes in the equity ownership of the partnership is not considered a liquidation, put, call, or conversion right.<sup>1295</sup> As such, these conversion rights are not considered applicable retained interest subject to the zero valuation rule.

(2) A liquidation participation right (right to participate in a liquidating distribution) is considered neither an extraordinary payment right nor a distribution right. If the transferor and the transferor’s family have the right to compel liquidation, this right

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<sup>1290</sup> Ltr. Rul. 9848006.

<sup>1291</sup> § 2701(c)(1)(B)(i).

<sup>1292</sup> Treas. Reg. § 25.2701-2(b)(3)(i).

<sup>1293</sup> § 2702.

<sup>1294</sup> See § 170(f)(2), 642(c), 2055(e)(2)(B) and 2522(c)(2)(B).

<sup>1295</sup> § 2701(c)(2)(C) and Treas. Reg. § 25.2701-2(b)(4)(iv).

will be valued as if the ability to compel liquidation did not exist, or if the “lower of” rule applies, in a manner consistent with that rule.<sup>1296</sup>

3. Qualified Payment Interests

a. Assuming none of the exceptions above apply, for a distribution right (applicable retained interest) to avoid zero valuation under section 2701 of the Code, it must be considered a “qualified payment.”

b. A qualified payment “means any dividend payable on a periodic basis under any cumulative preferred stock (or a comparable payment under any partnership interest) to the extent that such dividend (or comparable payment) is determined at a fixed rate.”<sup>1297</sup> A payment will be treated as a “fixed rate” if the payment is “determined at a rate which bears a fixed relationship to a specified market interest rate.”<sup>1298</sup>

c. The Treasury Regulations provides that a qualified payment is:

(1) “A dividend payable on a periodic basis (at least annually) under any cumulative preferred stock, to the extent such dividend is determined at a fixed rate.”<sup>1299</sup>

(2) Any other cumulative distribution payable on a periodic basis (at least annually) with respect to an equity interest, to the extent determined at a fixed rate or as a fixed amount.”<sup>1300</sup>

d. A qualified payment made up to 4 years following its due date will be treated as having been made on the due date.<sup>1301</sup> If a qualified payment is made after the 4 year grace period, the unpaid qualified payments essentially accrue interest at the “appropriate discount rate”<sup>1302</sup> (the discount rate applied in determining the value of the qualified payment right at the time of the original transfer under Section 2701).

e. If there are unpaid qualified payments, upon a “taxable event”<sup>1303</sup> (generally, the transfer of the qualified payment interest during lifetime or at death or the termination of the interest holder’s right to the qualified payments), additional transfers taxes may become payable. The additional transfer taxes that become payable are implemented by increasing the taxable gifts of the transferor or the transferor’s taxable estate, as the case may be,

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<sup>1296</sup> Treas. Reg. § 25.2701-2(b)(4)(ii).

<sup>1297</sup> § 2701(c)(3)(A).

<sup>1298</sup> § 2701(c)(3)(B). *See* Treas. Reg. § 25.2701-2(b)(6)(ii).

<sup>1299</sup> Treas. Reg. § 25.2701-2(b)(6)(i)(A).

<sup>1300</sup> Treas. Reg. § 25.2701-2(b)(6)(i)(B).

<sup>1301</sup> § 2701(d)(2)(C).

<sup>1302</sup> *See* § 2701(d)(2)(A) and Treas. Reg. § 25.2701-4(c)(3).

<sup>1303</sup> § 2701(d)(3) and Treas. Reg. § 25.2701-4(b).

and is calculated through a series of computations that, significantly, assume all payments were made on the date payment was due and such payments were “reinvested by the transferor as of the date of payment at a yield equal to the discount rate.”<sup>1304</sup>

f. A qualified payment right that has no additional bells and whistles (in particular, liquidation, put, call, or conversion rights) will be valued without regard to Section 2701, using traditional gift tax rules.<sup>1305</sup>

g. If a qualified payment right has certain bells and whistles (“1 or more liquidation, put, call, or conversion rights with respect to such interest”<sup>1306</sup>), the value of the qualified payment right will be determined as if these bells and whistles are exercised in a manner resulting in the lowest value being determined for such rights.<sup>1307</sup> The Treasury Regulation labels these types of bell and whistle as an “extraordinary payment right” and defines them “any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or nonexercise of which affects the value of the transferred interest. A call right includes any warrant, option or other right to acquire one or more equity interests.”<sup>1308</sup> This is sometimes referred to as the “lower of” rule, which essentially requires that a qualified payment preferred interest will not be valued according to its terms (preferred rate, liquidation coverage, etc.) but rather will have a value, if lower, of the extraordinary payment right (for example, if the preferred interest provides a conversion right to common interest that have a value less than the qualified payment right).

h. The Code provides that a transferor or applicable family member may make an election to treat a distribution right that is not a qualified payment under the definition above to treat it as a qualified payment.<sup>1309</sup> The election applies to specified amounts to be paid at specified times and “only to the extent that the amounts and times so specified are not inconsistent with the underlying legal instrument giving rise to such right.”<sup>1310</sup>

#### 4. Subtraction Method of Valuation

a. If section 2701 applies to a transfer, the value of the transferred interest will be determined using the “subtraction method” described in the Treasury Regulations.<sup>1311</sup> The value of the transferred interest is determined in the 4 steps (simplified for purposes of this outline):

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<sup>1304</sup> § 2701(d)(2)(A)(i)(II).

<sup>1305</sup> § 2701(a)(3)(C).

<sup>1306</sup> § 2701(a)(3)(B)(ii).

<sup>1307</sup> § 2701(a)(3)(B) and Treas. Reg. § 25.2701-2(a)(3). *See also* § 25.2701-2(a)(5).

<sup>1308</sup> Treas. Reg. § 25.2701-2(b)(2).

<sup>1309</sup> § 2701(c)(3)(C)(ii).

<sup>1310</sup> § 2701(c)(3)(C)(ii).

<sup>1311</sup> Treas. Reg. § 25.2701-3.

(1) Step 1: Determine the fair market value of all family-held<sup>1312</sup> interests in the entity immediately before the transfer.

(a) Fair market value is determined assuming that all of the interests are held by one individual (presumably to eliminate minority interest discount issues but still allow for discounts due to lack of marketability).<sup>1313</sup>

(b) There has been some commentary that having all of the interest held by one individual essentially means that the value in this step is liquidation value. However, in the guidance cited in the commentary, both the taxpayer and the IRS stipulated that the value of the company was book value and the question of whether lack of marketability should be assigned to such interests was not at issue.<sup>1314</sup>

(2) Step 2: Subtract the value of all family-held senior equity<sup>1315</sup> interests (e.g., the preferred interests).

(a) If the interest is an applicable retained interest held by the transferor and applicable family members, the value as determined under section 2701 of the Code. This value could, obviously be zero by application of the zero valuation rule.

(b) If held by persons other than the transferor and applicable family members, the value is the fair market value.<sup>1316</sup>

(c) In traditional forward freeze planning, the retained preferred interest is commonly structured to be a qualified payment interest in an effort to minimize the value of the transferred common interest (determined ultimately in step 4 below). Section 2701 of the Code prevents taxpayers from over valuing the qualified payment preferred interest through the “lower of” rule discussed above. As such, planners need to avoid creating an extraordinary payment right or distribution right that would be valued at less than full fair market value (e.g., the liquidation value of the preferred interest). As pointed out in the context of Revenue Ruling 83-120, the preferred rate will be affected by the preferred payment coverage and the protection of the liquidation preference.

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<sup>1312</sup> For these purposes, “family” means the transferor, applicable family members, and any lineal descendants of the parents of the transferor or the transferor’s spouse (held directly or through attribution). *See* Treas. Regs. §§ 25.2701-3(a)(2)(i) and 25.2701-2(b)(5)(i).

<sup>1313</sup> Treas. Reg. § 25.2701-3(b)(1)(i).

<sup>1314</sup> *See* TAM 9447004.

<sup>1315</sup> Senior equity interest is “an equity interest in the entity that carries a right to distribution of income or capital that is preferred as to the rights of the transferred interest.” Treas. Reg. § 25.2701-3(a)(2)(ii).

<sup>1316</sup> The Treasury Regulations provide, “the fair market value of an interest is its pro rata share of the fair market value of all family-held senior equity interests of the same class (determined, immediately after the transfer, as is [if] all family-held senior equity interests were held by one individual).” Treas. Reg. § 25.2701-3(b)(2)(i)(A).

(3) Step 3: Allocate the balance among the transferred interests and other family-held subordinate equity interests, as follows:

(a) if more than one class of family-held subordinate equity interest exists, the remaining value is allocated in a manner that would most fairly approximate their value if all zero-valued rights under section 2701 did not exist; and

(b) if there is no “clearly appropriate method” of allocation, the remaining value is allocated in proportion to their fair market values without regard to section 2701 of the Code.<sup>1317</sup>

(4) Step 4: Apply certain discounts and other appropriate deductions, but only to the extent permitted by the Treasury Regulations.

(a) The Treasury Regulations provide if the value of the transferred interest would have been determined (but for Section 2701) with a “minority or similar discount,” the amount of the gift is reduced by the excess of a “pro rata portion of the fair market value<sup>1318</sup> of the family-held interests of the same class” over “the value of the transferred interest (without regard to section 2701).”<sup>1319</sup>

(b) The IRS has ruled that “minority or similar discount” includes a “discount for lack of marketability” with respect to the transferred interest.<sup>1320</sup>

(c) The Treasury Regulations provide, the value of the family-held interests of the same class is “determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701.”<sup>1321</sup>

(d) It stands to reason also that non-preferred limited partnership interests should also be entitled to an additional discount for being subordinate to the rights of the preferred interests with respect to cash flow distributions and liquidation proceeds (sometimes referred to as a “subordination discount”). As a result, non-preferred limited partnership interests will often be entitled to a significantly larger valuation discount than single class share FLP interests. As a result, even when the subtraction method is applied to a transfer, the value of the gift is often much smaller than most practitioners anticipate.

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<sup>1317</sup> Treas. Reg. § 25.2701-3(b)(3).

<sup>1318</sup> The Treasury Regulations provide, the value is “determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701.” Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

<sup>1319</sup> Treas. Reg. § 25.2701-3(b)(4)(ii).

<sup>1320</sup> TAM 9447004.

<sup>1321</sup> Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

b. 10% Minimum Value Rule

(1) If section 2701 applies to a transfer of a “junior equity interest,” then such transferred interest must be assigned at least that pro rata value which it would have if the total value of all of the common stock of the corporation, or junior equity interests of a partnership (or LLC), were equal to 10 percent of the sum of (a) the total value of all of the equity interests in the entity, plus (b) the total amount of indebtedness of the entity to the transferor and applicable family members.<sup>1322</sup>

(2) For purposes of the 10% Minimum Value Rule, the following types of indebtedness are included in this calculation:

(a) Short-term indebtedness with respect to the current conduct of the partnership’s trade or business;

(b) Third-party debt solely because it is guaranteed by the transferor or an applicable family member; and

(c) Amounts set aside in a qualified deferred compensation arrangement, to the extent unavailable for use by the partnership.<sup>1323</sup>

(3) For purposes of the 10% minimum value rule, a “junior equity interest” as, “common stock or, in the case of a partnership, any partnership interest under which the rights to income and capital are junior to the rights of all other classes of partnership interests.”<sup>1324</sup>

(4) Many practitioners wrongly believe that the 10% minimum value rule creates a phantom gift each time a forward freeze transaction occurs (transferor retains the preferred interest and transfers the common interest, even when the preferred interest is a qualified income right). The only time a phantom gift would occur under the minimum value rule is if the value of the common interest transferred is less than 10% of the total value of the entity.

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<sup>1322</sup> § 2701(a)(4).

<sup>1323</sup> Treas. Reg. § 25.2701-3(c)(3)(i).

<sup>1324</sup> Treas. Reg. § 25.2701-3(c)(2). The Treasury Regulations go on to provide, “Common stock means the class or classes of stock that, under the facts and circumstances, are entitled to share in the reasonably anticipated residual growth in the entity.” *Id.*

5. Revenue Ruling 83-120

a. Many commentators<sup>1325</sup> and the IRS in rulings<sup>1326</sup> have asserted that the appropriate standard for valuing the preferred interest is under Revenue Ruling 83-120,<sup>1327</sup> pertaining to preferred corporate stock. The Revenue Ruling provides a methodology for valuing preferred interests, based upon 3 primary factors:<sup>1328</sup> yield, preferred payment coverage and protection of the liquidation preference.

(a) Yield of the preferred interest is compared with the dividend yield of “high-grade, publicly traded preferred stock.” The required credit rating is not explicitly stated in the ruling. The ruling does point out, however, that “If the rate of interest charged by independent creditors to the [entity] on loans is higher than the rate such independent creditors charge their most credit worthy borrowers, then the yield on the preferred [interest] should be correspondingly higher than the yield on the high quality preferred stock.”<sup>1329</sup>

(b) The ruling provides that “Coverage of the dividend is measured by the ratio of the sum of the pre-tax and pre-interest earnings to the sum of the total interest to be paid and the pre-tax earnings needed to pay the after-tax dividends.”<sup>1330</sup> Obviously, in the partnership context, due to pass-thru taxation under Subchapter K, concerns about pre-tax earnings and after-tax dividends are not relevant. Coverage is further supported if the partnership agreement provides that the preferred payment can be satisfied from both cash flow of the partnership and distributions in-kind of partnership assets.

(c) Protection of the liquidation preference is determined by comparing the value of the partnerships assets (net of liabilities) to the liquidation preference amount. In other words, what is the ratio of preferred interests in comparison to non-preferred interests?

b. From a planning perspective, dividend (preferred payment) coverage and liquidation protection are within the control of the planner (whereas the yield on publicly-traded preferred stocks is determined by the vagaries of the market at the time of the purported transfer). In other words, if a FLP is being recapitalized into a qualified payment preferred FLP, then how much dividend coverage or liquidation protection is a function of the sizing between the preferred and common interests. For example, dividend coverage and liquidation protection would be quite different if AB partnership, which holds \$10,000,000 of assets is structured, as

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<sup>1325</sup> See, e.g., Milford B. Hatcher, Jr. and Edward M. Manigault, *Warming Up to the Freeze Partnership*, Estate & Personal Financial Planning (June 2000).

<sup>1326</sup> See, e.g., PLR 9324018.

<sup>1327</sup> Rev. Rul. 83-120, 1983-2 C.B. 170.

<sup>1328</sup> The ruling also indicates that voting rights and lack of marketability are secondary factors, but these may cancel each other out in many instances. Rev. Rul. 83-120, 1983-2 C.B. 170 at Sections 4.01, 4.05 and 4.06.

<sup>1329</sup> Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.02.

<sup>1330</sup> Rev. Rul. 83-120, 1983-2 C.B. 170 at Section 4.03.

follows: (i) A holding a 7% preferred on a \$5,000,000 liquidation preference amount and B holding the common shares, and (ii) A holding a 7% preferred on a \$9,000,000 liquidation preference amount and B holding the common shares. In the first instance, the effective yield that must be paid from the portfolio is 3.5% per year and there is 2:1 ratio of liquidation protection (\$10,000,000 of assets to satisfy a \$5,000,000 liquidation preference), and in the second instance, the effective yield is 6.3% and there is a 10:9 ratio of liquidation protection (\$10,000,000 of assets to satisfy a \$9,000,000 liquidation preference). In the latter instance, the value of the preferred interest would most likely be much less than the liquidation preference of \$9,000,000 because the required yield from the partnership is considerably higher (less dividend coverage) and there is very little cushion of liquidation protection.

c. In addition, the amount of dividend coverage and liquidation protection will affect the preferred rate. The preferred rate will generally be lower if the capital coverage and liquidation protection is greater. Generally, particularly with forward freeze planning, in order to maximize the future value of the transferred common interests, planners will seek to lower the preferred rate (the cash flow required to be paid on the preferred) as much as possible by providing sufficient dividend coverage and liquidation protection. The object is to lower the preferred rate to match the market rate, as instructed by Revenue Ruling 83-120.

### C. Transfer Tax Planning

#### 1. Generally

a. As mentioned above, there are very good reasons for trying to retain as much Basic Exclusion Amount as possible, even for very wealthy clients who have significant estate tax exposure. If the doubling of Basic Exclusion Amount under TCJA becomes a permanent feature, retention becomes twice as valuable to individuals as a “free base” opportunity. Of course, if the doubling of the Basic Exclusion Amount is only temporary, wealthy individuals will seek to use the increase in the exclusion through taxable gifts, particularly if the Treasury Regulations provide there is no risk of “claw back.” Preferred partnerships provide a structure that can provide significantly more valuation discounts with a forward freeze transaction or significant appreciation a reverse freeze transfer.

b. Preferred partnership structures can be utilized in a number of ways such that even if an individual decides to make a taxable gift, using all or a portion of his or her Basic Exclusion Amount, the gift can be maximized by the leverage inherent in the preferred partnership structure. In a relatively low interest rate environment, preferred rates may be two or three times the interest rate or discount rate associated with a GRAT, CLAT, or installment sale to an IDGT. In addition, the preferred rate will likely be significantly higher than bond yields on fixed income. That arbitrage can be valuable to clients in their planning. For example, if preferred rates are 8% and bond yields on fixed income instruments are 2%, a forward freeze transaction would allow a client who needs cash flow for living expenses to retain an interest in a pool of assets (inside the FLP) that yields 8%, but allow for a transfer of a portion of the corpus (in the form of the common interests) without affecting the client’s annual cash flow. With a reverse freeze transaction, for a client who has no cash flow needs from the FLP assets, the client can transfer the preferred interest that will appreciate, in the form of the preferred yield, 8%. That appreciation provides significant annual wealth transfer as time, without even taking into account any valuation discount that might be associated with the transfer because normal gift tax rules apply to the transfer due to junior equity exception.

c. To avoid many of the complications associated with partnership taxation, practitioners will likely seek to ensure that the preferred partnership will be treated as a disregarded entity. Thus, as discussed later in these materials, a limited liability company owned solely by a grantor and his or her grantor trust will likely be the vehicle of choice.

d. As one can see, preferred partnership planning can be used in many different situations depending on the goals of the client. Today, interest rates remain relatively low, and wealthy individuals, as a result of TCJA, are armed with twice the Basic Exclusion Amount. These factors provide a fertile environment to consider preferred partnerships for clients.

## 2. Traditional Forward Freeze: Qualified Payment Interests

a. As discussed above, traditional forward freeze planning is often utilized with clients who wish to retain cash flow but also transfer appreciation (if there is appreciation above the cash flow preference). The potential for appreciation depends, of course, on the underlying assets held by the FLP, and also on the capital structure of the preferred FLP. By way of example, consider a preferred FLP holding \$10 million in assets, capitalized with voting preferred shares bearing an 8% preferred rate and \$5 million liquidation preference (\$400,000 preferred distribution). Assume that the common shares are non-voting, and they have been transferred (gifted or sold) to an IDGT. If the underlying assets appreciate by 10% (\$1 million of appreciation), then after they payment of the preferred payment, \$600,000 of appreciation will accrue for the benefit of the common holder. If, on the other hand) the preferred FLP is capitalized with preferred shares bearing an 8% preferred rate and a \$4 million liquidation (\$320,000 preferred distribution), then \$680,000 of appreciation will accrue for the benefit of the common holder.

b. In the previous example, of course, the value of the transferred common interest to the IDGT would be different because the common shares would have an initial nominal or liquidation value of \$5 million and \$6 million respectively. However, where the preferred shares are structured as qualified payment rights (e.g., cumulative annual payments at a fixed rate) under section 2701 of the Code, the subtraction method provides a mechanism to claim significant valuation discounts on the common interests. As noted above, when planning with qualified payment rights, the key to minimizing the value of the common interests is to maximize the value of the retained qualified preferred interest in step 2 of the subtraction method (in this example, \$5 or \$4 million, which is equal to the liquidation preference). Assuming the starting value in step 1 is \$10 million (as discussed above, the value in step 1 is likely to be reduced for lack of marketability), then if the value of the senior (preferred) equity interest is liquidation value, then step 3 would provide a nominal value for the common interest of \$5 or \$6 million). In step 4 of the subtraction method, the taxpayer is allowed to apply all appropriate deductions, which include lack of marketability, minority interest (because the common is non-voting), and subordination discounts. In other words, the common interests will carry larger valuation discounts than a single class share FLP share would carry.

c. If, for example, the \$5 million common interest is entitled to a 40% valuation, then the common interest will carry a gift tax value of \$3 million, and if the FLP assets appreciate by 10%, then after payment of the preferred interest, the \$600,000 of wealth accruing to the common represents a 20% increase in value in comparison to the value calculated under the subtraction method. In contrast, if the FLP had been structured as a single class share FLP and if a transfer of 50% of the FLP only carried a 20% discount, then the common would have a gift tax value of \$4 million, and the appreciation accruing to the common (50% of 10%

appreciation or \$500,000) would only represent a 12.5% increase in value over the gift tax value. As one can see, a traditional forward freeze with a qualified payment preferred interest allows taxpayers to retain significant cash flow but also transfer the common interests with greater valuation discounts and potential for appreciation with the common.

d. In a traditional forward freeze, the client will retain the preferred interest, which might be includible in the client's gross estate. Practitioners should consider including a provision in the partnership agreement that provides upon death the preferred interest will be liquidated in an amount equal to the liquidation preference. This should limit the value of the preferred interest to its liquidation value (capital account balance, which will include any unpaid but accrued preferred payments). This should alleviate the risk of the preferred interest actually carrying a valuation premium for estate tax purposes if preferred rates have dropped. Further, whether a section 754 election is in place or not, any assets received in liquidation of the preferred interest will receive a basis equal to the liquidation value.

### 3. Qualified "Cost-of-Living" Preferred Interests

a. One twist that taxpayers may want to consider with a forward freeze transaction is the preferred liquidation preference would be adjusted for inflation to provide inflation-adjusted cash flow and ensure that the retained preferred interest in the gross estate would equal the grantor's Basic Exclusion Amount on the grantor's death. Pursuant to this technique:

(1) The retained preferred interest would be structured as a "qualified payment right" (e.g., cumulative annual payment at a fixed rate) under section 2701, so the zero valuation rule would not be applicable.

(2) The liquidation preference of the preferred interest would be adjusted to provide for a cost-of-living increase, calculated in the same manner as the Basic Exclusion Amount.

(3) The retained preferred interest would be structured so that the preferred holder would have the right to put the interest to the partnership for the liquidation preference (as adjusted for the cost-of-living increase, which as mentioned above, was permanently tied to chained CPU or C-CPU-I) and at death, the partnership has the right to liquidate the preferred interest at the liquidation preference.

(4) The gift or sale of the common interest would qualify for significant valuation discounts, in excess of those that would typically apply to a traditional single class or pro rata family limited partnership (step 4 of the subtraction method, as discussed above).

b. A common inflation-sensitive interest rate investment is a Treasury Inflation-Protected Security (TIPS). TIPS, unlike certain U.S. savings bonds, adjust for inflation by providing inflation adjustments to the underlying principal amount and keeping the yield fixed. For example, if a \$100,000 TIPS is issued with a 4% yield, then \$4,000 of interest will be

paid in the first year. Assume inflation is 3% in the ensuing year. The TIPS adjusted principal amount will be \$103,000 but the yield remains at 4%. As a result, the ensuing year's interest payment will be \$4,120. TIPS are an example of a larger category of investments under the Code, called inflation-indexed debt instrument ("IIDI").<sup>1331</sup> An IIDI is defined as a debt instrument that has the following features:<sup>1332</sup>

- (1) It is issued for U.S. dollars and all payments are denominated in the same;
- (2) Except for a minimum guarantee,<sup>1333</sup> each payment is indexed for inflation or deflation; and
- (3) No payments are subject to any contingencies other than inflation or deflation.<sup>1334</sup>

c. Terms of the Qualified "Cost-of-Living" Preferred Interests

(1) The partnership will provide a cumulative preferential right to partnership cash flow. Typically, this preferential right will be a percentage of a stated liquidation preference amount (for example, 6% of an amount that is tied to the Basic Exclusion Amount. The liquidation preference can be \$6.03 million if one believes that the doubling of the Basic Exclusion Amount under TCJA will not be permanent or can be \$12.06 if it turns out that the doubling of the exemption becomes permanent. In this instance, the liquidation preference would be structured similarly to take into account future inflation or deflation as TIPS would be adjusted.

(2) The preferred payment will accrue annually and will be cumulative to the extent payments are not made in any given year.

(3) The preferred payment may go into arrears for up to 4 years after the due date without interest being due on the unpaid preference. After the 4-year period, the unpaid payments will accrue interest at the specified preferred rate (for example, 6%).

(4) The partnership agreement will provide that payments may be paid from available cash, first, and, at the discretion of the general partner, with in-kind distributions of partnership property.

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<sup>1331</sup> See Treas. Reg. § 1.1275-7.

<sup>1332</sup> Treas. Reg. § 1.1275-7(c)(1).

<sup>1333</sup> An additional payment made at maturity if the total inflation-adjusted principal paid on the IIDI is less than the IIDI's stated principal amount. Treas. Reg. § 1.1275-7(c)(5).

<sup>1334</sup> A qualified inflation index is any general price or wage index that is updated and published at least monthly by an agency of the U.S. Government. The Treasury Regulations specifically mentioned the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U). Treas. Reg. § 1.1275-7(c)(3).

(5) Upon dissolution, the preferred interest will receive liquidating distributions equal to the liquidation preference amount (\$6.03 million as adjusted for inflation) before any distributions are made to non-preferred interest holders.

(6) The partnership agreement will provide the partnership the right to call the preferred interest at the liquidation preference amount upon the death of the preferred holder. This effectively freezes the value for transfer tax purposes at the liquidation preference amount and at the taxpayer's Basic Exclusion Amount. Assuming the taxpayer has not used his or her Basic Exclusion Amount through taxable gifts, then the retained preferred interest will be fully sheltered by the exclusion amount.

d. The yield on a qualified "cost-of-living" preferred interest will be less than the yield on a liquidation preference that is fixed, just as the yield on TIPS is less than the yield on bonds that are not inflation-adjusted. This difference is referred to as "breakeven inflation." Breakeven inflation is the difference between the nominal yield on a fixed rate investment and the "real yield" on an inflation-adjusted investment of similar maturity and credit quality.

#### 4. "Busted" (Non-Qualified) Preferred Interests

a. A "busted" section 2701 preferred interest (sometimes referred to as the "intentionally defective preferred interest") involves the creation of a preferred interest in a partnership or limited liability company that is *not* a qualified payment right under section 2701(c)(3) and gifting the common interest in a manner that mandates the "zero valuation" rule under the "subtraction method." Typically, the preferred interest payment is non-cumulative, thereby intentionally failing the definition of a "qualified payment."

b. This technique would have had particular relevance in light of the temporary doubling of the Base Exclusion Amount to \$12.06 million per person for 2022 and the Anti-Clawback Regulations. However, the recently issued Proposed Anti-Abuse Regulations,<sup>1335</sup> if passed as written, would eliminate the ability to get credit for the use of the bonus exclusion, as described herein. For example, taxpayer owns an LLC that holds \$12.06 million in assets. Taxpayer recapitalizes the LLC into preferred and common interests. The preferred interests have a \$6.03 million liquidation preference and a 6% non-cumulative preferred annual payment (\$361,800). The preferred holder has the right to put the preferred interest to the LLC at any time for the liquidation preference. The LLC has the right to liquidate the preferred interest for \$6.03 million at the death of the preferred holder. The taxpayer gifts the common interests to an IDGT.

(1) The preferred interest is not a "qualified payment" under section 2701(c)(3). As such, the value of the gifted common interest will be determined using the "subtraction method" described in the Treasury Regulations,<sup>1336</sup> with the preferred interest

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<sup>1335</sup> REG-118313-21, 87 Fed. Reg. 24918 (4/27/22) (the "Proposed Anti-Abuse Regulations").

<sup>1336</sup> Treas. Reg. § 25.2701-3.

(family-held senior equity<sup>1337</sup> interest) being assigned a value of zero in step 2 of the subtraction method.

(2) The value attributed (with the preferred interest having a zero value) to transferred common interest may be entitled to valuation discounts. The Treasury Regulations provide if the value of the transferred interest would have been determined (but for section 2701) with a “minority or similar discount,” the amount of the gift is reduced by the excess of a “pro rata portion of the fair market value<sup>1338</sup> of the family-held interests of the same class” over “the value of the transferred interest (without regard to section 2701).”<sup>1339</sup> The Service has ruled that “minority or similar discount” includes a “discount for lack of marketability” with respect to the transferred interest (when the preferred interest was valued at zero).<sup>1340</sup>

c. For the sake of simplicity, we assume, under the subtraction method with the zero valuation rule applying in this example, the gift of the common is calculated to be exactly \$12.06 million. Why would a taxpayer consider making this gift? The answer lies in the calculation of the estate tax upon the taxpayer’s death. The tentative federal estate tax (before credits) is essentially computed against the sum of the decedent’s taxable estate,<sup>1341</sup> and the “amount of adjusted taxable gifts.”<sup>1342</sup> The Treasury Regulations provide that if an individual (referred to as the “initial transferor”) makes a transfer subject to section 2701, “in determining the Federal estate tax with respect to an initial transferor, the executor of the initial transferor’s estate may reduce the amount on which the decedent’s tentative tax is computed under section 2001(b)... by the amount of the reduction.”<sup>1343</sup>

(1) Assuming there has been no subsequent transfer of the retained preferred interest, the amount of the reduction (to adjusted taxable gifts) is the “amount by which the initial transferor’s taxable gifts were increased as a result of the application of section 2701 to the initial transfer.”<sup>1344</sup>

(2) In other words, in our simple example, the amount of the reduction is exactly \$6.03 million (the increase of the gift of the common or the value of

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<sup>1337</sup> Senior equity interest is “an equity interest in the entity that carries a right to distribution of income or capital that is preferred as to the rights of the transferred interest.” Treas. Reg. § 25.2701-3(a)(2)(ii).

<sup>1338</sup> The Treasury Regulations provide, the value is “determined as if all voting rights conferred by family-held equity interests were held by one person who had no interest in the entity other than the family-held interests of the same class, but otherwise without regard to section 2701.” Treas. Reg. § 25.2701-3(b)(4)(ii)(A).

<sup>1339</sup> Treas. Reg. § 25.2701-3(b)(4)(ii).

<sup>1340</sup> TAM 9447004.

<sup>1341</sup> § 2001(b)(1)(A).

<sup>1342</sup> § 2001(b)(1)(B).

<sup>1343</sup> Treas. Reg. § 25.2701-5(a)(3).

<sup>1344</sup> Treas. Reg. § 25.2701-5(b)(2).

preferred interest if it had been a “qualified interest”). However, because the non-cumulative preferred can be liquidated at \$6.03 million, the amount includible is also \$6.06 million. As such, these two amounts will cancel each other out, and the value in the gross estate attributable to the preferred interest is zero.

d. The Treasury Regulations provide the following example that makes it clear that the reduction in adjusted taxable gifts is frozen in value:

P, an individual, holds 1,500 shares of \$1,000 par value preferred stock of X corporation (bearing an annual noncumulative dividend of \$100 per share that may be put to X at any time for par value) and 1,000 shares of voting common stock of X. There is no other outstanding common stock of X.<sup>1345</sup>

P continues to hold the preferred stock until P's death. The chapter 11 value of the preferred stock at the date of P's death is the same as the fair market value of the preferred stock at the time of the initial transfer. In computing the Federal estate tax with respect to P's estate, P's executor is entitled to a reduction of \$1,500,000 under paragraph (a)(3) of this section.<sup>1346</sup>

e. A significant practical benefit to the taxpayer is that for as long as the taxpayer holds the preferred interest, the taxpayer presumably can choose to receive the preferred payment or not. If no preferred payment is received, all of the appreciation effectively passes to the common interests. On the other hand, the preferred holder always has the option to receive the distribution if the cash flow is needed for any reason. The preferred interest is frozen in value with a reduction for estate tax purposes that essentially “zeroes-out” the estate tax liability attributable to the preferred. Prior to the issuance of the Proposed Anti-Abuse Regulations, decedents would have gotten the added benefit of the claw-back adjustment, but the proposed Treasury Regulations cast serious doubt on that. If passed, as written, no claw-back adjustment (credit for the use of the bonus exclusion) will be given for transfers “described in §25.2701-5(a)(4) or §25.2702-6(a)(1) of this chapter.”<sup>1347</sup> As such, a single taxpayer using both the base and bonus exclusion on this type of transfer would not get the benefit of the claw-back adjustment. However, spouses, using both of their respective original Base Exclusion Amounts (no bonus) in separate transfers would get the reduction to adjusted taxable gifts described above, along with the credit attribute to the original Base Exclusion Amount.

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<sup>1345</sup> Treas. Reg. § 25.2701-5(d)(1)(i).

<sup>1346</sup> Treas. Reg. § 25.2701-5(d)(3), Ex. 2.

<sup>1347</sup> Prop. Treas. Reg. § 20.2010-1(c)(3)(i)(C).

5. Reverse Freeze Planning

a. As mentioned above, reverse freeze planning involves the transferor retaining the common interest and transferring the preferred interest. Because the transferor is transferring the preferred cash flow preferences, a reverse freeze is only for those individual who do not need to retain the cash flow. The primary transfer tax benefit of a reverse freeze is that it qualifies under the junior equity exception under section 2701. As such, normal gift tax rules apply in valuing the transferred preferred interest. Because preferred rates tend to be significantly higher than the interest rate or discount rate associated with many zeroed-out transfer techniques, a reverse freeze can provide a consistent and steady appreciation above the so-called hurdle rate associated with GRATs, CLATs, and installment sales. This arbitrage is can be further increased by the valuation discounts that would be associated with the preferred interest.

b. For example, consider a preferred partnership that holds \$10 million of assets, capitalized as follows: a preferred interest with a \$6 million liquidation preference and a cumulative annual cash flow preference of 8% (\$480,000), and a common interest having a nominal value of \$4 million based on its initial capital account. The preferred interest is non-voting, and the common is voting. A grantor who holds all of the preferred and common interests make a transfer of the preferred interest. Because normal gift tax rules apply, assume that the preferred interests carry a 25% valuation discount due to lack of control and marketability. The resulting transfer tax value is \$4.5 million, but the annual cash flow is \$480,000, which represents an annual return of over 10% in comparison to the transfer tax value. Whether the transfer is a taxable gift, zeroed-out transfer to a GRAT, or a sale to an IDGT for an installment note, a greater than 10% annual return is a sizeable amount of wealth transfer each year, particularly if the 7520 rate and AFR rates remain relatively low.

c. If, in this example, the partnership assets have less than 4.8% annual return, then the assets in the partnership will go down in value after the preferred payment of \$480,000 each year, thereby reducing the value of the common interest held by the grantor. If, on the other hand, the partnership assets are by 10% in the first year, then 5.2% of the appreciation will accrued to retained common interest. As one can see, the capital ratio between the preferred and common interests should be carefully considered depending on the expected return of the underlying assets and the objectives and situation of the client.

D. Income Tax Planning

1. Generally

a. With the higher income tax rates, progressivity in the marginal income tax brackets provides an opportunity for taxpayers to take advantage of “running the brackets” and taxing income at lower effective tax rates. With the highest income tax rates becoming effective at \$647,850 of taxable income for joint filers (in 2022) and the 3.8% Medicare Tax being applied when MAGI exceeds \$250,000, the tax savings can be quite significant.<sup>1348</sup>

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<sup>1348</sup> See Rev. Proc. 2021-45, 2021-48 I.R.B. 764.

b. As a result, taxpayers will increasingly look for opportunities to not only defer the payment of income taxes (which provides a present value economic benefit) but to have the income spread out over many taxable years and over multiples of taxpayers. This will provide the benefit of having the income taxed at a lower tax rate by running the brackets, and to also fully avoid the imposition of certain taxes like the NIIT (for such annual amounts that remain below \$200,000 to \$250,000 of MAGI).

## 2. Splitting Income with Preferred Partnerships

a. The most flexible vehicles available to practitioners to “split” income among taxpayers are entities taxed as partnerships. While an S corporation will spread the entity’s income across the shareholders, the capital structure of an S corporation investment is limited to one class of stock so there is no ability to disproportionately allocate income to certain shareholders (who are taxed at lower marginal income tax brackets and who may not be subject to state income tax) to the exclusion of other shareholders (who are already at the highest income tax brackets and who may be residents of a high income tax state like California).<sup>1349</sup>

b. Generally, the Code and the IRS take the position that if a partner holds a preferred interest in a partnership, then taxable income should follow with the preferred interest payment.

(1) For guaranteed payment rights, the taxation to the partnership and the partners is relatively straightforward. A partnership that makes a guaranteed payment to partner is entitled to either deduct the payment as an ordinary and necessary business expense<sup>1350</sup> of the partnership or capitalize<sup>1351</sup> the expense as a capital expenditure, depending on the nature of the payment.<sup>1352</sup> The partner receiving the guaranteed payment must include the payment as ordinary income<sup>1353</sup> in the year in which the partnership paid or accrued the payment under its method of accounting.<sup>1354</sup>

(2) For the other types of preferred interests, the allocation of income is a bit more convoluted. Generally, the income allocated to the preferred payment depends on the distributive share of the partnership. The McKee, Nelson and Whitmire treatise provides that the Service expects a preferred return to be matched by a corresponding allocation of available income or gain.<sup>1355</sup> The Treasury Regulations, in the context of the disguised sale rules, provide that a preferred return means “a preferential distribution of partnership cash flow to

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<sup>1349</sup> § 1361(b)(1)(D).

<sup>1350</sup> § 162(a).

<sup>1351</sup> § 263.

<sup>1352</sup> § 707(c).

<sup>1353</sup> See § 61(a).

<sup>1354</sup> § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

<sup>1355</sup> McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, ¶ 13.02[3][b][iii], at 3-19 (3d ed. 1997).

a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of gain.”<sup>1356</sup>

c. With the goal of disproportionately allocating income to lower taxed individuals, practitioners should consider a “reverse freeze” transfer where the higher taxed individual transfers the preferred interest to the lower taxed individual. As discussed above, this transfer is excepted under section 2701 of the Code, and normal gift tax rules would apply to such transfer.

### 3. Non-Grantor Trusts: Distributions and Partnerships

a. As mentioned above, non-grantor trusts are taxed at the highest rates once taxable income exceeds \$13,450 (for 2022). As such, non-grantor trusts carry an inherent federal income tax disadvantage when compared to how those same assets would grow if they were held by an individual or group of individual taxpayers. Trustee should consider whether making distributions to trust income might better serve the overall purposes of the grantor and the grantor’s family, in terms of total wealth accumulation.

b. Even with trusts where the primary objective is to accumulate as much wealth in the trust as possible (for example, a “dynasty trust” or GST tax exempt trust), trustees may be able to produce more total wealth by distributing trust income out to the trust beneficiaries, especially if the trust beneficiaries would be taxed at lower income tax rates, would not be subject to state income tax, and have sufficient Applicable Exemption Amount and GST exemption available to shelter whatever assets may accumulate in the gross estates of the beneficiaries. Given the potential number of taxpayers or beneficiaries a trust could spread the income across, the savings could be significant.

c. Trust distributions that carry out distributable net income (“DNI”)<sup>1357</sup> of the trust would effectively ensure taxation of the income to the beneficiaries. DNI determines the amount of income that may be deducted by the trust resulting from distributions and determines the character of the income items taxable to the beneficiaries.<sup>1358</sup> Determining DNI for a trust requires first determining the taxable income of the trust and modifying that figure in a number of ways. With respect to capital gain, the Code provides, “[g]ains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not . . . paid, credited or required to be distributed to any beneficiary during the taxable year.”<sup>1359</sup> In other words, absent certain circumstances, capital gain is excluded from DNI and is taxable to the trust, rather than to the beneficiary receiving the distributions.

d. Often the governing instrument will give the trustee the authority to allocate gains between income and principal. Under the Treasury Regulations, however, “Trust

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<sup>1356</sup> Treas. Reg. § 1.707-4(a)(2).

<sup>1357</sup> § 643.

<sup>1358</sup> §§ 651(b), 652(a), 652(b), 661(a), 662(a) and 662(b).

<sup>1359</sup> I.R.C. § 643(a)(3). *See* Treas. Reg. § 1.643(a)-3(a) regarding the treatment of capital gains and losses in the taxable year in which the trust or estate terminates.

provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized.”<sup>1360</sup> The Treasury Regulations provide that capital gain is ordinarily excluded from DNI, with a number of notable exceptions:<sup>1361</sup>

*Capital gains included in distributable net income.* Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law)—

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of the distributable net income determined without regard to this subparagraph 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust’s books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

e. Notwithstanding the limited discretion granted to fiduciaries under the foregoing provisions, given the potential limitations of including capital gain in DNI and the fact that many clients would prefer not to have the asset held personally by the beneficiaries, practitioners may be able to accomplish the same types of tax savings by utilizing a partnership structure where the beneficiary is a partner along with the trust. By way of example, the trust could form an entity taxable as a partnership like a limited partnership or limited liability company and distribute an interest in the entity to the beneficiary. Whether such distribution carries out DNI to the beneficiary is secondary to the fact that on an ongoing basis a proportionate amount of partnership income will be allocated to the beneficiary. While a preferred interest partnership structure can be utilized, as discussed above, and practitioners should be aware of the implications under section 2701 upon the creation of the preferred partnership with the beneficiary or the distribution of a preferred interest in the partnership to the beneficiary.

f. Given that any partnership interest held by a trust beneficiary will be in his or her gross estate for estate tax purposes, practitioners will want to consider utilizing IDGTs to minimize the estate tax impact but still retain the income tax benefits of having the partnership income taxed to the beneficiary-grantor. For example, the beneficiary may want to sell his or her

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<sup>1360</sup> Treas. Reg. § 1.643(b)-1.

<sup>1361</sup> Treas. Reg. § 1.643(a)-3(a).

partnership interest to an IDGT created by the beneficiary, as the grantor for grantor trust purposes.

4. Trust to Trust Preferred Partnership

a. Consider the following hypothetical situation:

(1) Trust A is an irrevocable resident trust of State A, which is a no or low income tax state. Trust B is an irrevocable resident trust of State B, which is a high income tax state. Trust A and Trust B were created many years ago by grantors who are now deceased, and both trusts are held for benefit of the same beneficiaries. The terms of both trusts, particularly the provisions describing the beneficial interests of the beneficiaries, are substantially similar to each other. Trust A and Trust B each hold \$10 million in publicly-traded securities.

(2) Trust A and Trust B consolidate their assets by contributing them to a limited liability company (now holding \$20 million), with Trust A receiving preferred interests in the LLC, and with Trust B receiving common interests in the LLC, as follows: (i) the preferred interest held by A; and (ii) the common interest held by B retains all of the residual interest in any annual cash flow, liquidation proceeds, and earnings of the LLC after the preferred interest holders have been paid. The preferred interest held by A is structured as follows:

(a) \$10 million liquidation preference (upon dissolution of the LLC, this amount will be paid to the preferred partner in cash or in-kind before any liquidating distributions are made to the common holder); and

(b) An annual, cumulative preferential right to partnership cash flow equal to 10% of the liquidation preference (\$1,000,000 annually).

(3) Each year, the LLC pays \$1,000,000 of cash flow to Trust A. The portfolio of the LLC generates \$1,000,000 or less of taxable income (capital gain and portfolio income). Assuming no tax items need to be allocated to Trust B under section 704(c) of the Code, all of the taxable income will be allocated to Trust A, the low or no state income tax Resident Trust. No income will be allocated to Trust B.

b. There are strong arguments to support the conclusion that when Trust A and Trust B create the preferred LLC described above, section 2701 of the Code either does not apply or at worst has no transfer tax consequences:

(1) Section 2701 of the Code is gift tax provision. For it to apply, Trust A or Trust B must be making a gift to the other. For example, as a result of the formation of the LLC, Trust B is deemed to make a gift to Trust A. It is unclear whether an irrevocable trust can even make a gift like that. The original transfer to Trust B was made by a grantor or testator who is now deceased.

(2) Perhaps, there is a deemed gift from the beneficiaries of Trust B to the beneficiaries of Trust A. As mentioned above, section 2701 of the Code provides that in

determining whether a gift has been made and the value of such gift, when a person transfers an interest in a partnership to a “member of the transferor’s family”<sup>1362</sup> the value of certain “applicable retained interests” will be treated as zero.<sup>1363</sup> Further, “transfer” is broadly defined and is deemed to include “a contribution to capital or a redemption, recapitalization, or other change in the capital structure of a corporation or partnership.”<sup>1364</sup> A “member of the transferor’s family” means: (a) the transferor’s spouse, (b) a lineal descendant of the transferor or the transferor’s spouse, or (c) the spouse of any such lineal descendant.<sup>1365</sup> For these purposes, an individual is treated as holding any interest to the extent held indirectly through a trust.<sup>1366</sup> If the beneficiaries of Trust A are making a gift to the beneficiaries of Trust B, aren’t they making a gift to themselves because they have the same beneficial interests in both trusts? For a taxable gift to occur, property must be transferred for less than adequate and full consideration in money or money’s worth.<sup>1367</sup>

(3) As discussed above, the vertical slice exception of section 2701 of the Code provides “to the extent the transfer by the individual results in a proportionate reduction of each class of equity interest held by the individual and all applicable family members in the aggregate immediately before the transfer.”<sup>1368</sup> This is often referred to as the vertical slice exception. The Treasury Regulations provide, for interests held in trust:

A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of the equity interest.<sup>1369</sup>

c. In our hypothetical, the beneficial interest of the beneficiaries of Trusts A and Trust B are substantially similar. It would seem that even if Section 2701 of the Code applied, the vertical slice exception would also apply. That being said, out of an abundance of caution, practitioners should structure the preferred interest as a qualified payment right.

d. The preferred interest held by Trust A provides for a cumulative fixed annual payment of \$1 million to Trust A, so it is considered a qualified payment interest. This

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<sup>1362</sup> § 2701(a).

<sup>1363</sup> § 2701(a)(1)(3)(A).

<sup>1364</sup> § 2701(e)(5).

<sup>1365</sup> § 2701(e)(1).

<sup>1366</sup> § 2701(e)(3).

<sup>1367</sup> § 2512(b).

<sup>1368</sup> Treas. Reg. § 25.2701-1(c)(4).

<sup>1369</sup> Treas. Reg. § 25.2701-6(a)(4)(i).

avoids the risk of the zero valuation rule applying and reduces the value of any deemed gift from Trust A to Trust B under the subtraction method (as discussed in more detail later in this outline). When one runs through the attribution rules, given that the beneficiaries have substantially similar beneficial interests in both trusts, it is likely any net gift would be nominal (if section 2701 of the Code actually applied to this hypothetical).

E. Preferred Partnerships: An Alternative to Split-Dollar Life Insurance

1. Generally

a. Preferred partnership structures can be used in interesting ways to own, manage, and finance the purchase of life insurance. In such a structure, the common shares (growth interest) represent the future death benefit, and the preferred shares represent the fixed return on capital for funding the life insurance. It could provide an alternative ownership and management structure to private split-dollar arrangements, particularly in light of recent court cases dealing with the same.

b. Split-dollar insurance arrangements are a funding and ownership agreement between parties. In a common private split-dollar arrangements between the insured and an irrevocable life insurance trust (ILIT) created by the insured/grantor, the grantor provides the funding for the life insurance owned by the ILIT. Pursuant to that arrangement, the ILIT holds legal title and all incidents of ownership<sup>1370</sup> over the policy, including a right to some or all of the death benefit, and the grantor is repaid his or her investment once the economic arrangement ends (e.g., death of the insured). The grantor's interest in the repayment of his or her investment is typically included in the grantor's gross estate for transfer tax purposes. Split-dollar arrangements are utilized, in part, to reduce the gift tax payable by the grantor if the grantor had, instead, contributed all of the funds to the ILIT required to fully fund the premiums on the life insurance (without any right of reimbursement). However, depending on the type of split-dollar arrangement, there is an economic cost to the arrangement.

c. The split-dollar Treasury Regulations<sup>1371</sup> provide two mutually exclusive regimes that are applicable to these types of arrangements: the economic benefit regime and the loan regime. The Treasury Regulations quantify the "cost" under each of the two regimes to the grantor or the ILIT. Under the economic benefit regime, any "economic benefit" provided by the grantor to the ILIT is treated as a taxable gift. Under the Treasury Regulations, the value of that economic benefit is: (i) cost of life insurance protection; (ii) any increase in cash value to which the ILIT has current or future access; and (iii) any other economic benefit not described in the previous two categories to the extent not actually taken into account in previous years.<sup>1372</sup> Under the loan regime, the "cost" takes the form of imputed interest, as each premium paid is treated as a loan from the grantor to the ILIT.<sup>1373</sup> However, in a loan regime, there are typically no gift tax consequences.

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<sup>1370</sup> See § 2042(2).

<sup>1371</sup> Treas. Reg. §§ 1.61-22 and 1.7872-15.

<sup>1372</sup> Treas. Reg. § 1.61-22(d)(2).

<sup>1373</sup> Treas. Reg. § 1.7872-15(a)(2)(i).

d. To fall under the economic benefit regime, the ILIT typically has legal ownership and all incidents of ownership, and the grantor retains the right to be repaid, the greater of: (i) all premiums paid, or (ii) the cash value of the policy. The retention of the greater of those two figures ensures that the economic benefit afforded to the ILIT is the cost of insurance. The Treasury Regulations provide that the economic benefit regime (as opposed to the loan regime) when the “arrangement is entered into between a donor and a donee (for example, a life insurance trust) and the donor is the owner of the life insurance contract (or is treated as the owner of the contract under paragraph (c)(1)(ii)(A)(2) of this section).”<sup>1374</sup> In turn, the cited paragraph of the Treasury Regulations provide, “A donor is treated as the owner of a life insurance under a split-dollar life insurance arrangement that is entered between a donor and a donee (for example, a life insurance trust) if, at all times, the only economic benefit that will be provided under the arrangement is the current life insurance protection.”<sup>1375</sup> In such arrangements, the economic benefit regime results in the grantor making deemed taxable gifts of the cost of current life insurance protection based on rate Table 2001, which depends on the age of the insured and increases each year as the insured gets older.

e. To fall under the loan regime, the parties would need to designate the ILIT as the owner of the policy and providing that the premiums paid by the grantor will be repaid in a manner that the payments represent bona fide loans secured by the policy.<sup>1376</sup> Often, in split-dollar arrangements, the term of the promissory note will be for the life of the insured, often referred to as a hybrid loan. The Treasury Regulations provide that hybrid loans are tested for sufficient interest under section 7872 of the Code as if the loan is a term loan, with the term being set at the life expectancy of the insured.<sup>1377</sup> As such, the short, mid, or long-term AFR will apply depending on the life expectancy of the insured. If premium payments are made each year, each premium payment is treated as a separate loan, with interest set at the applicable AFR at such time. To avoid such complications, it is often recommended that the insured/grantor should make a lump sum loan to the ILIT sufficient to pay all expected premiums on the policy. This type of arrangement should fall with the definition of a split-dollar loan arrangement, to wit:

(1) A payment is made directly or indirectly by the non-owner to the owner (including a premium payment made by the non-owner directly or indirectly to the insurance company with respect to the policy held by the owner);<sup>1378</sup>

(2) The payment is a loan under general principles of Federal tax law or a reasonable person nevertheless would expect the payment to be repaid in full to the non-owner (whether with or without interest);<sup>1379</sup> and

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<sup>1374</sup> Treas. Reg. § 1.61-22(b)(3)(ii)(B).

<sup>1375</sup> Treas. Reg. § 1.61-22(c)(1)(ii)(A)(2).

<sup>1376</sup> See Treas. Reg. §§ 1.7872-15(a) and 1.7872-15(b).

<sup>1377</sup> Treas. Reg. § 1.7872-15(e)(5)(ii).

<sup>1378</sup> Treas. Reg. § 1.7872-15(a)(2)(i)(A).

<sup>1379</sup> Treas. Reg. § 1.7872-15(a)(2)(i)(B).

(3) The repayment is to be made from, or is secured by, the insurance policy's death benefit proceeds, the policy's cash surrender value, or both.<sup>1380</sup>

f. If sufficient interest is charged and paid by the ILIT, there are no gift tax consequences.<sup>1381</sup> The ILIT may not, however, have sufficient liquidity to pay all of the interest. Another option is to have the interest accrued, compound, and then ultimately paid when the death benefit is paid. This would avoid the gift tax liability. In theory this type of loan would cause the original issue discount rules<sup>1382</sup> to apply, but as long as the loan is between the grantor and a grantor trust (ILIT), there are no income tax implications. If the parties do not accrue the interest, the loan could be structured to provide for sufficient interest at the AFR to be paid annually, and the grantor/insured lender could forgive the interest each year. Under such circumstances, the Treasury Regulations provide that the forgiven interest is treated as if it had been paid by the ILIT to the lender and retransferred by the lender to the borrower (as a taxable gift).<sup>1383</sup>

g. In *Estate of Cahill v. Commissioner*,<sup>1384</sup> the Tax Court dealt with an economic benefit regime split-dollar arrangement, where the funded life insurance was on the lives of the decedent's son and his wife. These types of arrangements are sometimes referred to as "multi-generational" private split-dollar arrangements (where the insured is younger than the grantor). The estate valued the decedent's right of reimbursement under the economic benefit regime at \$183,700, even though the decedent had paid \$10 million toward the policies under the split-dollar agreement and the cash surrender value of the policies at death was approximately \$9.6 million. The estate argued that pursuant to split-dollar arrangement, the estate would not be entitled to receive reimbursement until the insureds actually passed away.

(1) Citing its recent decision in *Powell v. Commissioner*,<sup>1385</sup> as discussed above, the Tax Court held that sections 2036(a)(2) and 2038(a)(1) could apply because the decedent, in conjunction with the irrevocable trusts that owned the policies, could agree to terminate the split-dollar arrangement, and the decedent would have been entitled to the cash surrender value of the policies. In coming to that conclusion, the court held that the split-dollar arrangement itself was not bona fide sale for full and adequate consideration (an exception to sections 2036 and 2038) because "the value of what decedent received was not even close to the value of what decedent paid."

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<sup>1380</sup> Treas. Reg. § 1.7872-15(a)(2)(i)(C).

<sup>1381</sup> On the other hand, if the loan is a below market loan, the Treasury Regulations provide that the difference between the present value of all the payments required under the loan (discounted at the appropriate AFR) and the total amount loan is treated as a gift in the year the loan is made. Treas. Reg. § 1.7872-15(e)(4)(iv).

<sup>1382</sup> See §§ 1271-1274.

<sup>1383</sup> Treas. Reg. § 1.7872-15(h)(1)(i).

<sup>1384</sup> *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018).

<sup>1385</sup> *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017).

(2) In addition, the Tax Court held that section 2703(a) of the Code, relating to certain restrictions and rights that will be disregarded for transfer tax valuation purposes, is applicable. As such, the rights of the trust (ILIT), which was the legal owner of the policies, to restrict the decedent from causing an early termination of the split-dollar arrangement (and recouping the cash surrender value on the policies) will be ignored for estate tax purposes. The court concluded that the split-dollar agreements, specifically the provisions that prevent the decedent from withdrawing his investment, are agreements to acquire or use property at a price less than fair market value under section 2703(a)(1) of the Code. In addition, the split-dollar agreement that gives the trust the ability to prevent an early termination by the decedent was a restriction on the right to sell or use property under section 2703(a)(2) of the Code.

(3) The Tax Court rejected the estate's argument that section 2703(a) of the Code is inapplicable to split-dollar arrangements because they are like promissory notes and partnership interests. Based on the facts, the court held that the arrangement (which was not under the loan regime) was not like a promissory note, noting that the trust did not pay interest and did not provide compensation to the decedent for the indeterminate term of the arrangement. Further, the court concluded that split-dollar arrangements are not analogous to partnerships, citing *Estate of Strangi v. Commissioner*<sup>1386</sup> (which held that section 2703 does not function as a look-through rule for entities, such as partnerships, that are valid under state law).

(4) The Tax Court provided that the Treasury Regulations under the economic benefit regime<sup>1387</sup> applies for income and gift tax purposes, not for estate tax purposes. Therefore, those Treasury Regulations do not apply in valuing the decedent's rights under the plan for estate tax purposes and are not in conflict with the application of sections 2036, 2038, and 2703 of the Code.

(5) While the decision in *Cahill* might provide an avenue to get a different result had the split-dollar arrangement been structured under the loan regime, many practitioners are concerned that all multi-generational private split-dollar arrangements may not provide the type of estate tax benefit as previously thought. However, it also seems clear that the use of a partnership structure continues to be a viable ownership and management structure.

## 2. Guaranteed Payment Preferred Structures

a. The Code defines guaranteed payments as “payments to a partner . . . for the use of capital” but only “to the extent determined without regard to the income of the partnership to a partner for . . . the use of capital.”<sup>1388</sup> The Treasury Regulations go on to explain that a guaranteed payment is meant to provide the partner with a return on the partner's investment of capital (as opposed to payments designed to liquidate the partner's interest in the partnership).<sup>1389</sup>

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<sup>1386</sup> *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *aff'd in part, rev'd on another issue*, 293 F.3d 279 (5<sup>th</sup> Cir. 2002).

<sup>1387</sup> Treas. Reg. § 1.61-22.

<sup>1388</sup> § 707(c).

<sup>1389</sup> Treas. Reg. § 1.707-4(a)(1)(i).

b. Guaranteed payments are not dependent or contingent upon partnership profits. The primary differences between a guaranteed payment interest and a more traditional preferred interest are:

(1) How the payments are treated for income tax purposes by the holder of the interest (recipient of the preferred payment) and the partnership (if the entity is taxed like a partnership, as opposed to a disregarded entity);

(2) How the payments are treated for capital account purposes; and

(3) How guaranteed payment interests are treated under section 2701 of the Code.

c. A partnership that makes a guaranteed payment to a partner is entitled to either deduct the payment as an ordinary and necessary business expense<sup>1390</sup> of the partnership or capitalize<sup>1391</sup> the expense as a capital expenditure, depending on the nature of the payment.<sup>1392</sup> The partner receiving the guaranteed payment must include the payment as ordinary income<sup>1393</sup> in the year in which the partnership paid or accrued the payment under its method of accounting.<sup>1394</sup>

d. Other than for determining the taxability and deductibility of the payment and other limited purposes, guaranteed payments are considered interests in the partnership. The Treasury Regulations provide that “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...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.”<sup>1395</sup>

e. Reasonable Guaranteed Payments

(1) Guaranteed payments are made pursuant to a written provision of a partnership agreement and payable only to the extent that the payment is made for use of capital after the date on which the provision is added to the partnership agreement.

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<sup>1390</sup> § 162(a).

<sup>1391</sup> § 263.

<sup>1392</sup> § 707(c).

<sup>1393</sup> See 61(a).

<sup>1394</sup> § 706(a) and Treas. Reg. §§ 1.706-1(a)(1) and 1.707-1(c).

<sup>1395</sup> Treas. Reg. § 1.707-1(c).

(2) For disguised sale purposes, guaranteed payments are deemed to be reasonable if the sum of any guaranteed payment for the year does not exceed the amount determined by multiplying:

(a) The partner's unreturned capital at the beginning of the year, or at the option of the partner, the partner's weighed average capital balance for the year, by

(b) The safe harbor interest rate for that year. Safe harbor interest rate equals 150% of the highest applicable Federal rate, at the appropriate compounding periods, in effect at any time from the time that the right to the guaranteed payment for capital is first established.<sup>1396</sup>

f. As discussed above, for purposes of section 2701, guaranteed payment interests are excluded from the definition of "distribution right" and as such, cannot be considered an "applicable retained interest." Effectively what this means is that if a partner retains a guaranteed payment preferred interest in a FLP and transfers a non-guaranteed interest in the FLP to a family member or IDGT, the subtraction rule does not apply and the transfer will be valued under normal gift tax rules.

### 3. Guaranteed Payment Preferred FLPs and Premium Financing

a. A guaranteed payment preferred partnership structure may be an ideal way to hold, manage, and finance the purchase of life insurance. Conceptually, a partnership having a guaranteed payment preferred and common interests would be created to own, purchase, and be the beneficiary of life insurance on one of the partners (the holder of the guaranteed payment interest). The common interest (the growth interest above the guaranteed payment obligation, which will take the form of the future death benefit minus guaranteed payment capital) will be owned by an ILIT.

b. Such a structure could be created in the following manner. Insured creates a partnership (including, most likely an LLC to ensure that the entity remains a disregarded entity for income tax purposes) with \$1 million in cash or securities in return for a guaranteed payment interest (the preferred interest) of 4% for the use of the \$1 million of capital contributed to the partnership. In addition, the insured also receives all of the common or growth interest in the partnership over the guaranteed capital and guaranteed payment right. The insured transfers (by gift or installment sale) the common interest to an ILIT. Presumably the value of the transferred common interest will be very small because, as mentioned above, guaranteed payment interests are not an applicable retained interest, and normal gift tax rules will apply to the transfer. The partnership is capitalized with \$1 million of assets, which is represented by the guaranteed payment capital (preferred) interest, against which the partnership has an annual obligation to pay 4%, regardless of the partnership profits. As such, it's likely the common interest will have very little value, particularly since valuation discounts due to lack of marketability (and perhaps minority interest) are likely to apply. The partnership then purchases a life insurance policy on the life of the guaranteed payment preferred holder, making the beneficiary of the policy the partnership. When the policy matures upon the death of the insured,

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<sup>1396</sup> Treas. Reg. § 1.707-4(a)(3)(ii).

the \$1 million of capital can be paid in liquidation of the guaranteed payment interest (which will be included in the estate of the insured if the insured continues to hold the preferred interest) and any excess will accrue to the common interests held by the ILIT.

c. In order to avoid inclusion of the life insurance proceeds in the insured's gross estate, it is important to ensure that the insured does not hold an incidents of ownership over the policy under section 2042 of the Code, directly or through the partnership. As such, the general partner of the partnership or manager of the LLC will need to be someone other than the insured.<sup>1397</sup> Although generally allowable, caution should be given to the insured guaranteed payment interest holder having the right to acquire assets held by the ILIT.<sup>1398</sup>

d. Given that an ILIT, a grantor trust, will be the holder of the common interest, and the grantor/insured will hold the guaranteed payment preferred interest, the partnership will likely be formed as an LLC and considered a disregarded entity. As such, all guaranteed payment will be ignored for Federal income tax purposes, generating no deductions or ordinary income when paid.

e. As noted above, the guaranteed payment preferred interest, if owned by the insured at death, will be included in the estate of the insured. The value of such interest will be no greater than the guaranteed payment capital contributed (in the example, \$1 million), although valuation discounts may be applicable. The amount of capital required will need to be sufficient to pay the required premiums and make the anticipated guaranteed payments during the lifetime of the insured. The required capital, and consequently the potential amount includible in the insured's gross estate, can be significant. One way to reduce the amount of required capital is to have the partnership purchase the life insurance through a funding mechanism commonly known as premium financing.

f. Premium financing, in this context, would involve a third party lending funds to the partnership to cover the cost of the insurance premiums. In order to secure the loan, the insurance policy is pledged as collateral for the loan. In addition, the third party lender also requires additional collateral to be posted to the extent that the policy's cash surrender values are lower than the loan. Loan interest to the third party is typically a percentage amount above an external benchmark rate like LIBOR. Depending on the internal investment performance of the policy, the amount of additional collateral required can increase in the short term but most likely will decrease over time. The key, however, is the additional collateral required is typically a fraction of the loan amount and premiums paid. Thus, the guaranteed payment capital amount (and the potential estate tax) is typically much smaller than it would be if the partnership sought to pay all of the premiums itself. By structuring the arrangement as guaranteed payment interest, there are no gift tax consequences to the insured preferred holder.

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<sup>1397</sup> See Rev. Rul. 83-147, 1983-2 C.B. 258, and PLRs 9623024, 9843024, 200017051, 200111038, and 200747002.

<sup>1398</sup> See *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1, PLR 9843024, PLR 200603040, Rev. Rul. 2008-22, 2008-16 I.R.B. 796, Rev. Rul. 2011-28, 2011-49 I.R.B. 830, and PLR 201235006.

g. While a guaranteed payment preferred partnership has similarities to a split-dollar insurance arrangement, it is quite different in many respects. This preferred partnership structure alleviates the gift tax issues associated with split-dollar arrangements, and if the partnership utilizes premium financing, the capital contributed for the guaranteed payment preferred interest is reduced, thereby reducing the potential estate tax liability to the insured preferred holder. Furthermore, the use of the partnership reduces the concerns raised under the *Cahill*, and the estate is typically not claiming significant valuation discounts as the taxpayers did in both *Cahill* and *Powell*.

## IX. PLANNING WITH DISREGARDED ENTITIES

### A. Generally

1. A “disregarded entity” has come to mean an entity that is ignored for Federal income tax purposes (but is legally recognized for other purposes as a separate entity for state law purposes).<sup>1399</sup> As the Treasury Regulations provide, “if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.”<sup>1400</sup> Effectively, the entity is “disregarded as an entity separate from its owner if it has a single owner,”<sup>1401</sup> and this applies for “federal tax purposes.”<sup>1402</sup> Generally, there are three types of entities that are considered “disregarded” for tax purposes: (a) single-owner entities (like wholly-owned LLCs) that have not elected corporate treatment, (b) qualified subchapter S corporation subsidiaries, and (b) qualified real estate investment trust subsidiaries. For purposes of these materials, only LLCs are discussed.

2. Despite the single owner requirement, the IRS has ruled that if an entity is wholly owned by two spouses as community property, it will nevertheless be considered a disregarded entity, provided the spouses report the entity as such.<sup>1403</sup> The ruling does not require that the parties file a joint return. It further provides that a change in reporting position (presumably by either spouse) will be treated as a conversion of the entity (e.g., to a partnership). The ruling provides that the business entity must be “wholly owned” by the spouses as community property and “no person other than one or both spouses would be considered an owner for federal tax purposes.”<sup>1404</sup>

3. Further, the IRS has ruled that a state law partnership formed between an entity disregarded under the elective classification (wholly owned LLC of a corporation) regime

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<sup>1399</sup> Generally, a business entity that is not classified as a corporation (eligible entity), that has a single owner, and that has not elected to be taxed as an association taxed as a corporation. See Treas. Reg. § 301.7701-3(a) and -3(b)(1)(ii).

<sup>1400</sup> Treas. Reg. § 301.7701-2(a).

<sup>1401</sup> Treas. Reg. § 301.7701-3(b)(1)(ii).

<sup>1402</sup> Treas. Reg. §§ 301.7701-1(a) and -2(c)(2).

<sup>1403</sup> Rev. Proc. 2002-69, 2002-45 I.R.B. 831.

<sup>1404</sup> *Id.*

and its owner (the corporation) is itself disregarded because it only has one owner for tax purposes.<sup>1405</sup>

B. Are Grantor Trusts Disregarded Entities?

1. While many practitioners believe a grantor trust (grantor trust as to both the income and the corpus and over the entire trust<sup>1406</sup>) is treated like a disregarded entity, the law is not clear.<sup>1407</sup> In *Rothstein v. Commissioner*,<sup>1408</sup> the taxpayer purchased property from his grantor trust with an installment note. The taxpayer then resold the property to a third party, computing the resulting gain using a cost basis arising from the original purchase from the grantor trust. While the IRS argued that the trust should be treated as a disregarded entity, the court held for the taxpayer. In coming to its conclusion, the court interpreted the phrase “shall be treated as the owner of the trust assets”<sup>1409</sup> as applying only for purposes of including the trust’s income and deductions.

2. Echoing the *Rothstein* ruling, Professor Jeffrey N. Pennell writes, as to grantor trusts being disregarded for tax purposes:<sup>1410</sup>

The Code and Regs, however, are not entirely consistent with that treatment. Instead, every grantor trust rule (§§673-677) begins by saying “The grantor shall be treated as the owner of any portion of a trust . . .” The significance of this is found in §671:

Where it is specified . . . that the grantor . . . shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.

Notice that this does not mention losses, which are considered along with gains only in determining the trust's income. This also does not say that an exchange with a grantor trust is not recognized, or that the trust is ignored...

In a nutshell, then, the tax attributes of a grantor trust are reported by the grantor on the grantor's income tax return, as if the trust's income (which includes net

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<sup>1405</sup> Rev. Rul. 2004-77, 2004-31 I.R.B. 119.

<sup>1406</sup> See Treas. Reg. § 1.671-3.

<sup>1407</sup> See Mark L. Asher, *When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction*, 41 Tax. L. Rev. 253 (1986).

<sup>1408</sup> 735 F.2d 704 (2<sup>nd</sup> Cir. 1984).

<sup>1409</sup> § 671.

<sup>1410</sup> Jeffrey N. Pennell, (Mis)Conceptions about Grantor Trusts, 50<sup>th</sup> Annual Southern Federal Tax Institute, Outline V, p. 1-2 (Oct. 2015).

gain in excess of any offsetting losses), deductions, and credits belonged to the grantor.

The actual treatment, however, is as if the trust's DNI was entirely taxable to the grantor. Losses would offset gains in the trust for this purpose, and gain that is attributed out to the grantor thus would be less. But excess losses are trapped in the trust by virtue of the rule in §642(h) ... And these results apply only to the extent the grantor is treated as the owner of the trust. It is not necessarily true for the entire trust, depending upon application of the portion rules.

As a result, the conclusion articulated by various authorities that the trust is "ignored" is not what either the Code or Regulations themselves actually specify. Yet the government itself makes pronouncements that are interpreted by taxpayers in a vast number of different situations to mean that a grantor trust is treated as if it did not exist. This especially is true involving transfers by a grantor into an intentionally defective grantor trust, based on the government's ruling position that the grantor can have no gain or loss on a transfer involving the grantor trust — that an exchange between the grantor and the trust is not a gain or loss realization event

3. Notwithstanding the foregoing, the IRS has ruled in Revenue Ruling 85-13,<sup>1411</sup> on facts similar to *Rothstein*, that the taxpayer in question did not obtain cost basis when he purchased the assets from the grantor trust. Specifically, the ruling provides:<sup>1412</sup>

In *Rothstein*, as in this case, section 671 of the Code requires that the grantor includes in computing the grantor's tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner. Section 1.671-3(a)(1) of the regulations. It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust

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<sup>1411</sup> Rev. Rul. 85-13, 1985-1 C.B. 184.

<sup>1412</sup> *Id.* See also Rev. Rul. 88-103, 1988-2 C.B. 304 and PLR 8729023 (grantor and grantor trust will be treated as a single taxpayer for purposes of qualifying for involuntary conversion treatment under section 1033 of the Code), and Rev. Rul. 2004-86, 2004-33 I.R.B. 191 (a taxpayer may exchange interests in a grantor trust—a Delaware statutory trust—for real property and qualify for like-kind treatment under section 1031 of the Code). *But see* Rev. Rul. 2004-88, 2004-32 I.R.B. 165 (disregarded entity will be treated as an entity separate from its owner for purposes of the TEFRA unified audit rules), Treas. Reg. § 1.001-2(c), Ex. 5 (if a grantor trust holds a partnership interest and the trust ceases to be a grantor trust, then it is treated as a disposition of the partnership interest, and Prop. Treas. Reg. § 1.108-9(c)(1), (2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent).

property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.

The court's decision in Rothstein, insofar as it holds that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transactions with the grantor, is not in accord with the views of the Service.

4. Consistent with Revenue Ruling 85-13, the IRS has ruled that an LLC created by the taxpayer and the taxpayer's grantor trust will be treated as a disregarded entity because the LLC is deemed to have only one taxpayer-owner.<sup>1413</sup>

5. For purposes of this outline and the discussion herein, the government's position under Revenue Ruling 85-13 (grantor trusts are ignored for income tax purposes) is assumed to be correct. In reality, the vast majority of practitioners treat grantor trusts as disregarded entities for all income tax purpose, having all tax items (including losses) reported by the grantor and ignoring all transactions between the grantor and his or her grantor trust. As such, it is assumed if all interests in an LLC are owned by a grantor and grantor trusts, the LLC is treated, at least for Federal income tax purposes, as a disregarded entity.

#### C. May Discounts Be Used When Valuing Interests in Disregarded Entities?

1. The critical issue for estate planning purposes is whether valuation discounts must be disregarded when valuing transfers (gifts, bequests, sales, and exchanges) of interests in disregarded entities to and among the grantor and grantor trusts. Does the "willing buyer/willing seller" standard<sup>1414</sup> apply to transfers of interests in disregarded entities? In other words, just as transfers between a grantor and grantor trust are ignored for Federal income tax purposes, are they also ignored for Federal transfer tax purposes?

2. In *Pierre v. Commissioner*,<sup>1415</sup> the Tax Court held the transfers of interests in a disregarded entity should be valued for gift tax purposes as transfers of interests in the entity, rather than transfers of the underlying assets of the entity. The Tax Court pointed out, "[s]tate law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed." As such, the transferred interests in the disregarded entity would qualify for marketability and minority interest discounts. In the case at issue, however, the court concluded that the step transaction applied, in part, because the entity was funded (cash and marketable securities) by the taxpayer less than two weeks prior to the transfers of the entity interests. The taxpayer transferred her entire interest in the wholly-owned LLC to two trusts (9.5% gift and 40.5% sale to each trust).

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<sup>1413</sup> PLR 200102037.

<sup>1414</sup> See generally Treas. Reg. §§ 20.2031-1(b) and 25.2512-1 and Rev. Rul. 59-60, 1959-1 C.B. 237.

<sup>1415</sup> *Pierre v Commissioner*, 133 T.C. 24 (2009).

3. Importantly, the Tax Court in *Pierre* wrote:<sup>1416</sup>

While we accept that the check-the-box regulations govern how a *single-member LLC* will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a *donor* must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond *classifying* the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. We do not accept that the check-the-box regulations apply to define the property interest that is transferred for such purposes. The question before us (i.e., how a transfer of an ownership interest in a validly formed LLC should be valued under the Federal gift tax provisions) is not the question addressed by the check-the-box regulations (i.e., whether an LLC should be taxed as a separate entity or disregarded so that the tax on its operations is borne by its owner). To conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be “manifestly incompatible” with the Federal estate and gift tax statutes as interpreted by the Supreme Court.

4. In other cases, courts have generally supported the position that transfers of interests in disregarded entities are entitled to valuation discounts based on the rights of the transferee under applicable state law and under the LLC operating agreement.<sup>1417</sup>

D. Conversion of Disregarded Entity to Partnership

1. Given that grantor trust status must necessarily terminate with the death of the grantor, all disregarded entities owned by a grantor and one or more grantor trusts will be converted to another type of entity upon the death of the grantor (unless, in theory, the grantor’s interest is transferred to the trust and the trust is the only other member of the LLC). It is important then to understand the tax consequences of the conversion of the disregarded entity to (most likely) a partnership.

2. In Revenue Ruling 99-5,<sup>1418</sup> the IRS provided guidance on the tax issues involved in a conversion of a disregarded entity to a partnership. The ruling addresses 2 situations with respect to a wholly-owned LLC that is disregarded for tax purposes and that is

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<sup>1416</sup> *Id.*

<sup>1417</sup> See e.g., *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74 (Mar. 26, 2008). But see *Pope & Talbot Inc., et al. v. Commissioner*, 105 T.C. 574 (1995) (The court ignored the existence of a newly created partnership in valuing the tax paid upon a distribution of the interests to its shareholders under section 311 of the Code).

<sup>1418</sup> Rev. Rul. 99-5, 1999-1 C.B. 434.

initially owned by a single member A. The ruling assumes that the LLC has no liabilities, the assets are not subject to any indebtedness, and all of the assets are capital assets or property described in section 1231 of the Code.

a. In situation 1, B purchases 50% of A's ownership in the LLC for \$5,000. The ruling concludes that the LLC is converted to a partnership when B purchases the interest in the LLC from A. The purchase of the LLC interest is treated for tax purposes as if B purchased 50% of each of the LLC's assets (which are, in turn, treated as if held by A for tax purposes). Immediately thereafter, A and B are deemed to contribute their respective interests in those assets to a newly formed partnership. Under such treatment, the ruling further provides:

(1) Member A recognizes gain or loss on the deemed sale under section 1001 of the Code. However, there is no further gain or loss under section 721(a) of the Code for the contribution of asset to the partnership in exchange for partnership interests in the newly formed entity.

(2) Under section 722 of the Code, B's outside basis in the partnership is \$5,000, and A's outside basis is equal to A's basis in A's 50% share of the assets in the LLC. Under section 723 of the Code, the partnership's tax basis in the assets is the adjusted basis of the property in A and B's hands immediately after the deemed sale.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes his or her holding period in the assets held by the LLC, and B's holding period for the partnership interests begins on the day following the date of B's purchase of the LLC interest from A.<sup>1419</sup> Under section 1223(2) of the Code, the partnership's holding period for the assets deemed transferred to it includes A's and B's holding periods for such assets.

b. In situation 2, B contributes \$10,000 in the LLC for a 50% ownership interest in the LLC. In this instance, as in the previous situation, the ruling concludes that the LLC is converted to a partnership when B contributes the cash to the LLC in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to a newly formed partnership. Under such treatment and facts, the ruling provides:

(1) There is no gain or loss to A or B under section 721(a) of the Code.

(2) Under section 722 of the Code, B's outside basis is equal to \$10,000, and A's outside basis is his or her basis in the assets of the LLC which A is treated as contributing to the new partnership. Under section 723 of the Code, the basis of the property contributed to the partnership by A is the adjusted basis of that property in A's hands. The basis of the property contributed to the partnership by B is \$10,000, the amount of cash contributed to the partnership.

(3) Under section 1223(1) of the Code, A's holding period for the partnership interest includes A's holding period in the LLC assets deemed contributed when the

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<sup>1419</sup> The ruling cites Rev. Rul. 66-7, 1966-1 C.B. 188.

disregarded entity converted to a partnership. B's holding period for the partnership interest begins on the day following the date of B's contribution of money to the LLC. Under section 1223(2), the partnership's holding period for the assets transferred to it includes A's holding period.

3. Unfortunately, the foregoing ruling does not address (i) non-taxable transactions like sales or exchanges of a disregarded entity interests between a grantor and his or her grantor trust (situation 1 is a taxable sale) or (ii) contributions of assets to a disregarded entity by a grantor or grantor trust. Under those circumstances, how should the tax basis be allocated among the grantor and the grantor trust? It seems that given the IRS's position in Revenue Ruling 85-13 that grantor trusts are "ignored" or also disregarded, that the unitary basis rules would apply in such a way that if B was a grantor trust in the situations described in Revenue Ruling 99-5, B's outside would not be \$5,000/\$10,000 respectively. Rather, the aggregate basis of A (the grantor) and B (the grantor trust) would be allocated pursuant to the unitary basis rules, as discussed in more detail above (essentially B would receive a portion of A's basis in the transferred asset).

4. Further, the ruling does not address the conversion of a disregarded entity to a partnership when grantor trust status is lost and the trust holds only a portion of the entities interest.

#### E. Conversion of Partnership to Disregarded Entity

1. In Revenue Ruling 99-6,<sup>1420</sup> the IRS provided guidance on the tax issues involved in a conversion of partnership to a disregarded entity. The ruling addresses 2 situations with respect to an LLC that is classified as a partnership but becomes a disregarded entity when a transaction consolidates all of the ownership with a single member. The ruling provides that the LLC has no liabilities, and the assets are not subject to any indebtedness.

a. In situation 1, A and B are equal partners in an LLC taxed as a partnership. A sell's his or her entire interest in the LLC to B for \$10,000. The ruling concludes the partnership terminates under section 708(b)(1)(A) when B purchases A's entire interest. A must treat the transaction as a sale of A's partnership interests, and with respect to the treatment of B, there is a deemed liquidating distribution of all of the assets to A and B, followed by B treated as acquiring the assets deemed to have been distributed to A in liquidation of A's interests. Under such treatment:

(1) A has gain or loss resulting from the sale of the partnership interest under section 741 of the Code. As discussed above, section 741 of the Code provides that gain or loss resulting from the sale or exchange of an interest in a partnership shall be recognized by the transferor partner, and that the gain or loss shall be considered as gain or loss from a capital asset, except as provided in section 751 of Code (relating to "hot assets," unrealized receivables and inventory items).

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<sup>1420</sup> Rev. Rul. 99-6, 1999-6 I.R.B. 6.

(2) B's basis in the assets attributable to A's one-half interest in the partnership is \$10,000 under section 1012 of the Code. B does not get to retain the holding period of the partnership on such assets deemed liquidated and distributed to A under section 735(b) of the Code. Rather, these are newly acquired assets, and B's holding period for these assets begins on the day immediately following the date of the sale.

(3) With respect to B's portion of the deemed liquidation, B will recognize gain or loss (if any) under section 731(a) of the Code (generally, no gain or loss except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution, assuming there are no "hot assets" in the partnership). B's basis in the assets received in the deemed liquidation of B's interest is determined under section 732(b) of the Code (generally, the adjusted basis of B's interest in the partnership, reduced by any money distributed in the same transaction). Under section 735(b) of the Code, B's holding period for the assets includes the partnership's holding period for such assets.<sup>1421</sup>

b. In situation 2, C and D are equal partners in an LLC taxed as a partnership. C and D sell their entire interests in the LLC to E, an unrelated person, for \$20,000 (\$10,000 each). As under the previous situation, the ruling concludes the partnership terminates under section 708(b)(1)(A) when E purchases all of the LLC interests. C and D must treat the transaction as a sale of their respective partnership interests, and with respect to E, there is a deemed liquidating distribution of all of the assets to C and D, followed by E treated as acquiring all of the former assets of the partnership from C and D.

(1) C and D have gain or loss under section 741 of the Code.

(2) E's basis in the assets in the partnership is \$20,000 under section 1012 of the Code, and E's holding period begins on the day immediately following the date of the sale.

2. In typical estate planning transactions, a conversion from a partnership to a disregarded entity could occur in a taxable transaction (e.g., sale of a partnership interest from a non-grantor trust to another partner) or in a non-taxable transfer (e.g., the distribution of a partnership interest from a non-grantor trust to a beneficiary that is the only other partner or in a gratuitous transfer of the partnership interest (subject to gift or estate tax) to the only other partner. Presumably, the Revenue Ruling 99-6 would apply to the taxable transactions, but it is unclear how they might apply to the non-taxable transactions.

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<sup>1421</sup> Except for inventory items. See § 735(a)(2).

F. Disregarded Entities: Subchapter K and Capital Accounts

1. One of the practical benefits of utilizing disregarded entities with grantor trusts is that the income tax consequences of every transaction (transfers of partnership interests, contributions of capital, distributions, etc.) can be essentially ignored until there is a conversion event, whether that occurs because of the death of the grantor, relinquishing grantor trust status, or admitting a partner that is not the grantor for tax purposes. As long as 100% of the ownership interest is held by the grantor or grantor trusts, there are no complications relating to the allocation of built-in gains and losses under section 704(c) of the Code (or “reverse 704(c)” due to the admission of new partners), no recognition events due to the sale or exchange of a partnership interest, and no need to account for inside or outside basis.

2. Even if a partner has more than one interest in a partnership (held individually or through grantor trusts, presumably) that partner is deemed to have a single capital account. Maintaining capital accounts only becomes important when the disregarded entity is converted to a partnership or if there is a liquidation of the disregarded entity among the members. As discussed in more detail above, the “safe harbor” Treasury Regulations provide that an allocation will have “economic effect” if, in part, the partnership maintains capital accounts under the Treasury Regulations,<sup>1422</sup> and the partnership makes liquidating distributions in accordance with the partners’ positive capital account balances.<sup>1423</sup>

3. The Treasury Regulations provide that upon a transfer of all or a part of a partnership interest, the transferor’s capital account “that is attributable to the transferred interest carries over to the transferee partner.”<sup>1424</sup> The Treasury Regulations take the position that the portion of the transferor’s capital account that carries over to the transferee equals the percentage of the transferor’s total interest that is sold or transferred. This methodology is not how tax basis is allocated. As discussed above, in Revenue Ruling 84-53,<sup>1425</sup> the IRS ruled in the context of calculating outside basis of a transferred partnership interest, “the basis of the transferred portion of the interest generally equals an amount which bears the same relation to the partner's basis in the partner's entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest.”<sup>1426</sup>

4. As discussed in more detail above, each partner is deemed to have a single unitary basis for all interests held in a partnership. Similarly, each partner has a single capital account for all interests in the same partnership. The Treasury Regulations provide, “a partner who has more than one interest in a partnership shall have a single capital account that reflects all

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<sup>1422</sup> Treas. Reg. § 1.704-1(b)(2)(iv).

<sup>1423</sup> Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

<sup>1424</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(l).

<sup>1425</sup> Rev. Rul. 84-53, 1984-1 C.B. 159.

<sup>1426</sup> *Id.* The ruling relies Treasury Regulation § 1.61-6(a) which provides that when a part of a larger property is sold, the basis of the entire property shall be equitably apportioned among the several parts for purposes of determining gain or loss on the part sold.

such interests, regardless of the class of interests owned by such partner (e.g., general or limited) and regardless of the time or manner in which such interests were acquired.”<sup>1427</sup>

5. In the disregarded entity context, B owns a wholly-owned LLC that is recapitalized into preferred and common shares. B transfers the preferred shares to grantor trust C and the common shares to grantor trust D. The allocation of tax basis and capital account has no meaning in this context because it remains a disregarded entity. What if C becomes a non-grantor trust? The IRS has taken the position that when grantor trust status is lost, it will be treated as if the grantor transferred the interest to trust C at that time. If that is the case, what value is used for determining the allocation of outside basis? Certainly, Chapter 14 value under section 2701 of the Code can't be the answer because what if the preferred shares are deemed to have a zero value under section 2701 of the Code because they do not fall under the qualified payment interest exception? Revenue Ruling 99-5 would treat the loss of grantor trust status as a conversion from a disregarded entity to a partnership (deemed transfer) which would treat C as having purchased a portion of the LLC's assets and then contributed them to a new partnership. What portion of the assets is C deemed to have purchased and how does one value that? For capital account purposes, should the common shares get any balance if the preferred liquidation preference is equal to the section 704(b) book value at that time?

G. Planning Opportunities with Disregarded Entities<sup>1428</sup>

1. Inherent Leverage with No Income Tax Consequences

a. Because transfers of less than 100% of a disregarded entity to a grantor trust (another disregarded entity) will likely carry valuation discounts (see the discussion above), but liquidations must occur according to positive capital accounts, there is inherent wealth transfer leverage in any zeroed-out transfer to an IDGT or GRAT (if and when the disregarded entity or converted entity is finally liquidated). This assumes that the contribution or transfer to the trust carries a valuation discount, but the liquidation will occur on basis that does not include the discount. It further assumes the transfer and the ultimate liquidation is not subject to recharacterization under the economic substance doctrine under section 7701(o) of the Code or non-statutory doctrines like substance-over-form, step-transaction, or sham-transaction.

b. While grantor trust status is retained, the grantor will continue to be treated as if the grantor owned all of the assets for income tax purposes. This allows the assets in the IDGT or GRAT to grow without the burden of paying income tax, which is borne by the grantor. If the grantor also has a power to exchange assets of equivalent value under section 675(4)(C) of the Code, assets that carry a valuation discount can be exchanged to further increase the wealth transfer. For example, if the IDGT directly holds assets that have been liquidated from a disregarded entity, then those assets could be reacquired with shares in another disregarded

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<sup>1427</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(b).

<sup>1428</sup> See Richard A. Oshins and David A. Handler, *Estate Planning with Disregarded Entities*, presented at the Society of Trust and Estates Practitioners Institute on Tax Estate Planning and the Economy (Jan. 2014) for an excellent discussion of the topic and additional planning opportunities including using a disregarded entity with a residence in lieu of a qualified personal residence trust and a tiered LLC strategy to maximize the leverage of an installment sale.

entity but the value of which carries a discount. All of these transactions can be consummated without recognizing any gain or loss.

2. Disregarded Entities and S Corporations

a. S corporations cannot have more than one class of stock, which generally requires that all of the outstanding stock must have identical rights to distributions and liquidation proceeds, but the S corporation may have voting and non-voting shares.<sup>1429</sup> In addition, partnerships are not eligible S corporation shareholders.<sup>1430</sup> Because of the single class of stock requirement, S corporation shareholders are not able bifurcate their economic interests into preferred and common interests and effectuate transactions similar to a preferred partnership freeze or reverse freeze.

b. S corporation shareholders may be able to create preferred and commons interests through a disregarded entity. Pursuant to this idea, S corporation shareholder would create a wholly-owned LLC that is treated as a disregarded entity and contribute his or her S corporation shares to the entity. The disregarded entity would then recapitalize its shares into preferred and common shares, thereby allowing the taxpayer to do a forward or reverse freeze transaction with his or her IDGT. While the taxpayer is alive and the trust remains a grantor trust, the individual taxpayer should continue to be deemed the eligible S corporation shareholder.<sup>1431</sup> The IRS has ruled that an S corporation may be owned by a partnership or a limited liability company (or a combination of them) as long as the partnership and limited liability company are disregarded for income tax purposes.<sup>1432</sup> If the disregarded entity is liquidated during the life of the grantor, then the S corporation shares will be distributed among the grantor and the trust, which will either remain a grantor trust or become either an electing small business trust<sup>1433</sup> or a qualified subchapter S trust.<sup>1434</sup>

c. If, however, the grantor dies prior to the liquidation of the disregarded entity, then an issue arises as to whether the entity will be deemed to have converted to a partnership (as an entity owned by a non-grantor trust and the estate of the taxpayer), thereby terminating the S corporation status of the corporation. This termination might be avoided, as follows:

d. If the operating agreement of the disregarded entity requires an immediate termination and liquidation upon the death of the grantor, then the LLC would, in theory, cease to exist and the assets (the S corporation shares) would immediately be divided

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<sup>1429</sup> See § 1361(b)(1)(D), Treas. Reg. § 1.1361-1(l)(1).

<sup>1430</sup> See § 1361(b)(1)(B).

<sup>1431</sup> See § 1361(c)(2)(A)(i) allowing grantor trusts of U.S. citizens and residents to be S corporation shareholders.

<sup>1432</sup> PLR 200513001.

<sup>1433</sup> § 1361(c)(2)(A)(v).

<sup>1434</sup> § 1361(d)(1)(A) treating such qualified subchapter S trusts as grantor trusts of U.S. citizens or residents under § 1361(c)(2)(A)(i).

among the estate of the decedent and the trust (that must also qualify as an ESBT or QSST).<sup>1435</sup> In most forward freeze transactions, the grantor would hold a preferred interest that had a fixed liquidation amount, and the trust would hold any excess value. The value of the S corporation shares would need to be determined in allocating the fixed liquidation amount to the estate, with any excess shares passing to the trust.

e. Another possible way of avoiding S corporation termination is to ensure that upon the death of the taxpayer, the LLC shares held by the decedent would pass directly to the trust, thereby unifying 100% of the LLC ownership in the trust (which is either an ESBT or QSST). It appears that bequeathing the shares under the decedent's Will may still cause termination of S status. The IRS has ruled that if a corporation's stock is subject to the possession of the executor or administrator of the decedent's estate, the estate is considered a shareholder as of the date of death, notwithstanding the fact that applicable state law provides that legal title to the stock passes directly to the heirs under the Will.<sup>1436</sup> However, termination might still nonetheless be avoided by providing that the LLC interests pass directly to the trust outside of probate. The operating agreement could provide an immediate transfer of the grantor's interest in the LLC to the trust, similar to a transfer on death provision or beneficiary designation. Whether a transfer on death provision in a revocable living trust (as opposed to under the Will) would also be effective is unclear.

f. Even if there is a deemed termination of S corporation status, The IRS has granted relief in circumstances where the S corporation stock was held by disregarded entities and the death of the grantor caused the termination. In PLRs 201730002 and 200841007, the IRS concluded that a termination of S corporation status caused by the death of the grantor—during life the taxpayer had created grantor trusts that held shares in a disregarded entity that, in turn, owned S corporation shares—was inadvertent within the meaning of section 1362(f) of the Code. In both rulings, the taxpayer was granted relief and S corporation status was maintained after the death of the taxpayer.<sup>1437</sup> Of course, private letter rulings have no precedential value, so practitioners are advised to obtain a ruling in advance to ensure that S corporation status will not be terminated.

### 3. Eliminating Outstanding Installment Notes

a. As mentioned above, the conversion from grantor to non-grantor trust (e.g., death of the grantor) is treated as a transfer by the grantor of the underlying property in the trust. Often, the original transfer of the property is pursuant to an installment sale to an IDGT, with the purchase effectuated by a promissory note from the IDGT to the grantor and the IDGT's debt obligations collateralized by the transferred property. If the promissory note is outstanding

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<sup>1435</sup> See *Guzowski v. Commissioner*, T.C. Memo 1967-145. A partnership that ceased to exist based on the stated term in the partnership agreement was not deemed to be the shareholder. The partners were deemed to be the shareholders.

<sup>1436</sup> Rev. Rul. 62-116, 1982-2 C.B. 207.

<sup>1437</sup> See also PLRs 200237014, 200237011, 9010042, and 8934020 where the IRS ignored momentary ownership of a newly formed corporation's stock by a partnership during the process of incorporating the partnership or taking remedial measures.

at the time of conversion from grantor to non-grantor trust, gain will be recognized to the extent that the debt encumbering the property is in excess of its tax basis.<sup>1438</sup>

b. Grantors and their IDGTs may be able to use disregarded entities to eliminate the potential gain and provide for a step-up in basis on the underlying assets upon the death of the grantor. To illustrate how this might be accomplished, consider an IDGT that holds an asset worth \$100x and an adjusted basis of \$0, but the asset is encumbered by a \$50x liability of the IDGT to the grantor, as evidenced by an installment note (e.g., paying interest annually and with an outstanding principal amount of \$50x) held by the grantor. If the grantor dies, (i) the promissory note would be includable in the grantor's estate and get a "step-up" in basis, (ii) the asset in the IDGT would be out of the grantor's estate but would not get a "step-up" in basis, and (iii) \$50x of gain would have to be recognized by the estate because of the liability in excess of tax basis.

c. To avoid this result, the grantor and the IDGT could simultaneously contribute their respective interests in the property and the debt to a newly formed LLC. IDGT would contribute the asset, along with its \$50x liability to grantor, to the LLC. Grantor would contribute the installment note with a principal amount of \$50x. Assuming, the net value of the asset and the promissory note were both equal to \$50x, IDGT and grantor would be equal (each 50% owners) members in the LLC, but the LLC would continue to be a disregarded entity because they are considered the same taxpayer. As such, the contribution of the asset (subject to the debt) and the promissory note should not have any tax ramifications.

d. The LLC, as a separate legal entity, now owns an asset with a gross value of \$100x, has a debt liability of \$50x, and it owns the right to receive the \$50x debt. In other words, if a person has a debt but also owns the right to be paid on the debt, the debt should by law be extinguished. Further, because the LLC is disregarded and the members of the LLC are the same taxpayer due to the grantor trust rules, the extinguishment of the debt should have no tax ramifications. This leaves the LLC simply holding an asset worth \$100x (and no liabilities) with the IDGT and grantor each owning 50% of the LLC.

e. Upon the death of the grantor, there is a deemed transfer of 50% of the LLC to the trust (no longer a grantor trust) which converts the disregarded entity to a partnership for tax purposes under situation 1 of Revenue Ruling 99-5. As discussed above, such a conversion is treated as an acquisition of the LLC assets by the members and a contribution of those assets to a new partnership. Significantly, if the conversion is treated this way, then for step-up in basis purposes, the estate does not own a 50% interest in a partnership, rather the estate is deemed to own 50% of the assets which are simultaneously contributed to a partnership at death. As such, the estate should be entitled to claim a step-up in basis under section 1014(a) of the Code for 50% of the value of the asset in the LLC without risk of losing basis due to valuation discounts.

f. Under sections 722 and 723 of the Code, the estate should have an outside basis in the LLC of \$50x, and the LLC should have an inside basis of \$50x on the asset

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<sup>1438</sup> See, e.g., *Crane v. Commissioner*, 331 U.S. 1 (1947); see also, Treas. Reg. §§ 1.1001-2(a)(4)(v), 1.1001-2(c), Ex. 5, and Rev. Rul. 77-402, 1977-2 C.B. 222, in the partnership context.

which is worth \$100x. Practitioners taking this position will likely want to report the inclusion of 50% LLC asset in the estate of the grantor, rather than a 50% interest in the LLC, and out of an abundance of caution, ensure that the LLC makes a section 754 election, entitling it to an inside basis adjustment under section 743(b), in case there is a question as to whether the LLC has \$50x of inside basis on the asset.

## X. CONCLUSION

A. Estate planners tailor tax strategies to the client's non-tax objectives. Traditionally, the primary taxes were those involved in wealth transfer taxation – the estate, gift, and generation-skipping transfer taxes. As the amount insulated from those taxes by ever increasing Base Exclusion Amounts (the temporary doubling of the Base Exclusion Amount under TCJA) strategies to minimize the income tax consequences of the client's planning become increasingly necessary. Just as there are many estate, gift and, generation-skipping tax planning strategies, so too are there multiple income tax planning strategies.

B. This paper deals with methods to acquire new basis for assets, and to shift that basis within a family to the owner who needs it the most or can make the best use of it. Much of that planning is not new but has not been consistently used in everyday practice. To illustrate, for decades a client has been able to make gifts to a *Crummey* trust for the benefit of the client's parents, and the *Crummey* trust has been able to give the parents general powers of appointment so that when the parents die the assets will receive new basis before passing back to or for the benefit of the client. Why has the strategy been rarely used? Because until recently the amount the parents could have in their estates without incurring estate tax has been small (\$600,000 from 1981 to 2001, with gradual increases thereafter). Since 2012 the amount has exploded making this planning shockingly attractive.

C. Similarly, new developments in the partnership, international, and grantor trust areas have created new planning opportunities. No client could possibly benefit from every strategy discussed in these materials, or even most of the strategies. On the other hand, it will be the rare client whose family could not benefit from at least one of them. We are at the beginning of a new frontier with exciting times ahead.



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## Hot Topics In Estate Planning

### *(Finding Gems in the Ashes of the Dumpster Fire)*

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**Paul S. Lee, J.D., LL.M.**  
Chief Tax Strategist  
The Northern Trust Company  
New York, NY  
[PSL6@ntrs.com](mailto:PSL6@ntrs.com)

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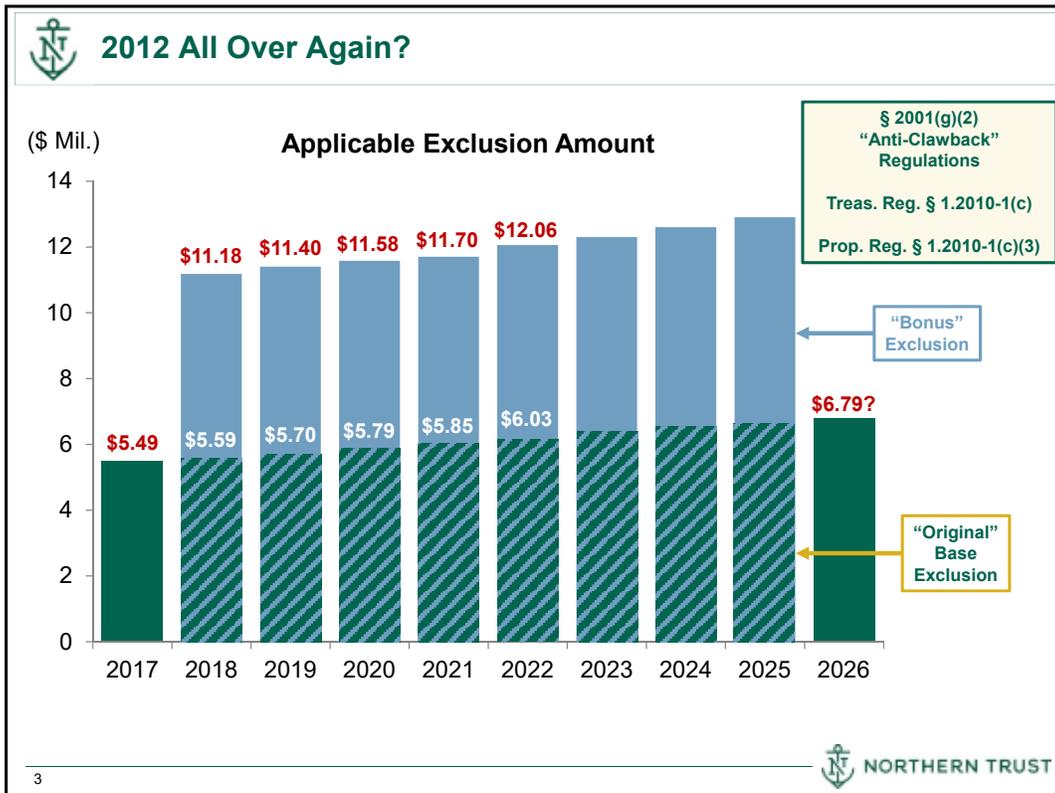
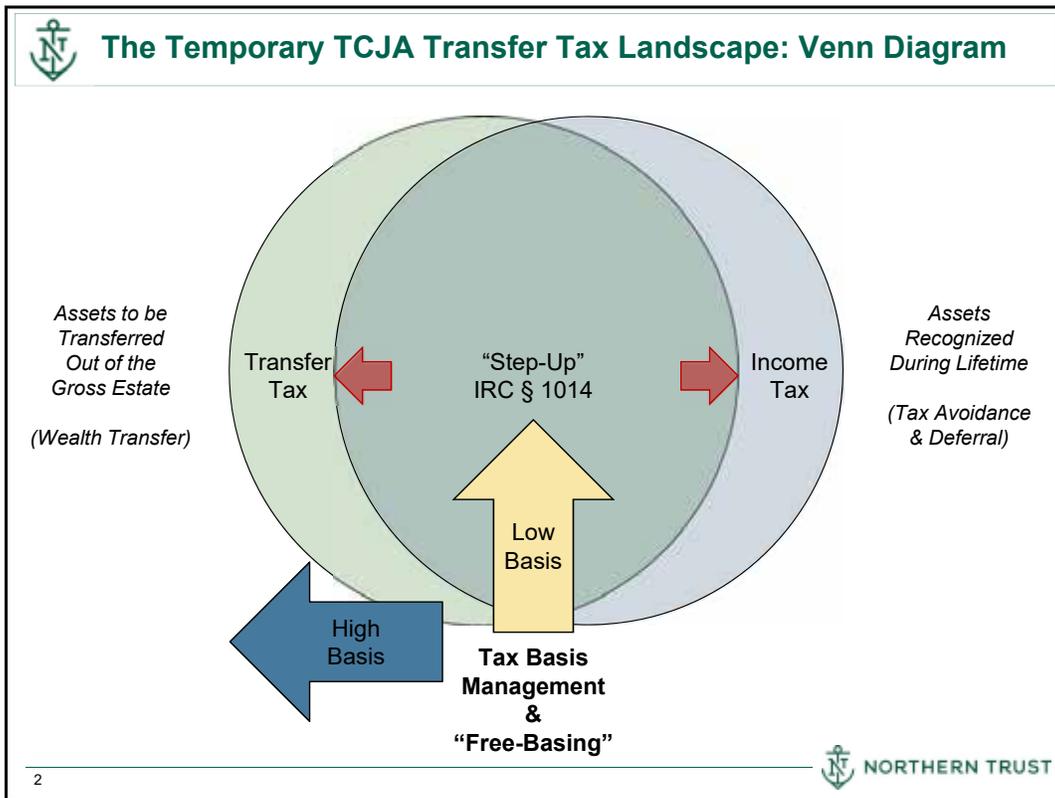


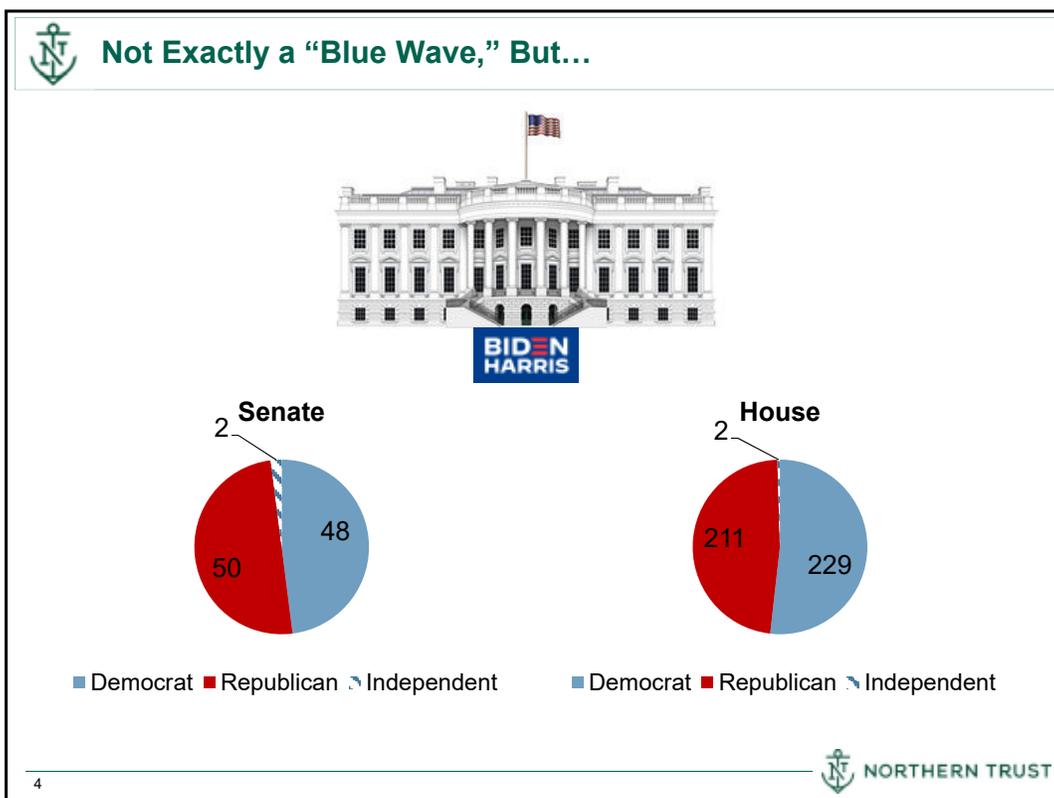
### Planning Landscape

## *Expiring Tax Provisions & Potential Tax Legislation*

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### Build It Up... Back Down... Better? Income Tax, Pt. 1

	BBB (H.R. 5376)	2023 Greenbook
<b>Rates for Individuals, Trusts &amp; Estates</b>	<ul style="list-style-type: none"> <li>• 5% surcharge on MAGI &gt;\$10 Mil./\$200K T&amp;E</li> <li>• § 642(c) deduction allowed in MAGI</li> <li>• 3% on MAGI &gt;\$25 Mil./\$500K T&amp;E</li> <li>• SALT cap of \$80,000</li> </ul>	<ul style="list-style-type: none"> <li>• 39.6% (\$400K Single/\$450K Joint)</li> </ul>
<b>Long-Term Capital Gains Rates</b>		<ul style="list-style-type: none"> <li>• 37%/39.6% &gt; \$1 million taxable income</li> <li>• Includes qualified dividends</li> <li>• <b>Eff. date of enactment</b></li> </ul>
<b>Recognition Events</b>		<ul style="list-style-type: none"> <li>• Gift or transfer on death is a recognition event (deductible for estate tax purposes)</li> <li>• Trust, partnership, or other non-corporate entity every 90 years (since 12/31/1939 = first recognition would occur 12/31/2030)</li> <li>• Includes transfer to or from trusts and partnerships (if gift)</li> <li>• Exceptions for transfers to U.S. spouses and charity (partially for split-interest trusts), tangible personal property (excluding collectibles)</li> <li>• \$5 mil. exclusion (portable &amp; indexed after 2022) + Base Exclusion Amount</li> <li>• \$250K exclusion on personal residences would be applicable</li> <li>• QSBS exclusion would be applicable</li> <li>• Election to defer recognition on family-owned and –operated businesses until sold or no longer family-owned and –operated.</li> <li>• 15-year fixed rate payment plan on transfers at death (other than liquid assets)</li> </ul>
<b>“Billionaire” Tax</b>		<ul style="list-style-type: none"> <li>• Minimum 20% tax on total income, including unrealized capital gain, for taxpayers with wealth greater than \$100 Mil.</li> <li>• Minimum 20% tax would be fully phased-in for taxpayers with wealth greater than \$200 Mil.</li> <li>• Elect to pay first year in 9 equal, annual installments, 5 annual installments in subsequent years</li> <li>• Taxpayers above \$100 Mil. required to report to IRS on annual basis</li> <li>• Non-tradable assets would be valued at the greater of adjusted cost basis, last valuation event, or other methods approved by IRS with adjustments at conservative floating return in between valuations</li> <li>• “Illiquid” taxpayers (tradeable assets less than 20% of wealth) may elect to include unrealized gain of only tradeable assets (subject to deferral charge not to exceed 10% of unrealized gains)</li> </ul>

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 <b>Build It Up... Back Down... Better? Income Tax, Pt. 2</b>		
	BBB (H.R. 5376)	2023 Greenbook
<b>IRAs &amp; Qualified Plans</b>	<ul style="list-style-type: none"> <li>Prohibition on Roth conversions with \$400/\$450K AGI—<b>Eff. 1/1/32</b></li> <li>Prohibition on Roth conversion from qualified plans, unless taxable</li> <li>Prohibition of contributions to large qualified accounts (\$10 Mil.-\$400K/\$450K AGI)</li> <li>Mandatory distributions (50% from mega-IRAs (\$10-\$20 Mil.) then 100% (\$20+)-\$400K/\$450K ATI)</li> </ul>	
<b>Corporate Taxes</b>	<ul style="list-style-type: none"> <li>15% (alternative minimum tax) on corporations with adjusted financial income &gt; \$1 billion</li> <li>1% tax on share repurchase of publicly-traded companies</li> </ul>	<ul style="list-style-type: none"> <li>28%</li> </ul>
<b>Net Investment Income Tax</b>	<ul style="list-style-type: none"> <li>NIIT on all passthrough business income of trusts, estates, and individuals with MAGI &gt;\$400K</li> </ul>	
<b>QSBS</b>	<ul style="list-style-type: none"> <li>100% &amp; 75% exclusion disallowed for individuals with AGI of \$400K or more and trusts &amp; estates—<b>Eff. sales after 9/13/21</b></li> </ul>	
<b>Carried Interest</b>		<ul style="list-style-type: none"> <li>Income from "Investment Services Partnership Interest" is treated as ordinary income if taxable income &gt; \$400K (§ 1061 still applicable for partners &lt; \$400K in taxable income)</li> </ul>
<b>Basis Shifting</b>		<ul style="list-style-type: none"> <li>Prohibit any partner in the partnership that is related to the distributee partner from benefiting from a basis increase until distributee partner has a taxable sale of the property</li> </ul>
<b>Like-Kind Exchanges</b>		<ul style="list-style-type: none"> <li>Gains from like-kind exchanges in excess of \$500K (\$1 Mil. joint) would be recognized</li> </ul>
<b>Recapture</b>		<ul style="list-style-type: none"> <li>§ 1250 recapture treated as ordinary income to the extent of depreciation deductions taken after effective date for taxpayers with AGI of \$400K or above</li> </ul>


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 <b>Build It Up... Back Down... Better? Transfer Tax</b>		
	BBB (H.R. 5376)	2023 Greenbook
<b>GRATs</b>		<ul style="list-style-type: none"> <li>Term of at least 10 years and not more than life expectancy of the grantor plus 10 years</li> <li>No decreasing annuities</li> <li>Taxable gift equal to the greater of 25% or \$500K</li> <li><b>Eff. trusts created on or after enactment</b></li> </ul>
<b>Grantor Trusts</b>		<ul style="list-style-type: none"> <li>Transfer of an asset for consideration between grantor trust and its deemed owner as one that is regarded for income tax purposes (recognizing gain), including sales as well as the satisfaction of an obligation (i.e., annuity or unitrust payment)—<b>Eff. all transactions on or after enactment</b></li> <li>Payment of income tax on grantor trust income is a gift on 12/31 of that year, immediately before death, or owner's renunciation of reimbursement right—<b>Eff. all trusts created on or after enactment</b></li> </ul>
<b>Promissory Notes</b>		<ul style="list-style-type: none"> <li>Promissory notes with sufficient interest to avoid income and gift tax consequences must be valued for transfer tax purposes by limiting the discount rate to the greater of the actual rate of interest, or the applicable minimum interest rate for the remaining term of the note on date of death—<b>Eff. valuation dates or after introduction</b></li> </ul>
<b>GST Tax</b>		<ul style="list-style-type: none"> <li>GST Exemption applies only to: (1) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the time of the creation of the trust; and (2) taxable terminations while any person described above is a beneficiary of the trust</li> <li>No "reset" of generation assignment</li> <li><b>Eff. on or after enactment, but pre-enactment trust treated as created on date of enactment</b></li> </ul>
<b>Conservation Easements</b>		<ul style="list-style-type: none"> <li>Qualified conservation deduction by a partnership is limited to 250% of each relevant partner's basis in the partnership, unless a 3-year holding requirement is satisfied</li> <li>Limitation does not apply to pass-through entities where substantially all of the interests are held, directly or indirectly, by an individual and family members</li> <li><b>Eff. contributions after 12/23/16 (12/31/18 for certified historic structures)</b></li> </ul>
<b>Special Use Valuation</b>		<ul style="list-style-type: none"> <li>Increase maximum reduction on "qualified real property" to \$11.7 Mil. (from \$1.23 Mil. in 2022)</li> <li><b>Eff. decedents dying on or after enactment</b></li> </ul>
<b>Trust Reporting</b>		<ul style="list-style-type: none"> <li>Trusts administered in the U.S. will be required to report annually with information including name, address, and TIN of each trustee and grantor, and general information regarding the nature and estimated total value of trust's assets</li> <li>Each trust with total value &gt; \$300K or gross income &gt; \$10K</li> </ul>


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 <b>Build It Up... Back Down... Better? International Planning</b>		
	BBB (H.R. 5376)	2023 Greenbook
<b>Section 250 Deduction</b>	<ul style="list-style-type: none"> <li>Deduction for global intangible low-tax income (GILTI) reduced from 50% to 28.5% and foreign-derived intangible income (FDII) reduced to from 37.5% to 24.8%</li> </ul>	<ul style="list-style-type: none"> <li>Increase C corporation rate to 28% with GILTI deduction constant under a BBB Act baseline (effective 20% applied on country-by-country basis)</li> </ul>
<b>CFCs</b>	<ul style="list-style-type: none"> <li>Repeal of 1-month deferral of taxable year of CFCs (majority U.S. shareholder); <b>Eff. taxable years after 11/20/22</b></li> <li>Deduction under § 245A (deduction for foreign-source dividend) limited to CFCs (not 10-percent owned foreign corporations)</li> <li>Restore § 958(b)(4) (stock owned by foreign person not attributed downward to U.S. person)</li> <li>New § 951B added applying subpart F to foreign controlled U.S. shareholder (U.S. shareholder owning more than 50% of foreign corporation and downward attribution from foreign persons apply)</li> </ul>	
<b>Foreign Tax Credit</b>	<ul style="list-style-type: none"> <li>Any amount paid by a dual capacity taxpayer to a foreign country for any period is not considered a tax (a) if such foreign country does not impose a generally applicable income tax, or (b) to the extent such amount exceeds the amount which would be paid by the taxpayer under generally applicable income tax imposed by such country if the taxpayer were not a dual capacity taxpayer</li> <li>Foreign tax credit limitations applied on a country-by-country basis (on a taxable unit basis)</li> </ul>	
<b>GILTI</b>	<ul style="list-style-type: none"> <li>Country-by-country application of GILTI on a CFC taxable unit basis</li> <li>Reduction of net deemed tangible income return from 10% to 5% (except property located in a U.S. possession)</li> <li>Elimination of exception for foreign oil and gas extraction income from CFC tested income</li> <li>Increases deemed foreign taxes paid from 80% to 95% (100% for foreign income taxes paid to a U.S. possession)</li> </ul>	
<b>Other Provisions</b>	<ul style="list-style-type: none"> <li>Base erosion and anti-abuse tax (BEAT) applicable to all taxpayers with gross receipts greater than \$500 million making payments to foreign related parties (no longer limited to corporations with a 3% base erosion percentage or higher); <b>Eff. taxable years after 12/31/23</b></li> </ul>	<ul style="list-style-type: none"> <li>Repeal BEAT. Replace with undertaxed profit rule (UTPR). Reporting groups that have global revenue of \$850+ million, UTPR domestic corporations and branches would be disallowed U.S. tax deductions by reference to low-taxed income of foreign entities. Effective rate of at least 15% in the foreign entities; <b>Eff. taxable years after 12/31/23</b></li> <li>Expand retroactive QEF election for PFIC shareholders</li> </ul>



## If some portions of BBB Passes...

# Income Tax Considerations

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### Surcharges Are More Than Another Marginal Tax Bracket

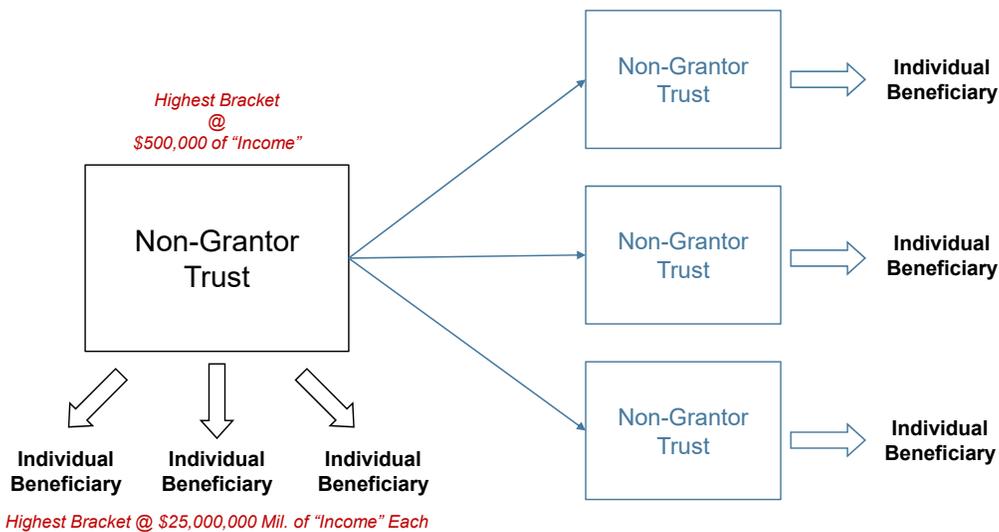
STCG/ Ordinary Rate	Single	Joint	Trusts & Estates
10%	\$0 to \$10,275 <b>Taxable Income</b>	\$0 to \$20,550 <b>Taxable Income</b>	\$0 to \$2,750 <b>Taxable Income</b>
12%	\$10,275 to \$41,775	\$20,550 to \$83,550	
22%	\$41,775 to \$89,075	\$83,550 to \$178,150	
24%	\$89,075 to \$170,050	\$178,150 to \$340,100	\$2,750 to \$9,850
32%	\$170,050 to \$215,950	\$340,100 to \$431,900	
35%	\$215,950 to \$539,900	\$431,900 to \$647,850	\$9,850 to \$13,450
37%	\$539,900+	\$647,850+	\$13,450+
(+5%) 43%	\$10,000,000+ <b>MAGI</b>	\$10,000,000+ <b>MAGI</b>	\$200,000+ <b>MAGI</b>
(+3%) 46%	\$25,000,000+ <b>MAGI</b>	\$25,000,000+ <b>MAGI</b>	\$500,000+ <b>MAGI</b>

LTCG/QD Rate with NIIT	Single	Joint	Trusts & Estates
0%	\$0 to \$41,675 <b>Taxable Income</b>	\$0 to \$83,350 <b>Taxable Income</b>	\$0 to \$2,800 <b>Taxable Income</b>
15%	\$41,675 to \$200,000 <b>MAGI</b>	\$83,350 to \$250,000 <b>MAGI</b>	\$2,800 to \$13,700
18.8%	\$200,000 <b>MAGI</b> to \$459,750	\$250,000 <b>MAGI</b> to \$517,200	
23.8%	\$459,750+	\$517,200+	\$13,700 + <b>MAGI</b>
(+5%) 28.8%	\$10,000,000+ <b>MAGI</b>	\$10,000,000+ <b>MAGI</b>	\$200,000+ <b>MAGI</b>
(+3%) 31.8%	\$25,000,000+ <b>MAGI</b>	\$25,000,000+ <b>MAGI</b>	\$500,000+ <b>MAGI</b>

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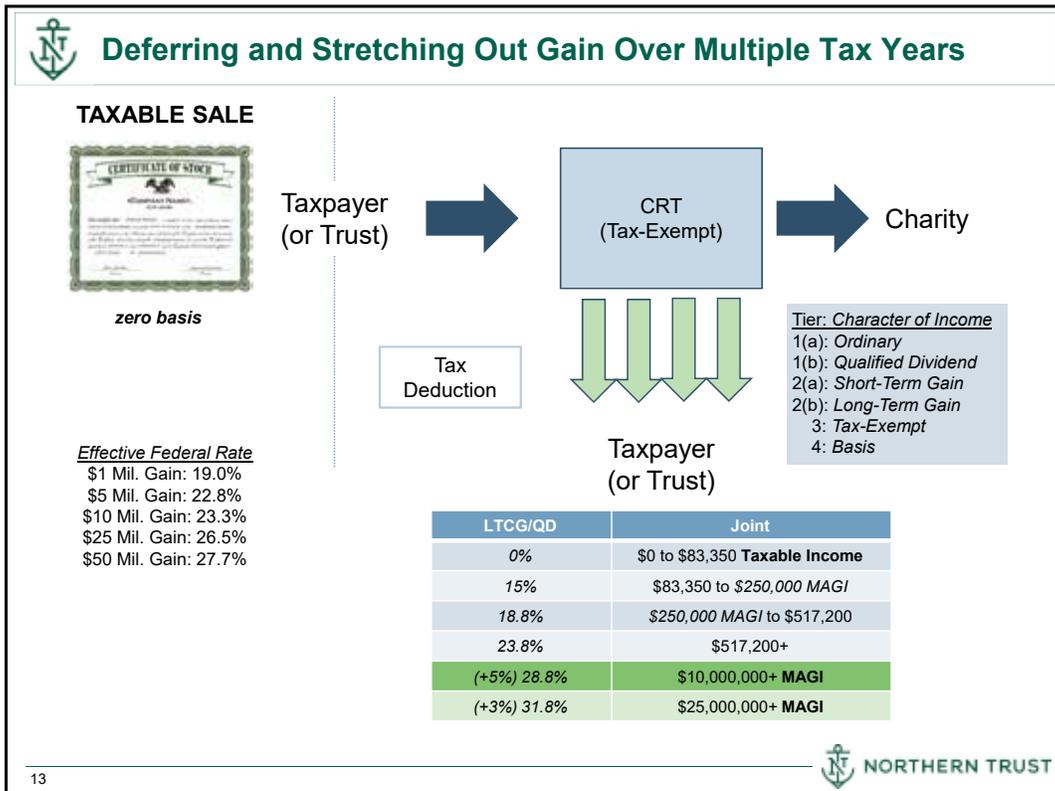
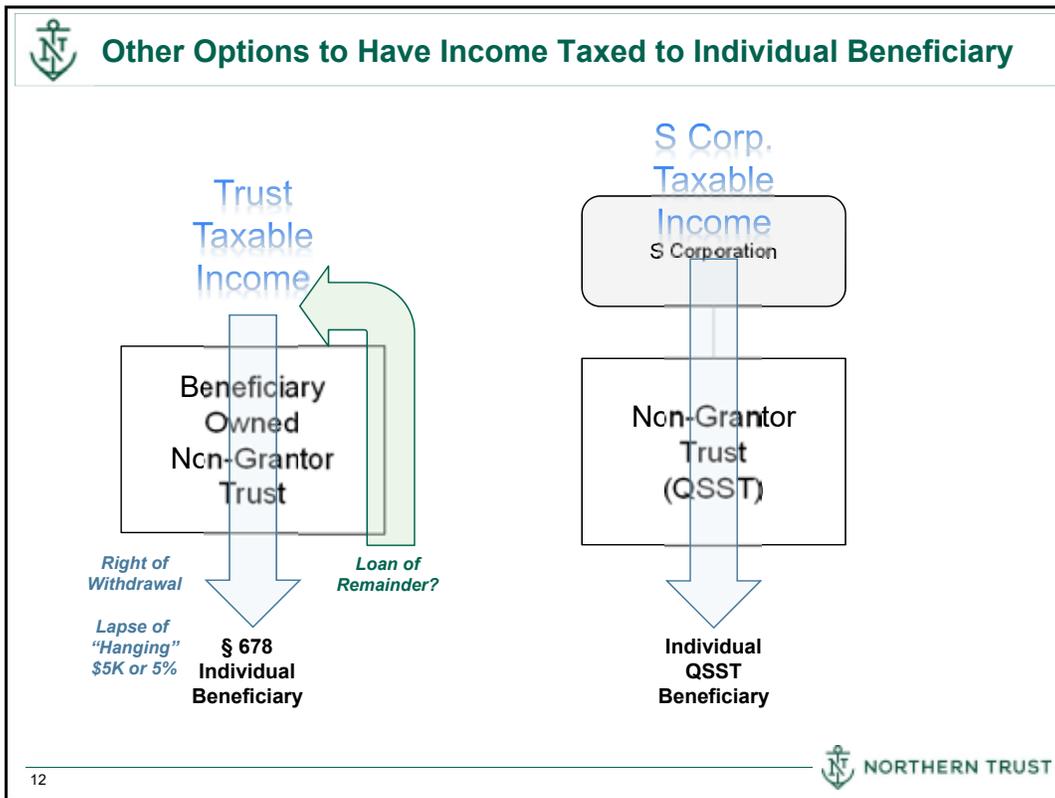


### Tax Policy: Non-Grantor (Taxable) Trusts Are Evil



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### Taxable Installment Obligations

Disposition

←

Interest  
+  
Taxable  
Gain  
(60%)  
+  
Basis  
(40%)

Seller

←

Installation Payment

→

Buyer

Resale

→

AB/FMV  
\$40x/\$100x

AB/FMV  
\$100x/\$100x

- Death of Seller
  - Installment note is IRD
  - Estate distribution of note to the obligor is a taxable disposition
- Taxable Dispositions
  - Sale or exchange
  - Gift, contribution to trust, and distribution to beneficiary
- Not a Taxable Disposition
  - Transfers between grantor and grantor trust
  - Transfer to former spouse incident to divorce
  - § 721 contributions and § 731 distributions (partnerships)
  - § 351 contributions and § 361 distributions (corporations)

- Taxation
  - Gross profit percentage (profit divided by total contract price) determines gain
  - Minimum interest at AFR
  - Installment method by default (may elect out by due date of income tax return)
  - Can have variable principal payments or interest only
  - Only applies to gain, not loss
- Installment Method Not Allowed
  - Dealer Dispositions
  - Inventory Sales
  - Marketable Securities
  - Depreciable Property Sales to Related Persons
  - Portion of Gain Attributable to Recapture

- Resales by Related Party
  - Second disposition within 2 years of the first disposition
  - Amount realized on second disposition treated as payment to original seller
- Tolling of 2-Year Period
  - Related party's risk of loss is substantially diminished
  - Put, short, right to acquire, or other transaction
- Second Disposition
  - Sale, exchange, **gift**, or cancellation of installment obligation
  - Does NOT include any transfer after earlier of death of original seller or related party

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### Capturing Basis and “Rushing” a Subsequent Sale

Interest  
+  
Taxable  
Gain  
(80%)  
+  
Basis  
(20%)

Seller

←

Installation Payment

→

Buyer

AB/FMV  
\$20 Mil./\$100 Mil

AB/FMV  
\$100 Mil./\$100 Mil.

Amortized 20-Year Obligation

2021	Grantor		Non-Grantor Trust	
2022		\$4 Mil. Gain (\$1 Mil. Basis) + Interest		
2023		\$4 Mil. Gain (\$1 Mil. Basis) + Interest		
BOY 2024			Non-Grantor Trust \$100 Mil. Cash	<p>←</p> <p>Resale</p> <p>→</p> <p>Third Party</p> <p style="text-align: center;">AB/FMV \$100 Mil./\$100 Mil.</p>

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 **If BBB Passes or Doesn't Pass**

*Transfer  
Tax  
Considerations*

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 **To Gift or Not to Gift: That's the Question...**

<b>Up to Wealthy</b>	<b>"Middle Class" Wealthy</b>	<b>Ultra-Wealthy</b>
\$0 to ~\$12.06 Mil.	~\$12.06 Mil. to ~\$50.0 Mil.	Above ~\$50.0 Mil.

- Limit taxable gifts
- Preserve Applicable Exclusion
- Take advantage of free "step-up" in basis
- Limit valuation discounts
- Transfers of wealth in excess of the Applicable Exclusion via "zeroed-out" techniques
- Transfer high basis assets to IDGTs with "swap" power

- Taxable gifts in excess of the "Original" Applicable Exclusion depend on whether taxpayer can afford to make such gift
- Careful consideration of "split-gift" election (or NOT) in certain years
- Spousal Lifetime Access Trusts
- Retained cash flow techniques (i.e., preferred partnership freezes)
- Trusts that provide maximum "flexibility"

- Large taxable gifts to use "Original" and "Bonus" Applicable Exclusion
- Transfer to IDGTs (with "swap" power)
- Valuation discount planning
- "Zeroed-out" techniques, leveraging taxable gifts (i.e., installment sale)
- "Free-basing" with marital deduction and estate reduction planning with surviving spouse

**Consider:**  
Applicable Exclusion gifts of cash (or marketable securities), and  
Exercise of "swap" power in the future.

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## Post-Transfer Flexibility

### “Undoing” Taxable Gifts after the Transfer

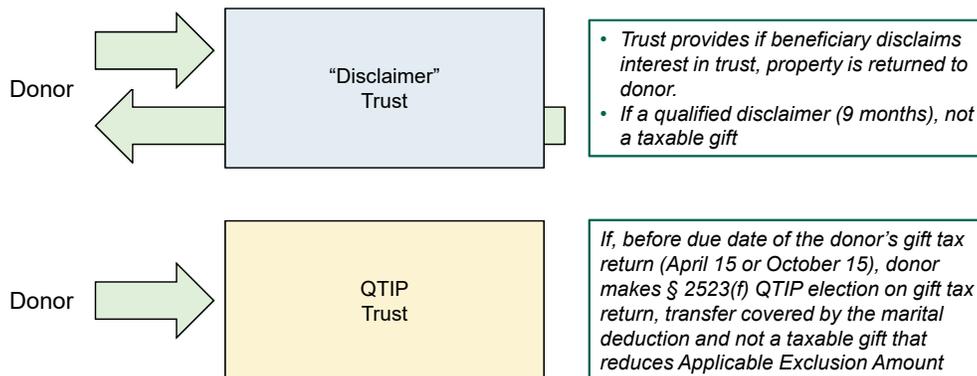
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## Undoing Gifts: Disclaimer Trusts & QTIP Elections

### Reasons to “Undo” Taxable Gifts:

- Current Applicable Exclusion Amount becomes permanent
- Gifted asset depreciates in value
- Loss of “step-up” in basis
- NY donor dies soon after gift (gifts within 3 years of death are subject to NY estate tax but with no corresponding federal estate tax deduction): 49.6% v. 56% effective transfer tax



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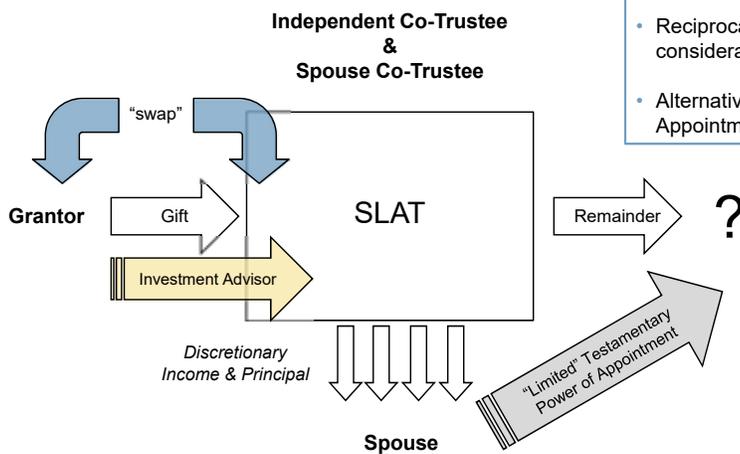
## Retaining Indirect Access

### Spousal Lifetime Access Trusts, Grantor Trusts & Flexibility

20



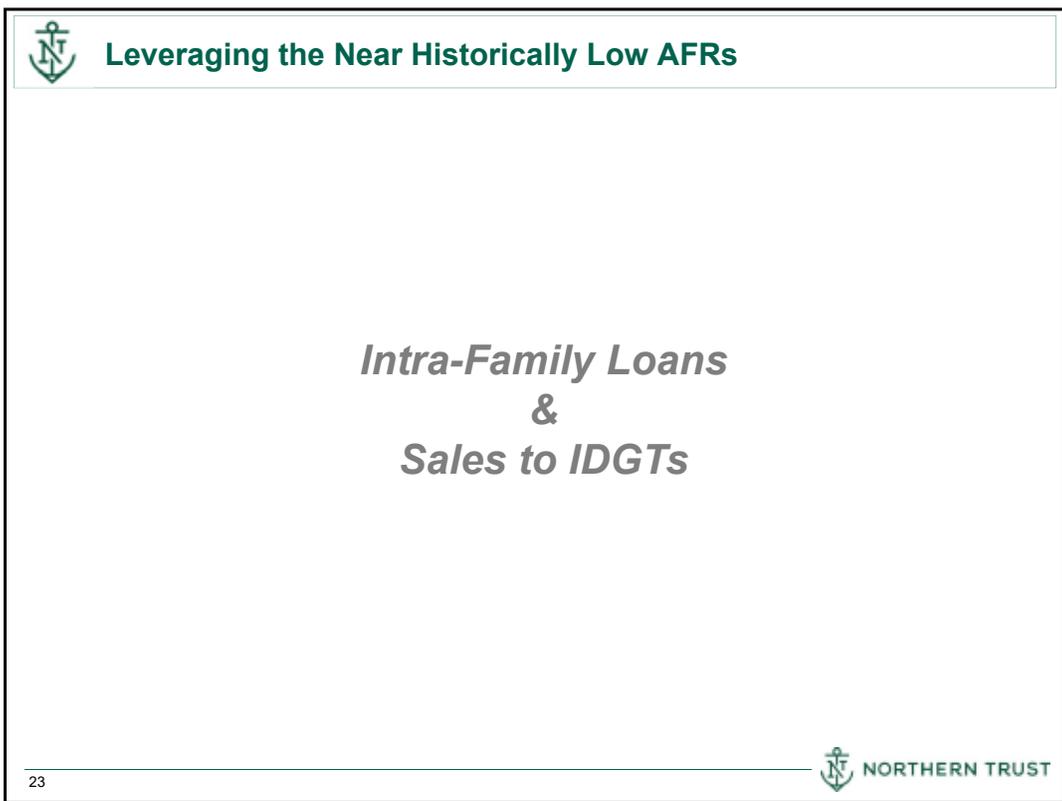
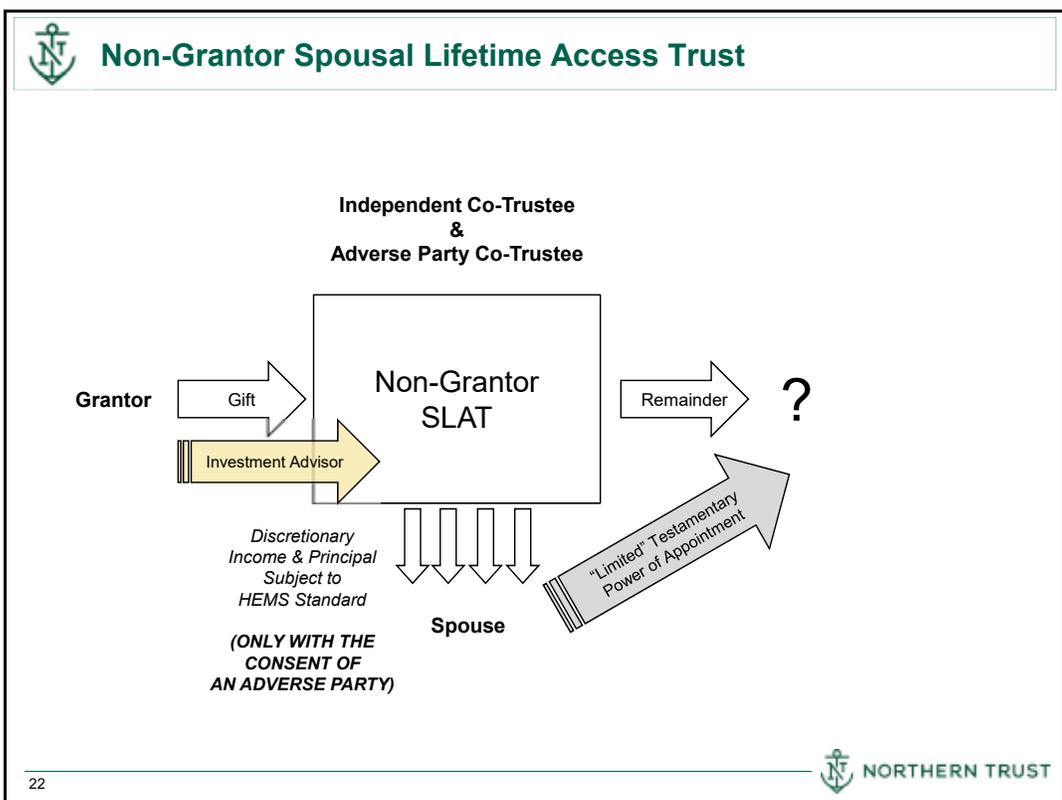
## Spousal Lifetime Access Trust

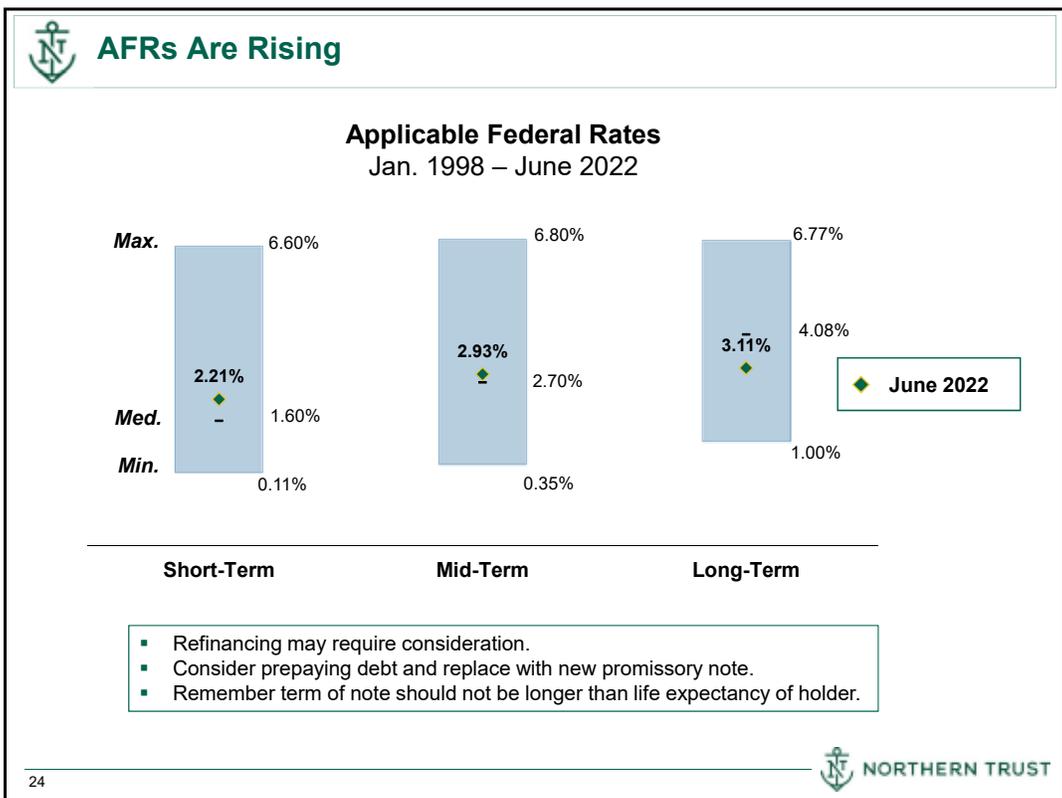


- Applicable state law on donor's creditor claims critical to know
- Reciprocal trust doctrine considerations (*Grace* or *Levy*)
- Alternative: Special Power of Appointment Trust (SPAT)

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### The Valuation of Promissory/Installment Notes in the Future?

"In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the nonpassive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds." Prop. Treas. Reg. 25.2704-3(b)(iv).

- Loans and Installment Sales Today
  - Applicable federal rate (long-term, not short or mid-term);
  - 10% (or less) equity;
  - No prepayment penalty; and
  - Adequate security not required.
- Promissory Notes Will Need to Be:
  - Adequately secured;
  - Requires periodic payments on a non-deferred basis;
  - Issued at market interest rates; and
  - Has a fair market value equal to the liability.

FMV  
\$1.0 MM

\$1.0 MM  
@ AFR

Today

↔

FMV  
\$1.0 MM  
(Minus)  
Discount

\$1.0 MM  
@ AFR

Tomorrow

**Using Notes to Avoid Section 2036 Issues:**

- Sell Family-Owned Entity to IDGT for FMV in Exchange for Installment Note.
- Gift the Installment Note to IDGT (Borrower).

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## Leveraging the Low 7520 Rate

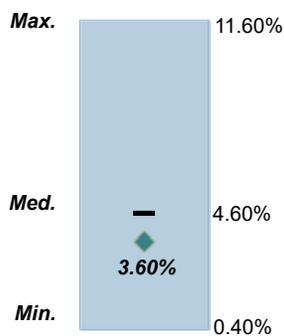
*Long-Term GRATs  
Back-Loaded CLATs  
Deferred & Increasing Private Annuities*

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## Section 7520 Rate

**Section 7520 Rate**  
(Since Inception)  
Mar. 1989 – June 2022



◆ June 2022

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## 100 Years? 365 Years?

Estate Tax Inclusion is LESSER of:

- FMV of GRAT assets; or
- Amount of Principal to Pay Annuity in PERPETUITY  

$$= \frac{\text{Annuity Payment}}{7520 \text{ Rate at Death}}$$

### 100 Year GRAT

Annuity	\$ 370,793.35
7520 Rate	3.6%
Years	100
PV of Grantor's Retained Interest	\$ 10,000,000
Annuity Factor	26.96919971
Life Factor	0.970891189
Remainder Factor	0.029108811

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 37,079,335
2.0%	\$ 18,539,668
3.0%	\$ 12,359,778
4.0%	\$ 9,269,834
5.0%	\$ 7,415,867
6.0%	\$ 6,179,889
7.0%	\$ 5,297,048

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 11,893,182
10	\$ 14,548,467
15	\$ 18,272,641
20	\$ 23,495,989
25	\$ 30,822,004

### 365 Year GRAT

Annuity	\$ 360,000.89
7520 Rate	3.6%
Years	365
PV of Grantor's Retained Interest	\$ 10,000,000
Annuity Factor	27.77770901
Life Factor	0.999997524
Remainder Factor	2.47565E-06

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 36,000,089
2.0%	\$ 18,000,045
3.0%	\$ 12,000,030
4.0%	\$ 9,000,022
5.0%	\$ 7,200,018
6.0%	\$ 6,000,015
7.0%	\$ 5,142,870

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 11,955,246
10	\$ 14,697,580
15	\$ 18,543,845
20	\$ 23,938,431
25	\$ 31,504,616

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## Long-Term GRATs with a Bonus Exclusion Gift

\$10 Mil. Contribution - \$3.97 Mil. Retained Annuity = \$6.03 Mil. Taxable Gift

### 50 Year GRAT

Annuity	\$ 172,320.05
7520 Rate	3.6%
Years	50
PV of Grantor's Retained Interest	\$ 3,970,000
Annuity Factor	23.03852658
Life Factor	0.829386957
Remainder Factor	0.170613043

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 17,232,005
2.0%	\$ 8,616,002
3.0%	\$ 5,744,002
4.0%	\$ 4,308,001
5.0%	\$ 3,446,401
6.0%	\$ 2,872,001
7.0%	\$ 2,461,715

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 13,034,550
10	\$ 17,290,663
15	\$ 23,260,081
20	\$ 31,632,499
25	\$ 43,375,249

### 60 Year GRAT

Annuity	\$ 162,370.04
7520 Rate	3.6%
Years	60
PV of Grantor's Retained Interest	\$ 3,970,000
Annuity Factor	24.4503229
Life Factor	0.880211624
Remainder Factor	0.119788376

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 16,237,004
2.0%	\$ 8,118,502
3.0%	\$ 5,412,335
4.0%	\$ 4,059,251
5.0%	\$ 3,247,401
6.0%	\$ 2,706,167
7.0%	\$ 2,319,572

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 13,091,770
10	\$ 17,428,136
15	\$ 23,510,115
20	\$ 32,040,405
25	\$ 44,004,577

### 70 Year GRAT

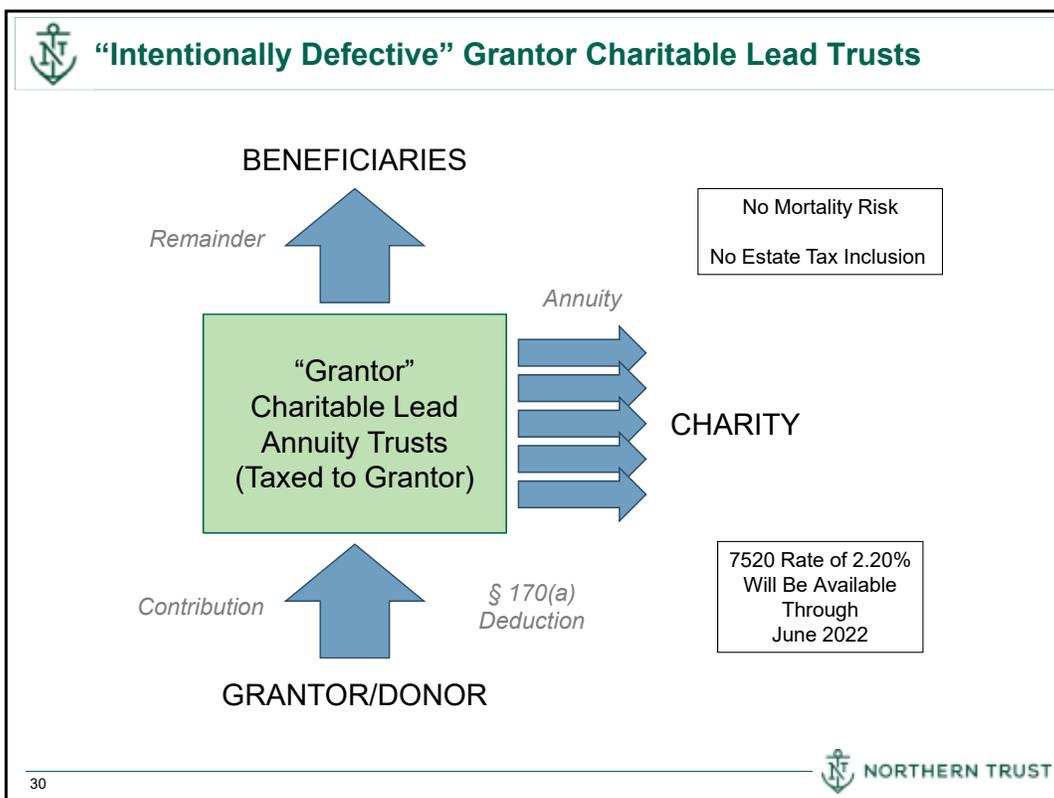
Annuity	\$ 156,043.93
7520 Rate	3.6%
Years	70
PV of Grantor's Retained Interest	\$ 3,970,000
Annuity Factor	25.44155303
Life Factor	0.915895909
Remainder Factor	0.084104091

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 15,604,393
2.0%	\$ 7,802,197
3.0%	\$ 5,201,464
4.0%	\$ 3,901,098
5.0%	\$ 3,120,879
6.0%	\$ 2,600,732
7.0%	\$ 2,229,199

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 13,128,149
10	\$ 17,515,541
15	\$ 23,669,084
20	\$ 32,299,747
25	\$ 44,404,698

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- 
- Rev. Proc. 2007-45, 2007-29 I.R.B. 89**
- IRS Forms for Charitable Lead Trusts
  - Guaranteed Annuity
    - ◆ Determinable amount
    - ◆ Paid periodically
    - ◆ Not less than annually
  - Payment Requirements
    - ◆ Not subject to any minimum or maximum payout
    - ◆ May provide for an annuity amount that is
      - ▶ Fixed dollar
      - ▶ Increases during the annuity period
      - ▶ Provided that the value of the annuity is ascertainable at the time the trust is funded
- 31
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### Possible Guaranteed Annuities (\$10 Mil. for 20 Yrs. @ 2.2%)

Year	Level	20% Increase	50% Increase	"Shark-Fin"
1	\$ 623,434	\$ 74,762	\$ 2,222	\$ 1,000
2	\$ 623,434	\$ 89,714	\$ 3,334	\$ 1,000
3	\$ 623,434	\$ 107,657	\$ 5,000	\$ 1,000
4	\$ 623,434	\$ 129,189	\$ 7,501	\$ 1,000
5	\$ 623,434	\$ 155,027	\$ 11,251	\$ 1,000
6	\$ 623,434	\$ 186,032	\$ 16,876	\$ 1,000
7	\$ 623,434	\$ 223,238	\$ 25,315	\$ 1,000
8	\$ 623,434	\$ 267,886	\$ 37,972	\$ 1,000
9	\$ 623,434	\$ 321,463	\$ 56,958	\$ 1,000
10	\$ 623,434	\$ 385,756	\$ 85,437	\$ 1,000
11	\$ 623,434	\$ 462,907	\$ 128,155	\$ 1,000
12	\$ 623,434	\$ 555,488	\$ 192,232	\$ 1,000
13	\$ 623,434	\$ 666,586	\$ 288,348	\$ 1,000
14	\$ 623,434	\$ 799,903	\$ 432,523	\$ 1,000
15	\$ 623,434	\$ 959,884	\$ 648,784	\$ 1,000
16	\$ 623,434	\$ 1,151,861	\$ 973,176	\$ 1,000
17	\$ 623,434	\$ 1,382,233	\$ 1,459,764	\$ 1,000
18	\$ 623,434	\$ 1,658,679	\$ 2,189,646	\$ 1,000
19	\$ 623,434	\$ 1,990,415	\$ 3,284,469	\$ 1,000
20	\$ 623,434	\$ 2,388,498	\$ 4,926,704	\$ 15,429,395
<b>Total</b>	<b>\$12,468,684</b>	<b>\$ 13,957,177</b>	<b>\$ 14,775,666</b>	<b>\$15,448,395</b>

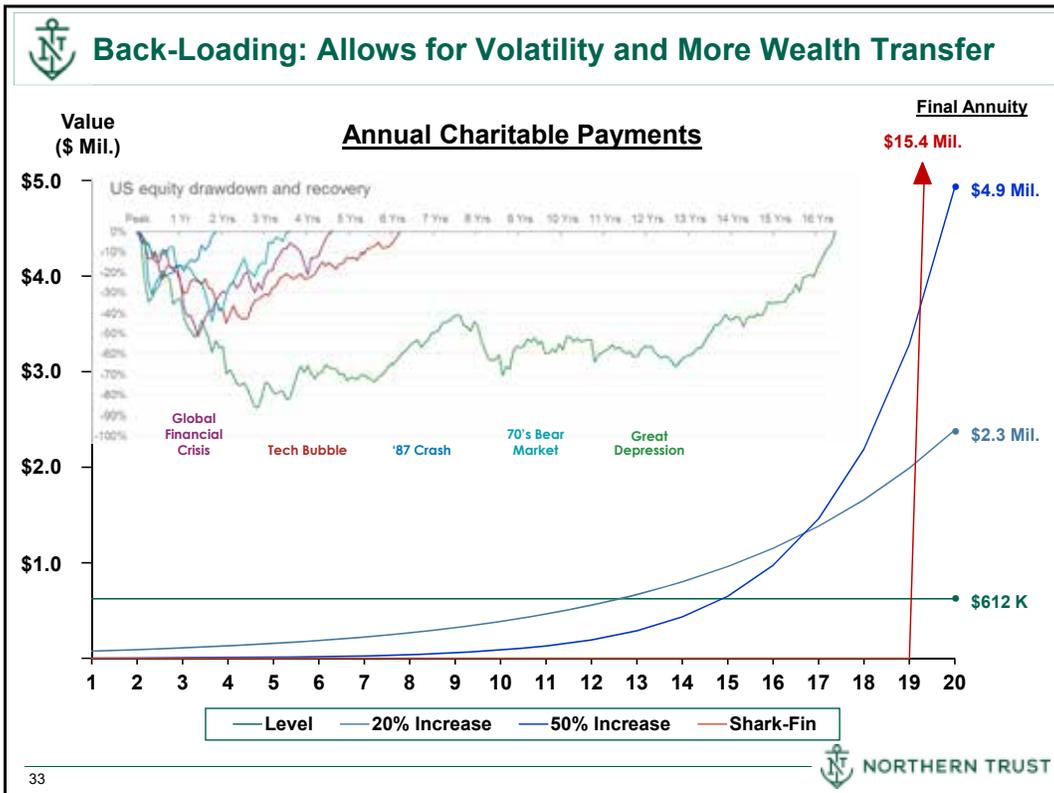
Present Value of \$10 Mil.

(Gift or Estate Tax Deduction)

(Income Tax Deduction if Grantor CLAT)

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### Return Will Determine Value to Children at End of 20 Years

Ending Remainder Value to Children (\$10 Mil. Contribution)

Return	Level	20% Increase	50% Increase	Shark-Fin
3%	\$ 1,309,202	\$ 1,995,413	\$ 2,346,131	\$ 2,605,847
5%	\$ 5,918,531	\$ 8,747,433	\$ 10,123,736	\$ 11,071,516
7%	\$ 13,138,853	\$ 18,874,599	\$ 21,530,670	\$ 23,227,454

Aggregate Amount Paid to Charity Over Term

	Level	20% Increase	50% Increase	Shark-Fin
Charity	\$ 12,468,684	\$ 13,957,177	\$ 14,775,666	\$ 15,448,395

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### Private Annuities: Flexible Annuity Pattern

**IDGT**

Grantor  
(Annuitant)

←

\$3.97 Mil.  
Private Annuity Sale

→

\$6.03 Mil.  
Taxable Gift

←

*Needed to Meet  
Exhaustion Test*

**Private Annuity Payments to 60-Year-Old Annuitant  
(7520 Rate of 3.6%)**

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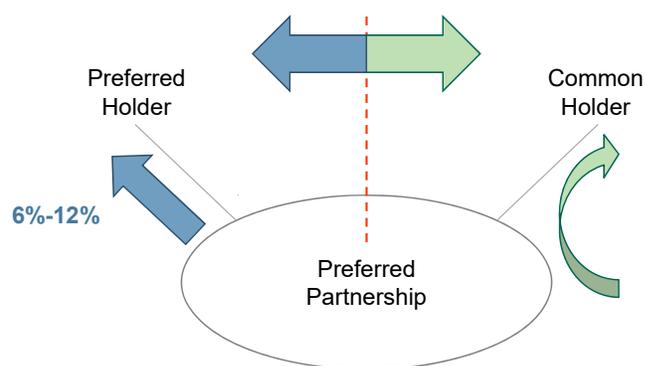
## Retaining Cash Flow & Transferring Future Growth

### Qualified Preferred Partnerships

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## Preferred & Common: Retain or Transfer?

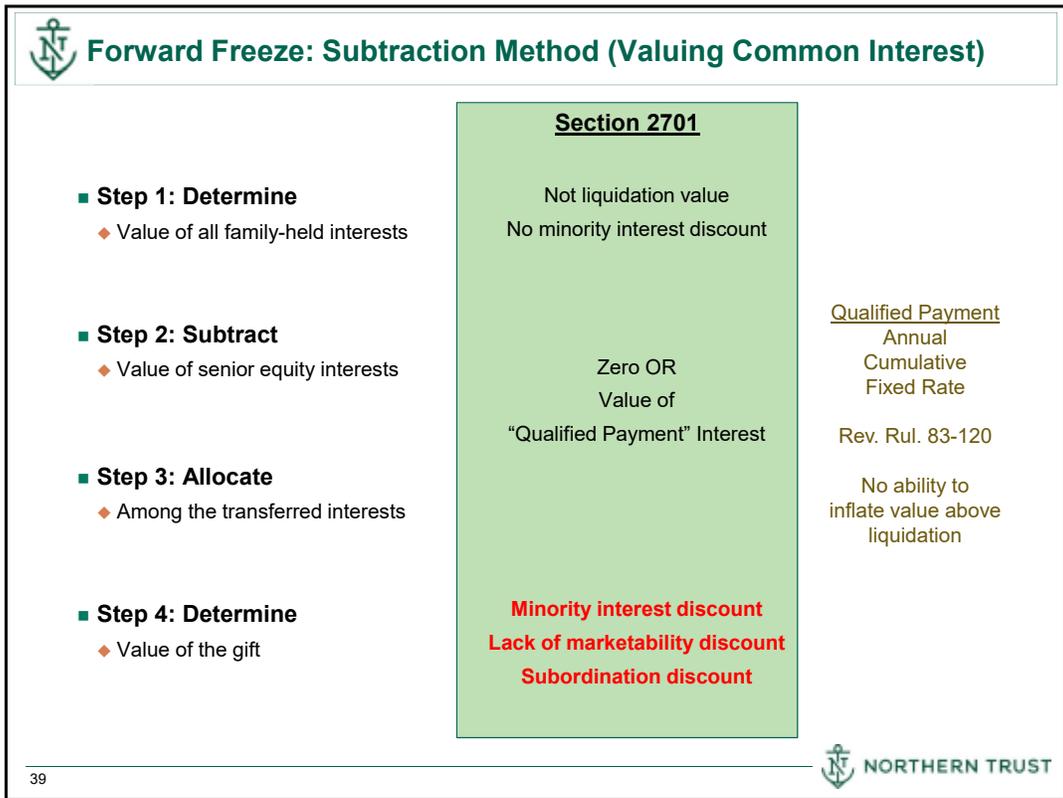
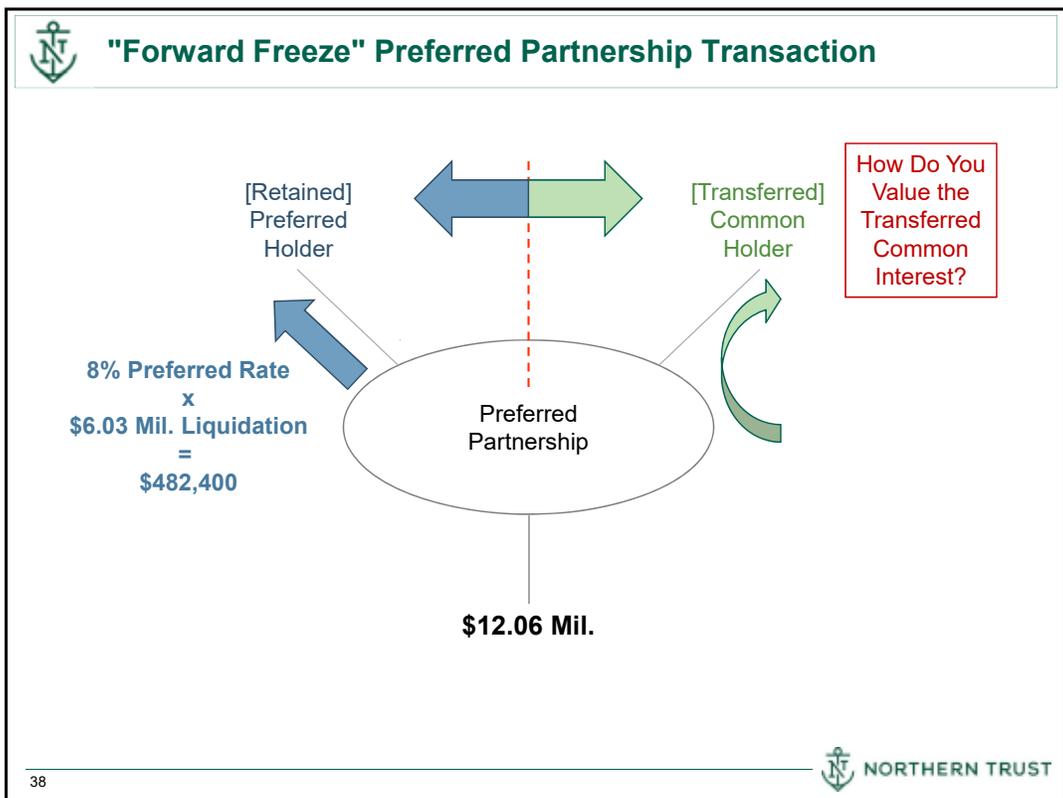


- Fixed Liquidation Value
- Annual Distribution at Fixed Rate/Amount
- Tax Items Preferentially Allocated
- Retain (Traditional), § 2701 Applies
- Transfer (Reverse), Normal Gift Tax Rules

- All Value in Excess of Preferred
- No Fixed Annual Distribution
- Residual Tax Items
- If Retain, Normal Gift Tax Rules
- If Transfer, § 2701 Applies

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**Retain Preferred/Transfer Common: Qualified or Non-Qualified**

**Estate Tax**

Qualified Preferred Interest  
Fair Market Value  
(Liquidated at Death?)  
(Cost-of-Living Liquidation?)

Non-Qualified Preferred Interest  
Fair Market Value (Liquidated?)  
less  
Reg. § 25.2701-5(a)(3) Adjustment

*In  
The  
Estate*

*Out of  
The  
Estate*

**Gift Tax**

Common Interest  
Family Interests  
less  
Qualified Interest  
less  
Discounts

Common Interest  
Family Interests  
less  
Zero

Preferred Partnership

Preferred Holder      Common Holder

6%-12%

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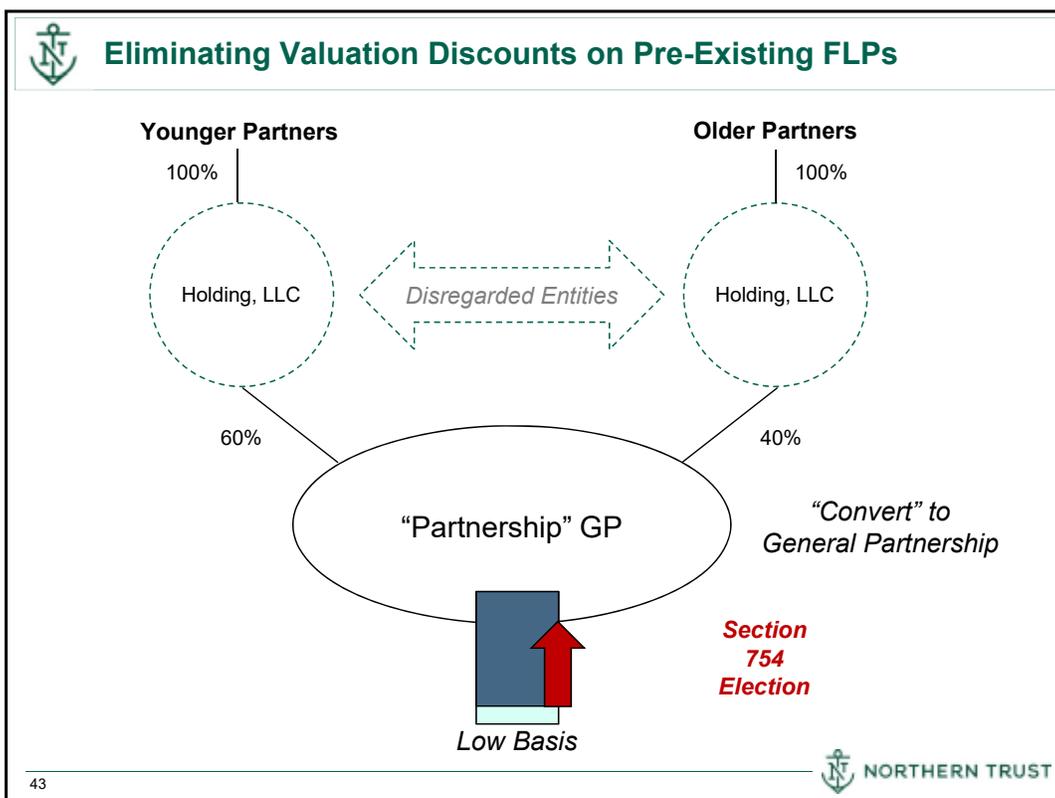
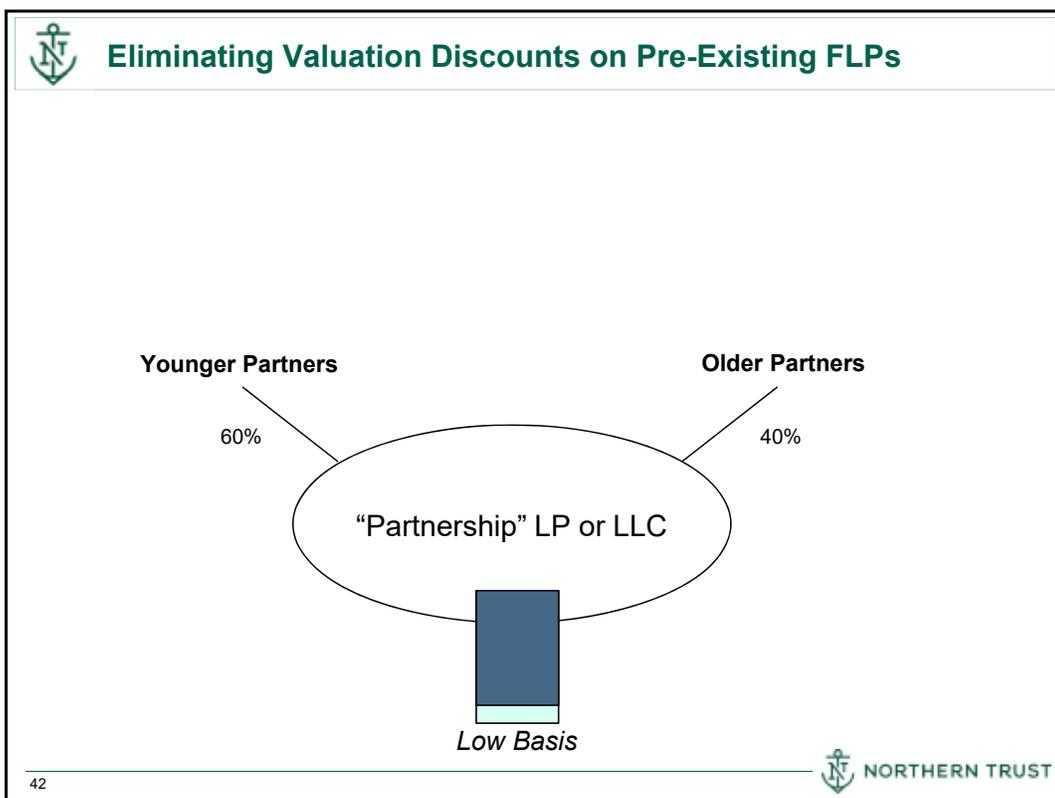
40

**Maximizing the Step-Up in Basis**

*Eliminating Valuation Discounts  
On Pre-Existing FLP Interests  
Included in the Gross Estate*

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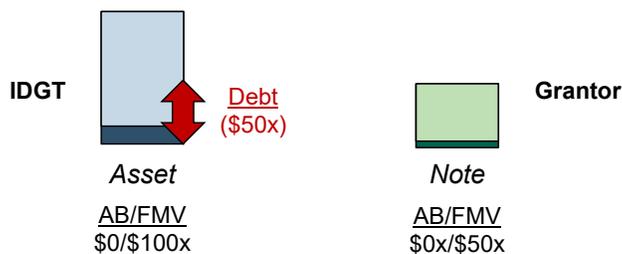
## Planning with Outstanding Installment Notes

*Eliminating Outstanding Installment Notes,  
Avoiding Gain At Death, and  
Getting A “Step-Up” On The IDGT Property*

44



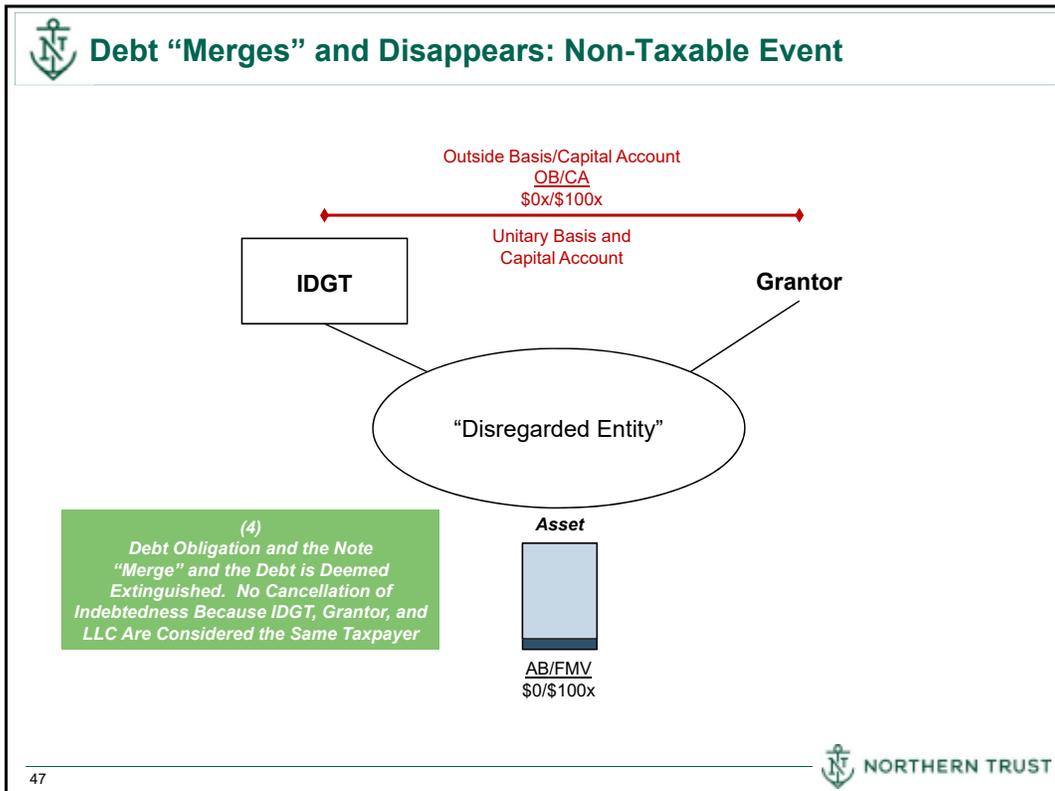
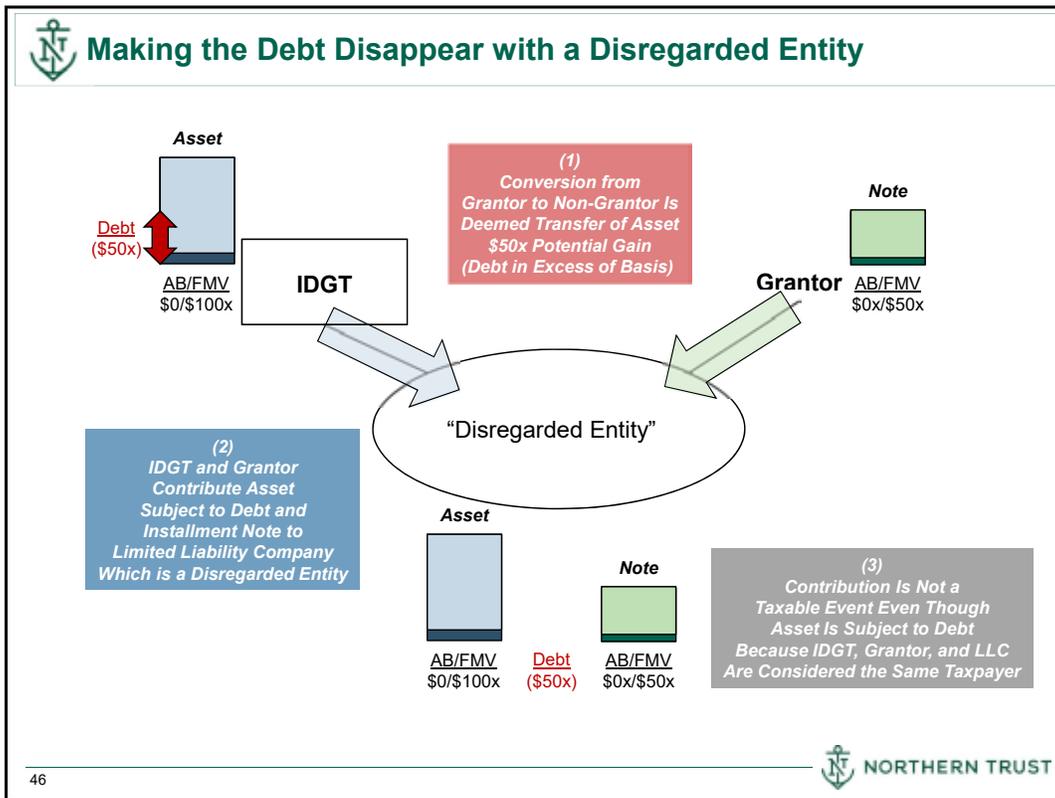
## Installment Sale to IDGT and Outstanding Note



**Potential \$50x Taxable Gain  
Upon Conversion of  
Grantor Trust to Non-Grantor Trust**

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**Death of Grantor: Disregarded Entity to a Partnership**

Rev. Rul. 99-5:  
Conversion of disregarded entity to partnership created by transfer of an LLC interest to another taxpayer treated as purchase of assets and contribution to a new partnership.

OB/CA \$0x/\$50x      OB/CA \$50x/\$50x

Non-Grantor Trust      Estate of Grantor

Partnership

Asset

AB/FMV \$50x/\$100x

(5) Grantor's Death Converts the LLC to a Partnership for Tax Purposes. Treated as the Creation of a New Partnership: Grantor's Portion of the Asset Gets a "Step-Up" in Basis and Is Contributed to a Newly Formed Partnership.

(6) End Results:

- a) No Gain on the Grantor's Death;
- b) Asset in IDGT Gets a Partial Basis Adjustment under § 1014; and
- c) No Installment Note Included in Grantor's Estate.

48

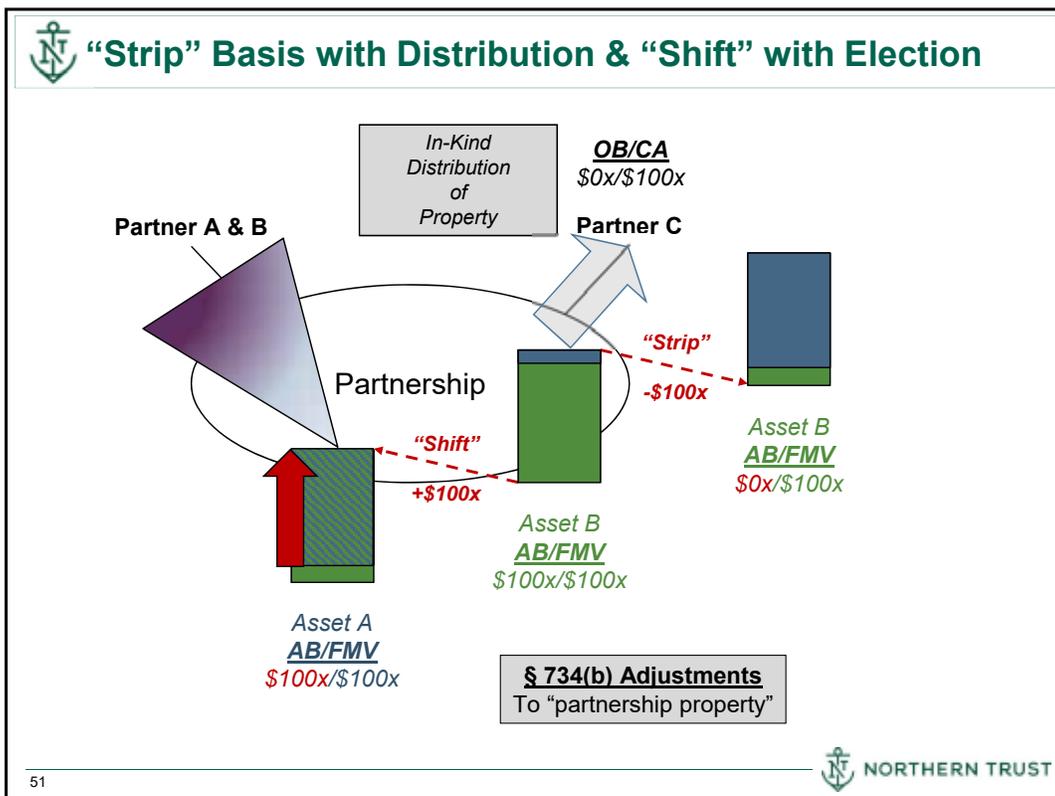
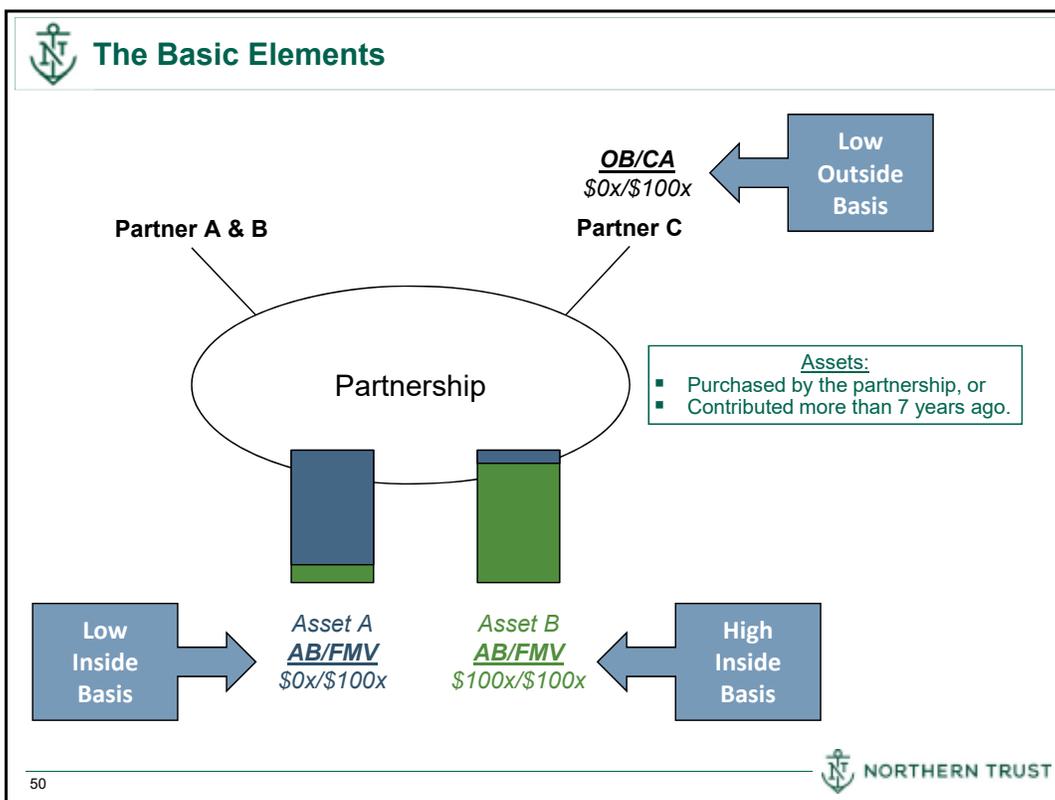
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**Tax Basis Management with Partnerships**

*The Basics of Basis Stripping, Shifting, and Swapping*

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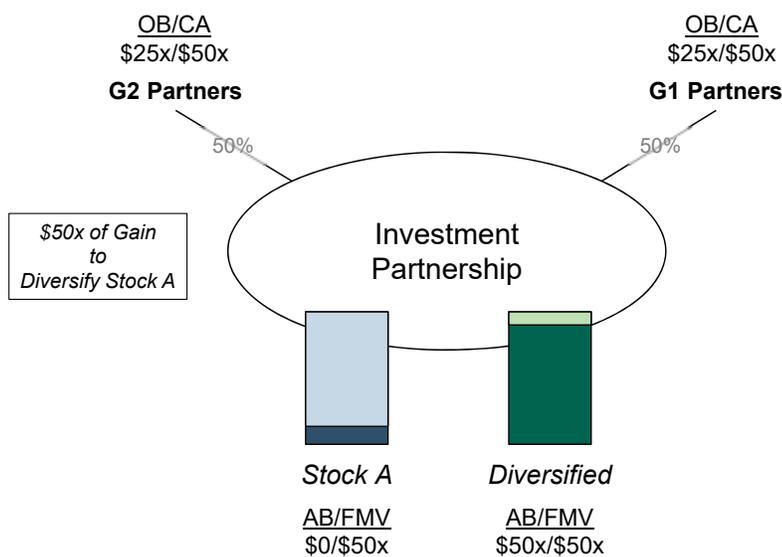
**Marketable Securities**

*Creating, Stripping, and Shifting Basis  
(Even with Marketable Securities)*

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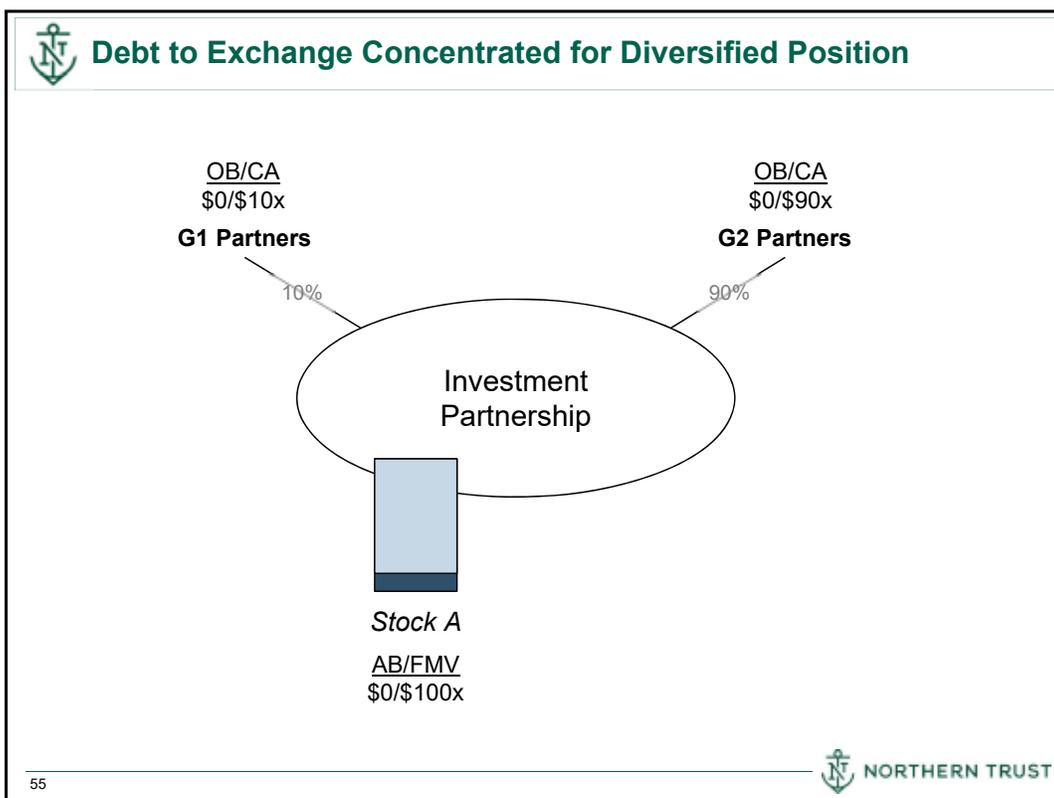
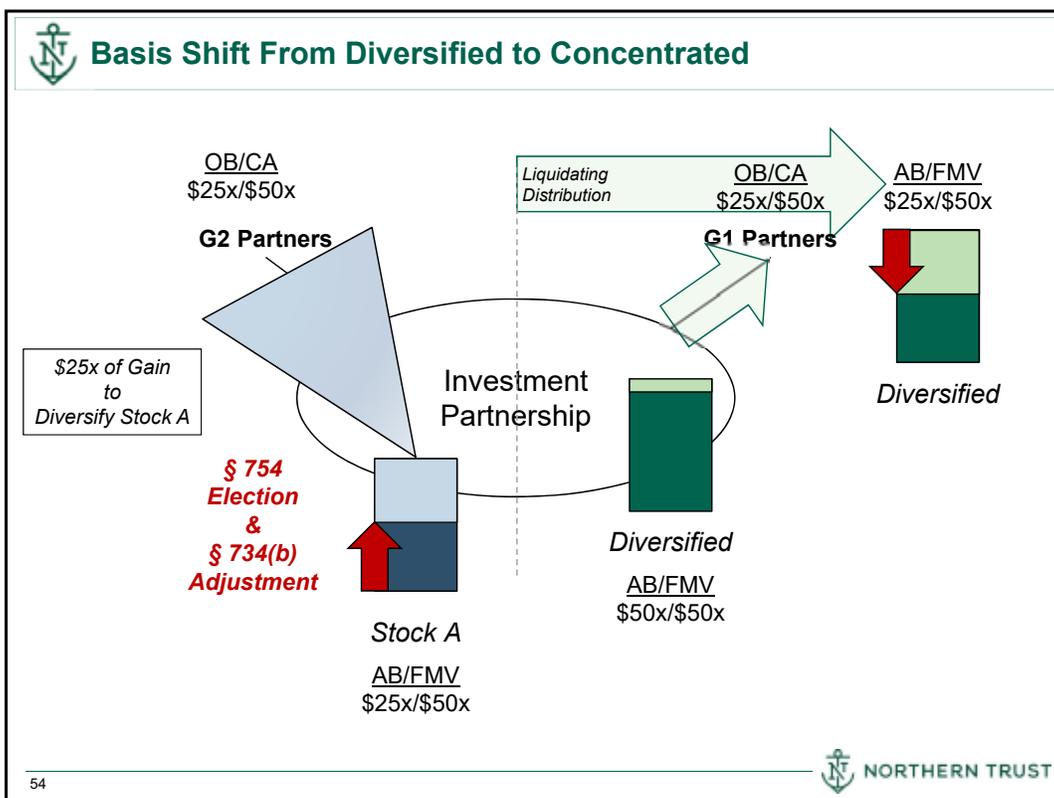


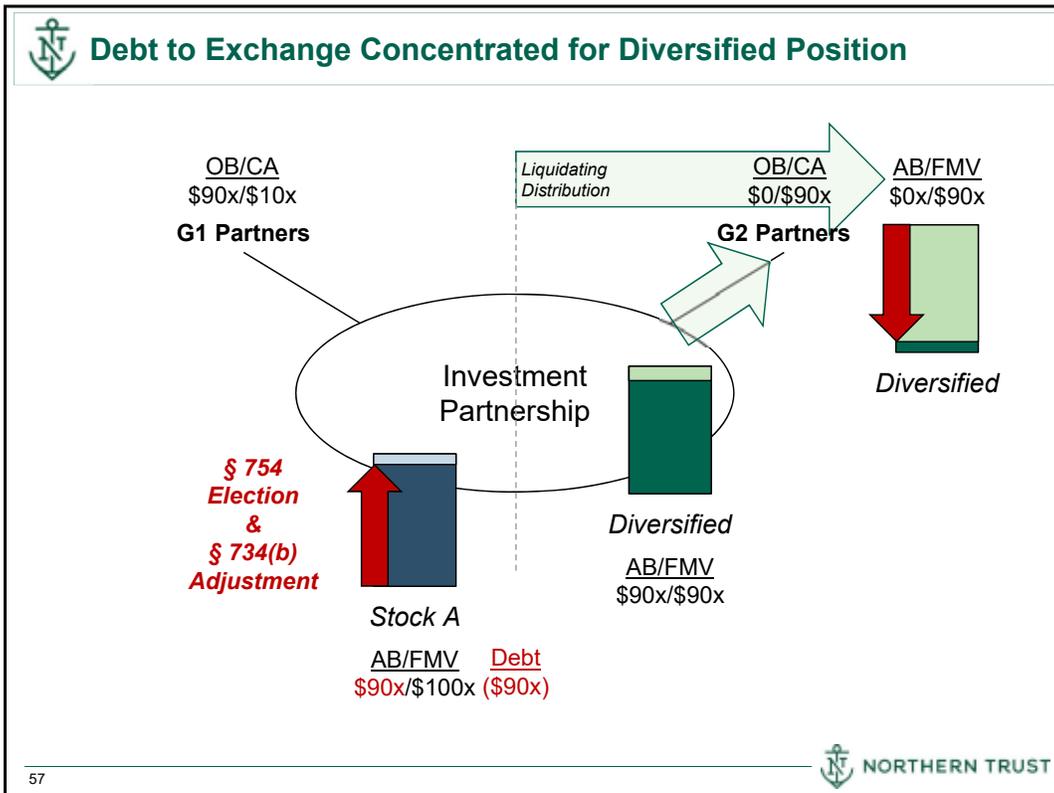
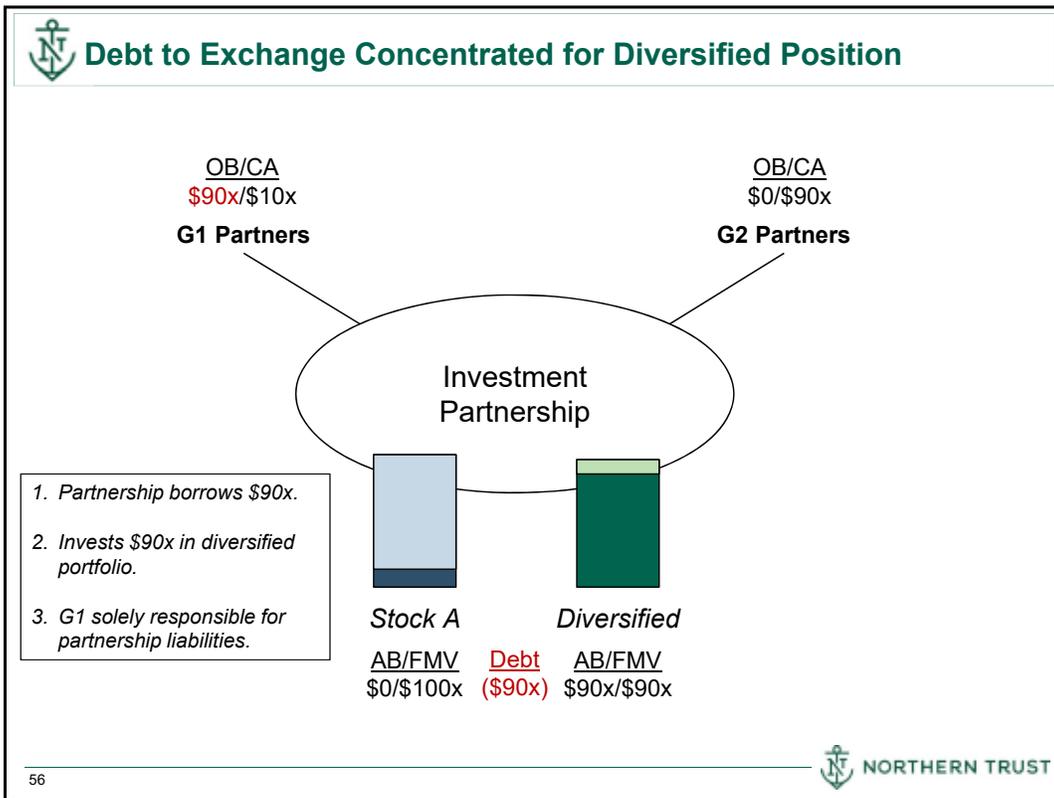
**Basis Shift From Diversified to Concentrated**



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## Debt to Exchange Concentrated for Diversified Position

**G1 Partners**

$\frac{OB/CA}{\$9x/\$10x}$

**Former G2 Partners**

$\frac{AB/FMV}{\$0x/\$90x}$

**Diversified**

**Investment Partnership**

**Stock A**

$\frac{AB/FMV}{\$9x/\$10x}$

1. Sells 90x of Stock A (\$81x of AB).
2. Recognizes \$9x of gain (+9x OB of G1=\$99x).
3. Repays \$90x to lender (-\$90x OB of G1=\$9x).

Isn't this just an exchange fund?

Can this be used with tangible personal property in lieu of a "like-kind" exchange?

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 <b>Build It Up... Back Down... Better?</b>		
	Current	BBB (H.R. 5376)
<b>Individuals, Trusts &amp; Estates</b>	<ul style="list-style-type: none"> <li>• Top rate of 37%</li> <li>• SALT deductions capped at \$10,000</li> </ul>	<ul style="list-style-type: none"> <li>• 5% surcharge on MAGI &gt;\$10 Mil./ \$200,000 T&amp;E</li> <li>• 3% surcharge on MAGI &gt;\$25 Mil./\$500,000 T&amp;E</li> <li>• § 642(c) deduction allowed in MAGI</li> <li>• State and local tax deduction cap increased to \$80,000</li> </ul>
<b>Corporate Taxes</b>	<ul style="list-style-type: none"> <li>• Top tax rate of 21%</li> </ul>	<ul style="list-style-type: none"> <li>• 15% (alternative minimum tax) on corporations with adjusted financial income &gt; \$1 billion</li> <li>• 1% tax on share repurchase of publicly-traded companies</li> </ul>
<b>Net Investment Income Tax</b>		<ul style="list-style-type: none"> <li>• NIIT on all passthrough business income of trusts, estates, and individuals with MAGI &gt;\$400,000</li> </ul>
<b>IRAs &amp; Qualified Plans</b>		<ul style="list-style-type: none"> <li>• Prohibition on Roth conversions with \$400/\$450K AGI--Eff. 1/1/32</li> <li>• Prohibition on Roth conversion from qualified plans, unless taxable</li> <li>• Prohibition of contributions to large qualified accounts (\$10 Mil.)-\$400/\$450K AGI</li> <li>• Mandatory distributions (50%) from mega-IRAs (\$10-\$20 Mil.) then 100% (\$20+)-\$400K/\$450K ATI</li> </ul>
<b>QSBS</b>	<ul style="list-style-type: none"> <li>• 50%, 75% &amp; 100% exclusion</li> </ul>	<ul style="list-style-type: none"> <li>• 100% &amp; 75% exclusion disallowed for individuals with AGI of \$400,000 or more and trusts &amp; estates on sales after <b>9/13/21</b></li> </ul>


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 <b>House Ways &amp; Means Committee Tax Proposal</b>		
	Current	Proposal (Eff. 1/1/22 unless noted)
<b>Individual Income Tax</b>	<ul style="list-style-type: none"> <li>• Top rate of 37%</li> <li>• SALT deductions capped at \$10,000</li> </ul>	<ul style="list-style-type: none"> <li>• Top rate of 39.6% (\$400,000 Single/\$450,000 Joint/\$12,500 T&amp;E)</li> <li>• No provision for SALT deductions</li> <li>• 3% surcharge on amounts of MAGI above (\$5 Mil. Single or Joint/\$100,000 T&amp;E)</li> </ul>
<b>Long-Term Capital Gains</b>	<ul style="list-style-type: none"> <li>• Top rate of 20%</li> <li>• 3.8% NIIT</li> </ul>	<ul style="list-style-type: none"> <li>• Top rate of 25%--<b>Eff. 9/13/21</b></li> <li>• Material participation exception for NIIT does not apply to high income (\$400K/\$500K MAGI) individual S corporation shareholders and partners, trusts &amp; estates</li> </ul>
<b>Transfer Tax</b>	<ul style="list-style-type: none"> <li>• Doubled base exclusion amount</li> <li>• 40% tax rate</li> <li>• \$1.19 Mil. (\$740K + Infl.) limit on special use valuation</li> </ul>	<ul style="list-style-type: none"> <li>• Doubling of base exclusion amount (and GST exemption) repealed</li> <li>• No rate changes</li> <li>• Increased to \$11.7 Mil. + Infl.</li> </ul>
<b>Valuation Discounts</b>	<ul style="list-style-type: none"> <li>• Marketability discounts allowed</li> </ul>	<ul style="list-style-type: none"> <li>• "Nonbusiness asset" (passive asset held for income and not used in the active conduct of a trade or business) in an entity will be treated as if transferred directly</li> <li>• <b>Eff. Date of Enactment</b></li> </ul>
<b>Corporate Tax</b>	<ul style="list-style-type: none"> <li>• Top tax rate of 21%</li> </ul>	<ul style="list-style-type: none"> <li>• Top tax rate of 26.5% (\$5 Mil.)-graduated rate benefit phases out above \$10 Mil.</li> </ul>
<b>Qualified Business Income Deduction</b>	<ul style="list-style-type: none"> <li>• 20% deduction on QBI of pass-thru entities (Exp. 12/31/25)</li> </ul>	<ul style="list-style-type: none"> <li>• Deduction capped (\$400,000 Single/\$500,000 Joint/\$10,000 T&amp;E)</li> </ul>
<b>QSBS</b>	<ul style="list-style-type: none"> <li>• 50%, 75% &amp; 100% exclusion</li> </ul>	<ul style="list-style-type: none"> <li>• 100% &amp; 75% exclusion disallowed for individuals with AGI of \$400,000 or more and trusts &amp; estates on sales after <b>9/13/21</b></li> </ul>
<b>IRAs Qualified Plans</b>		<ul style="list-style-type: none"> <li>• Prohibition on Roth conversions with \$400/\$450K AGI--<b>Eff. 1/1/32</b></li> <li>• Prohibition on Roth conversion from qualified plans, unless taxable ("backdoor")</li> <li>• Prohibition of contributions to large qualified accounts (\$10 Mil.)-\$400/\$450K AGI</li> <li>• Mandatory distributions (50%) from mega-IRAs (\$10-\$20 Mil.) then 100% (\$20+)-\$400K/\$450K ATI</li> <li>• Prohibition of investment in entities if owner has a substantial interest (50%/10%)</li> <li>• Prohibition on "accredited investor/qualified purchaser" investments</li> </ul>
<b>Other</b>	<ul style="list-style-type: none"> <li>• 3-year holding period under § 1061</li> <li>• Taxable conversion of S corporation</li> </ul>	<ul style="list-style-type: none"> <li>• 5-year holding period under § 1061-\$400K AGI (otherwise 3-year)</li> <li>• <b>5/13/96</b> S corporations can convert tax free to partnership until <b>12/31/23</b></li> </ul>


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 <b>The Grantor Trust Provisions</b>		
	Section 2901	Section 1062
<b>Provision</b>	<p><u>Assets of grantor trust of a deemed owner subject to:</u></p> <ul style="list-style-type: none"> <li>Estate tax upon <b>death</b> of deemed owner</li> <li>Gift tax on any <b>distribution</b> to beneficiary other than the deemed owner (and spouse)</li> <li>Gift tax on <b>conversion</b> to non-grantor trust</li> </ul> <p><u>Exception/Adjustment:</u></p> <ul style="list-style-type: none"> <li>Any trust <b>includible</b> in gross estate of deemed owner</li> <li><b>"Proper adjustment"</b> for amounts previously treated as taxable gifts</li> </ul> <p><u>Deemed owner defined:</u></p> <ul style="list-style-type: none"> <li>Any <b>person</b> treated as the owner of "a <b>portion</b> of a trust" under §§ 671-679</li> </ul>	<ul style="list-style-type: none"> <li>"In the case of <b>any transfer</b> of property between a <b>trust</b> and a <b>person</b> who is the <b>deemed owner</b> of the trust (or portion thereof), such treatment of the person as the <b>owner of the trust shall be disregarded</b> in determining whether the transfer is a <b>sale or exchange</b> for purposes of <b>this chapter.</b>"</li> <li>Exception for any trust that is <b>fully revocable</b> by the deemed owner</li> <li>Related party loss of § 267 amended to include transactions between grantor trust and <b>owner</b> under §§ 671-679</li> </ul>
<b>Effective Date/ Applicability</b>	<ul style="list-style-type: none"> <li>Trusts created on or after the <b>date of enactment</b></li> <li>Any portion of a trust established before the date of enactment which is attributable to a <b>contribution</b> made on or after such date</li> </ul>	
<b>Questions</b>	<ul style="list-style-type: none"> <li>Does "proper adjustment" include zeroed-out gifts? Does it include appreciation and income on the gift?</li> <li>Does this only apply to grantor ("with respect to which the <b>grantor</b> is the deemed owner")? § 678 deemed owners? \$5k or 5% powers?</li> <li>Would ILITs be subject to estate tax upon the death of insured? How would "proper adjustment" be calculated?</li> <li>What happens upon termination of the term of GRAT or grantor CLAT and assets go to another grantor or non-grantor trust? What happens when grantor passes away?</li> <li>SLATs are almost always grantor trusts, so distributions to descendants could be subject to gift tax?</li> <li>When do you determine when a trust is includible and otherwise excepted from this rule?</li> <li>Is a new trust created on a decanting?</li> </ul>	<ul style="list-style-type: none"> <li>If grandfathered IDGT and grantor do an installment sale after the effective date, is this transaction disregarded or is it considered a "contribution"?</li> <li>If grandfathered non-grantor trust is converted to a grantor trust, is § 1062 applicable?</li> <li>If grandfathered IDGT converts to non-grantor trust, is that considered a "contribution" after the effective date?</li> <li>Does "person" include LLCs that are disregarded entities?</li> <li>Is a sale or exchange-type transaction required to trigger recognition under § 1062? What about contributions and distributions with respect to LLCs or partnerships?</li> </ul>
<b>Planning</b>	<ul style="list-style-type: none"> <li>Establish and fund trusts (GRATs, SLATs, grantor or non-grantor, etc.) before the effective date</li> <li>Funding level can be small apparently (at least as currently written)</li> <li>Leveraging transactions (bona fide sales, loans, etc.) seem allowable after enactment (at least as currently written)</li> </ul>	

How defined?  
By whom?

 <b>Biden "Greenbook"</b>			
	Current	"Campaign Biden"	Biden "Greenbook"
<b>Individual Income Tax</b>	<ul style="list-style-type: none"> <li>Top rate of 37%.</li> <li>SALT deductions capped at \$10,000.</li> <li>Pease limitations repealed.</li> <li>Exp. 12/31/25</li> </ul>	<ul style="list-style-type: none"> <li>Top rate of 39.6%.</li> <li>Restore Pease limitations for income &gt;\$400,000</li> <li>Limit itemized deduction to 28% rate.</li> </ul>	<ul style="list-style-type: none"> <li>Top rate of 39.6% (+3.8%)</li> <li>After 12/31/2021</li> </ul>
<b>Long-Term Capital Gains</b>	<ul style="list-style-type: none"> <li>Top rate of 20%.</li> <li>3.8% NIIT.</li> <li>QOZ investments.</li> </ul>	<ul style="list-style-type: none"> <li>Tax long-term capital gains (and qualified dividends) at 39.6% for taxpayers with income &gt;\$1 million.</li> </ul>	<ul style="list-style-type: none"> <li>Tax long-term capital gains (and qualified dividends) at 39.6% (+3.8%) for taxpayers with AGI greater than \$1,000,000 (\$500,000 for spouses filing separately)</li> <li>Effective for gains "after the date of announcement"</li> </ul>
<b>"Step-Up" in Basis</b>	<ul style="list-style-type: none"> <li>IRC § 1014.</li> </ul>	<ul style="list-style-type: none"> <li>"Eliminate" the "step-up" in basis</li> </ul>	<ul style="list-style-type: none"> <li>Capital gain tax realization on transfers of appreciated property by gift and at death</li> </ul>
<b>Transfer Tax</b>	<ul style="list-style-type: none"> <li>40% tax rate</li> <li>Doubled applicable exclusion amount (exp. 12/31/25).</li> </ul>	<ul style="list-style-type: none"> <li>Restore "historical norms"</li> </ul>	
<b>Other Tax Provisions of Note</b>	<ul style="list-style-type: none"> <li>Corporate tax rate of 21%.</li> <li>20% deduction on Qualified Business Income of pass-thru entities (exp. 12/31/25).</li> </ul>	<ul style="list-style-type: none"> <li>Corporate tax rate of 28%</li> <li>15% minimum tax on "book income" of corporations that report &gt;\$100 million in the U.S. but pay zero federal income tax</li> <li>Phase out the QBI deduction for filers with taxable income &gt; \$400,000</li> <li>QBI deduction would not be available to real estate investors</li> </ul>	<ul style="list-style-type: none"> <li>Corporate tax rate of 28%</li> <li>15% minimum tax on "book tentative minimum tax" (BTMT) of corporations with such income in excess of \$2 billion</li> <li>NIIT or SECA on all pass-through business income of taxpayers with AGI &gt;\$400,000</li> <li>§ 1031 Like-Kind Exchange: Limited to \$500k per taxpayer, per year</li> <li>Carried Interest: ordinary income/Investment Services Partnership</li> <li>All effective after 12/31/2021</li> </ul>

 <b>The Game Changer</b>	
	<b>"Elimination" of the "Step-Up" in Basis</b>
<b>Proposal</b>	<ul style="list-style-type: none"> <li>• Transfers of appreciated property by gift or at death are recognition events</li> <li>• Effective Dates: Transfers after December 31, 2021, and property owned by trusts, partnerships, and other non-corporate entities on January 1, 2022</li> </ul>
<b>Exclusions</b>	<ul style="list-style-type: none"> <li>• Tangible personal property including household furnishings and personal effects (but not collectibles)</li> <li>• \$1,000,000 exclusion per person—Portable to surviving spouse &amp; indexed for inflation after 2022</li> <li>• \$250,000 exclusion on personal residences would be applicable</li> <li>• Transfers by a decedent (no mention of gifts) to a U.S. spouse or charity (carryover basis)</li> <li>• Transfers to grantor trusts "deemed wholly owned and revocable" by the donor</li> <li>• Transfers from revocable trusts to deemed owner or U.S. spouse (other than to discharge obligation of deemed owner)</li> </ul>
<b>Transfers</b>	<ul style="list-style-type: none"> <li>• Transfer is defined under gift and estate tax rules</li> <li>• Transfers of partial interest would be proportional share of fair market value of entire property (no valuation discounts)</li> </ul>
<b>Trusts Partnerships Non-Corporate Entities</b>	<ul style="list-style-type: none"> <li>• Transfers to and from trusts (other than revocable trusts), partnerships, and other non-corporate entities would be recognition events (no mention of disregarded entities)</li> <li>• All assets recognized in revocable trusts at death of grantor or whenever the trust becomes "irrevocable"</li> <li>• Transfers to split-interest charitable trusts are realization events with an exclusion for charitable portion</li> <li>• Gain recognized by a trust, partnerships, or other non-corporate entity on property that has not been the subject of a recognition event within the prior 90 years, starting January 1, 1940 (as early as December 31, 2030)</li> </ul>
<b>Payment of Tax</b>	<ul style="list-style-type: none"> <li>• Taxable income of the donor/decedent on gift or estate tax return or separate income tax return</li> <li>• Capital losses and carry-forwards allowed against gains</li> <li>• Taxes would be deductible on the decedent's estate tax return (no mention of gift tax return)</li> <li>• Tax on "certain family-owned and -operated businesses" would not be due until business is sold or ceases to be family-owned and operated</li> <li>• 15-year "fixed-rate payment plan" for transfers at death (not gifts), other than liquid assets and businesses for which the deferral election is made</li> </ul>
<b>Other Details</b>	<ul style="list-style-type: none"> <li>• Treasury given broad regulatory authority on implementation, including determining the basis of assets where complete records are unavailable and reporting requirements on transfers</li> <li>• Other legislation including deductions for appraisal costs, liens, waiver of penalty for underpayment of estimated tax, right of recovery, consistency in valuation for transfer and income tax purposes</li> </ul>


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 <b>Can You Feel the Bern? He's Bernin' for You!</b>	
	<b>Sanders &amp; Whitehouse: "For the 99.5 Percent Act"</b>
<b>Estate, Gift, GST Tax Exclusions &amp; Rates</b>	<ul style="list-style-type: none"> <li>• \$3.5 Mil. (not increased by inflation) for Estate Tax</li> <li>• \$1.0 Mil. for Gift Tax</li> <li>• Transfer Tax Rates                             <ul style="list-style-type: none"> <li>• 45% (Over \$3.5 Mil. to \$10.0 Mil.)</li> <li>• 50% (Over \$10.0 Mil. to \$50.0 Mil.)</li> <li>• 55% (Over \$50.0 Mil. to <b>\$1.0 Bil.</b>)</li> <li>• 65% (Over <b>\$1.0 Bil.</b>)</li> </ul> </li> </ul> <div style="text-align: right; border: 1px solid black; padding: 2px; display: inline-block;">Effective Date: 1/1/22</div>
<b>Valuation of Nonbusiness Assets &amp; Limitation on Minority Discounts</b>	<ul style="list-style-type: none"> <li>• "Nonbusiness asset" in an entity will be treated as transferred directly if interests in the entity are transferred. Defined as any asset not used in the active conduct of 1 or more trades or businesses. Does not include:                             <ul style="list-style-type: none"> <li>• Inventory or property held primarily to sales to customers</li> <li>• Depreciable property used in a trade or business or in the production of income</li> <li>• Real property in a real property trade or business in which the taxpayer materially participates</li> </ul> </li> <li>• On a transfer of any interest in an entity, no discount is allowed by reason of the fact the transferee does not have control of such entity if the transferor, transferee and members of the family have control of the entity or own a majority (by value) of the ownership interests in such entity.</li> </ul>
<b>Grantor Retained Annuity Trusts</b>	<ul style="list-style-type: none"> <li>• Term of at least 10 years and not more than 10 years plus life expectancy of the grantor</li> <li>• No decreasing annuities</li> <li>• Taxable gift equal to the greater of 25% or \$500k</li> </ul>
<b>Intentionally Defective Grantor Trusts</b>	<ul style="list-style-type: none"> <li>• <b>No basis adjustment under § 1014 unless assets included in grantor's gross estate.</b></li> <li>• Sale or exchange (or comparable transaction) with IDGT will cause the property subject to such transaction (including all income and appreciation) to be:                             <ul style="list-style-type: none"> <li>• Subject to estate taxes upon death of the deemed owner (grantor or beneficiary owner);</li> <li>• Subject to gift tax if grantor trust status terminated; or</li> <li>• Treated as a taxable gift if distributed to another beneficiary during grantor's life.</li> </ul> </li> <li>• Trusts subject to new law:                             <ul style="list-style-type: none"> <li>• Trusts created on or after date of enactment</li> <li>• Any portion of a trust created before enactment attributable to a <b>contribution</b> on or after the enactment date</li> <li>• Any trust created before enactment that has a <b>sale or exchange</b> on or after the enactment date</li> </ul> </li> </ul>
<b>Generation-Skipping Transfer Tax</b>	<ul style="list-style-type: none"> <li>• GST tax exemption on assets in trust limited to <b>50 years</b>.</li> <li>• GST exempt trusts created prior to enactment be exempt for no more than 50 years after the enactment date.</li> </ul>


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## STEP Right Up and Take Your Medicine

<b>Van Hollen: Sensible Taxation and Equity Promotion Act (Discussion Draft)</b>	
<b>Realization at death (No “Step-Up” in Basis)</b>	<ul style="list-style-type: none"> <li>• Property treated as sold for its fair market value when transferred by gift, bequest, or to a non-grantor trust.</li> <li>• \$1 mil. (adjusted for inflation) exclusion for individuals.</li> <li>• \$100,000 exclusion can be used for gifts each year, reducing total \$1 mil. exclusion.</li> </ul>
<b>Grantor Trust</b>	<ul style="list-style-type: none"> <li>• Not treated as sold when assets are transferred to a grantor trust.</li> <li>• Treated as sold when:                             <ul style="list-style-type: none"> <li>• Assets are distributed to another person other than the grantor.</li> <li>• Grantor trust status is terminated.</li> </ul> </li> <li>• Property transferred to or held by a grantor trust will be treated as sold if the property would not be included in the grantor’s estate for estate tax purposes.</li> </ul>
<b>Non-Grantor Trusts</b>	<ul style="list-style-type: none"> <li>• Property held by a non-grantor trust will be treated as sold for its fair market value every <b>21 years</b>.</li> <li>• Trusts created prior to <b>December 31, 2006</b>, will have deemed realization event in 2026.</li> </ul>
<b>Special Rules</b>	<ul style="list-style-type: none"> <li>• Exceptions for:                             <ul style="list-style-type: none"> <li>• Tangible personal property (other than collectibles) not held in connection with a trade or business or for investment under § 212.</li> <li>• Transfers to spouses (only U.S. persons) or to marital deduction trusts, but realization occurs upon disposition of the property or death of spouse.</li> <li>• Transfers to charity.</li> </ul> </li> <li>• Related party disallowance of loss rules under § 267 would apply for gifts <b>but not at death</b>.</li> <li>• Capital gain tax recognized are deductible for estate tax purposes.</li> </ul>
<b>Extension of Time to Pay Resulting Tax</b>	<ul style="list-style-type: none"> <li>• 15-Year Period                             <ul style="list-style-type: none"> <li>• Realizations at death.</li> <li>• Non-grantor trusts subject to 21-year rule.</li> </ul> </li> <li>• Interest                             <ul style="list-style-type: none"> <li>• Interest only for up to 5 years.</li> <li>• Tax liability and interest for up to 10 years in annual installments.</li> </ul> </li> </ul>

## Chapter 6

# Mandatory Abuse Reporting and Ethics for Oregon Lawyers

**NIK CHOUREY**  
Oregon State Bar  
Tigard, Oregon

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# Mandatory Abuse Reporting & Ethics for Oregon Lawyers

## 22nd Annual Oregon Tax Institute

NIK T. CHOUREY

DEPUTY GENERAL COUNSEL  
OREGON STATE BAR

## General Counsel's Office: Our Connection

- ▶ **Why is bar counsel here to talk about Reporting?**
- ▶ Because GCO's legal ethics guidance to membership keeps me closely in the loop on lawyers' concerns.

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## Oregon Statutory Abuse Reporters [summarized and condensed]

- ▶ Medical Professionals
- ▶ Audiologists and Therapists
- ▶ Police Officers, Firefighters, EMTs
- ▶ School and College Employees
- ▶ Health and Human Services Workers
- ▶ Care Providers and Legal Custodians
- ▶ Clergy and Mental Health Professionals
- ▶ Physical, Speech and Occupational Therapists
- ▶ Members of the Legislative Assembly
- ▶ Attorneys

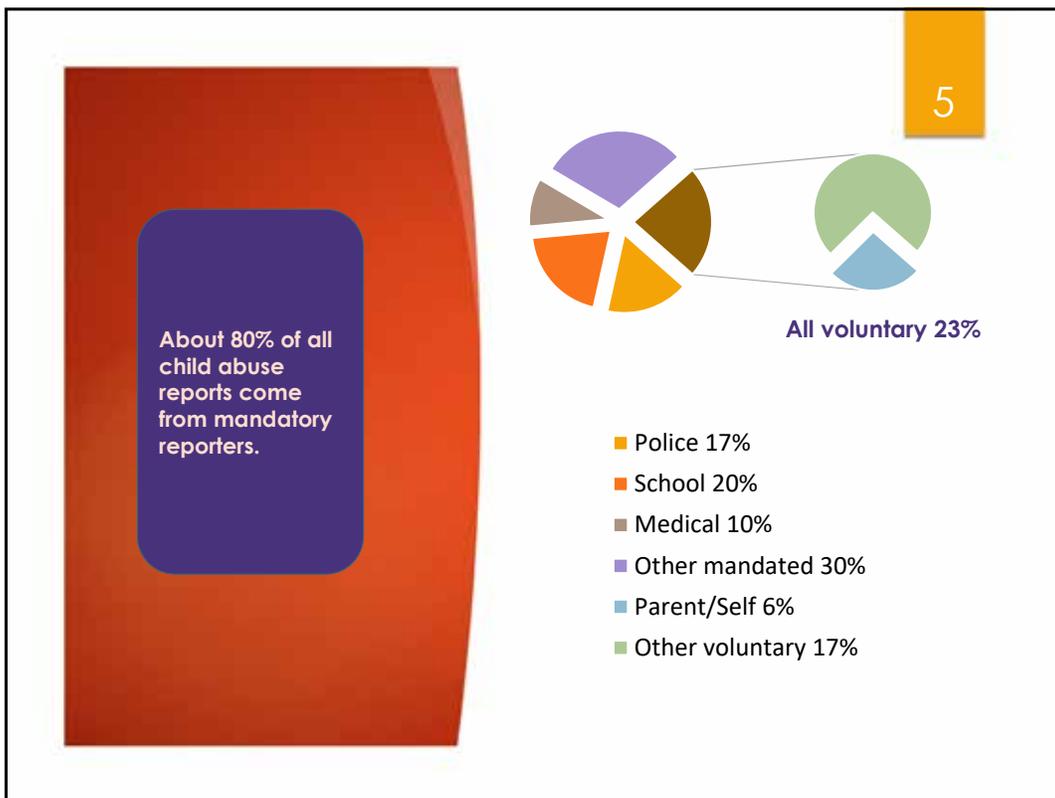
4

## Legislative Purpose [example: elder abuse reporting]

“The Legislative Assembly finds that for the purpose of **preventing abuse, safeguarding and enhancing the welfare of elderly persons**, it is necessary and in the **public interest to require mandatory reports** and investigations of allegedly abused elderly persons.”

ORS 124.055





6

### Attorneys' Abuse Reporting Duties

- ELDERS [ORS 124.060]**
- CHILDREN [ORS 419B.010]**
- MENTAL ILLNESS/ DEVELOPMENTAL DISABILITY [ORS 430.765]**
- LONG-TERM CARE RESIDENT [ORS 441.640]**

## Our Abuse Reporting Duty

7

You **must** report abuse if you have:

- ☎ **Contact** with an abuser or a victim, and
- ☎ **Reasonable cause** to believe that
- ☎ A **protected person**
- ☎ Has Been **abused**,

➡ UNLESS an exception applies.

This duty exists 24 hours a day, 7 days a week!

Following an employer's policy is not enough!

## Core Legal Ethics Considerations

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- ▶ RPC 2.1 & RPC 1.6
- ▶ **RULE 2.1 ADVISOR** In representing a client, **a lawyer shall exercise independent professional judgment** and render candid advice. In rendering advice, a lawyer may refer not only to law but to other **considerations such as moral, economic, social and political factors, that may be relevant to the client's situation.**

9

## How to Report

- ☎ Immediately = without delay
- ☎ To DHS or law enforcement
- ☎ Oral report required
- ☎ Give as much information as possible
- ☎ Explain allegation of abuse

**Reporting Hotline:**

**1-855-503-SAFE**

or call DHS Branch Offices

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## Report Should Include ...

- ▶ Names and addresses
- ▶ Nature and extent of the abuse
- ▶ Explanation given for the abuse
- ▶ Cause of abuse and identity of perpetrator.

## CHILD ABUSE REPORTING

11



## The Battered Child Syndrome

12

- ▶ C. H. Kempe, Frederic N. Silverman, Brandt F. Steele, William Droegemuller & Henry K. Silver, *The Battered Child Syndrome*, 181 J Am Med Ass'n 17 (1962).

Foundation  
of child  
abuse as a  
diagnosis.

Also called  
Tardieu's syndrome;  
Caffey-Kempe  
syndrome.

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- Alcoholism and Alcohol Abuse
- Chronic Obstructive Pulmonary Disease (COPD)
- Depression
- Fetal Death
- Health-related Quality of Life
- Illicit Drug Use
- Ischemic Heart Disease (IHD)
- Liver Disease
- Risk for Intimate Partner Violence
- Multiple Sexual Partners
- Sexually Transmitted Diseases (STDs)
- Smoking
- Suicide Attempts
- Unintended Pregnancies
- Early Initiation of Smoking
- Early Initiation of Sexual Activity
- Adolescent Pregnancy
- Psychotropic Medications Prescribed

14

## What is Contact?

- A touching or meeting; association or relationship
- Need not be to be linked to abuse BUT there must be physical or associational contact
- Receiving information in a public meeting about someone is not sufficient (AG opinion)
- Telephone or email contact?
- Can be before or after the abuse or the disclosure



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## What is Reasonable Cause?

- ▶ Any reasonable suspicion of abuse should be reported.
- ▶ Reasonable suspicion is more than a hunch.
- ▶ It requires an ability to point to articulable facts based on the totality of the circumstances.
- ▶ Your obligation to report does not depend upon whether abuse actually occurred

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## Let the Experts Decide

- ▶ You do not need to investigate
- ▶ OK to comment on injury or situation and observe
- ▶ Your job is not to determine whether abuse occurred.
- ▶ Do you have a reasonable suspicion of abuse?
- ▶ Consider making a voluntary report (assuming no confidentiality issue).
- ▶ If the explanation does not suit the injury, make a report.

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## Child Abuse Defined—ORS 419B.005

- ▶ Any assault; any injury not caused by accident; any injury at variance with the explanation given for it.
- ▶ Any mental injury caused by cruelty
- ▶ Rape, sexual abuse, or sexual exploitation
- ▶ Neglect
- ▶ Child selling
- ▶ Presence where methamphetamines are manufactured
- ▶ Unlawful exposure to controlled substance w/risk of harm
- ▶ Threat of harm
- ▶ No abuse exception for “reasonable discipline” if results in above

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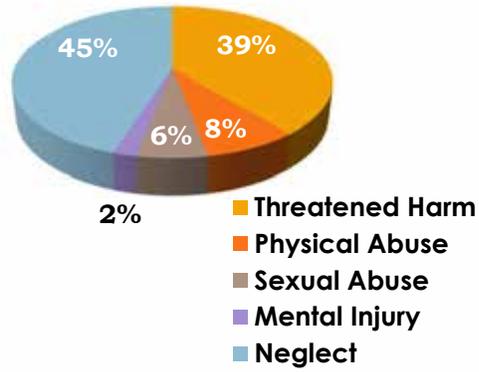
## Warning Signs of Child Abuse

- ▶ Unexplained injury or one that doesn't fit the explanation given for it
- ▶ Injuries in various stages of healing
- ▶ Multiple bruises or bruises on soft tissue; any bruise on a baby
- ▶ Child wary of parents or adults generally.
- ▶ Fatigue, listlessness, constant hunger
- ▶ Unusual sexual knowledge
- ▶ Inappropriately adult or infantile



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## Types of Child Abuse Reported



20

## ELDER ABUSE REPORTING



21

## Where does elder abuse occur?



- 66% at home
- 34% care facility

22

## Elder Abuse: The Case of Brooke Astor

- ▶ **Philanthropist**
- ▶ **Writer**
- ▶ **NYC Socialite**
- ▶ **Widow of Vincent Astor**
- ▶ **\$200 million estate**



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## The Brooke Astor Story

- ▶ Mrs. Astor was diagnosed with Alzheimer's and anemia
- ▶ Anthony "Tony" Marshall, her only son, was tasked with her care
- ▶ Anthony earned \$450,000/yr to take care of her portfolio



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## Brooke Astor: Reasonable Cause?

- ▶ Phillip Marshall, Mrs. Astor's grandson, sought a change in guardianship
- ▶ Phillip alleged that despite her great wealth Mrs. Astor was living in squalor and his father Anthony had reduced her necessary medication and doctor's visits



Francis X. Morrissey, Jr.  
John Marshall, Manila for the New  
York Times

25

## Elder Abuse Defined—ORS 124.050(1)

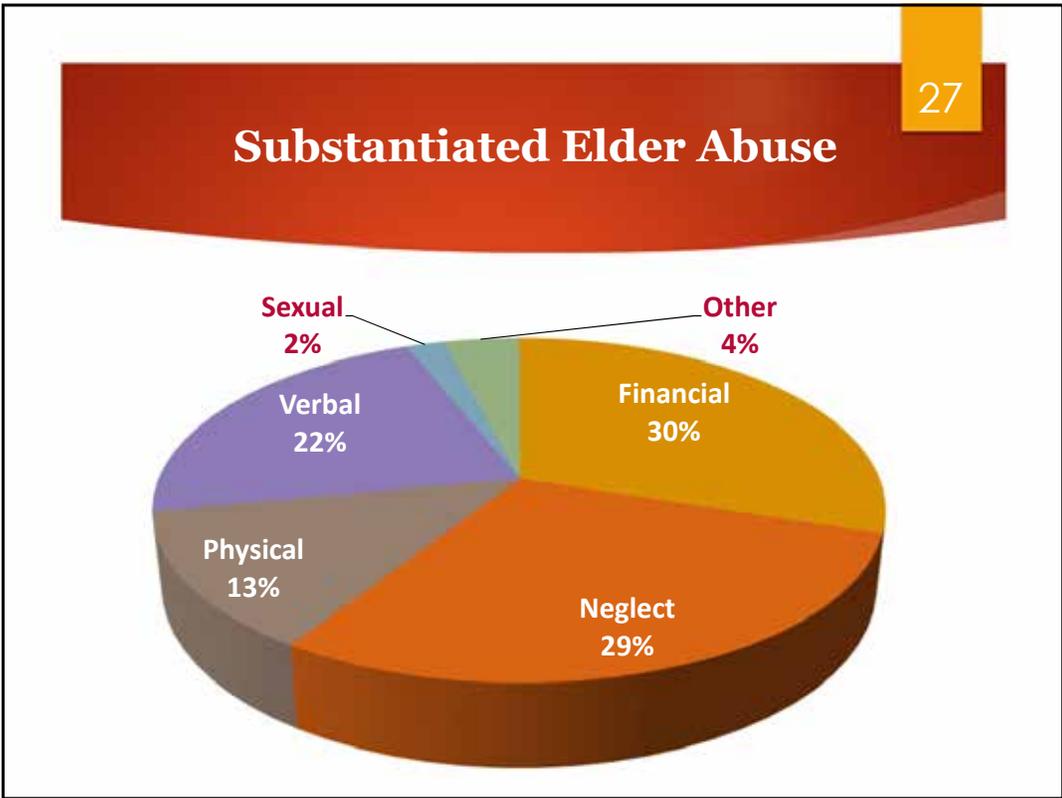
- ▶ Financial Exploitation
- ▶ Abandonment or Neglect
- ▶ Verbal Abuse
- ▶ Willful infliction of physical pain or injury
- ▶ Any injury not caused by accident; any injury at variance with the explanation given for it.
- ▶ Sex Abuse
- ▶ Seclusion or Restraint

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## Warning Signs of Elder Abuse

- ▶ Unexplained injury or one that doesn't fit the explanation given for it
- ▶ Elder not permitted to speak for themselves or without the presence of others.
- ▶ Being extremely withdrawn and non-communicative or non-responsive.
- ▶ Unpaid bills, overdue rent, utility shut-off notices





### 28

## The Brooke Astor Story: Consequences for Perpetrators

- ▶ **The jury convicted Anthony Marshall of one charge of grand larceny and Francis X. Morrissey Jr. of forgery.**
- ▶ **Both were sentenced to 1-3 years in prison.**
- ▶ **On February 10, 2010, Francis X. Morrissey Jr. was disbarred**



29

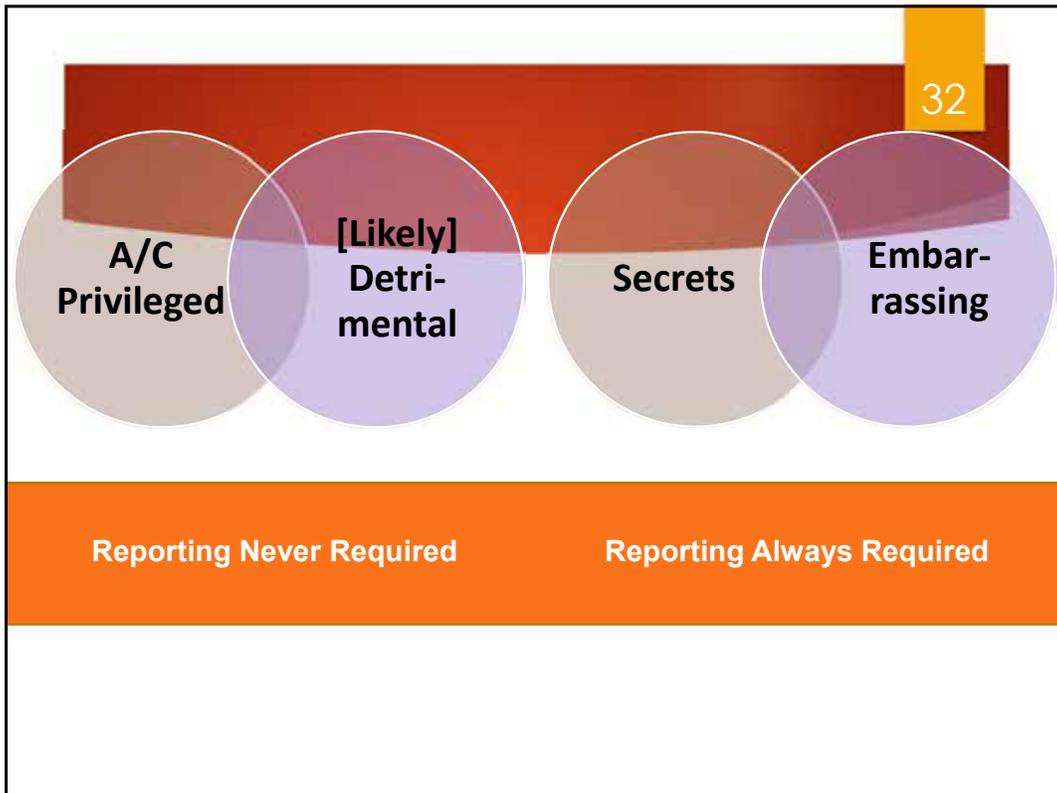
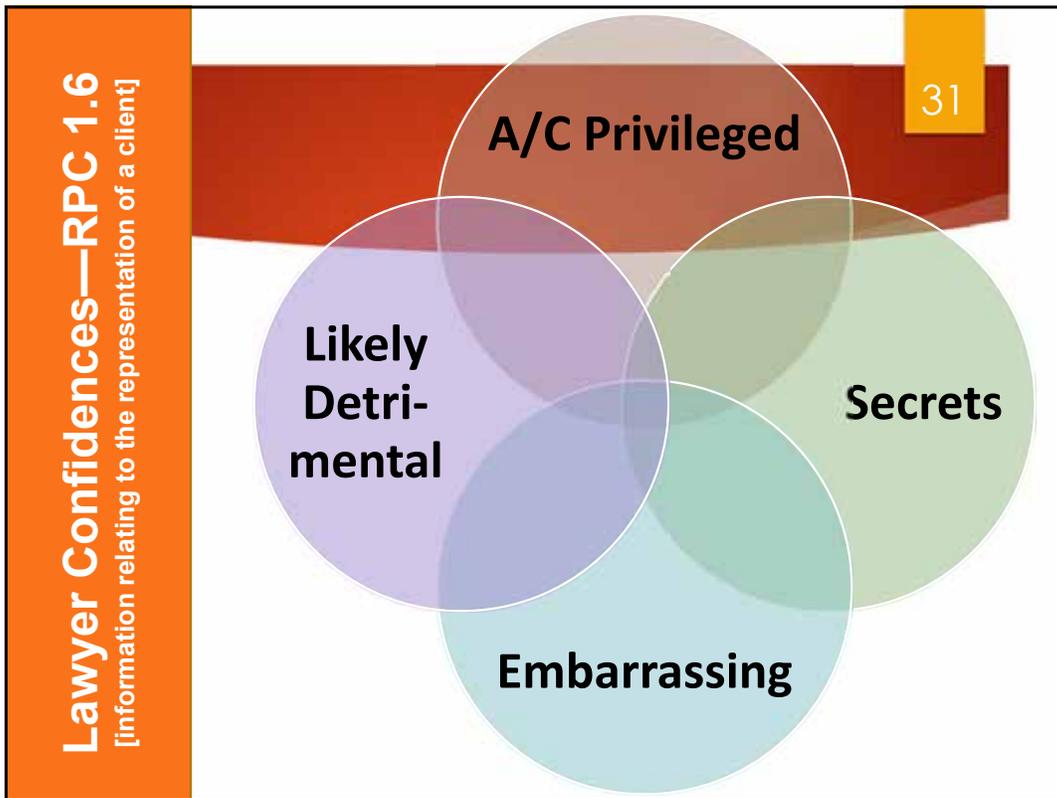
## EXCEPTIONS TO REPORTING

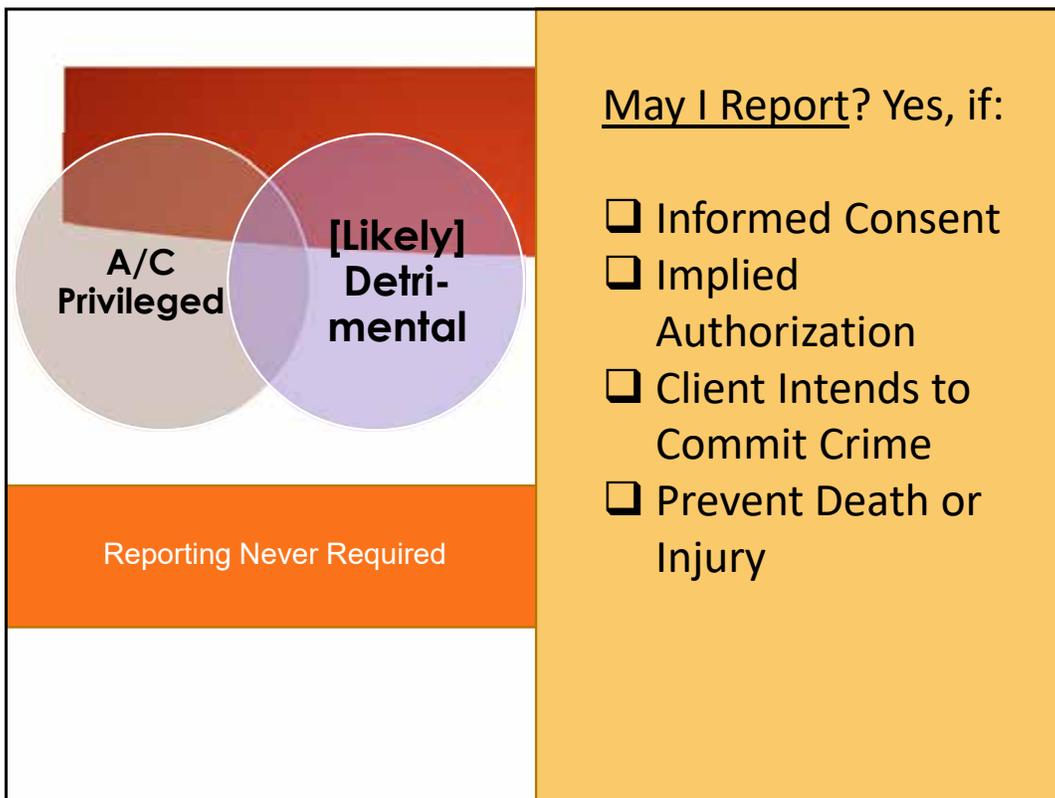


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## Exception: Certain Client Confidences

- 
- ▶ **Attorney-Client Privileged** under ORS 40.225 (OEC 503)
  - ▶ **Information communicated during representation that is *detrimental* to client if disclosed (reconciles RPC 1.6 duty)**





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**HYPOS**

- ▶ **Lawyer representing person charged with child abuse who admits past acts**
- ▶ **Lawyer representing person charged with child abuse who expresses intention to “pay back” child for speaking with prosecutor**

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## **HYPOS**

- ▶ **Lawyer representing wife in divorce is told by wife of physical abuse by husband of their child while meeting in a crowded restaurant. Lawyer has met the husband.**
- ▶ **Lawyer representing court-appointed guardian of elderly person suspects guardian is neglecting elderly person based upon interaction with protected person**

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## **Exception: “Reasonable Discipline” [of a child!]**

- ▶ **“Abuse” does not include reasonable discipline unless the discipline results in one of the conditions [specifically defined to constitute abuse].” ORS 419B.005(1)(b).**

### **Exception: Duplicative Reports** **[child abuse only]**

37

- ▶ **Report already made**  
**OR**
- ▶ **Proceeding already pending**  
**AND**
- ▶ **Reasonable belief the information is already known**

### **Exception: Spiritual Treatment** **[for an elder!]**

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- ▶ **Voluntary**
- ▶ **Through prayer**
- ▶ **Recognized church**
- ▶ **Duly accredited practitioner**
- ▶ **Reconciles “neglect” as not abuse**

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## Pandemic Reporting

### Isolation Impacts Reporting

- ▶ Public health emergencies increase risk for child abuse and neglect because of increased stressors and loss of financial and social supports.

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**Nik T. Chourey**  
**Deputy General Counsel**  
**Oregon State Bar**  
**503.431.6363**  
**[nchourey@osbar.org](mailto:nchourey@osbar.org)**

Oregon State Bar



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QUESTIONS AND ANSWERS ABOUT  
MANDATORY ABUSE REPORTING FOR LAWYERS

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Oregon State Bar General Counsel's Office

**Question 1: What Is Mandatory Abuse Reporting?**

Four Oregon statutory schemes require certain “public and private officials” present in the state, including lawyers, to report the abuse of persons to public authorities under certain circumstances. *See* ORS 124.060 (elder abuse); ORS 419B.010 (child abuse); ORS 430.765 (person with mental illness or developmental disability); ORS 441.640 (resident of long-term care facility). Only the first two have educational requirements for lawyers. The latter two function similarly to the first two, but practitioners should note that a lawyer’s duty to report under ORS 441.640 is limited to a lawyer representing the resident or their guardian or family member. *See* ORS 441.630(6)(i).

**Question 2: Why Require Mandatory Reports?**

Oregon is in the midst of a demographic shift. As baby boomers age, our population as a whole is aging. Each year, over 50,000 Oregonians turn 65 years old. The median age of Oregon’s population was 30.3 in 1980, but is forecast to rise to 39.7 by 2020. With advancing age come declining health and greater reliance on family members, caregivers and social services. And elder abuse is a significant problem. In 2014, DHS investigated and substantiated over 2,500 instances of elder abuse in Oregon. Nationally, one in ten elders living at home is subject to abuse, neglect, or exploitation. Abuse reporting helps the legislature assess the need for increased social services as the population ages.

At the same time, child abuse remains alarmingly prevalent. The field has undergone a sea change since child abuse was explicated as a medical diagnosis in the 1960s. Scientists now know that child abuse exacts a toll over the rest of a child’s lifetime, causing many abused children to adopt risky coping behaviors as adults and to develop related health problems. The

child abuse reporting statute expresses the state’s policy that all citizens have a responsibility to prevent such abuse and to protect children from harm. The statute encourages voluntary reporting in situations in which reporting is not required. Mandatory reporters are a critical link in the state’s system of child protection, accounting for about three-quarters of the child abuse reports received by Oregon authorities.

**Question 3: What Are Lawyers Required To Do?**

Lawyers are included in the definitions of “public or private officials” who have duties under Oregon law to report both child abuse and elder abuse. ORS 124.050(9); ORS 419B.005(5). Many others are also included. *Id.* Similar laws exist in every state, and a lawyer traveling to another state should consider whether that state’s law applies to them when present in the state. It appears that Oregon’s law applies to any licensed attorney present in the state, not just members of the Oregon State Bar.

Abuse reporting is a 24-hour-per-day, seven-days-per-week responsibility. It is not limited just to information acquired in your professional practice. Reporting is required whenever a mandatory reporter has “contact” with an abuser or a victim and has “reasonable cause” to believe that abuse has occurred. ORS 124.060; ORS 419B.010(1). Voluntary reports are encouraged where possible but are not required. ORS 419B.007; OAR 411-020-0020(2).

The duty to report child abuse is personal to the mandatory reporter. *See* ORS 419B.010(4). A mandatory reporter is required to report even if his or her employer has internal policies or procedures for addressing reports of child abuse. Failure to report as required by the statute is a Class A violation. ORS 124.990; ORS 419B.010(5). The penalty for a Class A violation is a maximum fine of \$2,000. ORS 153.018(2)(a).

Oregon Rule of Professional Conduct (RPC) 1.6(a) prohibits a lawyer from revealing information relating to the representation of a client. RPC 1.6(b)(5) permits, but does not require, a lawyer to disclose information relating to the representation of a client when required by law. A lawyer may report abuse as required by law without violating the lawyer’s ethical duty of confidentiality to a client.

Note that when one of the exceptions to reporting applies (Question 8, below), the abuse reporting laws do not require reporting, and therefore would not permit a lawyer to disclose information protected by RPC 1.6. In addition, RPC 1.6(b)(5) permits disclosure only to the extent required by law; it does not give a lawyer permission to reveal information that the law does not require to be reported.

**Question 4: What Is “Reasonable Cause?”**

There are no reported cases applying or interpreting this term specifically in connection with the abuse reporting statutes. The Department of Human Services interprets “reasonable cause” in related statutes as being equivalent to “reasonable suspicion.” *A.F. v. Dep’t of Human Res. ex rel. Child Protective Servs. Div.*, 251 Or App 576, 590, 98 P3d 1127 (2012); *Berger v. State Office for Services to Children and Families*, 195 Or App 587, 590, 98 P3d 1127 (2004). In that context, “[r]easonable suspicion’ means a reasonable belief given all of the circumstances, based upon specific and describable facts, that the suspicious physical injury may be the result of abuse.” The agency rule further explains:

“The belief must be subjectively and objectively reasonable. In other words, the person subjectively believes that the injury may be the result of abuse, and the belief is objectively reasonable considering all of the circumstances. The circumstances that may give rise to a reasonable belief may include, but not be limited to, observations, interviews, experience, and training. The fact that there are possible non-abuse explanations for the injury does not negate reasonable suspicion.”

OAR 413-015-0115(37). Similarly, “reasonable suspicion” for an officer to stop an individual in the criminal law context is defined as “a belief that is reasonable under the totality of the circumstances existing at the time and place the peace officer acts.” ORS 131.605(5). The standard is an “objective test of observable facts” and requires the officer “to point to specific articulable facts that give rise to a reasonable inference that a person has committed a crime.” *State v. Ehly*, 317 Or 66, 80, 854 P2d 421 (1993).

By contrast, the standard of “probable cause” for arrest in the criminal law context is a higher standard than that of “reasonable suspicion.” “Probable cause” is defined by ORS 131.005(11) as a “substantial objective basis for believing that more likely than not an offense has been committed and a person to be arrested has committed it.” In *State v. Childers*, 13 Or App 622, 511 P2d 447 (1973), the court held that a police officer did not have probable cause to make a warrantless search for marijuana since he was uncertain whether he had smelled it. The court cited the probable cause standard as the existence of circumstances that would lead a reasonably prudent person to believe that an event had occurred, and distinguished it from “mere suspicion or belief ... .” *Id.* at 629.

Interpreting “reasonable cause” in the context of obtaining a subpoena for bank records under ORS 192.565(6), the court in *State v. McKee*, 89 Or App 94, 99, 747 P3d 395 (1987), held that a showing of reasonable cause required a recital of known facts, not mere conclusory statements. In another case, a merchant was found to have reasonable cause to detain a suspected shoplifter when the merchant saw the person leaving the store with unpaid-for merchandise partially concealed in a pocket. *Delp v. Zapp’s Drug & Variety Stores*, 238 Or 538, 395 P2d 137 (1964).<sup>1</sup>

A potential “floor” for “reasonable cause” is found in ORS 124.075 and ORS 419B.025, which provide immunity to abuse reporters for criminal and civil liability. In order to qualify for immunity, the reporter must “participat[e] in good faith” in the reporting process, and have “reasonable grounds” for the making of the report. Outside the client representation context, attorneys are well advised to use this standard for determining when to make a report of potential abuse.

#### **Question 5: What Is “Comes In Contact?”**

“Comes in contact” is a more unfamiliar phrase that is also not defined in the statutes or case law. A dictionary definition of “contact” includes “a touching or meeting” and “association or relationship” (as in physical or mental or business or social meeting or communication).

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<sup>1</sup>The statute applied in *Delp*, which allowed merchants to detain suspected shoplifters, has since been amended to require “probable cause” as opposed to “reasonable cause.” See ORS 131.655(1).

Webster’s Third New International Dictionary 490 (unabridged ed 1993). That definition, and common usage, suggest that a lawyer is required to report elder abuse only when the lawyer has had some kind of physical or associational contact with a person who has abused an elder or with an elder who has been abused. This does not necessarily mean “in person” contact; telephone or even email or written contact would likely suffice.

The “comes in contact” requirement does not appear to modify the “reasonable cause” requirement. In other words, the statute does not appear to require reporting only when the lawyer learns of the abuse directly from the victim or the abuser. Reliable second- or third-hand information may provide reasonable cause to believe that abuse has occurred; reporting would then be required if the lawyer had come in contact with either the abuser or the victim. For example, if a neighbor tells a lawyer that she heard from another neighbor that an elder living down the street (with whom the lawyer has occasional contact) appears to have been abused, the lawyer may have reasonable cause to believe that abuse occurred if the lawyer believes the neighbors are reliable sources of information.

It is sometimes suggested, under a broad reading of the statute and its purpose, that “contact” includes knowledge of abuse even without any physical or associational contact with the victim or the abuser. The Attorney General does not interpret the statute so broadly, opining in another context that “physicians, psychologists and social workers who serve as members of the board of directors of a self-help child abuse prevention organization, but who do not provide direct services, are not required to report suspected child abuse when they acquire that information indirectly in their official capacities as board members.” Attorney General Letter of Advice to Sen Margie Hendriksen (OP-5543) (June 12, 1984). The basis for the opinion lies primarily in the fact that the list of mandatory reporters in Oregon consists of professionals and service providers who are most likely to come into direct contact with victims or perpetrators of child abuse. “We believe that if the drafters of [the statute] had intended to impose a mandatory reporting duty, violation of which is punishable by a substantial fine ... , upon persons who merely have knowledge about child abuse, from whatever source, they would have said so clearly.” *Id.*

**Question 6: What Is Elder Abuse?**

The elder abuse reporting statute identifies the types of conduct that constitute elder abuse:

- Infliction of Pain or Physical Injury: Pain or injury caused by other than accidental means or apparently inconsistent with the explanation given for it. According to regulation, this includes force-feeding and all physical punishments. OAR 411-020-0002(a)(B)(ii). Physical abuse is presumed to injure and inflict pain upon someone who is non-responsive. See OAR 411-020-0002(a)(C).
- Abandonment or Neglect: This includes desertion as well as withholding caretaking responsibilities.
- Sex Abuse: Commission of a crime enumerated in the statute, including both public and private indecency.
- Verbal Abuse: Threatening physical or emotional harm by words or gestures. Again, it does not matter whether the victim can comprehend.
- Financial Exploitation: Defined in ORS 124.050(4). Wrongful taking of an elder's property; a threat of taking that causes alarm to an elder; stealing or transferring account funds without authorization (even if jointly held); failing to use the elder's resources effectively for their support.
- Involuntary Seclusion: For convenience or discipline.
- Wrongful Use of Physical or Chemical Restraints: Authorized medical or legal uses are excluded.

ORS 124.050(1).

DHS has published a summary of the warning signs of abuse at <http://www.oregon.gov/DHS/SENIORS-DISABILITIES/ADULT-ABUSE/Pages/signs.aspx>. That said, lawyers, like many mandatory reporters, may not be experts in identifying abuse, and they are not expected to be. The law does not require lawyers to conduct investigations into suspected abuse, but lawyers should make reasonable inquiries where possible to follow up on initial observations or information that appears to involve elder abuse, to ensure that they have

“reasonable cause” to believe that abuse has occurred. The intent of the statute is to get at-risk seniors into a regulatory system where the circumstances will be evaluated and, as necessary, addressed by qualified professionals. Hence, the standard for reporting is only “reasonable cause,” not “certainty.”

**Question 7: How Is A Lawyer Expected To Identify Child Abuse?**

The child abuse reporting statute likewise identifies the types of conduct that constitute child abuse:

- Criminal assault or any physical injury to a child caused by other than accidental means, including any injury at variance with the explanation given for it.
- Any observable and substantial mental injury caused by cruelty to a child.
- Rape or sexual abuse—commission of a crime enumerated in the statute.
- Sexual exploitation, including any use of a child in a live or recorded erotic performance, or allowing a child to participate in an act of prostitution.
- Negligent treatment or maltreatment of a child.
- Threatened harm to a child.
- Buying or selling a child.
- Permitting a child to enter or remain in a place where methamphetamines are being manufactured.
- Unlawful exposure to a controlled substance that subjects a child to a substantial risk of harm.

ORS 419B.005(1)(a). “Abuse” does not include reasonable discipline unless the discipline results in one of the conditions listed above. ORS 419B.005(1)(b).<sup>2</sup>

Lawyers, like many mandatory reporters, may not be experts in identifying child abuse and are not expected to be. The intent of the statute is to get at-risk children into a system where the circumstances will be evaluated and, as necessary, addressed by qualified professionals. The standard for reporting is only “reasonable cause,” not “certainty.” Abuse that

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<sup>2</sup> For all intents and purposes, the statute is referring to spanking that does not leave a mark or injury of any kind. More extreme or “creative” punishments often constitute abuse.

leaves physical marks is relatively easy to recognize. Some forms of neglect are also visible, such as malnutrition or young children left unattended. Other kinds of child abuse, such as mental injury, may be more difficult to detect, particularly where contact with the child is limited. The mandatory reporting law does not require lawyers to conduct investigations into suspected child abuse, but lawyers should make reasonable inquiry where possible to follow up on initial observations or information that appears to involve child abuse to ensure that they have “reasonable cause” to believe that abuse has occurred.

The Oregon Department of Human Services publishes a booklet entitled *What You Can Do About Child Abuse* that lawyers may find helpful. It is available on-line at <http://dhsforms.hr.state.or.us/Forms/Served/DE9061.pdf>. DHS will also answer questions and consult about whether a situation should be reported.

**Question 8: Are There Any Exceptions To The Reporting Requirement?**

There are three exceptions to each statutory reporting requirement. Two of them are the same in child and elder abuse contexts. The third one is different. The first two:

- Lawyers are not required to report information communicated by a person if the communication is privileged. In addition to the evidence code, the child abuse reporting statute protects as well communications that are privileged under ORS 419B.234(6).
- A lawyer is also not required to report abuse based on information communicated to the lawyer “in the course of representing a client, if disclosure of the information would be detrimental to the client.” Note that this language captures part, but not all, of the information protected by RPC 1.6 on client confidences.

Next:

- No official is required to report *child* abuse if the information about the abuse is acquired “by reason of a report” or “by reason of a proceeding arising out of a report” already made under the abuse reporting statute, if the official “reasonably believes that the information is already known by a law enforcement agency or the Department of Human Services.” ORS 419B.010(2) (emphasis added).

And finally:

- “An *elderly* person who in good faith is voluntarily under treatment solely by spiritual means through prayer in accordance with the tenets and practices of a recognized church or religious denomination by a duly accredited practitioner thereof shall, for this reason alone, not be considered subjected to abuse by reason of neglect ... .”

ORS 124.095 (emphasis added).

A. Privileged Communications.

The first exception relates to statutory privileges. Lawyers are not required to report information that is “privileged under ORS 40.225 to 40.295.” ORS 40.225 is OEC 503, the lawyer-client privilege.<sup>3</sup> The reference, however, encompasses thirteen other privileges: psychotherapist-patient (OEC 504), physician-patient (OEC 504-1), nurse-patient (OEC 504-2), school employee-student (OEC 504-3), clinical social worker-client (OEC 504-4), husband-wife (OEC 505), clergy-penitent (OEC 506), counselor-client (OEC 507), stenographer-employer (508A), public officer (OEC 509), disabled person-sign language interpreter (OEC 509-1), non-English speaking person-interpreter (OEC 509-2), and informer (OEC 510).<sup>4</sup>

B. Information Detrimental to Client if Disclosed.

The second exception to mandatory reporting applies only to lawyers, and tracks to some extent a lawyer’s ethical obligation to protect confidential client information. Lawyers are prohibited by RPC 1.6(a) from revealing “information relating to the representation of a client.” “Information relating to the representation of a client” is defined in RPC 1.0(f) as both “information protected by the lawyer-client privilege under applicable law” and “other

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<sup>3</sup>A client has a privilege to refuse to disclose and to prevent any other person from disclosing confidential communications made for the purpose of facilitating the rendition of professional legal services to the client. A “confidential communication” is one that is “not intended to be disclosed to third persons other than those to whom disclosure is in furtherance of the rendition of professional legal services to the client or those reasonably necessary for the transmission of the communication.” Confidential communications include those (1) between the client or the client’s representative and the client’s lawyer or a representative of the lawyer, (2) between the client’s lawyer and the lawyer’s representative, (3) by the client or the client’s lawyer to a lawyer representing another in a matter of common interest, (4) between representatives of the client or between the client and a representative of a client, or (5) between lawyers representing the client. OEC 503.

<sup>4</sup> Also included is OEC 512, “privileged matter disclosed under compulsion or without opportunity to claim privilege.”

information gained in a current or former professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.”<sup>5</sup>

Clearly then, “information relating to the representation” is not limited to information that is privileged because communicated by the client. Information protected under RPC 1.6 includes information learned from witnesses and other third parties as well as information imparted by the client that is, for some reason, not covered by the privilege. All that is required under RPC 1.6 is that the information be gained during the course of the professional relationship between the lawyer and the client, and either that the client has requested it be “held inviolate” or that it would be embarrassing or detrimental to the client if revealed.

In creating a statutory exception for only some of the information that would be protected by RPC 1.6, the legislature limited the reporting exception to information that would be detrimental (not merely embarrassing) to the client if disclosed. This appears to be the legislature’s way of reconciling the sanctity of the lawyer-client relationship with the interest of protecting children. The legislature appears to have concluded that mere embarrassment to a client is not sufficient justification for the lawyer to ignore abuse.

C. Information Learned from an Official Report.<sup>6</sup>

The final exception to the child abuse reporting requirement applies to all mandatory reporters. Reporting is not required of information learned “by reason of a report” or “by reason of a proceeding arising out of a report” made under the mandatory child abuse reporting statute. The exception applies if the reporter “reasonably believes that the information is already known by a law enforcement agency or the Department of Human Services.” This exception appears to be the legislature’s attempt to clarify that mandatory reporters do not need to report when the only information they have comes from an existing report. The language is not crystal clear, however, as it suggests that reports may be made and

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<sup>5</sup> These are the definitions, respectively, of “confidences” and “secrets” from former DR 4-101.

<sup>6</sup> This exception does not apply in the elder abuse context.

proceedings may arise therefrom, yet the information might not be known to DHS. Although it is difficult to imagine a situation where that could actually be the case, a lawyer who learns about child abuse (involving a person with whom the lawyer has had contact) from another reporter's report would be prudent to confirm that DHS is aware of the situation. If DHS cannot confirm its existing knowledge of the abuse, then the lawyer should report.

The effect of these statutory exceptions to the duty to report is that most of the information a lawyer will be required to report will be that learned outside the lawyer's "official capacity." For instance, witnessing an act of child abuse in a public place will trigger the reporting obligation, despite the fact that the lawyer may not have a lot of information to report. Similarly, information that a non-client friend or neighbor is abusing a child or is a victim of abuse must be reported.

D. Treatment by Spiritual Means Through Prayer.<sup>7</sup>

This exception is not elaborated in case law or in regulation. Practitioners should note that it is very narrow. The treatment must be "voluntary"; beliefs of the caregiver are irrelevant to the determination of whether reporting is required. The treatment must be "through prayer." It must be "in accordance with the tenets and practices of a recognized church or religious denomination" and conducted "by a duly accredited practitioner" of the church. Here as elsewhere, attorneys should err on the side of reporting and letting DHS evaluate the situation.

**Question 9: What If Someone Expresses the Intent to Commit an Act of Abuse?**

The statutes mandate reporting only when there is reasonable cause to believe that abuse has already occurred. It does not require advance reporting of possible future abuse, with limited exceptions. A threat of future abuse can be "verbal abuse" of an elder. "Verbal abuse" includes "threatening significant physical harm or threatening or causing significant emotional harm to an adult ... ." OAR 411-020-0002(1)(d)(A). Also, a threat of future abuse can

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<sup>7</sup> This exception does not apply in the child abuse context.

be a threat of harm to a child, “which means subjecting a child to a substantial risk of harm to the child’s health or welfare,” ORS 419B.005(1)(a)(G), and be reportable abuse for that reason.

If the situation does not fit within either of those narrow categories, reporting may still be possible. RPC 1.6(b)(1) permits a lawyer to reveal confidential information, to the extent the lawyer reasonably believes necessary, “to disclose the intention of the lawyer’s client to commit a crime and the information necessary to prevent the crime.” There is also no lawyer-client privilege under OEC 503(4)(a) “if the services of the lawyer were sought or obtained to enable or aid anyone to commit or plan to commit what the client knew or reasonably should have known to be a crime or fraud.” RPC 1.6(b)(2) permits a lawyer to reveal information otherwise protected to the extent the lawyer reasonably believes necessary “to prevent reasonably certain death or substantial bodily harm,” whether or not a crime is involved. When used in reference to degree or extent, “substantial” denotes “a material matter of clear and weighty importance.” RPC 1.0(o).

It is not clear that all incidents of abuse identified in the statute constitute crimes. A lawyer whose client has expressed a clear intention to commit abuse in the future should ascertain first whether the intended conduct is a crime, or if it puts a person at risk of reasonably certain death or substantial bodily harm. If so, the lawyer may disclose information necessary to prevent the intended conduct.

A voluntary report of suspected future abuse that is not required under ORS 124.060 is subject to the same statutory confidentiality and immunity as a mandatory report. See ORS 124.075; ORS 419B.025; ORS 419B.035.

**Question 10: Are Lawyers Obligated to Report Abuse Occurring Outside Of Oregon?**

While all states have adopted some form of elder abuse prevention laws, the laws are not uniform and lawyers are not mandatory reporters in all jurisdictions. Lawyers who are licensed in multiple jurisdictions should be attentive to the statutory requirements of each jurisdiction as well as to the interplay between those statutory requirements and the disciplinary rules to which the lawyer is subject.

The scope of Oregon’s mandatory abuse reporting laws is not clear with respect to incidents occurring outside of Oregon. Nothing in the statute can be read to limit reporting only to incidents occurring within the state. The language of the statute sweeps broadly to include all victims within the protected populations and their abusers. A lawyer who wishes to act most cautiously should make a report to DHS of the out-of- state incident and allow DHS to determine whether and how to deal with the information. Reporting in that circumstance does not violate any ethical responsibility of the lawyer or violate any right of the persons involved. It is consistent with the policy behind both statutes and regulations that encourage voluntary reporting. *See, e.g.*, OAR 411-020-0020(2).

**Question 11: What Type Of Report Is Required And To Whom Must It Be Made?**

The abuse reporting statutes require that reports be made “immediately,” ORS 124.065(1); ORS 419B.010(1), and that the report must be “an oral report by telephone or otherwise.”<sup>8</sup> ORS 124.065(1); ORS 419B.015. Reports must be made to the local office of the Department of Human Services or to a law enforcement agency within the county where the person making the report is located at the time of the contact. Both ORS 124.050(6) and ORS 419B.005(4) define a law enforcement agency to mean:

- A city or municipal police department;
- A county sheriff’s office;
- The Oregon State Police;
- A police department established by a university; or
- A county juvenile department.

The report must contain, if known:

- the names and addresses of the victim and the persons responsible for the victim’s care;
- the child’s age, in the case of a child victim;
- the nature and extent of the abuse, including any evidence of previous abuse;

---

<sup>8</sup> The statewide telephone number for reporting suspected abuse is 1-855-503-SAFE (7233).

- the explanation given for the abuse; and
- any other information that might be helpful in establishing the cause of the abuse and the identity of the abuser.

ORS 124.065(1); ORS 419B.015(1). DHS and law enforcement are required to notify each other when receiving a report of possible crime or of any child abuse. ORS 124.065(2); ORS 419B.015(1)(b), (2).

**Question 12: Are Elder Abuse Reports Confidential?**

Notwithstanding Oregon’s public records law, the reports and records compiled under the abuse reporting laws are confidential and are not accessible for public inspection. ORS 124.090(1); ORS 419B.035. DHS is required to make the reports available in some circumstances and permitted to do so in other circumstances. ORS 124.090(2); ORS 419B.035. Recipients of records under DHS’s mandatory or permissive disclosure authority are also required to maintain the confidentiality of the records. ORS 124.090(3); ORS 419B.\_\_\_\_.

The confidentiality is not absolute, as a reporter may be required to testify in court proceedings relating to the report. In criminal proceedings, the alleged abuser’s constitutional right to confront witnesses would override the statutory confidentiality.

Confidentiality may be enhanced by reporting anonymously. While there is no requirement in the statutes that reporters identify themselves, it is also clear that the statutes do not contemplate anonymous reporting, and it is likely not preferred by DHS. Law enforcement and DHS will accept anonymous reports. Because of the liability that can result from not reporting, lawyers should weigh the desire for confidentiality with the possible need for proof that a report was in fact made as required.

## Chapter 7

# Presentation Slides: Oregon Local Taxes

**JENNIFER YOUNG**  
Moss Adams  
Portland, Oregon





# Oregon local taxes

Jennifer Young  
Director—State and Local Tax



## Objectives

- Overview of new Portland-area local taxes
- New Metro Supportive Housing Services tax—implications for business, including withholding requirements
- Sourcing rules for individuals
- Transactions



# Oregon State and Local Taxes

Corporations only
Business entities only
Individuals only
All business activity
All

TAX	TAXING JURISDICTION	TAXPAYERS	TAX BASE	TOP MARGINAL RATE
<i>Taxes in effect as of January 1, 2021</i>				
Corporate income tax	State	Corporations taxable under Subchapter C of the Internal Revenue Code	Net income	7.6%; minimum tax up to \$100,000
Corporate Activity Tax (CAT)	State	All business activity	Gross receipts with a limited subtraction for cost of goods sold (COGS) or labor cost	0.57%
Personal income tax	State	Individuals	Taxable income	9.90%
Transit tax	State	Wage earners	All wages of Oregon residents; Oregon-source wages of nonresidents	0.10%
Lane County Transit Tax	LCTD	Employers	Wages paid for services performed in district	0.75%
TriMet Transit Tax	Regional government	Employers and self-employed individuals	Wages paid for services performed in district	0.77%
Supportive Housing Services Tax	Regional government	Business entities and individuals; both residents and nonresidents	Business entities and nonresidents—net income derived from sources within the Metro district Residents—Oregon taxable income	1.00%
Preschool for All Tax	Multnomah County	Individuals (residents and nonresidents)	Nonresidents—net income derived from sources within Multnomah County Residents—Oregon taxable income	3.00%
<i>Additional tax effective January 1, 2023</i>				
Paid Family Medical Leave Tax	State	Tax paid 60% by employees and 40% by employers	Wages paid for services performed entirely in Oregon or partially in Oregon if non-Oregon service is incidental	1.00% on wages up to \$132,900

3



## Portland HVUT

**EXPIRED** 2019 ; **EXTENDED** through 2026

**INCREASED** from 2.8% to 3.0% of Oregon weight-distance tax

**UNAPPORTIONED**

**EXCEPTION:**

If less than 1% of total Oregon miles are driven on Portland owned *or operated* streets, can petition for reduction to up to 50% of tax

Must pay tax and file petition for reduction

Portland must *receive* petition within 60 days after filing the Portland Business License Tax form—”mailbox rule?” uncertain

4



# Oregon – New Local Taxes

## Portland Metro Supportive Housing Services Tax.

1% income tax on individuals with >\$125K (>\$200K joint); 1% business tax on businesses with more than \$5 million of worldwide gross receipts.

- *Individuals may exclude PTE income that was subject to the tax at the entity level.*
- *Metro includes three counties—Clackamas, Multnomah, and Washington—but not all parts of the county are in the boundaries. Check!!*

## Multnomah County Preschool for All Tax– Measure 26-214 (passed)

1.5% income tax (>125K, >\$200K joint) 3.0% income tax (>250K, >\$400K joint)

- *Individuals may receive a credit for income that was subject to the Multnomah County Business Income Tax.*

5



## New Local Taxes

- Both taxes are in addition to the Portland/Multnomah County income taxes on pass-through entities—with offsets for income previously taxed (not in measure that the voters passed).
- Final administrative rules adopted.
- Other rules generally follow Portland/Multnomah County income tax guidance.
- For 2021, a business must offer withholding to its employees in writing as soon as it can configure its payroll system to capture and remit the taxes withheld.
- City of Portland administers the new taxes along with the existing taxes.

6



# Supportive Housing Services Tax – Implications for Businesses

- Metro adopted the income-producing activity rule, often referred to as cost of performance, for assigning receipts from activities other than the sale of TPP. Under this rule, receipts are generally assigned to the location where the business is located and incurs most of its costs for income apportionment purposes.
- Oregon uses market-based sourcing for assigning receipts from activities other than the sale of TPP. Under this rule, receipts are generally assigned to the location where the benefit of a service is received (i.e., customer location).
- So, receipts from the same transaction may be included in the metro sales factor numerator for apportionment purposes but not the Oregon numerator, and vice versa.

7



# Supportive Housing Services Tax – Implications for Businesses

	OREGON	LOCAL
<b>SERVICES</b>	Market	Income-producing activity/cost of performance
<b>FINANCIAL INSTITUTIONS</b>		
<b>Bank</b>	Market	Through 12/31/21-Deposits Eff 1/1/22—follow Oregon
<b>Non-bank</b>	Same as bank	Through 12/31/21-ambiguous Eff 1/1/22—follow Oregon
<b>SALE OF TPP</b>	Destination with throwback	Possession, no throwback
<b>TRANSPORTATION</b>	Mileage	50% inbound/50% outbound
<b>GOODWILL</b>	Excluded	Included—domicile with exception for significant activities occurring elsewhere

8





## Polling Question #1

For a resident of Multnomah County Oregon, what is the highest combined state/local income tax rate (joint filers)?

- A) 9.9% on income over \$250,000/year
- B) 13.3% on income over \$1 million/ year
- C) 14.776% on income over \$25 million/year
- D) 13.9% on income over \$400K/year



## Polling Answer #1

- A) 9.9% on income over \$250,000/year
- B) 13.3% on income over \$1 million/ year
- C) 14.776% on income over \$25 million/year
- D) 13.9% on income over \$400K/year**



## Local Taxes—business considerations

- Review determinations of how Portland and Multnomah County source income
  - Did any work locations (i.e., WFH arrangements) change due to the pandemic?
  - Do you deliver property, if so, how? (difference in sourcing local vs. Oregon)
  - Selling a business or interest in a business—*review structure and tax implications*
  - Businesses must make estimated payments for the new local taxes—penalties begin in 2022
  - The Metro district boundaries aren't the same as the county boundaries—check addresses. Lookup tool provided that allows multiple lookups:
- : [HTTPS://GIS.OREGONMETRO.GOV/METRO-BOUNDARY-LOOKUP/? GA=2.264229769.4050046.1641830563-641815136.1601996475#/BATCH-ADDRESS-QUERY](https://gis.oregonmetro.gov/metro-boundary-lookup/?GA=2.264229769.4050046.1641830563-641815136.1601996475#/batch-address-query)

11



## Sourcing—*Powerex I*

*Powerex I* Oregon Tax Court, September 2012

Taxpayer sold natural gas to purchasers in California through an interstate pipeline running from Washington to California. Title to the gas transferred in Oregon at a point along the pipeline.

The court noted that the purchasers “do not use the natural gas in Oregon” and that the interstate pipelines “are, or function as, common carriers.” The natural gas was not consumed at the Oregon point of delivery but transferred along a common carrier line for further delivery to the ultimate destination.

While the Oregon Tax Court noted that delivery to the ultimate destination was made by a common carrier, as opposed to the taxpayer, the court also noted that the “purpose of the sales factor in apportionment is to recognize the contribution of the market state to the income producing process” and that this concept is *applicable especially when “delivery” is merely a title transfer within a common carrier.*

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## Sourcing—*Powerex II*

*Powerex II* Oregon Supreme Court, March 2015

The court analyzed the phrase “f.o.b. point or other conditions of sale” and determined that the “other conditions of sale” referred to “conditions of the sale that are similar to the f.o.b. point: and that “(t)he question where tangible property was delivered or shipped to the purchaser should not turn on legal technicalities.” The court also acknowledged that this conclusion, often referred to as an ultimate delivery test, is not a bright line. Indeed, controversy arises when “a seller ships goods to a loading dock in one state where the purchaser picks them up and then transports them to their ‘ultimate destination’ in another state.”

The court did not address this issue and concluded that “this case does not require us to decide what the rule should be when the purchaser takes physical possession of the goods at a loading dock in one state and transports them itself to their ultimate destination in another state.”

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## Sourcing—*Powerex III*

*Powerex III* Oregon Tax Court, August 2016

On remand for consideration of the sourcing of electricity sales, the Tax Court noted in its conclusion that the transfer point in Oregon, which the DOR argued was the delivery point, was “literally a place on the transmission line, on each side of which is simply more line and under and around which is dirt and a few plants.”

At either point in Oregon which the DOR argued was a “delivery” point for electricity, there were “no facilities for use, storage or diversion of electricity.”

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## Sourcing—Conclusion

- Inconclusive.
- Department has provided guidance with respect to automobile sales
  - Oregon dealers selling to Washington residents-not included in CAT
  - Washington dealers selling to Oregon residents-included in CAT

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## Polling Question #2

A Portland retail location must source all sales transacted at its location to Oregon and to Portland/Multnomah/Metro

- A) Depends, need to check a map
- B) Depends, is it an auto dealer?
- C) Depends, are there delivery considerations?



## Polling Answer #2

A Portland retail location must source all sales transacted at its location to Oregon and to Portland/Multnomah/Metro

- A) **Depends, need to check a map**
- B) **Depends, is it an auto dealer?**
- C) **Depends, are there delivery considerations?**

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## Local Taxes—withholding issues

Businesses must notify employees of option for new local tax withholding:

- MANDATORY for employees working in the district and earning at least \$200,000 (unless employee opts out)
- OPTIONAL for other employees (unless employee opts in)
- OPT IN/OUT form [METRO AND MULTCO OPT FORM 6-11-21.PDF \(MULTCO-WEB7-PSH-FILES-USW2.S3-US-WEST-2.AMAZONAWS.COM\)](#)

SHS code provides that if a nonresident has a permanent telecommuting arrangement only the wages earned in Metro are subject to withholding

- *A permanent telecommuting arrangement is the only statutory relief*
- *Multnomah County does not currently appear to have the same language*
- Conclusion—get the OPT form for nonresident employees to opt out

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## Local Taxes—sourcing issues—individuals

Residents pay tax on all income; sourcing not an issue

Nonresidents:

- Sourcing mirrors Oregon state rules except for stock options without a readily ascertainable market value granted in one year and exercised in another
- Oregon provides a detailed rule; Metro is silent
- Explicit inclusion of non-statutory stock options could subject it to the general rule for allocating compensation for personal services based on time spent
- Income from pass-throughs with total gross receipts <\$5 million
  - Business “may” apportion if income is from activity inside and outside the District-- per AR 7.06-1125 such a business “*must look to ORS 314.605-695 to determine the applicable apportionment methodology based on their business*”—i.e., market sourcing and throwback, among other provisions
    - Unanticipated result—request alternative apportionment

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## Local Taxes—sourcing issues—individuals

- Compensation allocation mirrors OAR 150-316-0165(3)(b)--  
*An exception to this general rule occurs when the compensation is received for performance of services that, by their nature, have an objective or an effect that takes place within the District. In the case of corporate officers and executives who spend only a portion of their time within the District, but whose compensation paid by a corporation operating in the District is exclusively for managerial services performed by these officers and executives, the entire amount of compensation so earned is taxable without apportionment.*
- Anyone considering moving?

20





## Polling Question #3

A sales manager lives in Washington and began working remotely due to COVID. She supports and manages sales activities for a Portland-headquartered business with global sales.

- A) Depends, need to check a map.
- B) Her base compensation is allocated to Portland/Multnomah/Metro but any commissions are allocated based on location.
- C) This is very uncertain as many terms in the rules are not defined.



## Polling Answer #3

A sales manager lives in Washington and began working remotely due to COVID. She supports and manages sales activities for a Portland-headquartered business with global sales.

- A) **Depends, need to check a map.**
- B) Her base compensation is allocated to Portland/Multnomah/Metro but any commissions are allocated based on location.
- C) **This is very uncertain as many terms in the rules are not defined.**



## Local Taxes—Transactions

### Business sale of assets

AR 7.07-1070

All gross income is represented in the factor.

- Tangible—location
- Intangible (including goodwill)—domicile/headquarters of business
  - If multiple *physical* locations, gains related to the sale of intangible property will be logically allocated to the locations
  - Example refers to a \$100 million transaction including \$50 million of goodwill, with a 1% Metro apportionment factor and a California sales office. A “small, reasonable allocation of the goodwill may be allowed.”

23



## Local Taxes—Transactions (cont'd)

### Individual disposition of interest in an entity

AR 7.06-1000-1140.2.c

Nonresidents:

- *In general, to calculate a nonresident's Metro taxable income or loss on the sale, exchange, or disposition of an interest in a business entity, a taxfiler must follow the sourcing treatment of the disposition for Oregon personal income tax purposes under OAR 150-316-0171 or its successor, substituting the District for the State of Oregon.*
- OAR 150-316-0171
  - S-corp stock 150-316-0171(1)(c)—in general not sourced to (Metro) unless the stock has acquired a business situs in (Metro)
  - General partnership interests—150-316-0171(1)(d)—allocated pursuant to ORS 314.635
  - Limited *partnership* interests—150-316-0171(1)(e)—S-corp rule
  - Limited *liability company* interests—*Bishop* rule

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## Local Taxes—Transactions (cont'd)

### Individual disposition of interest in an entity

- ORS 314.635
  - >50% intangibles? Sales factor of partnership for first full tax year immediately preceding the tax year in which the interest was sold
  - *Which sales factor methodology to use—Oregon (market) or Metro (IPA)? ORS 314.635 doesn't refer to the sections for apportionment so Metro rules likely apply*
  - Intangibles comprise 50% or less of value? Original cost of tangible property, determined at time of sale

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## Local Taxes—Transactions—conclusion

PLAN EARLY

26



## Local Taxes—other issues—individuals

- SHS and PFA both allow offset for income already subject to tax
- Methodology change in March 2022
  - Prior—entity reported apportionment percentage and individual applied % to distributive share
  - Change—individual subtracts apportioned net income
    - *Increased administrative reporting burden on PTEs*
- Fiscal year pass-through entities? (Metro nonresident)
- Pass-through entity with receipts <\$5 million?
- Credit for taxes paid to other states
  - Available only if credit shown on Oregon return
    - Reverse credit states?
    - Interplay with PTE election, i.e., California?

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## Local Taxes—What's next?

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## Polling Question #4

What's next?

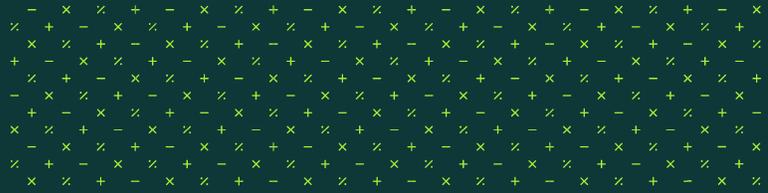
- A) Metro may be forced to use Oregon apportionment laws rather than local.
- B) We can likely expect residency audits at the local level.
- C) Portland/Multnomah/Metro may be forced to use Oregon apportionment laws rather than local.
- D) Depends, need to check the map. Is there a location for areas of ambiguity?



## Polling Answer #4

- A) Metro may be forced to use Oregon apportionment laws rather than local.**
- B) We can likely expect residency audits at the local level.**
- C) Portland/Multnomah/Metro may be forced to use Oregon apportionment laws rather than local.**
- D) Depends, need to check the map. Is there a location for areas of ambiguity?**





# QUESTIONS



The material appearing in this presentation is for informational purposes only and should not be construed as advice of any kind, including, without limitation, legal, accounting, or investment advice. This information is not intended to create, and receipt does not constitute, a legal relationship, including, but not limited to, an accountant-client relationship. Although this information may have been prepared by professionals, it should not be used as a substitute for professional services. If legal, accounting, investment, or other professional advice is required, the services of a professional should be sought.

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THANK YOU



# Chapter 8

## Recent Developments in Federal Income Taxation

**PROFESSOR BRUCE MCGOVERN**  
South Texas College of Law  
Houston, Texas

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## RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

We apologize to our readers. If we had more time, this outline would be much shorter.

By

Bruce A. McGovern  
Professor of Law and Director, Tax Clinic  
South Texas College of Law Houston  
Houston, Texas 77002  
Tele: 713-646-2920  
e-mail: bmcgovern@stcl.edu

Oregon Tax Institute  
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Note: This outline was prepared jointly with Cassady V. (“Cass”) Brewer, Associate Dean and Professor of Law, Georgia State University College of Law, Atlanta, GA, and James M. Delaney, Centennial Distinguished Professor of Law, University of Wyoming College of Law, Laramie, WY.

*This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code are discussed to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected items previously covered in the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.*

Although relatively little tax legislation was enacted in the last twelve months, there have nevertheless been many significant federal income tax developments. The Treasury Department and the IRS provided an abundance of administrative guidance and the courts issued many significant judicial decisions. The [American Rescue Plan Act of 2021](#), Pub. L. No. 117-2, enacted on March 11, 2021, made several significant changes. The changes made by this legislation include expanding credits such as the child tax credit and earned income credit, suspending the requirement to repay excess advance premium tax credit payments for 2020, and providing exclusions for up to \$10,200 of unemployment compensation received in 2020 and for cancellation of student loans. The [Infrastructure Investment and Jobs Act](#), Pub. L. No. 117-58, enacted on November 15, 2021, contains relatively few significant tax provisions but ends the employee retention credit of Code § 3134 for the fourth quarter of 2021. This outline discusses the major administrative guidance issued in the last year, summarizes recent legislative changes that, in our judgment, are the most important, and examines significant judicial decisions rendered in the last twelve months.

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**1. Required amortization of specified research or experimental expenditures incurred after 2021.** The [2017 Tax Cuts and Jobs Act](#), § 13206, amended Code § 174 to require the capitalization and amortization of specified research or experimental expenditures. The amortization period is 5 years (15 years for expenditures attributable to foreign research), beginning at the midpoint of the year in which the expenditures are paid or incurred. The term “specified research or experimental expenditures” is defined as research or experimental expenditures paid or incurred by the taxpayer during a taxable year in connection with the taxpayer’s trade or business. The term includes expenditures for software development. Expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas) are not subject to the required capitalization and amortization of § 174. Expenditures for the acquisition or improvement of land or for the acquisition or improvement of property that is depreciable under § 167 or subject to depletion under § 611 also are not subject to the required capitalization and

amortization of § 174; however, allowances for depreciation under § 167 or for depletion under § 611 are treated as expenditures subject to § 174. For further explanation and details, the complete Conference Report accompanying TCJA may be found [here](#). Amended § 174 applies to amounts paid or incurred in taxable years beginning after 2021.

**2. Legal expenses incurred related to the preparation of applications to the FDA for approval of generic drugs are capital expenditures while legal expenses incurred to defend patent infringement suits are currently deductible.** [Mylan, Inc. & Subsidiaries v. Commissioner](#), 156 T.C. No. 10 (4/27/21). The taxpayer, Mylan, Inc., and its subsidiaries manufacture both brand name and generic pharmaceutical drugs. Mylan incurred substantial legal expenses in two categories. First, Mylan incurred legal expenses in connection with its applications to the FDA seeking approval of generic drugs. To obtain this approval, Mylan submitted abbreviated new drug applications (ANDAs). The ANDA application process for generic drugs includes a requirement that the applicant certify the status of any patents covering the respective brand name drug previously approved by the FDA (referred to as a “paragraph IV certification”). One option available to the applicant is to certify that the relevant patent is invalid or will not be infringed by the sale or use of the generic version of the drug. An applicant making this certification is required to send notice letters to the holders of the patents informing them of the certification. Such a certification is treated by statute as patent infringement and the holder of the patent is entitled to bring suit in federal district court. Mylan incurred substantial legal expenses to prepare the notice letters it sent in connection with its ANDA applications. Second, Mylan incurred substantial legal expenses in defending patent infringement lawsuits brought by the name-brand drug manufacturers against Mylan in response to the notice letters that Mylan sent. Mylan claimed deductions for both categories of legal expenses. The IRS, however, determined that all of Mylan’s expenses were capital expenditures under § 263(a). The Tax Court (Judge Urda) held that the legal expenses incurred by Mylan to prepare notice letters were capital expenditures but the legal expenses Mylan incurred to defend patent infringement suits were currently deductible business expenses.

*FDA applications for generic drugs and notice letter costs.* The court first addressed the issue of whether the costs Mylan incurred to prepare the notice letters it sent in connection with its ANDA applications should be capitalized under § 263. The court’s analysis focused in large part on the regulations under § 263 regarding intangibles. These regulations require a taxpayer to capitalize both amounts paid to *create* an intangible and amounts paid to *facilitate* an acquisition or creation of an intangible. Reg. § 1.263(a)-4(b)(1)(ii), (iv). With respect to creation of an intangible, Reg. § 1.263(a)-4(d)(5)(I) provides:

A taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

With respect to facilitating the acquisition or creation of an intangible, Reg. § 1.263(a)-4(e)(1) provides:

[A]n amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances.

Mylan and the IRS disputed whether Mylan’s legal fees were incurred to “facilitate” the acquisition of a right obtained from a governmental agency and therefore were required to be capitalized. They agreed that the relevant “transaction” was *acquisition* of an FDA-approved ANDA with a paragraph IV certification. But they disagreed on when this acquisition occurs. Mylan argued that the acquisition of an FDA-approved ANDA occurs when the FDA completes its scientific investigation and issues an approval letter. The IRS asserted that the acquisition of an FDA approved ANDA with a paragraph IV certification occurs only when the approval letter issued by the FDA becomes effective. The distinction is that the FDA may issue an approval letter but the approval does not grant any rights to the applicant until it becomes effective. Only when the approval becomes effective does the applicant have the right to begin delivery of a generic drug. *See* 21 U.S.C. § 355(a). With respect to Mylan’s legal fees incurred in preparing the notice letters relating to the filing of its ANDA’s with paragraph IV certifications, the

court concluded that these costs were capital expenditures. The notice is a required step in securing FDA approval of an ANDA. According to the court, because the notice requirement was a prerequisite to securing FDA approval, “the legal expenses Mylan incurred to prepare, assemble, and transmit such notice letters constitute amounts incurred ‘investigating or otherwise pursuing’ the transaction of creating FDA-approved ANDAs ... and must be capitalized.”

*Litigation expenses.* The court reached a different conclusion regarding Mylan’s litigation expenses, holding that they were currently deductible. The IRS argued that a patent infringement suit is a step in obtaining FDA approval of an ANDA. The court disagreed, however, and reasoned that the outcome of a patent litigation action has no effect on the FDA’s review of a generic drug application. The FDA continues its review process during the course of a patent infringement action and may issue a tentative or final approval of an application before the infringement action is finally decided. A successful patent dispute does not guarantee that a generic drug manufacturer will obtain FDA approval of an ANDA. While it is true that a successful challenge by a patent holder will result in a prohibition of the marketing of a generic drug found to infringe, the court reasoned that the coordination of the FDA approval process with the outcome of related patent litigation does not insert the patent litigation into the FDA’s ANDA approval process. A patent on a name brand drug does not prevent FDA approval of a generic version of the drug and patent litigation on the part of the patent holder is not a step in the FDA’s approval process for a generic drug. In reaching its conclusion that the litigation expenses incurred by Mylan were currently deductible as ordinary and necessary expenses, the court also applied the “origin of the claim” test, which inquires as to “whether the origin of the claim litigated is in the process of acquisition”, enhancement, or other disposition of a capital asset.” *Woodward v. Commissioner*, 397 U.S. 572, 577 (1970); see also *Santa Fe Pac. Gold Co. v. Commissioner*, 132 T.C. 240, 264-265 (2009). Here, the court reasoned, Mylan’s legal expenses arose from legal actions initiated by patent holders in an effort to protect their patents. The court followed the decision of the U.S. Court of Appeals for the Third Circuit in *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954), which held that patent litigation arises out of the exploitation of the invention embodied in the patent and, therefore, costs incurred to defend a patent infringement suit are not capital expenditures because they are not costs incurred to defend or protect title but rather are expenses incurred to protect business profits. Because Mylan’s legal expenses arose out of the patent infringement claims initiated by the patent holders, the court held, they were currently deductible.

### **C. Reasonable Compensation**

### **D. Miscellaneous Deductions**

**1. Seinfeld warned us: no double-dipping (with your PPP money)! Or, on second thought, maybe you can!** Notice 2020-32, 2020-21 I.R.B. 1 (5/1/20). Section 1102 of the [CARES Act](#), in tandem with § 7(a)(36) of the Small Business Act (15 U.S.C. § 636(a)(36)), establishes the much-touted Paycheck Protection Program (“PPP”). The PPP was created to combat the devastating economic impact of the coronavirus pandemic. Generally speaking, the PPP facilitates bank-originated, federally-backed loans (“covered loans”) to fund payroll and certain other trade or business expenses (“covered expenses”) paid by taxpayers during an eight-week period following the loan’s origination date. Moreover, § 1106(b) of the [CARES Act](#) allows taxpayers to apply for debt forgiveness with respect to all or a portion of a covered loan used to pay covered expenses. Section 1106(i) of the [CARES Act](#) further provides that any such forgiven debt meeting specified requirements may be excluded from gross income by taxpayer-borrowers.

*Background.* The [CARES Act](#) does not address whether covered expenses funded by a forgiven covered loan are deductible for federal income tax purposes. Normally, of course, covered expenses would be deductible by a taxpayer under either Code § 162, § 163, or similar provisions; however, a long-standing provision of the Code, § 265(a)(1), disallows deductions for expenses allocable to one or more classes of income “wholly exempt” from federal income tax. Put differently, § 265(a)(1) generally prohibits taxpayers from double-dipping: taking deductions for expenses attributable to tax-exempt income. Section 265 most often has been applied to disallow deductions for expenses paid to seek or obtain tax-exempt income. (For example, a taxpayer claiming nontaxable social security disability benefits pays legal fees to pursue the claim. The legal fees are not deductible under Code § 265(a)(1). See Rev. Rul. 87-102, 1987-2 C.B. 78.) Covered expenses, on the other hand, presumably

would have been incurred by taxpayers (at least in part) regardless of the PPP. The question arises, therefore, whether covered expense deductions are disallowed by Code § 265 when all or a portion of a PPP covered loan *subsequently* is forgiven.

*Notice 2020-32.* The notice sets forth the IRS’s position that covered expenses funded by the portion of a PPP covered loan subsequently forgiven are not deductible pursuant to § 265. The IRS reasons that regulations under § 265 define the term “class of exempt income” as any class of income (whether or not any amount of income of such class is received or accrued) that is either wholly excluded from gross income for federal income tax purposes or wholly exempt from federal income taxes. *See* Reg. § 1.265-1(b)(1). Thus, because the forgiven portion of a covered loan is nontaxable (i.e., “wholly exempt”) and is tied to the taxpayer’s expenditure of the loan proceeds for covered expenses, § 265 disallows a deduction for those expenses. The IRS also cites several cases in support of its position. *See Manocchio v. Commissioner*, 78 T.C. 989 (1982) (taxpayer-pilot’s flight-training expenses funded with a nontaxable Veteran’s Administration allowance not deductible pursuant to § 265(a)(1)), *aff’d on other grounds*, 710 F.2d 1400 (9th Cir. 1983); *Banks v. Commissioner*, 17 T.C. 1386 (1952) (deduction for business-related educational expenses disallowed under § 265(a)(1) when paid by the Veterans’ Administration and not taxable to taxpayer); *Heffelfinger v. Commissioner*, 5 T.C. 985 (1945) (Canadian income taxes on income exempt from U.S. tax are not deductible in computing U.S. taxable income pursuant to § 265(a)(1)’s statutory predecessor). As if to convince itself, though, the IRS also cites as support—but without analysis—several arguably inapposite cases that do not rely upon § 265(a)(1). Instead, these cases hold that expenditures reimbursed from or directly tied to nontaxable funds are not deductible. *See, e.g., Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966) (living expenses advanced by personal injury attorney to clients pending outcome of lawsuit not deductible because the expenses will be reimbursed from the lawsuit proceeds); *Wolfers v. Commissioner*, 69 T.C. 975 (1978) (taxpayer cannot deduct relocation costs funded with nontaxable proceeds from Federal Reserve Bank); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977) (similar).

*A possible legislative solution?* The authors doubt that [Notice 2020-32](#) is the last word on the tax treatment of PPP covered loans and covered expenses. Apparently, many practitioners and at least a few members of Congress believe that the IRS’s position in [Notice 2020-32](#) contravenes congressional intent. *See* Chamseddine and Yauch, *Neal Plans PPP Fix to Provide Expenses Deduction*, 2020 TNTF 86-5 (5/4/20). Treasury Secretary Mnuchin, though, has defended the IRS’s position. *See* Chamseddine, “Tax 101”: Mnuchin Defends Nondeductibility of PPP Expenses, 2020 TNTF 87-2 (5/5/20). Furthermore, what happens to capitalized covered expenses? Are taxpayers forced to reduce basis when a portion of a covered loan is forgiven? What about outside basis adjustments for S corporations and partnerships that have paid covered expenses with the proceeds of a subsequently forgiven covered loan? Remember *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) (excludable cancellation of indebtedness increases S corporation shareholder’s outside basis allowing use of previously suspended losses) followed by enactment of § 108(d)(7)(A) (legislatively overruling *Gitlitz*)?

*A broader perspective.* Perhaps the unstated but no less unsettling aspect of [Notice 2020-32](#) is that the Notice fails to address adequately the inconsistent application of § 265 by the IRS and Treasury. It is well established that § 265(a)(1) disallows so-called “forward looking” deductions allocable to “wholly exempt” income (i.e., expenses paid to earn or obtain exempt income). For instance, as mentioned above § 265(a)(1) disallows a deduction for legal fees paid to pursue a nontaxable social security disability award. *See* Rev. Rul. 87-102, 1987-2 C.B. 78. Less established, however, is whether § 265 disallows so-called “backward looking” deductions (i.e., expenses funded with tax-exempt income but not paid to obtain such tax-exempt income). *Cf.* Rev. Rul. 75-232, 1975-1 C.B. 94 (taxpayer can exclude from income under § 104(a)(2) a settlement, including the portion allocated to future medical expenses, but cannot deduct that portion of the future medical expenses when incurred). For example, a taxpayer might receive an excludable bequest of artwork but nonetheless is allowed a charitable contribution deduction upon donating the artwork to a tax-exempt museum. For a thorough analysis, see Dodge, *Disallowing Deductions Paid with Excluded Income*, 32 Va. Tax Review 749 (2013).

**a. Don't think you can avoid having deductions disallowed just because your PPP loan has not yet been forgiven, says the IRS.** [Rev. Rul. 2020-27](#), 2020-50 I.R.B. 1552 (11/18/20). Following the IRS's issuance of Notice 2020-32, which provides that costs are not deductible to the extent they are paid with the proceeds of a PPP loan that is forgiven, many taxpayers questioned whether they could take deductions for costs paid in 2020 with the proceeds of a PPP loan if the loan is not forgiven in 2020. In this revenue ruling, the IRS has crushed the hopes of many taxpayers. According to the ruling:

A taxpayer ... [that paid expenses with the proceeds of a PPP loan] may not deduct those expenses in the taxable year in which the expenses were paid or incurred *if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan* on the basis of the expenses it paid or accrued during the covered period.”

(Emphasis added.) The revenue ruling illustrates this rule in two situations. In the first, the taxpayer paid qualifying costs (payroll, mortgage interest, utilities, and rent) in 2020 with the proceeds of a PPP loan, satisfied all requirements for forgiveness of the loan, and applied for forgiveness of the loan, but the lender did not inform the taxpayer by the end of 2020 whether the loan would be forgiven. In the second situation, the facts were the same except that the taxpayer did not apply for forgiveness of the loan in 2020 and instead expected to apply for forgiveness of the loan in 2021. The ruling concludes that, in both situations, the taxpayers have a reasonable expectation that their loans will be forgiven and therefore cannot deduct the expenses they paid with the proceeds of their PPP loans. The ruling relies on two distinct lines of authority to support this conclusion. One line involves taxpayers whose deductions are disallowed because they have a reasonable expectation of reimbursement at the time they pay the costs in question. *See, e.g., Burnett v. Commissioner*, 356 F.2d 755 (5th Cir. 1966) (attorney who advanced costs for client and was entitled to reimbursement if successful in the client's matter); *Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971) (same). The IRS reasons in the ruling that the taxpayers in the two situations described have a reasonable expectation of reimbursement in the form of forgiveness of their PPP loans. The second line of authority is under § 265(a)(1), which disallows deductions for any amount otherwise deductible that is allocable to one or more classes of tax-exempt income regardless of whether the tax-exempt income is received or accrued. *See* Reg. § 1.265-1(a)(1), (b). Thus, according to the ruling, the fact that the loans in the two situations have not yet been forgiven does not preclude the costs paid by the taxpayers from being allocable to tax-exempt income.

**b. But taxpayers can deduct expenses paid with the proceeds of a PPP loan to the extent their applications for loan forgiveness are denied or to the extent they decide not to seek forgiveness of the loan.** [Rev. Proc. 2020-51](#), 2020-50 I.R.B. 1599 (11/18/20). This revenue procedure provides a safe harbor that allows taxpayers to claim deductions in a taxable year beginning or ending in 2020 for otherwise deductible expenses paid with proceeds of a PPP loan that the taxpayer expects to be forgiven after 2020 to the extent that, after 2020, the taxpayer's request for loan forgiveness is denied or the taxpayer decides not to request loan forgiveness. The deductions can be claimed on a timely filed (including extensions) original 2020 income tax return or information return, an amended 2020 return (or, in the case of a partnership, an administrative adjustment request for 2020), or timely filed original income tax return or information return for the subsequent year in which the request for loan forgiveness is denied or in which the taxpayer decides not to seek loan forgiveness. The deductions the taxpayer claims cannot exceed the principal amount of the PPP loan for which forgiveness was denied or will not be sought. To be eligible for the safe harbor, the taxpayer must attach a statement (titled “Revenue Procedure 2020-51 Statement”) to the return on which the taxpayer claims the deductions. The statement must include information specified in the revenue procedure. The revenue procedure seems to acknowledge that, for taxpayers claiming the deductions in the subsequent taxable year in which loan forgiveness is denied, the safe harbor is unnecessary because such taxpayers would be able to deduct the expenses in the subsequent taxable year under general tax principles.

**c. Congress finally has stepped in and provided legislative relief.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 276 of the [2021 Consolidated Appropriations Act](#), provides that, for purposes of the Internal Revenue Code:

no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income [of the forgiveness of a PPP loan]

The legislation also provides that, in the case of partnerships and subchapter S corporations, any amount forgiven is treated as tax-exempt income, which has the effect of providing a basis increase to the partners or shareholders. The provision applies retroactively as if it had been included in the CARES Act. In a related development, Rev. Rul. 2021-2, 2021-4 IRB 495 (1/25/2021) obsoletes [Notice 2020-32](#) and [Rev. Rul. 2020-27](#) discussed above. Further, [Notice 2021-6](#), 2021-6 IRB 822 (1/19/21) waives any requirement that lenders file information returns or furnish payee statements under § 6050P (Form 1099-C, cancellation of debt) reporting the amount of qualifying forgiveness with respect to covered PPP loans (thereby obsoleting [Announcement 2020-12](#), 2020-41 I.R.B. 893 (9/22/2020)). Finally, [Announcement 2021-2](#), 2021-8 I.R.B. 892 (2/1/21) notifies lenders who have filed with IRS or furnished to a borrower a Form 1099-MISC, Miscellaneous Information, reporting certain payments on loans subsidized by the Administrator of the U.S. Small Business Administration as income of the borrower that the lenders must file and furnish corrected Forms 1099-MISC that exclude these subsidized loan payments.

**d. But, this seems a little weird to us.** [Rev. Proc. 2021-20](#), 2021-19 I.R.B. 1150 (4/22/21). In an unusual move arguably inconsistent with annual accounting principles, the IRS has announced a safe harbor for taxpayers who did not deduct PPP loan expenses on a previously filed 2020 tax return. Taxpayers may not have deducted such expenses based upon the IRS's prior position announced in [Notice 2020-32](#), 2020-21 I.R.B. 1 (5/1/20) and [Rev. Rul. 2020-27](#), 2020-50 I.R.B. 1552 (11/18/20), as discussed above. Under [Rev. Proc. 2021-20](#), "covered taxpayers" (as defined) who have not previously claimed deductions for PPP loan expenses paid or incurred between March 27, 2020 (the date the PPP loan program initially was authorized), and December 27, 2020 (the date Congress legislatively overruled the IRS) may elect to deduct those previously unclaimed expenses on their 2021 returns. Although this solution may be practical, it runs counter to annual accounting principles. *Of course, we're sure nothing can go wrong with allowing taxpayers who paid or incurred deductible expenses in 2020 to elect to deduct those expenses on their 2021 returns, right?* Granted, [Rev. Proc. 2021-20](#) has narrow applicability. Most taxpayers would not have filed their 2020 federal income tax returns prior to December 27, 2020, when, as noted above, Congress granted legislative relief for deducting PPP loan expenses. [Rev. Proc. 2021-20](#) also obsoletes [Rev. Proc. 2020-51](#) discussed above.

**e. The IRS has provided guidance on the timing of reporting tax-exempt income resulting from the forgiveness of PPP loans.** [Rev. Proc. 2021-48](#), 2021-49 I.R.B. 835 (11/18/21). Section 1106(i) of the [CARES Act](#) provides that the forgiveness of any PPP loan may be excluded from gross income by taxpayer-borrowers. In the case of partnerships and subchapter S corporations, any amount forgiven is treated as tax-exempt income, which has the effect of providing a basis increase to the partners or shareholders. (The clarification that the amount forgiven is treated as tax-exempt income was made with retroactive effect by a provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 276 of the [2021 Consolidated Appropriations Act](#).) A similar basis adjustment is required when one member of a consolidated group of corporations holds stock of another member and the other member has tax-exempt income. To apply these rules, and to take into account tax-exempt income for other purposes, such as including tax-exempt income in gross receipts, taxpayers must determine *when* the tax-exempt income resulting from forgiveness of a PPP loan should be taken into account. The IRS has provided guidance on this issue in [Rev. Proc. 2021-48](#). According to the revenue procedure, taxpayers may treat such income as received or accrued when (1) expenses eligible for forgiveness are paid or incurred; (2) an application for PPP loan forgiveness is filed; or (3) PPP loan forgiveness is granted. Taxpayers may report tax-exempt income on a timely filed original or amended federal income tax return, information return or administrative adjustment request (AAR) under § 6227 of the Code. If a partner or subchapter S corporation shareholder receives an amended Schedule K-1, the partner or shareholder must file an amended return to the extent necessary to reflect the amended K-1. If a taxpayer reports tax-exempt income resulting from forgiveness of a PPP loan and subsequently receives forgiveness of less than the full amount reported as tax-exempt income, the taxpayer must make appropriate adjustments on an amended return. The revenue procedure indicates that form instructions for the 2021 filing season will detail how

taxpayers can report tax-exempt income consistently with this guidance, but that taxpayers do not need to wait until the instructions are published to apply the guidance provided by this revenue procedure.

**f. Guidance for partnerships and consolidated groups regarding amounts excluded from gross income and deductions relating to PPP loans.** *Rev. Proc. 2021-49*, 2021-49 I.R.B. 838 (11/18/21). In this revenue procedure, the IRS has provided guidance for partnerships and their partners regarding (1) allocations under § 704(b) of tax-exempt income arising from the forgiveness of PPP loans and the receipt of certain other COVID-related relief, (2) allocations under § 704(b) of deductions resulting from expenditures attributable to forgiven PPP loan proceeds and the proceeds of certain other COVID-related relief, and (3) the corresponding adjustments to the partners' bases in their partnership interests (so-called "outside basis") under § 705. The revenue procedure also provides guidance for consolidated groups of corporations regarding the corresponding adjustments to the basis of stock of subsidiary members of the group held by other group members to reflect tax-exempt income resulting from the forgiveness of PPP loans and the receipt of certain other COVID-related relief.

With respect to partnerships, the revenue procedure generally provides that, if the partnership satisfies specified requirements and complies with certain information reporting requirements, the IRS will treat the taxpayer's allocation of tax-exempt income and deductions as made in accordance with § 704(b), i.e., will respect the allocation. The requirements the partnership must satisfy are: (1) the allocation of deductions resulting from expenditures giving rise to the forgiveness of a PPP Loan is determined under Reg. § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership, (2) the allocation of amounts treated as tax exempt is made in accordance with the allocation of the deductions just described, and (3) the partnership complies with special rules if any expenditure giving rise to the forgiveness of a PPP Loan is required to be capitalized. To comply with information reporting requirements, a partnership must report to the IRS all partnership items whose tax treatment is described in the revenue procedure as required by the IRS in forms, instructions, or other guidance.

With respect to consolidated groups, section 5 of the revenue procedure provides that the IRS will treat the forgiveness of a PPP loan (and the receipt of certain other COVID-related relief) as tax-exempt income for purposes of Reg. § 1.1502-32(b)(2)(ii). The result of this treatment is that a member of a consolidated group of corporations that holds stock of another member must adjust its basis in the stock for the PPP loan forgiveness (or other COVID-related relief) received by the other group member. A member of a consolidated group can rely on this treatment only if the consolidated group attaches a signed statement to its consolidated tax return indicating that all affected taxpayers in the consolidated group are relying on section 5 of the revenue procedure and are reporting consistently.

Taxpayers can apply this revenue procedure for any taxable year ending after March 27, 2020.

**g. Partnerships subject to the centralized audit regime that experienced PPP loan forgiveness and that filed returns before Rev. Proc. 2021-48 and Rev. Proc. 2021-49 were issued can file amended returns on or before December 31, 2021.** *Rev. Proc. 2021-50*, 2021-49 I.R.B. 844 (11/18/21). Generally, § 6031(b) prohibits partnerships subject to the centralized audit regime enacted by the Bipartisan Budget Act of 2015 (BBA partnerships) from amending the information required to be furnished to their partners on Schedule K-1 after the due date of the partnership return, unless specifically authorized by the Secretary of the Treasury or her delegate. This revenue procedure provides such authorization. Specifically, the revenue procedure authorizes BBA partnerships to file amended partnership returns and furnish amended Schedules K-1 to partners if they filed partnership tax returns on Form 1065 and furnished Schedules K-1 to partners prior to the issuance of Rev. Proc. 2021-48 or Rev. Proc. 2021-49 (discussed above) for partnership taxable years ending after March 27, 2020. To take advantage of this opportunity, a BBA partnership must file a Form 1065 (with the "Amended Return" box checked) and furnish corresponding amended Schedules K-1 to its partners on or before December 31, 2021. The BBA partnership must clearly indicate the application of this revenue procedure on the amended return and write "FILED PURSUANT TO REV PROC 2021-50" at the top of the amended return and attach a statement with each amended Schedule K-1 furnished to its partners with the same notation.

**2. Go ahead and deduct 100 percent of the cost of that business meal, at least through 2022.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 210 of the [2021 Consolidated Appropriations Act](#), amends § 274(n)(2), which sets forth exceptions to the normal 50 percent limitation on deducting business meals, to add an additional exception. The exception is for the cost of food or beverages provided by a restaurant paid or incurred before January 1, 2023. This rule applies to amounts paid or incurred after December 31, 2020.

**a. Seriously, it's come to this? Whole Foods and Costco are not “restaurants,” but your favorite food truck and street vendor are. As for your “go to” catering company, who knows?** [Notice 2021-25](#), 2021-17 I.R.B. 1118 (4/8/21). According to the IRS, a “restaurant” within the meaning of amended § 274(n)(2) means “a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business’s premises.” [Notice 2021-25](#) further states that a “restaurant” does not include a business primarily selling “pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk.” [Notice 2021-25](#) goes on to provide that regardless of whether the facility is operated by a third-party under contract with an employer, a § 274(n)(2) “restaurant” is neither (i) an employer’s on-premises eating facility used in furnishing meals excluded from its employees’ gross income under § 119 nor (ii) an employer-operated eating facility treated as a de minimis fringe under § 132(e)(2).

**b. Are your employees traveling on business getting by on Slim Jims from the 7-Eleven? No worries! Go ahead and treat the meal portion of the per diem rate as being attributable to food or beverages provided by a restaurant.** [Notice 2021-63](#), 2021-49 I.R.B. 835 (11/16/21). Generally, taxpayers must comply with the substantiation requirements of § 274(d) in order to deduct traveling expenses, including meals while away from home. Taxpayers can use a per diem rate to substantiate the amount of ordinary and necessary business expenses paid or incurred for lodging, meals, and incidental expenses. *See* Rev. Proc. 2019-48, 2019-51 I.R.B. 1392. Nevertheless, the meal portion of the per diem rate is normally subject to the 50 percent limitation of § 274(n)(1) on deducting meals as business expenses. Congress’s authorization of a 100 percent deduction for the cost of meals provided by a restaurant created a dilemma for employers using a per diem rate because employees receiving per diems normally are not required to turn in receipts, which means that employers providing per diems don’t have any basis for determining whether the meal portion of the per diem rate is subject to a 50-percent or a 100-percent limitation. The IRS has resolved this issue in [Notice 2021-63](#), which provides that, if an employer properly applies the rules of Rev. Proc. 2019-48, the employer can treat the meal portion of a per diem rate or allowance as being attributable to food or beverages provided by a restaurant. This means that, even if an employee traveling on business gets take-out sandwiches from a convenience store, or stays in an extended stay hotel room with a kitchen and cooks his or her own meals, the employer can deduct 100 percent of the meal portion of the per diem. This rule applies to costs paid or incurred after December 31, 2020, and before January 1, 2023.

- *Self-employed individuals.* The notice indicates that this same rule applies (and for the same period of time) to the meal portion of the per diem rate for self-employed individuals traveling away from home.

**3. Nice dreams. The Tax Court has rejected the taxpayer’s arguments that § 280E does not disallow deductions for depreciation and charitable contributions.** [San Jose Wellness v. Commissioner](#), 156 T.C. No. 4 (2/17/21). The IRS disallowed the deductions of the taxpayer, a corporation that operated a medical marijuana dispensary, under § 280E. Section 280E disallows any deduction or credit otherwise allowable if such amount is “paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances ....” The taxpayer challenged the disallowance on the grounds that § 280E does not disallow deductions for depreciation or charitable contributions. The Tax Court previously had rejected the argument that § 280E disallows only business expenses otherwise deductible under § 162 and not other deductions such as taxes deductible under § 164 or depreciation deductible under § 167. *See Northern California Small Business Assistants Inc. v. Commissioner*, 153 T.C. 65 (2019). In its previous decision, the court reasoned that both the language of § 280E, which provides that “[n]o deduction or credit shall be allowed,” and the

broader statutory scheme did not support that argument. Despite its prior decision, the court considered the taxpayer's arguments in this case because the taxpayer had "advanced more nuanced textual arguments ..." The Tax Court (Judge Toro) acknowledged that § 280E disallows a taxpayer's deductions only if the following three conditions are satisfied:

- the deduction is for an amount *paid or incurred during the taxable year*;
- that amount was paid or incurred *in carrying on any trade or business*; and
- that trade or business (or the activities that comprise the trade or business) *consisted of trafficking in certain defined controlled substances*.

*Depreciation.* The taxpayer argued that § 280E does not disallow deductions for depreciation because depreciation does not satisfy the first of the three conditions required for § 280E to apply, i.e., depreciation is not "paid or incurred during the taxable year." Section 7701(a)(25) provides that "[t]he terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A." The taxpayer in this case was an accrual method taxpayer. The court rejected the taxpayer's argument. Among other authorities, the court relied on the U.S. Supreme Court's decision in *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), in which the Court treated the taxpayer's depreciation deduction with respect to construction equipment as a capital expenditure because "*the cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset.*" (emphasis added). The court also relied on its own decision in *Fort Howard Corp. v. Commissioner*, 103 T.C. 345 (1994), in which the court concluded that the taxpayer's amortization deductions were disallowed by § 162(k)(1), which provides that "no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person ..."

*Charitable contributions.* With respect to charitable contributions, the taxpayer argued that § 280E does not apply because such contributions do not satisfy the second of the three conditions required for § 280E to apply, i.e., they are not paid or incurred "in carrying on any trade or business." The taxpayer's apparent argument was that, although charitable contributions might be paid or incurred *in connection with* a trade or business, they are not paid or incurred *in carrying on* a trade or business within the meaning of §§ 162 and 280E. The court rejected this argument. The taxpayer, the court observed, "chose to contribute the amounts at issue here, and we see no reason to conclude that this action was somehow separate from, or outside the scope of, its business activities."

*Consists of trafficking in controlled substances.* The Tax Court also rejected the taxpayer's argument that the words "consists of" in § 280E mean that the statute applies only to businesses that exclusively or solely engage in trafficking in controlled substances and does not apply to businesses, like the taxpayer's, that also engage in other activities such as selling T-shirts and other noncannabis items and offering acupuncture, chiropractic, and other "holistic" services. The court previously had rejected this same argument in *Patients Mutual Assistance Collective Corp. v. Commissioner*, 151 T.C. 176 (2018), but the taxpayer nevertheless made the argument in order to preserve it for appeal.

**4. Standard mileage rates for 2022.** Notice 2022-3, 2022-2 I.R.B. 308 (12/17/21). The standard mileage rate for business miles in 2022 goes up to 58.5 cents per mile (from 56 cents in 2021) and the medical/moving rate goes up to 18 cents per mile (from 16 cents in 2021). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation is unchanged compared to 2021 and remains 26 cents per mile for 2022. The maximum standard automobile cost may not exceed \$56,100 (up from \$51,100 in 2021) for passenger automobiles (including trucks and vans) for purposes of computing the allowance under a fixed and variable rate (FAVR) plan.

- The notice reminds taxpayers that (1) the business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed miscellaneous itemized deductions for 2022, and (2) the standard mileage rate for moving has limited applicability for the use of an automobile as part of a move during 2022 because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed the deduction of moving

expenses for 2022 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving).

### **E. Depreciation & Amortization**

**1. For real property trades or businesses that elect out of the § 163(j) limitation on deducting business interest, the recovery period for residential rental properties under the alternative depreciation system is 30 years instead of 40 years for properties placed in service before 2018.** Section 163(j), enacted by the [2017 Tax Cuts and Jobs Act](#), § 13301, generally limits the deduction for business interest expense to the sum of: (1) business interest income, (2) 30 percent of “adjusted taxable income,” and (3) floor plan financing interest. (Section 163(j)(10), enacted by the [CARES Act](#), increases to 50 percent (instead of 30 percent) the “adjusted taxable income” component of the § 163(j) limitation for taxable years beginning in 2019 and 2020.) The § 163(j) limit applies to businesses with average annual gross receipts (computed over 3 years) of more than \$25 million. Real property trades or businesses that are subject to § 163(j) can elect out of the limitation imposed by that provision. The cost of doing so, however, is that, pursuant to § 168(g)(1)(F) and (g)(8), a real property trade or business that elects out of the interest limitation of § 163(j) must use the alternative depreciation system (ADS) for nonresidential real property, residential rental property, and qualified improvement property. The [2017 Tax Cuts and Jobs Act](#), § 13204, modified the ADS to provide a recovery period of 30 years (rather than the former 40 years) for residential rental property subject to the ADS. This modification of the recovery period for residential rental property, however, applied only to property placed in service after December 31, 2017. This meant that, if a real property trade or business elected out of the interest limitation of § 163(j) in 2018 or future years, and if the business had placed residential rental property in service before January 1, 2018, it had to use the ADS for such property with a recovery period of 40 years. *See Rev. Proc. 2019-8*, § 4, 2019-3 I.R.B. 347. In the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 202 of the [2021 Consolidated Appropriations Act](#), Congress amended the [2017 Tax Cuts and Jobs Act](#), § 13204, to provide that the 30-year ADS recovery period applies to residential rental property that is held by an electing real property trade or business and that was placed in service before January 1, 2018. The effect of this amendment is that real property trades or businesses that elect out of the interest limitation of § 163(j) and therefore are subject to the ADS with respect to residential rental property can use a recovery period of 30 years for that property regardless of when the property was originally placed in service. This change applies retroactively to taxable years beginning after December 31, 2017.

**a. The IRS has issued guidance for real property trades or businesses that elect out of § 163(j) on how to change the method of computing depreciation for residential rental property placed in service before January 1, 2018.** *Rev. Proc. 2021-28*, 2021-27 I.R.B. 5 (6/17/21). This revenue procedure provides guidance to those affected by the retroactive change enacted by Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 202 of the [2021 Consolidated Appropriations Act](#), to the recovery period under the alternative depreciation system for residential rental property placed in service before January 1, 2018. Generally, the revenue procedure permits taxpayers to file an amended federal income tax return or information return, administrative adjustment request under § 6227 of the Code (AAR), or a Form 3115, Application for Change in Accounting Method, to change their method of computing depreciation of certain residential rental property held by an electing real property trade or business to use a 30-year ADS recovery period. If such property is included in a general asset account, the revenue procedure also permits eligible taxpayers to change their general asset account treatment for such property to comply with Reg. § 1.168(i)-1(h)(2). The revenue procedure also provides special rules for taxpayers that elected to be an electing real property trade or business for their taxable year beginning in 2019 (2019 taxable year), and thereby changed to a 40-year ADS recovery period for residential rental property placed in service before 2018 under the change in use rules for the 2019 taxable year. The revenue procedure modifies *Rev. Proc. 2019-8*, 2019-3 I.R.B. 347, which provides guidance under § 168(g) related to certain property held by an electing real property trade or business. It also modifies *Rev. Proc. 2019-43*, 2019-48 I.R.B. 1107, which provides the list of automatic changes in methods of accounting, to expand the applicability of automatic changes for a change in use of certain depreciable property.

**2. Section 280F 2022 depreciation tables for business autos, light trucks, and vans.** *Rev. Proc. 2022-17*, 2022-13 I.R.B. 930 (3/16/22). Section 280F(a) limits the depreciation

deduction for passenger automobiles. For this purpose, the term “passenger automobiles” includes trucks and vans with a gross vehicle weight of 6,000 pounds or less. The IRS has published depreciation tables with the 2022 depreciation limits for business use of passenger automobiles acquired after September 27, 2017, and placed in service during 2022:

2022 Passenger Automobiles with § 168(k) first year recovery:

1st Tax Year	\$19,200
2nd Tax Year	\$18,000
3rd Tax Year	\$10,800
Each Succeeding Year	\$ 6,460

2022 Passenger Automobiles (no § 168(k) first year recovery):

1st Tax Year	\$11,200
2nd Tax Year	\$18,000
3rd Tax Year	\$10,800
Each Succeeding Year	\$ 6,460

For leased vehicles used for business purposes, § 280F(c)(2) requires a reduction in the amount allowable as a deduction to the lessee of the vehicle. Under Reg. § 1.280F-7(a), this reduction in the lessee’s deduction is expressed as an income inclusion amount. The revenue procedure provides a table with the income inclusion amounts for lessees of vehicles with a lease term beginning in 2022. For 2022, this income inclusion applies when the fair market value of the vehicle exceeds \$56,000.

## F. Credits

**1. More guidance on the employee retention credit.** [Notice 2021-49](#), 2021-34 I.R.B. 316 (8/4/21). Section 9651 of the [2021 American Rescue Plan](#) added Code § 3134, which provides an employee retention credit against specified payroll taxes for eligible employers, including tax-exempt organizations, that pay qualified wages (including certain health plan expenses) to employees after June 30, 2021, and before January 1, 2022. Previously, Congress had provided for an employee retention credit in § 2301 of the [CARES Act](#), which applies to qualified wages paid after March 12, 2020, and before January 1, 2021, and in § 207 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE of the [2021 Consolidated Appropriations Act](#), which applies to qualified wages paid after December 31, 2020, and before July 1, 2021. Thus, the [CARES Act](#) provided an employee retention credit for much of 2020, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 provided an employee retention credit for the first two quarters of 2021, and the [2021 American Rescue Plan](#) provided an employee retention credit for the last two quarters of 2021. This notice provides guidance on the employee retention credit authorized by Code § 3134, which is available during the last two quarters of 2021. The notice also amplifies two earlier notices, [Notice 2021-20](#), 2021-11 I.R.B. 922, which addresses the employee retention credit in effect for 2020, and [Notice 2021-23](#), 2021-16 I.R.B. 1113, which addresses the employee retention credit in effect for the first two quarters of 2021.

As originally enacted in the CARES Act, the employee retention credit was not available to an employer if the employer or any member of its controlled group received a Paycheck Protection Program (PPP) loan. The Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE of the [2021 Consolidated Appropriations Act](#), enacted in December 2020, changed this rule retroactively. Under the revised rule, an employer that receives a PPP loan can still qualify for an employee retention credit, but cannot use the same wages to qualify for both forgiveness of the PPP loan and the employee retention credit.

[Notice 2021-49](#) provides guidance on several important issues, including:

- The definition of a “full-time employee” for purposes of the employee retention credit.
- Whether cash tips can be treated as qualified wages.

- Whether wages paid to an employee who owns more than 50 percent (majority owner) or to the spouse of a majority owner may be treated as qualified wages.

**Note:** the Infrastructure Investment and Jobs Act, enacted on November 15, 2021, ends the employee retention credit for the fourth quarter of 2021.

**a. The IRS has provided a safe harbor permitting taxpayers to exclude the forgiveness of a PPP loan and certain other items from gross receipts for purposes of determining eligibility for the employee retention credit.** [Rev. Proc. 2021-33](#), 2021-34 I.R.B. 327 (8/10/21). An employer may be eligible for the employee retention credit if its gross receipts for a calendar quarter decline by a certain percentage as compared to a prior calendar quarter. The method used to determine if an employer is an eligible employer based on experiencing the required percentage decline in gross receipts varies depending on the calendar quarter for which the employer is determining its eligibility for the employee retention credit. For example, according to section III.C of [Notice 2021-23](#), 2021-16 I.R.B. 1113, for the first and second calendar quarters of 2021, an employer generally is an eligible employer based on a decline in gross receipts if its gross receipts for the calendar quarter are less than 80 percent of its gross receipts for the same calendar quarter in 2019. For this purpose, a taxable employer's gross receipts are determined under the rules of § 448(c) and the gross receipts of a tax-exempt employer are determined by reference to § 6033. Under these rules, the forgiveness of a PPP loan would be included in an employer's gross receipts, which could have the effect of making the employer ineligible for the employee retention credit. This revenue procedure provides a safe harbor under which an employer can exclude the forgiveness of a PPP loan from gross receipts for purposes of determining eligibility for the employee retention credit. An employer can take advantage of the safe harbor by consistently applying it in determining eligibility for the employee retention credit. According to the revenue procedure, an employer consistently applies the safe harbor by (1) excluding the amount of the forgiveness of any PPP loan from gross receipts for each calendar quarter in which gross receipts for that calendar quarter are relevant in determining eligibility to claim the employee retention credit, and (ii) applying the safe harbor to all employers treated as a single employer under the employee retention credit aggregation rules. Employers are required to retain in their records support for the employee retention credit claimed, including their use of the safe harbor.

- *Safe harbor also applies to shuttered venue operator grants and restaurant revitalization grants.* The safe harbor provided by [Rev. Proc. 2021-33](#) also applies to two congressionally authorized grants. The first, known as shuttered venue operator grants, were authorized by section 324 of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act, enacted in December 2020 as part of the [Consolidated Appropriations Act, 2021](#). This legislation authorized the Small Business Administration to make grants to eligible live venue, performing arts, and museum operators and promoters to be used for certain qualifying expenses, including payroll costs. The second grant is the restaurant revitalization grant, which was authorized by section 5003 of the [American Rescue Plan Act of 2021](#), enacted in March 2021. Restaurant revitalization grants are authorized to be made to qualifying restaurants and food vendors to be used for certain qualifying expenses, including payroll costs. Like forgiveness of PPP loans, these two grants normally would be included in gross receipts in determining eligibility for the employee retention credit. According to [Rev. Proc. 2021-33](#), employers receiving these grants can use the safe harbor provided by the revenue procedure to exclude them from gross receipts in determining eligibility for the employee retention credit.

**b. Employers that had the employee retention credit rug pulled out from under them can avoid penalties.** [Notice 2021-65](#), 2021-51 I.R.B. 880 (12/6/21). Employers eligible for the employee retention credit had two options to receive the credit. They could (1) receive advance payment of the credit, or (2) reduce employment tax deposits in anticipation of receiving the credit. An advance payment of any portion of the employee retention credit to an employer in excess of the amount to which the employer is entitled is an erroneous refund that the employer must repay. In this notice, the IRS has provided relief from penalties for employers that used one of these options in anticipation of receiving an employee retention credit for the fourth quarter of 2021. The [Infrastructure Investment and Jobs Act](#), Pub. L. No. 117-58, enacted on November 15, 2021, ends the employee retention credit of Code § 3134 for the fourth quarter of 2021 (except for so-called “recovery startup businesses”). This notice clarifies steps employers (other than recovery startup businesses) should take if they (1) paid wages after Sept. 30, 2021, (2) received an advance payment of the employee retention

credit for those wages or reduced employment tax deposits in anticipation of the credit for the fourth quarter of 2021, and (3) are now ineligible for the credit due to the repeal of the employee retention credit. The notice provides that employers (other than recovery startup businesses) that received advance payments for fourth quarter wages of 2021 will avoid failure-to-pay penalties if they repay those amounts by the due date of their employment tax returns. Employers (other than recovery startup businesses) that reduced deposits on or before Dec. 20, 2021, for wages paid during fourth calendar quarter of 2021 in anticipation of receiving the employee retention credit, will not be subject to a failure-to-deposit penalty with respect to the retained deposits if they take specified steps.

- The notice provides that employers that do not qualify for penalty relief under the notice may reply to an IRS notice about a penalty with an explanation and the IRS will consider reasonable cause relief pursuant to § 6656(a).

**G. Natural Resources Deductions & Credits**

**H. Loss Transactions, Bad Debts, and NOLs**

**I. At-Risk and Passive Activity Losses**

**III. INVESTMENT GAIN AND INCOME**

**A. Gains and Losses**

**B. Interest, Dividends, and Other Current Income**

**C. Profit-Seeking Individual Deductions**

**D. Section 121**

**E. Section 1031**

**F. Section 1033**

**G. Section 1035**

**H. Miscellaneous**

**1. A taxpayer who excluded the discharge of qualified real property business indebtedness from gross income under § 108(a)(1)(D) had to reduce the basis of depreciable real property sold in the year of discharge (rather than the basis of property held in the subsequent year) because the property sold had been taken into account under § 108(c)(2)(B) in determining whether his exclusion was limited.** [Hussey v. Commissioner](#), 156 T.C. No. 12 (6/24/21). In 2012, the taxpayer sold sixteen investment properties that were subject to liabilities. He sold fifteen of the properties in short sales. The lending bank cancelled a total \$754,054 of debt and issued fifteen Forms 1099-C, Cancellation of Debt (one for each property sold in a short sale). After filing an original return for 2012, the taxpayer filed an amended return for 2012 on which he reported that he had excludable income of \$685,281 from the discharge of qualified real property business indebtedness that should be applied to reduce the basis of depreciable real property. The taxpayer filed a return for 2013 on which he reported losses from the sale of additional investment properties and filed a return for 2014 on which he reported a net operating loss carryover from 2013. The IRS issued a notice of deficiency for 2013 and 2014 in which the IRS disallowed the 2013 loss deductions and the 2014 loss carryover from 2013. Among other issues, the Tax Court (Judge Colvin) addressed whether the 2012 discharge of indebtedness required the taxpayer to reduce the basis of depreciable real properties sold in 2012 (the year of discharge) or instead the basis of depreciable real properties held in 2013 (the subsequent year). Although the court had no jurisdiction over 2012 because the notice of deficiency related to 2013 and 2014, the determination of whether a basis reduction was required in 2012 was necessary to resolve the amount of the taxpayer's tax liability for 2013. The parties agreed that the debt discharged in 2012 was qualified real property business indebtedness as defined in § 108(c)(3), that the taxpayer was eligible to exclude the discharged debt from gross income under § 108(a)(1)(D), and that the taxpayer was therefore required by § 108(c)(1) to reduce his basis in depreciable real property by the amount excluded from gross income. The issue was whether the taxpayer had to make the basis reduction in 2012, as the IRS contended, or instead in the subsequent year, 2013, as the taxpayer contended. Section

1017(a) generally provides that, when such a basis reduction is required, a taxpayer must reduce the basis of property “held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.” However, § 1017(b)(3)(F)(iii) provides that, “in the case of property taken into account under section 108(c)(2)(B),” the basis reduction must “be made immediately before disposition if earlier than the time under subsection (a).” The court interpreted this latter provision as requiring the taxpayer to reduce the basis of the properties he sold in 2012 (rather than the basis of properties he held in 2013) if the properties he sold in 2012 had been taken into account under § 108(c)(2)(B). Section 108(c)(2)(B) limits the exclusion for the discharge of qualified real property business indebtedness and provides that the exclusion cannot exceed “the aggregate adjusted bases of depreciable real property ... held by the taxpayer immediately before the discharge ....” The court determined that the taxpayer’s aggregate bases in depreciable real property immediately before the 2012 discharge of indebtedness exceeded \$754,054, the amount of qualified real property business indebtedness that was discharged. The properties he sold in 2012, the court reasoned, had been used to show that his aggregate bases in depreciable real properties exceeded the amount of the cancelled debt and that he therefore was not affected by the § 108(c)(2)(B) limitation. Accordingly, the court concluded, the taxpayer was required by § 1017(b)(3)(F)(iii) to reduce the bases of the properties he sold in 2012 immediately before those sales. The court also concluded that the taxpayer had not experienced a discharge of indebtedness in 2013 and that he was not subject to accuracy-related penalties under § 6662 for 2013 and 2014 because he had relied in good faith on professional tax advice in preparing his returns for those years.

#### IV. COMPENSATION ISSUES

##### A. Fringe Benefits

**1. Split-dollar life insurance benefits provided to an S corporation employee-shareholder are guaranteed payments taxable as ordinary income and not a distribution with respect to stock, says the Tax Court.** [De Los Santos v. Commissioner](#), 156 T.C. No. 9 (4/12/21). In this unanimous, reviewed opinion by Judge Lauber, the Tax Court addressed the appropriate tax treatment of benefits received by a shareholder-employee of an S corporation under a split-dollar life insurance arrangement provided by the corporation. The taxpayer was the sole shareholder of an S corporation of which both he and his wife were employees. Pursuant to a welfare benefit plan adopted by the S corporation, the corporation paid the premiums on a life insurance policy on the taxpayers’ lives. In an earlier, related decision, the Tax Court had ruled that the plan constituted a compensatory split-dollar life insurance arrangement under Reg. § 1.61-22(b). See *De Los Santos v. Commissioner (De Los Santos I)*, T.C. Memo 2018-155. The issue addressed in this decision is how benefits from such split-dollar arrangements are taxed. The taxpayers argued that the economic benefits the husband received under the split-dollar life insurance arrangement constituted a distribution to the husband as a shareholder under § 301 as opposed to compensation received as an employee.

*Taxation of split-dollar life insurance.* There are two basic types of split-dollar life insurance arrangements: “compensatory” arrangements and “shareholder” arrangements. A compensatory arrangement is entered into in connection with the performance of services, for example, by an employee for an employer. In contrast, a shareholder arrangement is entered into between a corporation and a shareholder. Under both arrangements, the “owner” (here the welfare benefit plan established by the S corporation) of the life insurance contract pays the premiums and the “non-owner” (here the taxpayer, Mr. De Los Santos) retains an interest in the policy, such as an interest in the policy’s cash value or the ability to name the policy’s beneficiary. Any economic benefits of a split-dollar arrangement are treated as being provided to the non-owner of the insurance contract. The non-owner must take into account the full value of all economic benefits less any consideration paid by the non-owner. See Reg. § 1.61-22(b)(2)(ii) and (iii).

*Background and Sixth Circuit’s decision in Machacek.* In arriving at its conclusion that this was a compensatory arrangement and not a corporate distribution, the Tax Court declined to follow the decision of the U.S. Court of Appeals for the Sixth Circuit in [Machacek v. Commissioner](#), 906 F.3d 429 (6th Cir. 2018), *rev’g* T.C. Memo. 2016-55 (3/28/16), upon which the taxpayers in this case rested their argument that their split-dollar arrangement was governed by the rules of § 301, which apply to corporate distributions. In *Machacek*, the taxpayer and his wife were the sole shareholders of a

subchapter S corporation of which the taxpayer also was an employee. Pursuant to a benefit plan adopted by the S corporation, the corporation paid the \$100,000 annual premium on a life insurance policy on the taxpayer's life under an arrangement that the parties agreed was a compensatory split-dollar arrangement. The Tax Court (Judge Laro) held that the taxpayers had to include in income the economic benefit of the arrangement. In an opinion by Judge White, the Sixth Circuit reversed and remanded and held that the economic benefits of the arrangement must instead be treated as distributions of property by the S corporation. The court relied on Reg. § 1.301-1(q)(1)(i), which provides:

the provision by a corporation to its shareholder pursuant to a split-dollar life insurance arrangement, as defined in § 1.61-22(b)(1) or (2), of economic benefits described in § 1.61-22(d) . . . is treated as a distribution of property.

The Sixth Circuit reasoned that the quoted cross reference to Reg. § 1.61-22(b) indicates that Reg. § 1.301-1(q)(1)(i) applies whether the split-dollar arrangement is a shareholder arrangement or a compensatory arrangement and is dispositive. Thus, according to the Sixth Circuit, when a shareholder-employee receives benefits under a compensatory arrangement, the “benefits are treated as a distribution of property and are thus deemed to have been paid to the shareholder in his capacity as a shareholder.” Subsequently, the Sixth Circuit denied the government's petition for rehearing, in which the government asserted that the decision in *Machacek* could lead to the unanticipated consequence of causing the termination of an employer's status as an S corporation because treating the economic benefits of a split-dollar arrangement as a distribution to only one shareholder (i.e., without a corresponding distribution to all other shareholders) may result in the S corporation having an impermissible second class of stock.

*Tax Court's analysis in this case.* In this case, the S corporation adopted an employee welfare benefit plan (the “Legacy Plan”) to provide its employees with, among other things, life insurance benefits. To be eligible under the Legacy Plan, the taxpayers were required to provide services to the S corporation as their employer. Under the Legacy Plan, the taxpayers were entitled to death benefits from a second-to-die life insurance policy. During the years in issue, the S corporation made substantial premium payments to the Legacy Plan to fund the death benefits. The taxpayers did not report any income from their participation in the Legacy Plan. The taxpayers conceded that the S corporation provided them with death benefits in exchange for their performance of services and that receipt of these benefits was through the Legacy Plan as employee benefits. However, like the taxpayers in *Machacek*, the taxpayers took the position that, when a shareholder receives economic benefits from a split-dollar insurance arrangement, such benefits should be treated as a distribution of property under § 301 and that this is true notwithstanding that the insurance benefits are received in exchange for services rendered to an employer by an employee. The Tax Court disagreed with the taxpayers' contention that, while the husband's annual salary was ordinary income and did not qualify as a corporate distribution, any welfare benefits under the Legacy Plan should be treated as corporate distributions. Because the split-dollar arrangement was based on the performance of services, the Tax Court concluded, it could not be an arrangement between the corporation and the taxpayer husband as a shareholder. Accordingly, the corporate distribution rules under § 301 were inapplicable. Instead, the court concluded, any economic benefits must be treated as compensation for services and therefore ordinary income to the taxpayers. After reviewing the Sixth Circuit's analysis in *Machacek*, the Tax Court indicated that, “[w]ith all due respect, we are unable to embrace the reasoning or result of the Sixth Circuit's opinion in *Machacek*.” Specifically, the Tax Court concluded that the regulation on which the Sixth Circuit had relied, Reg. § 1.301-1(q)(1)(i), does not apply because the same regulation provides that it “is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.” Reg. § 1.301-1(c). The Tax Court reasoned that it was not bound to follow the Sixth Circuit's decision in *Machacek* in the current case because the current case is appealable to a different federal court of appeals (the Fifth Circuit). See *Golsen v. Commissioner*, 54 T.C. 742, 756-757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). Having freed itself from the Sixth Circuit's reasoning in *Machacek*, the Tax Court held that, if a corporation provides a benefit to a shareholder in the shareholder's capacity as an employee, the payment does not constitute a distribution subject to the rules of § 301. Instead, the Tax Court concluded, the economic benefits

received by the taxpayers here were taxable as compensation for services under a compensatory split-dollar arrangement.

*Treatment of the economic benefits as a guaranteed payment under § 707.* Having arrived at the conclusion that the economic benefits received by the taxpayers were compensation for services taxable as ordinary income, the Tax Court turned to the question of how fringe benefits are taxed under subchapter S. The court applied § 1372, which provides that, for purposes of applying the provisions of subtitle A of the Code that relate to employee fringe benefits, (1) an S corporation is treated as a partnership, and (2) any 2-percent shareholder of the S corporation is treated as a partner of such partnership. The Tax Court then applied its prior decision in *Our Country Home Enterprises v. Commissioner*, 145 T.C. 1 (2015), in which the court held that, where a corporation provides economic benefits to its shareholder-employee under a compensatory split-dollar arrangement, it is generally treated as a payment of compensation. However, there is an exception to the general rule if the employer is an S corporation that provides benefits to a 2-percent shareholder in return for services rendered. Under such circumstances, the 2-percent shareholder is treated as a partner in applying the employee fringe benefit rules. Because the 2-percent shareholder is treated as a partner, the economic benefits under the split-dollar arrangement are treated as guaranteed payments under § 707(c) and included in gross income under § 61. Applying these rules, the Tax Court concluded that, because the taxpayer husband in this case owned 100 percent of the stock of the S corporation, the S corporation was treated as a partnership and taxpayer husband was treated as a partner under § 1372(a). Thus, the economic benefits received by taxpayer husband under the life insurance policy held by the Legacy Plan were “guaranteed payments” subject to § 707(c) and taxed as ordinary income.

**2. There are no adverse tax consequences for employees if they forgo their vacation, sick, or personal leave in exchange for the employer’s contributions to charitable organizations providing disaster relief for those affected by the COVID-19 pandemic.** Notice 2020-46, 2020-27 I.R.B. 7 (6/11/20). In this notice, the IRS has provided guidance on the tax treatment of cash payments that employers make pursuant to leave-based donation programs for the relief of victims of the COVID-19 pandemic in all 50 states, the District of Columbia, and certain U.S. territories (affected geographic areas). Under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments that the employer makes to charitable organizations described in § 170(c). The notices provide that the IRS will not assert that: (1) cash payments an employer makes before January 1, 2021, to charitable organizations described in § 170(c) for the relief of victims of the COVID-19 pandemic in affected geographic areas in exchange for vacation, sick, or personal leave that its employees elect to forgo constitute gross income or wages of the employees; or (2) the opportunity to make such an election results in constructive receipt of gross income or wages for employees. Employers are permitted to deduct these cash payments either under the rules of § 170 as a charitable contribution or under the rules of § 162 as a business expense if the employer otherwise meets the requirements of either provision. Employees who make the election cannot claim a charitable contribution deduction under § 170 for the value of the forgone leave. The employer need not include cash payments made pursuant to the program in Box 1, 3 (if applicable), or 5 of the employee’s Form W-2.

**a. The favorable treatment of leave-based donation programs has been extended to cash payments made through 2021.** Notice 2021-42, 2021-29 I.R.B. 19 (6/30/21). This notice extends the federal income and employment tax treatment provided in Notice 2020-46 to cash payments made to § 170(c) organizations after December 31, 2020, and before January 1, 2022, that otherwise would be described in Notice 2020-46.

## **B. Qualified Deferred Compensation Plans**

**1. Some inflation-adjusted numbers for 2022.** Notice 2021-61, 2021-47 I.R.B. 738 (11/4/21).

- The limit on elective deferrals in §§ 401(k), 403(b), and 457 plans is increased to \$20,500 (from \$19,500) with a catch-up provision for employees aged 50 or older that remains unchanged at \$6,500.

- The limit on contributions to an IRA remains unchanged at \$6,000. The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to \$68,000-\$78,000 (from \$66,000-\$76,000) for single filers and heads of household, increased to \$109,000-\$129,000 (from \$105,000-\$125,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to \$204,000-\$214,000 (from \$198,000-\$208,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to \$204,000-\$214,000 (from \$198,000-\$208,000) for married couples filing jointly, and increased to \$129,000-\$144,000 (from \$125,000-\$140,000) for singles and heads of household.

- The limit on the annual benefit from a defined benefit plan under § 415 is increased to \$245,000 (from \$230,000).

- The limit for defined contribution plans is increased to \$61,000 (from \$58,000).

- The amount of compensation that may be taken into account for various plans is increased to \$305,000 (from \$290,000), and is increased to \$450,000 (from \$430,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to \$68,000 (from \$66,000) for married couples filing jointly, increased to \$51,000 (from \$49,500) for heads of household, and increased to \$34,000 (from \$33,000) for singles and married individuals filing separately.

### **C. Nonqualified Deferred Compensation, Section 83, and Stock Options**

### **D. Individual Retirement Accounts**

**1. There are a lot of reasons not to establish a self-directed IRA. This is one of them.** [McNulty v. Commissioner](#), 157 T.C. No. 10 (11/18/21). The taxpayers in this case, a married couple, established self-directed individual retirement accounts (IRAs). To establish her self-directed IRA, Ms. McNulty used the services of Check Book IRA LLC (Check Book), through its website. The IRA became the sole member of a limited liability company (LLC) and transferred assets to the LLC. Ms. McNulty and her husband were the LLC's managers. The LLC invested in American Eagle Gold coins. The coins were shipped to the taxpayers' residence and kept in a safe there. The IRS audited the taxpayers' 2015 and 2016 tax returns and asserted that the taxpayers had received taxable distributions equal to the cost of the American Eagle Gold coins. With respect to Ms. McNulty, the IRS asserted that she had received taxable distributions of \$374,000 and \$37,380 for 2015 and 2016, respectively. The Tax Court (Judge Goeke) agreed with the IRS. According to the court, "an owner of a self-directed IRA may not take actual and unfettered possession of the IRA assets." Although the LLC was the nominal owner of the coins, the court reasoned, Ms. McNulty had unfettered possession of them. Accordingly, the court held, she had received a taxable distribution equal to the value of the coins. The court also upheld accuracy-related penalties for substantial understatement of income tax. The taxpayers, according to the court, were unable to establish a reasonable cause defense based on reliance on professional advice because they had received no such advice. The court "question[ed] whether Check Book's website and/or services could constitute professional advice upon which a reasonable person could rely for purposes of section 6664(c)(1)." In summary, the court stated:

Petitioners are both professionals. They liquidated nearly \$750,000 from their existing qualified retirement accounts to invest in a questionable internet scheme without disclosing the transactions to their C.P.A. They are not entitled to the reasonable cause defense, and we sustain the penalties for both years.

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

### B. Miscellaneous Income

1. 🎵🎵To everything (turn, turn, turn), There is a season (turn, turn, turn) ... 🎵🎵 **And this is the season to have your student loans cancelled. The cancellation of student loans from 2021 through 2025 is excluded from gross income.** Section 9675 of the [2021 American Rescue Plan](#) amends Code § 108(f) by striking § 108(f)(5) and replacing it with new § 108(f)(5), which provides that gross income does not include any amount resulting from the cancellation of certain loans to finance postsecondary educational expenses regardless of whether the loan is provided through the educational institution or directly to the borrower. This rule applies to several different kinds of loans, including loans made by federal or state governments, private educational loans (as defined in § 140(a)(7) of the Truth in Lending Act), and loans made by educational institutions. The definition of qualifying loans is broad enough to cover the vast majority of postsecondary educational loans. The exclusion does not apply if the lender is an educational organization or a private lender and the cancellation is on account of services performed for the lender. New § 108(f)(5) applies to discharges of loans that occur after December 31, 2020 and before January 1, 2026.

a. **The IRS has instructed lenders that cancel student loans not to issue Form 1099-C.** [Notice 2022-1](#), 2022-2 I.R.B. 304 (12/21/21). Generally, § 6050P and the regulations issued pursuant to it require a lender that discharges at least \$600 of a borrower's indebtedness to file Form 1099-C, Cancellation of Debt, with the IRS and to furnish a payee statement to the borrower. In this notice, the IRS has instructed those normally required to issue Form 1099-C not to do so for any student loan described in § 108(f)(5) (as amended by the [2021 American Rescue Plan](#)) that is discharged after 2020 and before 2026. The notice explains the rationale for the IRS's decision as follows:

The filing of an information return with the IRS, although not required, could result in the issuance of an underreporter notice (IRS Letter CP2000) to the borrower through the IRS's Automated Underreporter program, and the furnishing of a payee statement to the borrower could cause confusion for a taxpayer with a tax-exempt discharge of debt.

### C. Hobby Losses and § 280A Home Office and Vacation Homes

### D. Deductions and Credits for Personal Expenses

1. **Standard deduction for 2022.** [Rev. Proc. 2021-45](#), 2021-48 I.R.B. 764 (11/10/21). The standard deduction for 2022 will be \$25,900 for joint returns and surviving spouses (increased from \$25,100), \$12,950 for unmarried individuals and married individuals filing separately (increased from \$12,550), and \$19,400 for heads of households (increased from \$18,800). For individuals who can be claimed as dependents, the standard deduction cannot exceed the greater of \$1,150 (increased from \$1,100) or the sum of \$400 (increased from \$350) and the individual's earned income. The additional standard deduction amount for those who are legally blind or who are age 65 or older is \$1,750 (increased from \$1,700) for those with the filing status of single or head of household (and who are not surviving spouses) and is \$1,400 (increased from \$1,350) for married taxpayers (\$2,800 on a joint return if both spouses are age 65 or older).

2. **For 2021, the child tax credit is expanded and a portion of it will be paid in advance.**<sup>1</sup> The [2021 American Rescue Plan](#) made several significant changes to the child tax credit authorized by § 24. Section 9661 of the legislation amends Code § 24 to add new subsection 24(i). Section 24(i), which applies only in 2021, increases the child tax credit amount to \$3,600 in the case of a qualifying child younger than 6 at the end of 2021, and to \$3,000 in the case of other qualifying children. The provision also enlarges the definition of a qualifying child to include children who have not attained the age of 18 by the end of 2021 (rather than 17, as under the usual child tax credit rules).

<sup>1</sup> The authors thank Professor Lawrence A. Zelenak of the Duke University School of Law for this summary of the changes to the child tax credit and for allowing us to include it in this Article.

The total amount of the 2021 child tax credit (not the amount of the credit with respect to each child considered separately) is reduced by \$50 for each \$1,000 by which the taxpayer's modified AGI exceeds \$150,000 (joint return), \$112,500 (head of household), or \$75,000 (any other case). Although the per child credit amounts under the 2021 rules are considerably larger than the usual \$2,000 per child credit amount (in 2018 through 2025), the phaseout thresholds under the 2021 rules are much lower than the usual (2018 through 2025) thresholds of \$400,000 (joint return) and \$200,000 (any other case). Thus, the 2021 rules would actually produce smaller credit amounts (or no credit at all) for many higher-income parents than would be produced by the usual rules. Section 24(i)(4) includes an incredibly convoluted (even by Internal Revenue Code standards) "limitation on reduction" provision intended to insure that such parents are not disadvantaged by the special rules for 2021. The basic idea is simple enough—that parents in 2021 should be entitled to child tax credits based on the usual rules or based on the 2021 special rules, whichever produce a larger credit—but the statutory elaboration of the rule is almost impenetrable.

The following example of how all this is supposed to work is based on an example in the House Report on the legislation (H. Rept. 117-7, at 730). The taxpayer is a head of household with modified AGI of \$140,500, and with one qualifying child, age 7. Under the usual rules, the taxpayer would be allowed a \$2,000 credit. Under the special 2021 rules, without regard to the "limitation on reduction" provision, the taxpayer would be entitled to a credit of \$3,000, reduced by \$1,400 to \$1,600. (The \$1,400 reduction is calculated as  $[(\$140,500 - \$112,500)/\$1,000] \times \$50 = \$1,400$ .) However, with the "limitation on reduction" applying the reduction will be only \$1,000, and the taxpayer will be entitled to a \$2,000 credit (reduced from \$3,000 by the phaseout). The "limitation on reduction" rules provide that the phaseout reduction cannot exceed the lesser of (1) the difference between the 2021 full credit amount and the usual full credit amount (here,  $\$3,000 - \$2,000 = \$1,000$ ), or (2) 5 percent of the difference between the usual phaseout threshold and the 2021 phaseout threshold (here,  $0.05 \times (\$200,000 - \$112,500) = \$4,375$ ). The result on these facts is that the reduction is limited to \$1,000, and the credit is \$2,000.

Section 7527A, also added by the 2021 legislation, provides for advance payment of 2021 child tax credits, in periodic equal amounts totaling 50 percent of the taxpayer's anticipated total child tax credits for 2021. The anticipated credits are determined based on a taxpayer's modified AGI for a "reference year," and on the taxpayer's qualifying children in the reference year (with the children's ages adjusted to reflect the passage of time). The reference year is generally the preceding year (2020), but it is the second preceding year (2019) if the taxpayer has not (or not yet) filed a return for the preceding year. The IRS may modify the annual advance payment amount—and thus the amount of the periodic payments—during the year to take into account a return newly filed by the taxpayer, or any other information provided by the taxpayer. The statute directs the IRS to establish an online information portal which taxpayers can use to provide credit-relevant information to the IRS, and to elect out of advance payments (in which case taxpayers can still claim their child tax credits on their 2021 returns, in the usual way).

Section 24(j) provides for reconciliation between the amount of the advance payments and the proper amount of credits (as determined after all information for 2021 is known). As one would expect, advance payments received under § 7527A reduce the amount of the credit a taxpayer can claim on her return, dollar-for-dollar. If advance payments exceed the proper credit amount based on actual 2021 results (which should not be common, given the 50 percent ceiling on advance payments), reconciliation (i.e., repayment by the taxpayer of the excess) is generally required. But if the taxpayer's actual modified AGI for 2021 does not exceed \$60,000 (joint return), \$50,000 (head of household), or \$40,000 (any other case), reconciliation is not required to the extent of the "safe harbor amount," defined as \$2,000 multiplied by the excess (if any) of the number of qualifying children taken into account in determining the amount of the advance payments, over the number of qualifying children actually taken into account under § 24. The safe harbor is phased out, ratably, as modified AGI rises between the income threshold and 200 percent of the threshold.

**a. The IRS has added an online portal to allow taxpayers to verify eligibility for the child tax credit, update bank account information, and opt out of advance payments.** [IR-2021-143](#) (6/30/21). The IRS has made available online tools to implement the recently enacted changes to the child tax credit. *See* [IR-2021-130](#) (6/22/21). The new Child Tax Credit Eligibility

Assistant allows families to answer a series of questions to quickly determine whether they qualify for the advance credit. The Child Tax Credit Update Portal allows families to verify their eligibility for the payments and if they choose to, unenroll, or opt out from receiving the monthly payments so they can receive a lump sum when they file their tax return next year. Most recently, the IRS added a feature to allow individuals to update their bank account information for direct deposit of the child tax credit. Any updates made by August 2, 2021, will apply to the August 13 payment and all subsequent monthly payments for the rest of 2021. Families will receive their July 15 payment by direct deposit in the bank account currently on file with the IRS. Those who are not enrolled for direct deposit will receive a check.

**3. Home mortgage interest is deductible despite the fact that the taxpayers received a discharge in bankruptcy, which converted the debt to nonrecourse debt, and sold their home in a short sale.** [Milkovich v. United States](#), 28 F.4<sup>th</sup> 1 (9th Cir. 3/2/22). The taxpayers purchased their home in Renton, Washington, using the proceeds of a mortgage loan and subsequently refinanced the loan. They later filed for Chapter 7 bankruptcy. The taxpayers received a discharge in the bankruptcy proceeding. The taxpayers and the government agreed that the effect of the discharge was to change their home mortgage loan from recourse to nonrecourse because it eliminated the ability of the lender, CitiMortgage, to enforce the mortgage debt personally against the taxpayers. Instead, the lender was able to enforce only the value of its lien against the property. The taxpayers were unable to make the mortgage payments and the value of their home was significantly less than their outstanding mortgage debt. Given this situation, the lender agreed to a short sale of the property, i.e., a sale for less than the amount of mortgage debt owed. From the sale, CitiMortgage received just over \$522,000, of which it credited approximately \$115,000 towards accumulated unpaid interest on the loan. CitiMortgage issued Form 1098 reporting the amount of mortgage interest paid and the taxpayers claimed a deduction for the mortgage interest, presumably on Schedule A of their return. The IRS mailed a notice of deficiency to the taxpayers disallowing their deduction of mortgage interest. The taxpayers never received the notice of deficiency because the IRS mailed it to the address of the home they had sold. The taxpayers paid the tax allegedly due and brought this action seeking a refund. The IRS argued in this litigation that the taxpayers' deduction for the mortgage interest was disallowed by § 265(a)(1), which disallows deductions "allocable to one or more classes of income ... wholly exempt from the taxes imposed by [subtitle A of the Code]." The U.S. District Court dismissed the taxpayers' refund action not on the basis of § 265(a)(1), but instead on the basis that they had engaged in a transaction that lacked economic substance analogous to the transaction in *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). In *Estate of Franklin*, the taxpayer acquired property using the proceeds of nonrecourse debt that significantly exceeded the value of the property acquired. Although the taxpayers in this case did not acquire their property using nonrecourse debt that exceeded the value of the property, the District Court reasoned that their position was analogous to that of the taxpayer in *Estate of Franklin* and therefore disallowed their mortgage interest deductions. In an opinion by Judge Collins, the U.S. Court of Appeals for the Ninth Circuit reversed the District Court's decision. According to the Ninth Circuit, the District Court erred in extending the holding of *Estate of Franklin* to the taxpayers' situation. There was no suggestion, the court observed, that the taxpayers had acquired their mortgage loan in a transaction that lacked economic substance. According to the court:

Nothing in *Estate of Franklin* suggests that, without more, a subsequent collapse in real estate values means that the now-underwater mortgage should be considered a sham debt that cannot support a mortgage interest deduction.

The fact that the discharge the taxpayers received in bankruptcy changed the debt to nonrecourse debt, the court reasoned, did not alter the fact that the debt was bona fide debt that supported an interest deduction.

The court also rejected the government's argument that § 265(a)(1) disallowed the taxpayers' deduction. The court reviewed basic principles under which a taxpayer experiences discharge of indebtedness income if the taxpayer engages in a short sale of property subject to recourse indebtedness followed by cancellation of the remaining balance owed. See Reg. §§ 1.1001-2(a)(2), 1.1001-2(c) (ex. 8). In contrast, if the debt is nonrecourse, the entire amount of the debt is included in the taxpayer's amount realized. See, e.g., *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Simonsen v. Commissioner*,

150 T.C. 201 (2018); Reg. §§ 1.1001-2(a)(1), 1.1001-2(c) (ex. 7). When the debt is nonrecourse and fully included in amount realized, the taxpayer does not experience cancellation of indebtedness income. Accordingly, the taxpayers did not have any cancellation of indebtedness that was excluded from their income and therefore it was inappropriate to disallow their mortgage interest deduction under § 265(a)(1). The court also concluded that, even if a discharge of indebtedness had occurred in the context of the bankruptcy proceeding, § 265(a)(1) did not preclude the taxpayer's deduction of the mortgage interest in question. The court reasoned that taxpayers who exclude cancellation of indebtedness income from gross income pursuant to § 108(a)(1)(A) because the cancellation occurred in a bankruptcy proceeding must reduce favorable tax attributes pursuant to § 108(b) by the amount of cancelled debt they excluded from gross income. For this reason, the court observed, the "exclusion" from gross income provided by § 108(a)(1)(A) is not a true exclusion, but rather a deferral of income. For this reason, the court concluded, "cancellation-of-indebtedness income exempted under § 108(a)(1)(A) is not 'wholly exempt' from income taxation within the meaning of § 265(a)(1)."

*Dissenting opinion by Judge Stearns.* Judge Stearns dissented, primarily on the basis that the taxpayers had not actually "paid" the mortgage interest in question.

## **E. Divorce Tax Issues**

**1. A taxpayer can deduct as alimony his payments of his wife's health insurance premiums even though he paid the premiums with amounts excluded from his gross income, says the Tax Court.** [Leyh v. Commissioner](#), 157 T.C. No. 7 (10/4/21). The taxpayer and his wife signed an agreement pursuant to which he agreed to pay alimony until their final decree of divorce, which was granted in a later year. As part of the agreement, the taxpayer agreed to pay the premiums for his wife's health and vision insurance. In 2015 he paid \$10,683 for his wife's health insurance premiums as pretax payroll reductions from his wages through his employer's cafeteria plan. The taxpayer excluded from his gross income the health care coverage premiums he and his wife received through his employer's cafeteria plan and also claimed a deduction for the \$10,683 as alimony. The IRS did not dispute that the taxpayer's payments constituted alimony but asserted that he could not deduct the payments as alimony because he had paid it from funds that he excluded from income. The Tax Court (Judge Greaves) disagreed and upheld the taxpayer's deduction of alimony. The court noted that, absent a clear declaration of congressional intent, double deductions or their equivalent are not permitted, but reasoned that the taxpayer's situation did not present such a scenario. The court explained that the tax consequence to the payee was relevant to the question whether the husband, the payor, was entitled to a deduction. Under the regime that applied to alimony in 2015, § 215 permitted an above-the-line deduction for the payor of alimony and § 71 required the recipient to include the alimony in gross income. According to the court, under this matching regime, if the taxpayer's wife was required to include the alimony payments in gross income, then the taxpayer should be entitled to a deduction for the payments. This result is consistent, the court reasoned, with the result that would have occurred had the taxpayers, who were still married at the time, filed a joint return rather than separate returns. If they had filed a joint return, the health insurance premiums would have been excluded from their gross income, the husband would have had no deduction, and the wife would not have had any income. The court also rejected the IRS's argument that § 265 precluded the husband's deduction. Section 265(a)(1) generally provides that an amount may not be deducted if it is allocable to wholly tax-exempt income (other than interest). According to the court:

Our decisions broadly interpreting section 265(a)(1) have instead generally shared the same basic concern: But for the application of section 265, a taxpayer would have recognized a double tax benefit where one was not otherwise available to him. See, e.g., [Induni v. Commissioner](#), 98 T.C. 618, 623 (1992), *aff'd*, 990 F.2d 53 (2d Cir. 1993); [Rickard v. Commissioner](#), 88 T.C. 188, 193 (1987); [Manocchio v. Commissioner](#), 78 T.C. at 994-995, 997. Such application is consistent with the text of the statute. As we have explained *supra*, this threat does not exist here given the special nature of the alimony regime. Furthermore, the alimony payments are not considered allocable to wholly tax-exempt income for section 265 purposes as Ms. Leyh was required to include it in *her* income. For these reasons, we decline to extend the reach of section 265 to petitioner's alimony deduction.

- In the 2017 Tax Cuts and Jobs Act, Congress repealed §§ 71 and 215 for divorce or separation instruments executed or modified after 2018.

**F. Education**

**G. Alternative Minimum Tax**

**VI. CORPORATIONS**

**A. Entity and Formation**

**B. Distributions and Redemptions**

**1. Tax Court holds management fees paid by C corporation to its shareholders were constructive dividends.** [Aspro, Inc. v. Commissioner](#), T.C. Memo. 2021-8 (1/21/21). The issue in this case was whether Aspro, Inc. (Aspro) was entitled to deduct management fees paid to its shareholders. Aspro was an Iowa C corporation for federal tax purposes and was engaged in the asphalt paving business. The company had three shareholders: Jackson Enterprises, Corp. (40%) (Jackson), Mannatt's Enterprises, Ltd. (40%), and Mr. Dakovich, Aspro's president (20%). In each year relevant to this dispute, the shareholders received, among other forms of payment, substantial management fees that Aspro deducted. In examining whether the payments were in fact distributions of earnings rather than compensation for services rendered, the Tax Court (Judge Pugh) turned for guidance to Reg. § 162-7(b)(1), which governs the classification of such payments. This regulation provides:

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

The Tax Court concluded that Aspro had failed to show the management fees were paid purely or wholly for services and agreed with the IRS that Aspro could not deduct the fees. The Tax Court came to this conclusion for numerous reasons. Aspro did not enter into any written agreement and did not agree on any management fee rate or billing structure with any one or more of its shareholders. Rather, the board of directors approved management fees each year. The minutes of the board of directors meetings did not reflect how the directors determined to approve the management fees paid to the shareholders. The board did not attempt to value or quantify any of the management services performed. The management fees paid to each shareholder were approximately the same each year even though the services provided by each shareholder varied from year to year. The percentage of management fees paid roughly corresponded to each of the three shareholders' respective ownership interests. Aspro paid the management fees as a lump sum at the end of each year even though services were rendered throughout the year. Another circumstance that influenced the Tax Court was the coincidence that Aspro had very little income after deducting management fees. Finally, it was unfortunate for Aspro that none of the witnesses that testified could explain how the company had determined the appropriate amount of management fees. The testimony regarding how management fees were valued was vague and contradictory. No expert testimony was introduced to aid the court in establishing the reasonableness of the amounts paid for the purported management services. For these reasons, Aspro failed to prove that the management fees it had paid to shareholders qualified as compensation for services rendered.

*Whether management fees along with other compensation paid to Mr. Dakovich was reasonable compensation.* Having found at every turn that Aspro had failed to provide any evidence to support its deduction for management fees as compensation for services rendered, the court then turned to whether the payments to Mr. Dakovich in his capacity as president of the company were deductible as reasonable compensation. With respect to shareholder-employees, one approach to determining reasonable compensation commonly used by courts is a multi-factor test. *See, e.g., Charles Schneider & Co. v. Commissioner*, 500 F.2d 148, 152 (8th Cir. 1974). The Tax Court relied on these factors and

on the analysis in the report of the IRS's expert, Mr. Nunes (the Nunes Report), which the court found persuasive. Mr. Dakovich had decades of experience as Aspro's top executive. He had wide ranging duties and worked long hours. Only this factor was found to weigh in favor of treating Mr. Dakovich's compensation as reasonable. On the other hand, under the prevailing economic conditions, which were found to be stable, Aspro's sales declined by 7 percent. Further, the Nunes Report supported a finding that individuals with positions similar to Mr. Dakovich within the same industry had an upper quartile compensation rate substantially less than Mr. Dakovich did. Because the management fees paid to Mr. Dakovich were in addition to his salary, and his salary was in excess of that paid to individuals in comparable positions, this factor weighed heavily against treating the management fees as reasonable compensation. In computing compensation paid to shareholders as a percentage of net income before shareholder compensation is paid, the Tax Court found that Aspro's shareholder compensation was 90 percent, over 100 percent, and 67 percent of net income for the years in issue. These high percentages were found to weigh against treating the amounts paid to Mr. Dakovich as reasonable compensation. Finally, the Tax Court observed that Aspro had never paid dividends. By paying such high shareholder compensation, Aspro was less profitable than its industry peers. Low profits led to low retained earnings which, in turn, led to low returns for Aspro shareholders. Needless to say, the Tax Court found Mr. Dakovich's compensation to be unreasonably high.

*Aftermath and observations.* Because the management fees that Aspro paid to its shareholders did not constitute reasonable compensation, the court upheld the IRS's disallowance of the corporation's deductions and treated the management fees as nondeductible distributions to shareholders. The decision presents a roadmap of how not approach compensation of shareholders who provide services to the corporation. In the inverse, this case provides an excellent menu of how a closely held C corporation can structure reasonable compensation and avoid or survive a challenge by the IRS. Given the court's heavy reliance on the Nunes Report, one of the most important steps that might be taken is to seek a qualified valuation expert who can support the compensation paid by the corporation to a employee-shareholders in high level positions.

**a. The Eighth Circuit agrees: management fees paid by C corporation to its shareholders were constructive dividends.** Aspro, Inc. v. Commissioner, \_\_\_ F.4th \_\_\_ (8th Cir. 4/26/22). In an opinion by Judge Gruender, the U.S. Court of Appeals for the Eighth Circuit has affirmed the Tax Court's decision that disallowed the deductions taken by Aspro, Inc., a subchapter C corporation, for "management fees" paid to its shareholders. As previously discussed, the corporation had three shareholders: Jackson Enterprises, Corp. (40%) (Jackson), Mannatt's Enterprises, Ltd. (40%) (Mannatt's), and Mr. Dakovich, Aspro's president (20%). The court first considered the management fees paid to Jackson and Mannatt's. The court concluded that the Tax Court had not clearly erred in finding that Aspro had failed to meet its burden to show that these management fees were reasonable. Aspro, the court observed, had failed to quantify the value of services provided, failed to produce documentary evidence of a service relationship with Jackson and Mannatt's, and produced no evidence of how it had determined the amount of the management fees. Further, the court agreed with the Tax Court that the management fees paid to Jackson and Mannatt's were not purely for services rendered and instead were disguised distributions of profit. The court noted that Aspro had not paid dividends since the 1970s and that the management fees were roughly proportional to the ownership interests of these two shareholders. The court next considered the management fees that Aspro had paid to its president, Mr. Dakovich, and concluded, for similar reasons, that Aspro could not deduct the management fees. According to the court, Aspro had not quantified the value of the management services provided by Mr. Dakovich. The government's expert, the court observed, had concluded that the salary and bonus that Aspro paid to him exceeded the industry average and median by a substantial margin and that the management fees, which were paid in addition to his salary and bonus, were not reasonable. In addition, the court noted, the sum of the management fees plus the excess salary and bonus paid to Mr. Dakovich was roughly proportional to his ownership interest in the corporation. Finally, the court concluded, the management fees paid to Mr. Dakovich were not purely for services rendered and instead were disguised distributions of profit:

Aspro paid the management fees as lump sums at the end of the tax year even though the purported services were performed throughout the year, had an unstructured process of setting the management fees that did not relate to the services performed,

and had a relatively small amount of taxable income after deducting the management fees.

Accordingly, the court concluded, the Tax Court did not clearly err in finding that Aspro had failed to carry its burden of showing that the management fees were reasonable and purely for services actually performed.

**2. Tax Court holds rent paid by corporation to its shareholders is partially a constructive dividend.** [Plentywood Drug, Inc. v. Commissioner](#), T.C. Memo. 2021-45 (4/26/21). Plentywood Drug, Inc. (Plentywood, Inc.) is a Montana C corporation that operates a pharmacy in a building located in Plentywood, Montana, that the corporation occupies as a tenant. Plentywood, Inc. has four shareholders (two married couples). In their individual capacities, the four shareholders equally co-own the building that is leased by Plentywood, Inc. In 2011, Plentywood, Inc. paid a total of \$83,548 in rent to the four shareholders. In 2012 and the following year, the rent was increased to \$192,000. By having the corporation deduct the rent from its income each year, Plentywood, Inc. and its shareholders were able, to an extent, to avoid the normal double taxation of a C corporation's income. On audit, the IRS disallowed substantial portions of the rental deductions and took the position that the rent paid far exceeded what the fair market rent would have been in each of the years. In the words of Judge Holmes, the IRS "lassoed" the shareholder owners of the building, characterized a portion of the rents as nondeductible constructive dividends to the four shareholders, and then "branded" the shareholders and the corporation with accuracy-related penalties. The Tax Court noted that the IRS does not often question the reasonableness of rents, but sometimes does so when the "landlord and tenant might not have an incentive to drive a hard bargain":

"When there is a close relationship between lessor and lessee and in addition there is no arm's length dealing between them, an inquiry into what constitutes reasonable rental is necessary to determine whether the sum paid is in excess of what the lessee would have been required to pay had he dealt at arm's length with a stranger. \* \* \*

*Place v. Commissioner*, 17 T.C. 199, 203 (1951), *aff'd*, 199 F.2d 373 (6th Cir. 1952). The issue was whether the rent paid by Plentywood, Inc. to the four shareholders was a fair market rent. To the extent that the rent paid by Plentywood, Inc. exceeded a fair market rent, the excess of the actual rent paid over a fair market rent would be a constructive dividend to the shareholders. As is typical in valuation cases, each side introduced expert testimony. The determination of a fair market rent was made more difficult by the small size of the town of Plentywood, which had a population of only 1,700. The taxpayer and the IRS each criticized the methodology and conclusion of the opposing side's expert. For example, the IRS argued that Plentywood, Inc.'s expert did not adhere to the Uniform Standards of Professional Appraisal Practice (USPAP). The USPAP, the court noted, are not federal rules of evidence. Although Montana requires licensed appraisers to follow USPAP, the court relied on its prior decisions in which it had declined to adopt USPAP as the sole standard for reliability of an expert appraiser. See *Whitehouse Hotel Ltd. P'ship v. Commissioner*, 131 T.C. 112, 128 (2008), *rev'd on other grounds*, 615 F.3d 321 (5th Cir. 2010). According to the court, although the failure of Plentywood, Inc.'s expert to follow USPAP may adversely affect the weight the court gives to expert testimony, it does not, by itself, make the testimony so unreliable as to be inadmissible. The court had its own criticisms of the methodology used by each side's expert. For example, Judge Holmes was critical of the use by Plentywood Inc.'s expert of comparables from the neighboring town of Williston, Montana, which is eight times larger than the town of Plentywood and had experienced an economic boom in the oil industry that affected rents. Judge Holmes was also critical of the use by the IRS's expert of two government-subsidized multifamily residential housing units and a very small donut shop as comparable properties in assessing the rent paid for space used for a retail drug store operation. Instead, Judge Holmes focused on the Post Office building in Williston as the most comparable building for purposes of determining a fair market rent. To "round up" the analysis of the Tax Court here, Plentywood, Inc. and its shareholders asserted that the annual rent of \$192,000 per year was reasonable while the Tax Court concluded that the fair market rent for the space was \$171,187.50. Finally, the court declined to uphold the accuracy-related penalties the IRS sought to impose under § 6662(a) on the shareholders because the IRS had failed to meet its burden of production to show that it had obtained supervisory approval of the initial determination of the penalties as required by § 6751(b). See, e.g., *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017). The corporation, the court reasoned,

could not rely on § 6751(b) to avoid accuracy-related penalties because the corporation bore the burden of production for its own case and had failed to show that the IRS had not obtained the required supervisory approval. Nevertheless, the court concluded, the corporation was not subject to accuracy-related penalties because neither ground relied on by the IRS (substantial understatement of income or negligence or disregard of rules) was satisfied. Given that the rent in question was overstated by only approximately \$20,000, the court concluded, there was no substantial understatement of income as that term is defined in § 6662(d)(1)(B). And given the difficulty in determining a fair market rent and the small overstatement of rent that occurred, the corporation had a reasonable cause, good faith defense to the claim that it had been negligent or disregarded rules. As valuation opinions go, one could reasonably conclude that these Montana taxpayers “wrangled” an excellent outcome.

**3. More than thirty years after the Technical and Miscellaneous Revenue Act of 1988, the regulations under § 301 are updated to make conforming changes.** [T.D. 9954, Treatment of Distributions of Property from a Corporation to a Shareholder](#), 86 F.R. 52612 (9/22/21). The IRS and the Treasury Department have finalized with no substantive changes proposed regulations issued in 2019 under § 301 regarding corporate distributions to reflect statutory changes made by the Technical and Miscellaneous Revenue Act of 1988. See [REG-21694-16, Updating Section 301 Regulations to Reflect Statutory Changes](#), 84 F.R. 11263 (3/26/19). The Technical and Miscellaneous Revenue Act of 1988 amended § 301(b)(1) and § 301(d), effective as if the amendments had been included in the Tax Reform Act of 1986, to eliminate certain distinctions that previously existed between corporate and non-corporate distributees and certain special rules for distributions to or from foreign corporations. As amended, these statutory provisions state that the amount of a corporate distribution is the amount of money received plus the fair market value of property received (§ 301(b)(1)), and that the basis of property received from a corporation is the fair market value of that property (§ 301(d)). These final amendments update Reg. § 1.301-1 to reflect these changes and make certain non-substantive changes including modifying cross-references and reorganizing some provisions. Although the final regulations apply to distributions made after September 22, 2021, the statutory changes that they reflect are already effective and apply to distributions made in taxable years beginning after December 31, 1986.

**C. Liquidations**

**D. S Corporations**

**E. Mergers, Acquisitions and Reorganizations**

**1. Wait, what? “I want a do-over” seems to have worked. Tax Court allowed taxpayer to disavow the form of its issuance of stock in exchange for assets in favor of the substance of the transaction and thereby deduct amortization expenses.** [Complex Media, Inc. v. Commissioner](#), T.C. Memo. 2021-14 (3/31/21). The opinion of the Tax Court (Judge Halpern) in this case is lengthy (more than 100 pages) and complex and could well have been classified by the court as a Tax Court division opinion. The opinion is novel in that the Tax Court allowed the petitioner, Complex Media, Inc. (CMI), to disavow the original form of its stock-for-assets transaction in favor of a different form, which allowed CMI to increase the amortizable basis of a portion of the intangible assets it received when it issued stock in exchange for assets in a transaction purportedly subject to § 351. On audit, the IRS disallowed amortization deductions claimed by CMI with respect to intangible assets CMI had acquired from a limited liability company (LLC) classified for federal tax purposes as a partnership, Complex Media Holdings, LLC (CMH LLC). At the time of CMI’s acquisition of the assets, Mr. Gerszberg, who was a member of (i.e., partner in) CMH LLC, was not interested in the acquisition and wanted to have his partnership interest redeemed. However, CMH LLC did not have sufficient liquid funds to redeem Mr. Gerszberg’s partnership interest prior to the transaction. In order to accomplish certain goals, CMI engaged in multiple related steps of an overall transaction. In one step, CMI acquired OnNetworks, Inc. (ONI) through a newly formed, wholly owned corporate subsidiary (Acquisition Sub) of CMI that merged into ONI. After the merger, CMI’s Acquisition Sub ceased to exist and only ONI remained. Pursuant to the merger agreement, the original shareholders of ONI exchanged stock in ONI for preferred stock in CMI. Contemporaneous with the ONI merger transaction, CMH LLC contributed assets it acquired from its two lower tier LLCs to CMI with CMH LLC receiving CMI stock in the exchange. Immediately after CMH LLC’s contribution of assets in

exchange for CMI stock, CMI redeemed a portion of its shares back from CMH LLC. The total consideration paid by CMI in the redemption was \$3 million, with \$2,700,000 being paid up front and \$300,000 to be paid later. The \$3 million of cash was then used by CMH LLC to completely redeem Mr. Gerszberg's partnership interest in CMH LLC. CMI and CMH LLC agreed in the relevant documents setting forth the parties' agreement to treat CMH LLC's contribution of assets in exchange for CMI stock as a transaction eligible for nonrecognition pursuant to § 351(a) and to treat CMI's redemption of a portion of the shares issued to CMH LLC as a separate transaction. However, CMI reported on its corporate return that the \$3 million paid to redeem a portion of the shares held by CMH LLC was taxable boot in the § 351 transaction, which triggered gain recognition for CMH LLC and increased CMI's basis in the assets it received by the amount of gain recognized by CMH LLC. CMI took amortization deductions under § 197 calculated on the assumption that CMH LLC recognized gain of \$3 million from its receipt of boot, i.e., CMI increased its basis in the assets by \$3 million. Stated another way, CMI initially agreed to treat the transactions as a § 351 nonrecognition transaction in which it acquired assets from CMH LLC with the same basis that CMH LLC had in those assets, followed by a redemption of stock owned by CMH LLC in a separate transaction. But, after the fact, CMI treated the \$3 million redemption as boot paid in the § 351 transaction. The IRS, however, argued that CMI was bound by the form of the transaction it had chosen, i.e., a nontaxable transaction subject to § 351 with no boot, and that CMI therefore was not entitled to a step-up of \$3 million in the basis of the intangible assets received.

*The issues.* According to the Tax Court, the issues were: (1) whether the tax consequences to CMI should follow the form of its written agreement wherein CMI issued shares of stock in exchange for assets in a transaction that qualified for nonrecognition under § 351; (2) if not, whether, the transaction should be recharacterized under the step transaction doctrine to treat as taxable boot the \$2.7 million in cash and the right to an additional \$300,000 (\$3 million total) that CMI paid to CMH LLC in redemption of CMI shares; and (3) if the step transaction doctrine applied, what portion of the boot received by CMH LLC in the exchange was allocable to certain § 197 intangibles thereby increasing CMI's amortizable basis in such intangibles. The increased basis and resulting amortization deductions related to these intangibles were at the core of this dispute between CMI and the IRS.

*Whether the tax consequences must follow the form of CMI's written agreement.* Initially, the Tax Court noted that CMI and the IRS both agreed that CMI acquired the assets from CMH LLC in a transaction eligible for nonrecognition under § 351. If the transaction did qualify for nonrecognition under § 351 and CMI's redemption of a portion of the stock held by CMH LLC was a separate transaction, then CMI would have inherited CMH LLC's basis in the assets that CMH LLC transferred. If the transaction qualified for nonrecognition under § 351 but the \$3 million paid to redeem a portion of CMH LLC's stock was taxable boot, then CMI's basis in the assets it acquired would have increased by the portion of the \$3 million boot allocated to the intangibles. In contrast, if the transaction did *not* qualify for nonrecognition under § 351, then CMH LLC's contribution of assets in exchange for CMI stock would have been a taxable asset acquisition that would have allowed CMI to capitalize the full \$7,616,852 value of the intangible assets and amortize that amount. CMI and the IRS both argued that the transaction qualified for nonrecognition under § 351. They differed as to the appropriate treatment of the \$3 million CMI paid to redeem a portion of the shares held by CMH LLC. CMI asserted that the \$3 million was boot in the § 351 transaction and the IRS argued that the \$3 million was a separate redemption of stock that did not affect CMI's basis in the assets it acquired from CMH LLC, i.e., the IRS asserted that CMI was bound by the form and tax treatment of the transaction to which it had agreed in the relevant documentation. The court expressed skepticism that the control test of § 351(a) (which requires those transferring property to the corporation to own stock possessing at least 80 percent of total combined voting power and value immediately after the exchange) was met. CMI argued that both the ONI shareholders, who received preferred stock, and CMH LLC shareholders should be considered together for purposes of determining control. Together, CMH LLC and ONI shareholders owned 100 percent of CMI after the transaction. The Tax Court concluded, however, that the ONI shareholders had not contributed property to CMI and therefore could not be included in determining control. CMH LLC clearly had transferred property to CMI in exchange for CMI common stock, but CMH LLC by itself was not "in control" of CMI immediately after the exchange as required under § 351(a). Although the Tax Court was not convinced that CMH LLC's transfer of assets to CMI in exchange for CMI stock qualified for nonrecognition under § 351, the court nevertheless treated the

transaction as qualifying under § 351. The court reasoned that CMI was the only party that would benefit from a determination that its acquisition of assets was a taxable purchase rather than a § 351 exchange, that CMI had steadfastly maintained that the acquisition was covered by § 351, and that the duty of consistency might well prevent CMI from taking a contrary position. Having concluded that it would accept the parties' characterization of the transaction as one that qualified under § 351, the court turned to the appropriate treatment of the \$3 million that CMI paid to redeem a portion of the stock held by CMH LLC. The court began this analysis by quoting the rule of law adopted by the U.S. Court of Appeals for the Third Circuit in *Commissioner v. Danielson*, 378 F.2d 771, 775 (3rd Cir. 1967), in which the court stated:

a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.

The IRS argued that, because CMI did not challenge the relevant agreements on grounds of fraud, mistake, undue influence, or duress, CMI could not deviate from the terms of the agreements, but the Tax Court disagreed. The Tax Court also acknowledged the rule in *Ullman v. Commissioner*, 264 F.2d 305, 308 (2nd Cir. 1959), in which the U.S. Court of Appeals for the Second Circuit held that a taxpayer may not be required to adhere to the form of its agreement if there is “strong proof” that the terms of the agreement do not comport with economic reality. While CMI did not claim that it satisfied the strong proof standard by proving that the provisions of the relevant agreements did not reflect economic reality, CMI did claim that the strong proof test did not apply because neither the policy concerns of that test nor the policy concerns in *Danielson* were raised by the facts of the case. According to CMI, this was so because the parties involved ultimately treated it as a § 351 transaction with \$3 million of boot. Mr. Gerszberg, whose interest in CMH LLC was redeemed with the cash received from CMI, reported the funds as income on his individual tax return. CMI treated the payment as taxable boot, stepped up its basis in the § 197 intangibles received in the exchange, and calculated its amortization deductions on the stepped-up basis. As discussed below, the Tax Court ultimately permitted CMI to disavow the form of its transaction and treat the \$3 million paid to CMH LLC as taxable boot rather than an amount paid to redeem stock, but first had to address what showing a taxpayer must make in order to disavow the form of a transaction.

*What a taxpayer must show to disavow the form of a transaction.* The Tax Court noted that it was, at one time, less willing to allow a taxpayer to disavow the form of a transaction but “has become more hospitable” to doing so. After a lengthy review of prior decisions addressing this issue, the court concluded “that the additional burden the taxpayer has to meet in disavowing transactional form relates not to the quantum of evidence but instead to its content—not how much evidence but what that evidence must show by the usual preponderance.” More specifically, the Tax Court concluded:

The Commissioner can succeed in disregarding the form of a transaction by showing that the form in which the taxpayer cast the transaction does not reflect its economic substance. For the taxpayer to disavow the form it chose (or at least acquiesced to), it must make that showing and more. In particular, the taxpayer must establish that the form of the transaction was not chosen for the purpose of obtaining tax benefits (to either the taxpayer itself, as in *Estate of Durkin*, or to a counterparty, as in *Coleman*) that are inconsistent with those the taxpayer seeks through disregarding that form. When the form that the taxpayer seeks to disavow was chosen for reasons other than providing tax benefits inconsistent with those the taxpayer seeks, the policy concerns articulated in *Danielson* will not be present.

After reviewing at length how the transaction would be taxed under the form to which CMI had agreed and how it would be taxed under the form that CMI reflected on its corporate tax return, and the reasons why CMI might have selected the form it chose, the court concluded that it had no reason to believe that tax benefits were the goal of CMI's planning or that such planning would be inconsistent with allowing CMI to obtain a basis step-up in the assets it acquired from CMH LLC. The Tax Court therefore concluded that CMI could rely on the substance-over-form doctrine and turned to the question of how the step transaction doctrine applied. Under the step transaction doctrine, the court reasoned,

CMI was required to disregard the step in which it issued and immediately redeemed for \$3 million a portion of the shares issued to CMH LLC because that step did not have economic substance. By application of the step transaction doctrine, the Tax Court concluded that CMI should be treated as having acquired assets from CMH LLC in exchange for shares of stock and boot of \$3 million.

*Assuming the transaction is recharacterized under the step transaction doctrine, whether a portion of the gain recognized by CMH LLC in the exchange was allocable to certain § 197 intangibles.* Finally, the court addressed the specific amount of the basis increase to amortizable § 197 intangibles to which CMI was entitled. The court applied the residual allocation method of § 1060 by subtracting from the total value of assets received by CMI (\$8 million) the estimated total value of the assets that were not § 197 intangibles (roughly \$383,000) to arrive at the value allocated to the § 197 intangibles (roughly \$7.62 million). Because the § 197 intangibles were worth approximately 95 percent of the total assets received by CMI, the court assigned the same percentage of the boot received by CMH LLC to the § 197 intangibles to determine the basis increase in the intangibles to which CMI was entitled.

#### **F. Corporate Divisions**

#### **G. Affiliated Corporations and Consolidated Returns**

#### **H. Miscellaneous Corporate Issues**

**1. After more than 200 pages, how about next time we just flip a coin? Four Circuits have rejected the government’s argument that the substance-over-form doctrine applies to recharacterize the ownership of DISC or FSC stock by a Roth IRA.** The following cases dramatically illustrate the uncertainties faced by advisors, the IRS, and the courts when deciding between transactions that constitute creative but legitimate tax planning and those that are considered “abusive.” The cases involve taxpayers using statutorily-sanctioned tax-planning devices in tandem (Roth IRAs coupled with a DISC or a FSC). Four U.S. Courts of Appeal have rejected the government’s argument that the substance-over-form doctrine applies to recharacterize the ownership of DISC or FSC stock by a Roth IRA. If this is no surprise to you, you can stop here. If you are intrigued, read further.

**a. Form is substance, says the Sixth Circuit. The IRS is precluded from recharacterizing a corporation’s payments to a DISC held by a Roth IRA.** [\*Summa Holdings, Inc. v. Commissioner\*](#), 848 F.3d 779 (6th Cir. 2/16/17), *rev’g* T.C. Memo 2015-119 (6/29/15). Two members of the Benenson family each established a Roth IRA by contributing \$3,500. Each Roth IRA paid \$1,500 for shares of a Domestic International Sales Corporation (DISC). These members of the Benenson family were the beneficial owners of 76.05 percent of the shares of Summa Holdings, Inc., the taxpayer in this case and a subchapter C corporation. Summa Holdings paid (and deducted) commissions to the DISC, which paid no tax on the commissions. The DISC distributed dividends to each of the Roth IRAs, which paid unrelated business income tax on the dividends (at roughly a 33 percent rate according to the court) pursuant to § 995(g). (The structure involved a holding company between the Roth IRA and the DISC, but the presence of the holding company appears not to have affected the tax consequences.) This arrangement allowed the balance of each Roth IRA to grow rapidly. From 2002 to 2008, the Benensons transferred approximately \$5.2 million from Summa Holdings to the Roth IRAs through this arrangement, including \$1.5 million in 2008, the year in issue. By 2008, each Roth IRA had accumulated over \$3 million. The IRS took the position that the arrangement was an impermissible way to avoid the contribution limits that apply to Roth IRAs. The IRS disallowed the deductions of Summa Holdings for the commissions paid to the DISC and asserted that, under the substance-over-form doctrine, the arrangement should be recharacterized as the payment of dividends by Summa Holdings to its shareholders, followed by contributions to the Roth IRAs by the two members of the Benenson family who established them. The IRS determined that each Roth IRA had received a deemed contribution of \$1.1. By virtue of their level of income, the two Benenson family members were ineligible to make any Roth IRA contributions. Pursuant to § 4973, the IRS imposed a 6 percent excise tax on the excess contributions.

*The Tax Court’s decision (Summa I).* The Tax Court (Judge Kerrigan) upheld the IRS’s recharacterization. Judge Kerrigan relied upon *Repetto v. Commissioner*, T.C. Memo 2012-168 and

Notice 2004-8, 2004-1 C.B. 333, both of which addressed using related-party businesses and Roth IRAs in tandem to circumvent excess contribution limits. Foreshadowing its argument in *Repetto*, the IRS had announced in Notice 2004-8 that these arrangements were listed transactions and that it would attack the arrangements on several grounds, including “that the substance of the transaction is that the amount of the value shifted from the Business to the Roth IRA Corporation is a payment to the Taxpayer, followed by a contribution by the Taxpayer to the Roth IRA and a contribution by the Roth IRA to the Roth IRA Corporation.” Importantly, subsequent Tax Court decisions, *Polowniak v. Commissioner*, T.C. Memo 2016-31 and *Block Developers, LLC v. Commissioner*, T.C. Memo 2017-142, adopted the IRS’s position in Notice 2004-8 and struck down tandem Roth IRA/related-party business arrangements like the one under scrutiny in *Summa I*.

*The Sixth Circuit’s decision (Summa II)*. In an opinion by Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit reversed.<sup>2</sup> The court emphasized that “[t]he Internal Revenue Code allowed Summa Holdings and the Benensons to do what they did.” The issue was whether the IRS’s application of the substance-over-form doctrine was appropriate. The court first expressed a great deal of skepticism about the doctrine:

Each word of the “substance-over-form doctrine,” at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it’s fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. “Form” is “substance” when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern “over” the written form of the law—and to call it a “doctrine” no less.

Although the court expressed the view that application of the substance-over-form doctrine makes sense when a “taxpayer’s formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process,” this was not such a case. The substance-over-form doctrine as applied by the IRS in this case, the court stated, was a “distinct version” under which the IRS claims the power to recharacterize a transaction when there are two possible options for structuring a transaction that lead to the same result and the taxpayer chooses the lower-tax option. The court concluded that the IRS’s recharacterization of Summa Holding’s transactions as dividends followed by Roth IRA contributions did not capture economic reality any better than the taxpayer’s chosen structure of DISC commissions followed by dividends to the DISC’s shareholders.

**b. The First Circuit has agreed with the Sixth Circuit and declined to recharacterize a corporation’s payments to a DISC held by a Roth IRA.** [Benenson v. Commissioner](#), 887 F.3d 511 (1st Cir. 4/6/18), *rev’g* T.C. Memo 2015-119 (6/29/15). In an opinion by Judge Stahl, the U.S. Court of Appeals for the First Circuit has upheld the same Roth IRA-DISC transaction considered by the Sixth Circuit in *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. 2/16/17). In that transaction, members of the Benenson family established Roth IRAs that acquired shares of a Domestic International Sales Corporation (DISC), to which a subchapter C corporation (Summa Holdings) paid (and deducted) commissions to the DISC. The Tax Court upheld the IRS’s recharacterization of the transaction under the substance over form doctrine. Under the IRS’s view of the transaction, the C corporation’s payments of commissions to the DISC should be recharacterized as nondeductible distributions by the C corporation to its shareholders, followed by the shareholders’ contributions of those amounts to their Roth IRAs in excess of applicable limits, which triggered the 6 percent excise tax of § 4973. The Sixth Circuit addressed the C corporation’s deductions and rejected the IRS’s argument that the C corporation’s deductions should be disallowed under the substance over form doctrine. In this case, the First Circuit considered the appeal of the Tax Court’s decision by shareholders who were residents of Massachusetts, who appealed the Tax Court’s decision

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<sup>2</sup> Although the Tax Court had both disallowed Summa Holdings’ deductions for the commissions paid to the DISC and upheld imposition of the 6 percent excise tax of § 4973 on the deemed excess Roth IRA contributions made by Summa Holdings’ shareholders, Summa Holdings appealed to the Sixth Circuit only the disallowance of its deductions. The shareholders have appealed to the First and Second Circuits the issue whether they made excess Roth IRA contributions. Those appeals are currently pending.

that they should be treated as having made excess Roth IRA contributions. Like the Sixth Circuit, the First Circuit declined to apply the substance over form doctrine, which the court characterized as “not a smell test,” but rather a tool of statutory interpretation. The court reasoned that Congress appeared to contemplate ownership of DISCS by IRAs when it enacted relevant statutory provisions such as § 995(g), which imposes unrelated business income tax on distributions that a DISC makes to tax-exempt organizations that own shares of the DISC. The court concluded:

The Benensons used DISCs, a unique, congressionally designed corporate form their family’s business was authorized to employ, and Roth IRAs, a congressionally designed retirement account all agree they were qualified to establish, to engage in long-term saving with eventual tax-free distribution. Such use violates neither the letter nor the spirit of the relevant statutory provisions.

...

Some may call the Benensons’ transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not. ... When, as here, we find that the transaction does not violate the plain intent of the relevant statutes, we can push the doctrine no further.

*In a dissenting opinion*, Judge Lynch argued that the IRS’s application of the substance over form doctrine should be upheld. In Judge Lynch’s view, the parties had not used the DISC for the purpose intended by Congress, but rather to evade the Roth IRA contribution limits. Judge Lynch also disagreed with the majority that the relevant statutory provisions contemplated a Roth IRA holding stock in a DISC. At most, Judge Lynch noted, Congress might have intended to allow traditional IRAs to own DISC stock, but taxpayers have not used DISCs as a way to circumvent the contribution limits on traditional IRAs because, in contrast to Roth IRAs, distributions from a traditional IRA are not tax-free.

**c. The Second Circuit has jumped on the bandwagon and declined to apply the substance-over-form doctrine to recharacterize a corporation’s payments to a DISC held by a Roth IRA.** [Benenson v. Commissioner](#), 910 F.3d 690 (2d Cir. 12/14/18). In an opinion by Judge Raggi, the U.S. Court of Appeals for the Second Circuit has agreed with the First and Sixth Circuits that the government could not apply the substance-over-form doctrine to recharacterize as nondeductible dividends the commissions paid by Summa Holdings, Inc. to a DISC, the stock of which was held (indirectly) by Roth IRAs formed by some of Summa Holdings’ shareholders. The court first rejected the taxpayers’ argument that the Sixth Circuit’s decision, which refused to uphold application of the substance-over-form doctrine with respect to Summa Holdings, precluded the government from relitigating the issue of recharacterization. The court observed that offensive collateral estoppel can preclude the government from relitigating an issue only when the parties opposing the government in the prior and subsequent action are the same. This requirement can be satisfied, the court stated, when the litigant in the subsequent action (the shareholders in this case) totally controlled and financed the litigant in the prior action (the corporation, Summa Holdings). According to the court, however, the taxpayers had failed to make this showing, and therefore the government was not precluded from litigating the issue of recharacterization. With respect to the issue of recharacterizing Summa Holdings’ payment of commissions to the DISC, the court held that “the substance-over-form doctrine does not support recharacterization of Summa’s payment of tax-deductible commissions to a DISC as taxable constructive dividends to Summa shareholders and, thus, cannot support the tax deficiency attributed to petitioners. The court also held that the step-transaction doctrine, when applied together with the substance-over-form doctrine, did not warrant a different conclusion.

**d. Things really are not going the government’s way on this issue. The Ninth Circuit has reversed the Tax Court’s decision and declined to recharacterize a corporation’s payments to a foreign sales corporation (FSC) held by a Roth IRA.** [Mazzei v. Commissioner](#), 998 F.3d 1041 (9th Cir. 6/2/21), *rev’g* 150 T.C. 138 (3/5/18).

*The Tax Court’s decision.* In [Mazzei v. Commissioner](#), 150 T.C. 138 (3/5/18), the taxpayers were members of the Mazzei family (husband, wife, and adult daughter). They owned 100 percent of the

stock of Mazzei Injector Corp., an S corporation. The taxpayers established separate Roth IRAs that each invested \$500 in a Foreign Sales Corporation (“FSC”). Under prior law and somewhat like DISCs, FSCs provided a Code-sanctioned tax benefit because they were taxed at much lower rates than regular corporations pursuant to an express statutory regime. After the taxpayers’ Roth IRAs invested in the FSC, Mazzei Injector Corp. paid the FSC a little over \$500,000 in deductible commissions from 1998 to 2002. These deductible payments exceeded the amounts the taxpayers could have contributed to their Roth IRAs over these years, and just as in *Summa Holdings*, the IRS argued that substance over form principles applied to recharacterize the entire arrangement as distributions by the S corporation to its shareholders, followed by excess Roth IRA contributions subject to the § 4973 excise tax and related penalties. Because the case is appealable to the Ninth Circuit, the Tax Court was not bound by the Sixth Circuit’s decision in *Summa Holdings*. Thus, the Tax Court could have followed its own decision in *Summa Holdings* to agree with the IRS that in substance the entire arrangement amounted to an end-run around Roth IRA contribution limits; however, the Tax Court did not adopt this *Summa Holdings*-inspired approach. Instead, in a reviewed opinion (12-0-4) by Judge Thornton, relying upon Ninth Circuit precedent as well as the U.S. Supreme Court’s decision in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), the Tax Court reasoned that the Roth IRAs had no real downside risk or exposure with respect to holding the FSC stock and thus were not the true owners of the stock. Judge Thornton determined that, for federal income tax purposes, the taxpayers should be considered the owners of the stock, stating:

[B]ecause petitioners (through various passthrough entities) controlled every aspect of the transactions in question, we conclude that they, and not their Roth IRAs, were the owners of the FSC stock for Federal tax purposes at all relevant times. The dividends from the FSC are therefore properly recharacterized as dividends from the FSC to petitioners, followed by petitioners’ contributions of these amounts to their respective Roth IRAs. All of these payments exceeded the applicable contribution limits and were therefore excess contributions. We therefore uphold respondent’s determination of excise taxes under section 4973.

Notably, though, the Tax Court declined to impose penalties on the taxpayers because they relied on independent professional advice in connection with setting up the FSC and their Roth IRAs.

*Dissenting opinion.* Four Judges (Holmes, Foley, Buch, and Morrison) dissented, with some joining only parts of the dissenting opinion written by Judge Holmes. Judge Holmes reasoned that the majority should have followed the Sixth Circuit’s decision in *Summa Holdings* instead of engaging in “judge-made doctrine.” In our view, Judge Holmes’s dissenting opinion is both entertaining and insightful, summing up the conflicting opinions in *Summa I*, *Summa II*, and *Mazzei* as follows: “What’s really going on here is that the Commissioner doesn’t like that the Mazzeis took two types of tax-advantaged entities and made them work together.” Judge Holmes also aptly observed:

After the Sixth Circuit released *Summa II* we told the parties here to submit supplemental briefs. The Mazzeis and the Commissioner agreed that the only difference between these cases and *Summa II* was that the Mazzeis used a FSC instead of a DISC. The Commissioner said this difference shouldn’t affect our analysis, and he admitted that the Mazzeis followed all of the necessary formalities. He nevertheless said we should ignore *Summa II* because it’s from a different circuit and only the commission payments’ deductibility was properly before the court there. He said we should instead follow *Court Holding*, look at the transaction as a whole, and decide the cases based on his views of the statute’s intent, not the Code’s plain language.

The Mazzeis urged us to follow *Summa II*’s reasoning. They said they should get the FSC and Roth IRA tax benefits the Code explicitly provides and that the Commissioner shouldn’t get to rewrite statutes based on his musings about congressional intent. And they said that their use of an FSC instead of a C corporation was enough to distinguish these cases from *Repetto*.

*The Ninth Circuit’s decision.* In a lengthy opinion by Judge Collins, *Mazzei v. Commissioner*, 998 F.3d 1041 (9th Cir. 6/2/21), the U.S. Court of Appeals for the Ninth Circuit has reversed the Tax Court’s decision. After reviewing in detail the relevant statutory provisions regarding IRAs and FSCs,

the court concluded that the Tax Court had erred in holding that, because the Roth IRAs had no real downside risk or exposure with respect to holding the FSC stock, the individuals who had established the Roth IRAs, rather than the IRAs themselves, should be treated as the owners of the FSC's stock. According to the court:

It makes no sense to ask whether the formal owner of the FSC stock would, by virtue of that purchase, be exposed to any risk as a result of that ownership because the statute allows FSCs to be set up so as to eliminate any risk from owning the FSC stock. Specifically, the statute explicitly authorizes the establishment of a FSC that will not conduct any operations itself, and in such cases the FSC will effectively be a shell corporation that generates value only by virtue of the reduced rate of taxation that is paid on moneys that are funneled through it in accordance with strict statutory formulas. .... Such a shell corporation presents little, if any, risk at all to its owner because it will be used *only* if and when there is value (in the form of tax savings) to be obtained by flowing funds through it.

In the court's view, Congress had expressly chosen to depart from substance-over-form principles in enacting the relevant statutory provisions governing Roth IRAs and FSCs. For this reason, the court concluded, the IRS could not invoke those principles in a way that would reverse the judgment of Congress.

## VII. PARTNERSHIPS

### A. Formation and Taxable Years

### B. Allocations of Distributive Share, Partnership Debt, and Outside Basis

1. 🎵You got to know when to hold'em, know when to fold'em, know when to walk away, and know when to run....🎵 **Carried (a/k/a profits) interests still qualify for preferential long-term capital gain rates, but the holding period is three years for specified interests in hedge funds and other investment partnerships.** The [2017 Tax Cuts and Jobs Act](#), § 13309, created new § 1061 and redesignated pre-TCJA § 1061 as § 1062. New § 1061 was Congress's lame attempt to close the carried interest (a/k/a profits interest) "loophole," under which managers of real estate, hedge fund, and other investment partnerships were taxed at preferential long-term capital gain rates (e.g., 20%) on their distributive shares of partnership income notwithstanding the fact that they received their interests in these partnerships as part of their compensation for services rendered (which compensation otherwise would be taxed at ordinary income rates). Essentially, § 1061 imposes a three-year holding period requirement before allocations of income or gain (including gain on disposition of an interest) with respect to an "applicable partnership interest" qualify for preferential long-term capital gain rates. An "applicable partnership interest" is one that is transferred to a taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any "applicable trade or business." An "applicable trade or business" means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of "raising or returning capital," and either "investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition)," or "developing specified assets." Specified assets for this purpose generally are defined as securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and (*big furrowed brow here*) "an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing" (e.g., tiered partnerships). There are significant exceptions, though, for (i) employees of another entity holding interests in a partnership that only performs services for that other entity; and (ii) partnership interests acquired for invested capital (including via a § 83(b) election for a capital interest in a partnership).

**a. Thirty-four new defined terms created under the final regulations.** [T.D. 9945, Guidance Under Section 1061](#), 86 F.R. 5452 (1/19/21). Recently-issued final regulations clarify the application of § 1061 and answer several questions that had been raised by tax advisors and commentators; however, the regulations do so by creating no less than *34 defined terms*. These defined terms are too numerous and intertwined to summarize here. Suffice it to say for our purposes that new

§ 1061 works by transmuted (i) otherwise net long-term capital gain (as defined in § 1222) attributable to an “applicable partnership interest” (i.e., all of a taxpayer’s net long-term capital gain as normally calculated) into short-term capital gain, but (ii) only to the extent such gain exceeds net long-term capital gain (as defined in § 1222) attributable to the disposition of partnership property (or a partnership interest) held by the partnership (or by the partner) for three years or more (i.e., net long-term gain that is excluded from transmutation under § 1061). The regulations define the above-described excess attributable to an applicable partnership interest (“API”) as the “recharacterization amount.” Reg. § 1.1061-4(a). Short- and long-term capital gains (or losses) attributable to an API (“API Gains and Losses”) are determined at the partnership (or partner) level under § 1222 by reference to the disposition of a “capital asset” as defined in § 1221. Importantly, the regulations impose new reporting rules for APIs that take effect for taxable years beginning on or after January 19, 2021. See Reg. § 1.1061-6. For more details regarding the determination and reporting of API Gains and Losses, see the regulations, especially Reg. § 1.1061-4.

*Section 1231 quasi-capital gains escape new § 1061.* Recall that § 1221 excludes § 1231 assets from the definition of “capital assets.” Thus, one question raised by tax advisors and commentators was whether API Gains and Losses subject to recharacterization under § 1061 would include § 1231 quasi-capital gains attributable to an API. The preamble to the final regulations answers this question in the negative, stating “API Gains and Losses do not include long-term capital gain determined under sections 1231 and 1256 [contracts marked to market], qualified dividends described in section 1(h)(11)(B), and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in section 1222.” Of course, this considerably reduces the impact of new § 1061, especially with respect to real estate investment partnerships.

*Treasury and IRS double down on the position that the term “corporation” in § 1061 does not include S corporations.* Under new § 1061(c)(4)(A), an interest in a partnership is not an API if it is held “directly or indirectly ... by a corporation.” This exception makes sense in the context of C corporations (which do not qualify for the capital gains preference), but if the exception includes S corporations, Congress created a major loophole in § 1061. In other words, an easy way to avoid new § 1061 would be to form an S corporation to hold a taxpayer’s APIs. In [Notice 2018-18](#), 2018-12 I.R.B. 443 (3/19/18), however, Treasury and the IRS announced that regulations under § 1061 “will provide that the term ‘corporation’ for purposes of section 1061(c)(4)(A) does not include an S corporation.” Sure enough, the final regulations provide that an API is subject to new § 1061 if it is held by an “Owner Taxpayer” (the person subject to federal income taxation) or a “Passthrough Entity” (which has the usual meaning, but expressly includes S corporations). See Reg. § 1.1061-3(b)(2). The preamble to the final regulations notes that one commentator argued that interpreting the term “corporations” to exclude S corporations “is subject to substantial doubt and contrary to the plain text of the statute.” [T.D. 9945, Guidance Under Section 1061](#), 86 F.R. at 5465 (1/19/21). Another commentator suggested that a legislative clarification should be enacted by Congress before Treasury and the IRS take this position. *Id.* Who’s right? *Stay tuned. This issue is almost certain to be litigated.*

*A bit of good news?* The final regulations reverse the Treasury’s and IRS’s position taken in the proposed regulations that certain dispositions of § 1061 carried interests to related parties trigger gain recognition, notwithstanding that the disposition otherwise is not a taxable event. Commentators heavily criticized this aspect of the proposed regulations. The final regulations, though, clarify that § 1061 is only a gain recharacterization provision, not a gain acceleration provision. Therefore, a gift of a § 1061 carried interest (not subject to debt) to a “related person” (within the meaning of § 1061(d)(2)), or a nontaxable capital contribution of such an interest to a “related-person” partnership, does not trigger gain recognition to the transferor. Instead, the carried interest remains subject to § 1061 in the hands of the transferee. See Reg. § 1.1061-5(f) *Examples 1 and 2*. On the other hand, a part-gift/part-sale transaction, or a partnership capital contribution in which gain is recognized in part, will trigger the application of § 1061 to the extent of the gain recognized. See Reg. § 1.1061-5(f) *Example 3*.

*Who cares?* Although it cannot be ignored by partnerships issuing carried (a/k/a profits) interests, the practical effect of new § 1061 appears minimal. The provision likely will catch only those rare taxpayers who either (i) fail to hold their carried interests for more than three years, or (ii) lack the sophisticated advice to plan around the statute. One commentator characterizes the new statute as a

“joke” given that most managers of real estate, hedge funds, and investment partnerships hold their carried interests for well over three years. See Sloan, *Carried Interest Reform is a Sham*, Washington Post, December 1, 2017.

### **C. Distributions and Transactions Between the Partnership and Partners**

**1. Tax Court holds that amounts transferred to the partnership by one partner are loans rather than capital contributions and their cancellation resulted in COD income to the partnership.** [Hohl v. Commissioner](#), T.C. Memo. 2021-5 (1/13/21). There were several issues in this case that arose out of several purported capital contributions by one partner, Mr. Rodriguez, which were treated by the other three partners, Mr. Hohl, Mr. Blake, and Mr. Bowles, as loans. Upon formation of Echo partnership (Echo), Messrs. Hohl, Blake, and Bowles owned 30 percent each while Mr. Rodriguez owned 10 percent. Over the life of the partnership, Mr. Hohl, the partnership’s bookkeeper, recorded loans to Echo in substantial amounts received by Echo from Mr. Rodriguez in sequential years. Echo’s partnership tax return on Form 1065 consistently reflected a note payable to Mr. Rodriguez in an amount equal to Mr. Rodriguez’ transfers to Echo. None of the partners’ Schedule K-1s for the year indicated a beginning capital contribution. Rather, Messrs. Hohl, Blake, and Bowles’ capital accounts were all based upon their respective contributions of services. On its Form 1065, Echo reported a net loss each year primarily related to deductions taken for guaranteed payments to partners. Each partner’s capital account balance began at zero and then reduced each year by Echo’s loss for the year. This resulted in negative capital account balances for the partners. Echo’s balance sheet showed an increase each year in liabilities related to amounts transferred by Mr. Rodriguez to Echo. After several years of operations, Echo filed a final return upon which the liability to Mr. Rodriguez was reflected on the balance sheet but no partner reported any allocation of a share of that liability. The partnership did not report any discharge of indebtedness, nor did Echo allocate any income to any of the partners. After an audit, the IRS adjusted Mr. Hohl’s and Mr. Blake’s income upward by the amount of each partner’s negative capital account balance. The increases represented each partner’s share of cancellation of indebtedness. The issue addressed by the Tax Court (Judge Buch) was whether Mr. Rodriguez’ transfers to Echo were loans or capital contributions. Mr. Hohl and Mr. Blake argued that the transfers were capital contributions while the IRS contended that the transfers to Echo were loans. Focusing on the substance of the transaction and applying the test developed in *Greenberg v. Comm’r*, T.C. Memo 1992-292, Judge Buch focused on three factors: (1) the presence of a written agreement, (2) the intent of the parties; and (3) the likelihood of obtaining a similar loan from disinterested investors. In finding that transfers by Mr. Rodriguez were loans, the Tax Court initially noted that there was no written document. In determining intent, Echo reported the amounts transferred by Mr. Rodriguez as loans on its Form 1065 and allocated a share of liabilities to each partner on their respective Forms K-1. Both Echo and Mr. Rodriguez failed to include the transfers in Mr. Rodriguez’ capital account balance and Mr. Rodriguez’ ownership percentage never changed as a result of any of the transfers. The Tax Court was persuaded that each of these facts was consistent with the transfers being treated as loans from Mr. Rodriguez to Echo and not capital contributions. Having concluded that the transfers were loans, the court concluded that, when Echo ceased operations and it became certain that Echo would not repay the debt to Mr. Rodriguez, Echo realized income from the discharge of indebtedness. The Tax Court declined to accept Mr. Hohl and Mr. Blake’s argument that all of the discharge of indebtedness income should be allocated to Mr. Rodriguez, finding instead that the partnership agreement lacked economic effect because the operating agreement allocated partners distributive shares based upon partner’s capital accounts. Relying on all the facts and circumstances, the Tax Court followed the partners’ course of conduct wherein Echo allocated losses 10 percent to Mr. Rodriguez and 30 percent to the other three partners. As such, Messrs. Hohl and Blake were allocated 30 percent of the cancellation of indebtedness (C.O.D.) income. The court adopted the IRS’s argument that Messrs. Hohl and Blake should each include their respective 30 percent allocation of C.O.D. in income.

*Aftermath and commentary.* While the court’s opinion focuses on the facts of the case and does not address new issues of law, the outcome can be instructive on “what not to do” in a partnership. Here, Messrs. Hohl and Blake contributed services but characterized the transfers by Mr. Rodriguez to the partnerships as loans. Because they contributed services rather than capital, their respective outside bases were determined to be zero. Therefore, the service contributors had no basis against which they

could deduct losses generated by the guaranteed payments the partnership made to them. Presumably, in order to obtain basis in their partnership interests, the partners succumbed to the allure of treating the transfers by Mr. Rodriguez to the partnership as loans which, in turn, resulted in each partner having a share of the resulting partnership liability and therefore an increased outside basis. When the venture ceased operations, the negative capital accounts generated by the losses represented each partner's share of the partnership's C.O.D. income. And, that C.O.D. income in the end was allocated not in accordance with their capital accounts. Rather, it was allocated in accordance with how they had allocated losses. These partners with zero (and ultimately negative) capital accounts ended up being allocated substantial C.O.D. income and, in turn, owing taxes accordingly. In retrospect, if these partners had properly characterized Mr. Rodriguez's transfers as contributions to capital, the noncontributing partners would have avoided any allocation of C.O.D. income.

**D. Sales of Partnership Interests, Liquidations and Mergers**

**E. Inside Basis Adjustments**

**F. Partnership Audit Rules**

**G. Miscellaneous**

**1. Relief for not reporting negative tax capital accounts.** Notice 2019-20, 2019-14 I.R.B. 927 (3/7/19). The updated 2018 Instructions for Form 1065 and accompanying Schedule K-1 now require a partnership that does not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's tax basis capital both at the beginning of the year and at the end of the year if either amount is negative. Aware that some taxpayers and their advisors may not have been prepared to comply with this new requirement for 2018 returns, the IRS, in Notice 2019-20, has provided limited relief. Specifically, the IRS will waive penalties (1) under § 6722 for failure to furnish a partner a Schedule K-1 (Form 1065) and under § 6698 for failure to file a Schedule K-1 (Form 1065) with a partnership return, (2) under § 6038 for failure to furnish a Schedule K-1 (Form 8865), and (3) under any other section of the Code for failure to file or furnish a Schedule K-1 or any other form or statement, for any penalty that arises solely as a result of failing to include negative tax basis capital account information provided the following conditions are met:

1. The Schedule K-1 or other applicable form or statement is timely filed, including extensions, with the IRS; is timely furnished to the appropriate partner, if applicable; and contains all other required information.
2. The person or partnership required to file the Schedule K-1 or other applicable form or statement files with the IRS, no later than one year after the original, unextended due date of the form to which the Schedule K-1 or other applicable form or statement must be attached, a schedule setting forth, for each partner for which negative tax basis capital account information is required: (a) the partnership's name and Employer Identification Number, if any, and Reference ID Number, if any; (b) the partner's name, address, and taxpayer identification number; and (c) the amount of the partner's tax basis capital account at the beginning and end of the tax year at issue.

The above-described supplemental schedule should be captioned "Filed Under Notice 2019-20" in accordance with instructions and additional guidance posted by the IRS on [www.irs.gov](http://www.irs.gov). The due date for this supplemental schedule is determined without consideration of any extensions, automatic or otherwise, that may apply to the due date for the form itself. Furthermore, the schedule should be sent to the address listed in the Notice, and the penalty relief applies only for taxable years beginning after December 31, 2017, but before January 1, 2019.

**a. The IRS has issued FAQ guidance on negative tax basis capital account reporting.** The IRS has issued guidance on the requirement to report negative tax basis capital account information in the form of frequently asked questions (FAQs) on its website. The FAQs are available at <https://www.irs.gov/businesses/partnerships/form-1065-frequently-asked-questions>.

*Definition and calculation of tax basis capital accounts.* In the FAQs, the IRS explains that “[a] partner’s tax basis capital account (sometimes referred to simply as ‘tax capital’) represents its equity as calculated using tax principles, not based on GAAP, § 704(b), or other principles.” The FAQs provide guidance on the calculation of a partner’s tax basis capital account. A partner’s tax basis capital account is *increased by the amount of money and the adjusted basis of any property contributed* by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) and is *decreased by the amount of money and the adjusted basis of any property distributed by the partnership to the partner* (less any liabilities assumed by the partner or to which the property is subject). The partner’s tax basis capital account is increased by certain items, such as the partner’s distributive share of partnership income and gain, and is decreased by certain items, such as the partner’s distributive share of partnership losses and deductions. The FAQs make clear that a partner’s tax basis capital account is not the same as a partner’s basis in the partnership interest (outside basis) because outside basis includes the partner’s share of partnership liabilities, whereas a partner’s tax basis capital account does not.

*Effect of § 754 Elections and Revaluations of Partnership Property.* If a partnership has a § 754 election in effect, then it increases or decreases the adjusted basis of partnership property pursuant to § 743(b) when there is a transfer of a partnership interest or pursuant to § 734(b) when there is a distribution by the partnership. These adjustments can also be triggered when the partnership does not have a § 754 election in effect but has a substantial built-in loss and a transfer of a partnership interest occurs (§ 743(b) basis adjustment) or experiences a substantial basis reduction in connection with a distribution (§ 734(b) basis adjustment). The FAQs clarify that a partner’s tax basis capital account is *increased or decreased by a partner’s share of basis adjustments under § 743(b) and § 734(b)*. In contrast, according to the FAQs, *revaluations of partnership property pursuant to § 704 (such as upon the entry of a new partner) do not affect the tax basis of partnership property or a partner’s tax basis capital account.*

*Examples.* The FAQs provide the following examples of the calculation of a partner’s tax basis capital account:

*Example 1:* A contributes \$100 in cash and B contributes unencumbered, nondepreciable property with a fair market value (FMV) of \$100 and an adjusted tax basis of \$30 to newly formed Partnership AB. A’s initial tax basis capital account is \$100 and B’s initial tax basis capital account is \$30.

*Example 2:* The facts are the same as in Example 1, except B contributes nondepreciable property with a FMV of \$100, an adjusted tax basis of \$30, and subject to a liability of \$20. B’s initial tax basis capital account is \$10 (\$30 adjusted tax basis of property contributed, less the \$20 liability to which the property was subject).

*Example 3:* The facts are the same as in Example 1, except in Year 1, the partnership earns \$100 of taxable income and \$50 of tax-exempt income. A and B are each allocated \$50 of the taxable income and \$25 of the tax-exempt income by the partnership. At the end of Year 1, A’s tax basis capital account is increased by \$75, to \$175, and B’s tax basis capital account is increased by \$75, to \$105.

*Example 4:* The facts are the same as in Example 3. Additionally, in Year 2, the partnership has \$30 of taxable loss and \$20 of expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures. A and B are each allocated \$15 of the taxable loss and \$10 of the expenditures which are not deductible in computing partnership taxable income and which are not capital expenditures. At the end of Year 2, A’s tax basis capital account is decreased by \$25, to \$150, and B’s tax basis capital account is decreased by \$25, to \$80.

*Example 5:* On January 1, 2019, A and B each contribute \$100 in cash to a newly formed partnership. On the same day, the partnership borrows \$800 and purchases Asset X, qualified property for purposes of §168(k), for \$1,000. Assume that the partnership properly allocates the \$800 liability equally to A and B under §752. Immediately after the partnership acquires Asset X, both A and B have tax basis capital accounts of \$100 and outside bases of \$500 (\$100 cash contributed, plus \$400 share of

partnership liabilities under §752). In 2019, the partnership recognizes \$1,000 of tax depreciation under §168(k) with respect to Asset X; the partnership allocates \$500 of the tax depreciation to A and \$500 of the tax depreciation to B. On December 31, 2019, A and B both have tax basis capital accounts of negative \$400 (\$100 cash contributed, less \$500 share of tax depreciation) and outside bases of zero (\$100 cash contributed, plus \$400 share of partnership liabilities under § 752, and less \$500 of share tax depreciation).

*Tax Basis Capital Account of a Partner Who Acquires the Partnership Interest from Another Partner.* A partner who acquires a partnership interest from another partner, such as by purchase or in a non-recognition transaction, has a tax basis capital account immediately after the transfer equal to the transferring partner's tax basis capital account immediately before the transfer with respect to the portion of the interest transferred. However, any § 743(b) basis adjustment the transferring partner may have is not transferred to the acquiring partner. Instead, if the partnership has a §754 election in effect, the tax basis capital account of the acquiring partner is increased or decreased by the positive or negative adjustment to the tax basis of partnership property under §743(b) as a result of the transfer.

*Safe Harbor Method for Determining a Partner's Tax Basis Capital Account.* The FAQs provide a safe harbor method for determining a partner's tax basis capital account. Under this method, “[p]artnerships may calculate a partner's tax basis capital account by subtracting the partner's share of partnership liabilities under § 752 from the partner's outside basis (safe harbor approach). If a partnership elects to use the safe harbor approach, the partnership must report the negative tax basis capital account information as equal to the excess, if any, of the partner's share of partnership liabilities under § 752 over the partner's outside basis.”

*Certain partnerships are exempt from reporting negative tax basis capital accounts.* Partnerships that satisfy four conditions (those provided in question 4 on Schedule B to Form 1065) do not have to comply with the requirement to report negative tax basis capital account information. This is because a partnership that satisfies these conditions is not required to complete item L on Schedule K-1. The four conditions are: (1) the partnership's total receipts for the tax year were less than \$250,000; (2) the partnership's total assets at the end of the tax year were less than \$1 million; (3) Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return; and (4) the partnership is not filing and is not required to file Schedule M-3.

**b. The IRS has issued a draft of revised Form 1065 and Schedule K-1 for 2019.** [IR-2019-160](#) (9/30/19). The IRS has issued a draft of the partnership tax return, Form 1065, and accompanying Schedule K-1 for 2019. The IRS has also released [draft instructions](#) for the 2019 Form 1065 and [draft instructions](#) for the 2019 Schedule K-1. Compared to the 2018 versions, the 2019 versions reflect several significant changes that likely will require a substantial amount of time in many cases on the part of those preparing the return to ensure compliance. Among the significant changes are the following:

- *Reporting of tax basis capital accounts for each partner on Schedule K-1.* Previous versions of Schedule K-1 gave partnerships the option to report a partner's capital accounts on a tax basis, in accordance with GAAP, as § 704(b) book capital accounts, or on some “other” basis. Tax basis capital accounts were required beginning in 2018 only if a partner's tax capital account at the beginning or end of the year was negative. The 2019 draft Schedule K-1 requires partnerships to report each partner's capital account on a tax basis regardless of whether the account is negative. For partnerships that have not historically reported tax basis capital accounts, this requirement would appear to involve recalculating tax capital accounts in prior years and rolling them forward.
- *Reporting a partner's share of net unrecognized § 704(c) gain or loss on Schedule K-1.* Previous versions of Schedule K-1 required reporting whether a partner had contributed property with a built-in gain or built-in loss in the year of contribution. The 2019 draft Schedule K-1 still requires partnerships to report whether a partner contributed property with a built-in gain or loss, but adds new item N in Part II, which requires reporting the “Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss).” This means that a partnership must report

on an annual basis any unrecognized gain or loss that would be allocated to the partner under § 704(c) (if the partnership were to sell its assets) as a result of either the partner contributing property with a fair market value that differs from its adjusted basis or the revaluation of partnership property (such as a revaluation occurring upon the admission of a new partner).

- *Separation of guaranteed payments for capital and services.* Previous versions of Schedule K-1 required reporting a single category of guaranteed payments to a partner. The 2019 draft Schedule K-1 refines this category in item 4 of Part III and requires separate reporting of guaranteed payments for services, guaranteed payments for capital, and the total of these two categories.
- *Reporting on Schedule K-1 more than one activity for purposes of the at risk and passive activity loss rules.* Items 21 and 22 have been added to Part III of Schedule K-1 to require the partnership to check a box if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules. The 2019 draft instructions for Form 1065 indicate that the partnership also must provide an attached statement for each activity with detailed information for each activity to allow the partner to apply correctly the at-risk and passive activity loss rules.
- *Section 199A deduction moved to supplemental statement.* The 2018 version of Schedule K-1 required reporting information relevant to the partner's § 199A deduction in item 20 of Part III with specific codes. The draft 2019 instructions for Form 1065 provide that, for partners receiving information relevant to their § 199A deduction, only code Z should be used in box 20 along with an asterisk and STMT to indicate that the information appears on an attached statement. According to the instructions, among other items, the statement must include the partner's distributive share of: (1) qualified items of income, gain, deduction, and loss; (2) W-2 wages; (3) unadjusted basis immediately after acquisition of qualified property; (4) qualified publicly traded partnership items; and (5) § 199A dividends (qualified REIT dividends). The statement also must report whether any of the partnership's trades or businesses are specified service trades or businesses and identify any trades or businesses that are aggregated.
- *Disregarded entity as a new category of partner on Schedule K-1.* Previous versions of Schedule K-1 required the partnership to indicate whether the partner was domestic or foreign. The 2019 draft Schedule K-1 adds a new category in item H of Part II in which the partnership must indicate whether the partner is a disregarded entity and, if so, the partner's taxpayer identification number and type of entity.

**c. The IRS has postponed the requirements to use tax basis capital accounts for Schedule K-1 and to report detailed information for purposes of the at-risk rules and has clarified certain other reporting requirements.** Notice 2019-66, 2019-52 I.R.B. 1509 (12/9/19). In response to comments expressing concern that those required to file Form 1065 and Schedule K-1 might be unable to comply in a timely manner with the requirement to report capital accounts on a tax basis for 2019, the Treasury Department and the IRS have deferred this requirement, which will now apply to partnership tax years beginning on and after January 1, 2020. According to the notice:

This means that partnerships and other persons may continue to report partner capital accounts on Forms 1065, Schedule K-1, Item L, or 8865, Schedule K-1, Item F, using any method available in 2018 (tax basis, Section 704(b), GAAP, or any other method) for 2019. These partnerships and other persons must include a statement identifying the method upon which a partner's capital account is reported.

The requirement to report capital accounts for 2019 using any method available in 2018 includes the requirement that partnerships that do not report tax basis capital accounts to partners must report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's tax basis capital both at the beginning of the year and at the end of the year if either amount is negative.

The draft 2019 Schedule K-1 included Items 21 and 22 in Part III to require the partnership to check a box if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules. The 2019 draft instructions for Form 1065 also required a partnership to provide an attached statement for each activity with detailed information for each activity to allow the partner to apply

correctly the at-risk and passive activity loss rules. In response to comments expressing concern that those required to file Form 1065 and Schedule K-1 might be unable to comply in a timely manner with the requirement to provide this detailed information in an attached statement, the notice defers this requirement. This requirement now will apply to partnership tax years beginning on and after January 1, 2020. The notice leaves in place for 2019 the requirement that a box be checked in Items 21 and 22 in Part III of Schedule K-1 if the partnership has more than one activity for purposes of the at-risk or passive activity loss rules.

The notice leaves in place for 2019 the requirement that a partnership must report on an annual basis a partner's share of "net unrecognized Section 704(c) gain or loss." The draft 2019 instructions for Schedule K-1, however, had not defined the term "net unrecognized Section 704(c) gain or loss." The notice defines this term as "the partner's share of the net (net means aggregate or sum) of all unrecognized gains or losses under section 704(c) of the Code (Section 704(c) in partnership property, including Section 704(c) gains and losses arising from revaluations of partnership property." This definition applies solely for purposes of completing 2019 forms. The notice clarifies that publicly traded partnerships need not report net unrecognized § 704(c) gain for 2019 and future years until further notice. The notice also indicates that commenters had requested additional guidance on § 704(c) computations, especially on issues such as those addressed in Notice 2009-70, 2009-34 I.R.B. 255, which solicited comments on the rules relating to the creation and maintenance of multiple layers of forward and reverse section § 704(c) gain and loss to partnerships and tiered partnerships. Notice 2019-66 provides that, "[f]or purposes of reporting for 2019, partnerships and other persons should generally resolve these issues in a reasonable manner, consistent with prior years' practice for purposes of applying Section 704(c) to partners."

The notice provides that taxpayers who follow the provisions of the notice will not be subject to any penalty for reporting in accordance with the guidance it provides.

**d. The Service has proposed two exclusive methods for satisfying the requirement to report tax basis capital accounts for partnership taxable years ending on or after December 31, 2020, and has asked for comments.** Notice 2020-43, 2020-27 I.R.B. 1 (6/5/20). In this notice, the IRS has proposed a requirement that partnerships use only one of two exclusive methods for reporting a partner's tax capital account that would apply to partnership taxable years that end on or after December 31, 2020. Pursuant to the proposed requirement, partnerships would no longer be permitted to report partner capital accounts using any other method, including reporting capital accounts in accordance with GAAP or as § 704(b) book capital accounts. The notice indicates that comments received in response to the notice "will help inform the development of the instructions to be included in Form 1065 ... for taxable year 2020."

*Background.* According to the notice, commenters have indicated that they determine tax basis capital accounts using what the notice refers to as a "Transactional Approach." It appears that this approach is analogous to the method for determining a partner's book capital account prescribed in the regulations regarding the substantial economic effect requirement of § 704(b), except that the adjusted basis of property is used instead of the property's fair market value. Under this Transactional Approach, a partner's tax capital account is (1) increased by the amount of money and the adjusted basis of property contributed by a partner (less any liabilities assumed by the partnership or to which the property is subject) and by allocations to the partner of partnership income or gain, and (2) decreased by the amount of money and the adjusted basis of property distributed to the partner (less any liabilities assumed by the partner or to which the distributed property is subject) and by allocations to the partner of partnership loss or deduction. The notice indicates that Treasury and the IRS understand that partnerships using the Transactional Approach may not have been adjusting partner tax capital accounts in the same way under similar fact patterns. Further, issuing detailed guidance to promote consistent application of the Transactional Approach, according to some commenters, would be a major project that would consume significant IRS resources. Accordingly, the notice rejects a Transactional Approach to determining tax capital accounts and indicates that tax capital accounts determined in this manner will not satisfy the requirement to report partner tax capital accounts. Instead, the notice prescribes two alternative proposed methods for determining a partner's tax capital account: (1) the "Modified Outside Basis Method," and (2) the "Modified Previously Taxed Capital Method." These methods are discussed below.

*Modified Outside Basis Method.* The notice indicates that a partnership using this method to determine a partner's tax capital account must determine, or be provided by the partner, the partner's adjusted basis in the partnership interest (determined under the principles and provisions of subchapter K, including §§ 705, 722, 733, and 742) and subtract from it the partner's share of partnership liabilities under § 752. (This method was described as a safe harbor approach in the FAQs discussed above, which appear on the IRS website.) If the partnership is using this method, a partner must notify the partnership in writing of changes to the partner's basis in the partnership during the year other than those attributable to contributions by the partner, distributions to the partner, and allocations to the partner of income, gain, loss or deduction that are reflected on the partnership's Schedule K-1. An example of a situation in which notification to the partnership would be required is if a person purchases a partnership interest. A partnership using the Modified Outside Basis Method is entitled to rely on information provided by partners regarding their basis in partnership interests unless the partnership has knowledge of facts indicating that the information is clearly erroneous.

*Modified Previously Taxed Capital Method.* This method is a modified version of the method prescribed in Reg. § 1.743-1(d). The method prescribed in this regulation is used in determining the adjustments to the basis of partnership property under § 743(b) when a person purchases a partnership interest and the partnership has in effect a § 754 election. One adjustment is to increase the adjusted basis of partnership property by the excess of the purchasing partner's basis in the partnership interest over the partner's *proportionate share of the adjusted basis of partnership property*. A partner's proportionate share of the adjusted basis of partnership property is the purchasing partner's *interest as a partner in the partnership's previously taxed capital*, plus his or her share of partnership liabilities. In essence, the method prescribed in Reg. § 1.743-1(d) determines the partner's interest in the partnership's previously taxed capital (i.e., tax capital account) by first determining the partner's share of total capital and then backing out the portion that has not yet been taxed. Specifically, Reg. § 1.743-1(d) provides that a partner's share of previously taxed capital is determined by performing a hypothetical disposition by the partnership of all of its assets in a fully taxable transaction for cash equal to the *fair market value of the assets* and ascertaining:

1. The amount of cash the partner would receive on a liquidation following the hypothetical disposition of assets, increased by
2. The amount of tax loss that would be allocated to the partner from the hypothetical disposition of assets, and decreased by
3. The amount of tax gain that would be allocated to the partner from the hypothetical disposition of assets.

The notice modifies this method in two ways. *First*, it modifies the hypothetical disposition of assets to permit partnerships to use the fair market of assets if the fair market value is readily available or, alternatively, the bases of assets determined under § 704(b) (i.e., § 704(b) book basis), GAAP, "or the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management." *Second*, for purposes of the second and third parts of the method set forth (allocation of tax loss and gain), the notice provides that all partnership liabilities are treated as nonrecourse "to avoid the burden of having to characterize the underlying debt and to simplify the computation." Partnerships that use the Modified Previously Taxed Capital Method will be required, for each year that the method is used, to attach to the partnership tax return a statement indicating that the Modified Previously Taxed Capital Method is used and the method used to determine the partnership's net liquidity value (such as fair market value, § 704(b) book basis, or GAAP).

*Consistency and Change of Methods.* The notice indicates that, whichever of the two methods the partnership uses, it must use the same method with respect to all partners. The first year for which the requirement to use one of these two methods to determine tax capital accounts will apply is 2020. For taxable years after 2020, the partnership can change methods by attaching a disclosure to each Schedule K-1 that describes the change (if any) to the amount attributable to each partner's beginning and end-of-year balances and the reason for the change.

*Request for Comments.* The IRS has requested comments, due by August 4, 2020, on the following five topics:

1. Whether the two proposed exclusive methods described above for determining tax capital accounts should be modified or adopted;
2. Whether, in connection with the hypothetical disposition of assets required as part of the Modified Previously Taxed Capital Method, an ordering rule should apply to the value used in the hypothetical disposition, e.g., use of fair market value might be required if readily available, and if it is not readily available, then § 704(b) book basis might be required unless the partnership does not maintain book capital accounts in accordance with § 704(b), in which case GAAP would be required;
3. How, if at all, the requirement to report tax capital accounts should be modified to apply to publicly traded partnerships;
4. Whether a Transactional Approach to determining tax capital accounts should be permitted and what additional guidance would be necessary to permit this approach; and
5. Whether (and in what circumstances) limitations should be imposed on partnerships to change from one method of determining tax capital accounts to another, including how partnerships would comply with such limitations in the case of the merger of partnerships using different methods.

**e. The instructions for Form 1065 and Schedule K-1 for 2020 require reporting tax basis capital accounts using a transactional approach.** [IR-2020-240](#) (10/22/20). The IRS released draft instructions for the 2020 Form 1065 and draft instructions for the 2020 Schedule K-1. The final version of the instructions was issued on February 12, 2021. Previous versions of Schedule K-1 gave partnerships the option to report a partner's capital accounts on a tax basis, in accordance with GAAP, as § 704(b) book capital accounts, or on some "other" basis. Tax basis capital accounts were required beginning in 2018 only if a partner's tax capital account at the beginning or end of the year was negative. The 2020 draft instructions for Form 1065 and Schedule K-1 require partnerships to report each partner's capital account on a tax basis regardless of whether the account is negative. Further, each partner's tax capital account must be determined using a transactional approach. For partnerships that reported capital accounts on a tax basis in the prior year (and those that did not report tax capital accounts but maintained tax basis capital accounts in their books and records), a partner's beginning tax capital account generally will be the partner's ending tax capital account from the prior year, or zero for a partner that acquired his or her partnership interest by making a contribution during the year, or the transferor partner's capital account for a partner that acquired his or her partnership interest during the year from another partner. For partnerships that did not report tax basis capital accounts in the prior year and did not maintain tax capital accounts in their books and records, a partner's beginning tax capital account can be determined for this year only using the tax basis method (presumably a transactional approach) or one of three alternative methods. These alternative methods are the (1) modified outside basis method, (2) modified previously taxed capital method, or (3) section 704(b) method. The first two of these methods were proposed in Notice 2020-43, discussed above. Under the section 704(b) method, the amount to report as the partner's beginning tax capital account is equal to the partner's § 704(b) book capital account, minus the partner's share of built-in gain that would be allocated to the partner under § 704(c) plus the partner's share of built-in loss that would be allocated to the partner under § 704(c) if the partnership were to sell its assets. Such allocations of built-in gain or loss under § 704(c) can result from either the partner contributing property with a fair market value that differs from its adjusted basis or the revaluation of partnership property (such as a revaluation occurring upon the admission of a new partner).

**f. IRS provides relief for partnerships from certain penalties related to the reporting of partners' 2020 beginning capital account balances.** [Notice 2021-13](#), 2021-6 I.R.B. 832 (1/20/21). This notice provides partnerships with relief from certain penalties that normally would result from incorrectly reporting partners' beginning capital account balances on the 2020 Schedules K-1 (Forms 1065 and 8865). Relief is also granted from accuracy-related penalties for the portion of an imputed underpayment attributable to incorrect information in a partner's beginning capital account balance for 2020. Pursuant to § 6031 and the corresponding provisions of the regulations, the IRS has

for many years required the reporting of partners' capital account balances. Prior to 2020, partnerships could report partner capital accounts on Schedule K-1 using one of several possible methods (tax basis, generally accepted accounting principles (GAAP), § 704(b) book, or other methods). Beginning in 2018, however, the instructions to the partnership tax return, Form 1065, required a partnership that did not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's tax basis capital account both at the beginning of the year and at the end of the year if either amount was negative. Beginning in 2020, the instructions to Form 1065 and Schedule K-1 require partnerships to report each partner's capital account on a tax basis regardless of whether the account is negative. Reporting capital accounts on another basis such as GAAP is no longer permitted. Further, each partner's tax capital account must be determined using a transactional approach. Under a transactional approach, partnerships must adjust a partner's capital account for contributions by and distributions to the partner, for the partner's share of items of income and loss, and for other appropriate events, all using tax basis principles. For partnerships that did not report tax basis capital accounts in 2019 and did not maintain tax capital accounts in their books and records, a partner's beginning tax capital account can be determined for 2020 only using the tax basis method (a transactional approach) or one of three alternative methods. These alternative methods are the (1) modified outside basis method, (2) modified previously taxed capital method, or (3) section 704(b) method (each as described in the 2020 Form 1065 Instructions).

*Penalties.* Section 6698 imposes a penalty for failing to timely file, show correct information, or not fully report information on a Form 1065 or Schedule K-1. A section 6698 penalty is not imposed if it is shown that the failure is due to reasonable cause. There are also penalties under § 6721 for failure to file timely, accurate information returns and under § 6722 for failure to furnish timely, accurate payee statement. Section 6724 provides that the penalties for any failure under §§ 6721 and 6722 do not apply if it is shown that the failure is due to reasonable cause and not to willful neglect. Under § 301.6724-1, a penalty may be waived for reasonable cause only if the filer establishes either that there are significant mitigating factors with respect to the failure or that the failure arose from events beyond the filer's control. In addition, the filer must establish that the filer acted in a responsible manner both before and after the failure occurred. Finally, § 6662 imposes an accuracy-related penalty on portions of an underpayment attributable to, among other things, negligence or a substantial understatement of income tax. For partnerships subject to the centralized audit regime enacted by the Bipartisan Budget Act of 2015, § 6221 provides that the applicability of any penalties, additions to tax, or additional amounts that relate to an adjustment to a partnership-related item must be determined at the partnership level. Under § 6233, partnerships subject to the centralized audit regime are liable for the § 6662 penalties calculated on the imputed underpayment.

*Relief from penalties under §§ 6698, 6721, and 6722.* Notice 2021-13 provides relief from the penalties imposed under §§ 6698, 6721, and 6722 that is in addition to the relief from penalties for reasonable cause described earlier. According to the notice, a partnership will not be subject to penalties under §§ 6698, 6721, or 6722 *due to the misreporting of its partners' beginning capital account balances on 2020 Schedules K-1* if the partnership can show that it took ordinary and prudent business care in following the 2020 Form 1065 Instructions to report its partners' beginning capital account balances using any one of the permissible methods for determining beginning tax capital accounts set forth in the instructions to Form 1065 and described earlier. In general, "ordinary and prudent business care" means the standard of care that a reasonably prudent person would use under the circumstances in the course of its business in handling account information." In addition, a partnership will not be subject to a penalty under §§ 6698, 6721, or 6722 *due to the inclusion of incorrect information in reporting its partners' ending capital account balances on Schedules K-1 in taxable year 2020 or its partners' beginning or ending capital account balances on Schedules K-1 in taxable years after 2020* to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1 for which relief under the notice is available. A partnership that fails to timely file or include beginning and ending capital accounts on a 2020 Form 1065, Form 8865, and Schedules K-1 is not eligible for the relief.

*Relief from penalties under § 6662.* According to the notice, the IRS will waive any accuracy-related penalty under § 6662 for any taxable year with respect to any portion of an imputed underpayment that is attributable to an adjustment to a partner's beginning capital account balance

reported by the partnership for the 2020 taxable year, but only to the extent the adjustment arises from the inclusion of incorrect information for which the partnership qualifies for relief under section 3 of this notice.

## VIII. TAX SHELTERS

- A. Tax Shelter Cases and Rulings
- B. Identified “tax avoidance transactions”
- C. Disclosure and Settlement
- D. Tax Shelter Penalties

## IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

### A. Exempt Organizations

**1. Multiple exempt organization regulatory projects closed (or “canned?”) in 2020 and early 2021.** The [2017 Tax Cuts and Jobs Act](#) made significant changes with respect to the taxation of exempt organizations, including one change that since has been retroactively repealed. We summarize below the recent developments with respect to these changes as well as final regulations relating to the reporting requirements of exempt organizations under Code § 6033.

**a. “Phubit” parking tax goes the way of the dodo.** The [2017 Tax Cuts and Jobs Act](#), § 13703, added new Code § 512(a)(7) effective as of January 1, 2018. The effect of new Code § 512(a)(7) was to create or increase an organization’s unrelated business taxable income by the amount of any expenses paid or incurred by an organization that are disallowed by the changes made to § 274 for qualified transportation fringe benefits (generally, subsidized parking for employees). In short, new Code § 512(a)(7) turned out to be a disaster—in part because for some organizations it worked not just to increase but to create phantom unrelated business income tax (a/k/a “phubit”) where none had existed previously. Wisely, perhaps, Congress retroactively repealed Code § 512(a)(7) in 2019 effective as of the date of enactment in 2017. *See* the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title III, § 302 of the [2020 Further Consolidated Appropriations Act](#). This retroactive repeal not only eliminated the need for guidance, but also engendered refund claims by affected exempt organizations. Those organizations may file an amended Form 990-T to claim refunds. *See also* [IR-2020-23](#) (1/28/20) (guidance for exempt organizations claiming refunds for any amount of “parking lot tax” paid since 2017).

**b. Final regulations consolidating, reconciling, and otherwise clarifying the numerous changes to the annual information return requirements of Code § 6033.** [T.D. 9898, Guidance Under Section 6033 Regarding the Reporting Requirements of Exempt Organizations](#), 85 F.R. 31959 (5/28/20). Pursuant to Code § 6033, organizations exempt from taxation under § 501(a) generally are required to file annual information returns and make such returns publicly available for inspection. Exceptions to filing exist (e.g., churches), including exceptions to public disclosure of certain items otherwise reportable on these annual information returns. The applicable rules and exceptions thereto have been modified over the past several years, so in 2020 Treasury and IRS finalized regulations reflecting the cumulative changes. For details, see the final regulations. The final regulations are effective on May 28, 2020, and generally apply to returns file on or after January 30, 2020.

**c. No more offsetting UBTI from one trade or business with UBTI from another trade or business.** [T.D. 9933, Unrelated Business Taxable Income Separately Computed for Each Trade or Business](#), 85 F.R. 77952 (12/2/20). Organizations described in § 401(a) (pension and retirement plans) and § 501(c) (charitable and certain other entities) generally are exempt from federal income taxation. Nevertheless, §§ 511 through 514 impose federal income tax upon the “unrelated business taxable income” (“UBTI”) of such organizations, including for this purpose state colleges and universities. The principal sources of UBTI are §§ 512 and 513 “unrelated trade or business” gross income (minus deductions properly attributable thereto) and § 514 “unrelated debt-financed income” (minus deductions), including a partner’s allocable share of income from a partnership generating UBTI. Under pre-TCJA law, if an exempt organization had unrelated business income (“UBI”) from

one activity, but unrelated losses from another activity, then the income and losses could offset, meaning that the organization would report zero or even negative UBI. New § 512(a)(6), effective as of January 1, 2018, provides that income and losses from separate unrelated trades or businesses no longer may be aggregated. The “catch” to new § 512(a)(6), though, is that exactly what constitutes a separate “trade or business” for UBTI purposes has never been defined, and new § 512(a)(6) did not do so either. See [Notice 2018-67](#), 2018-36 I.R.B. 409 (8/21/18). In 2020, Treasury and the IRS finalized regulations providing guidance on how exempt organizations segregate trades or businesses for purposes of determining UBI in accordance with § 512(a)(6). Generally, the new regulations, Reg. § 1.512(a)-6, provide that an exempt organization must identify and segregate each of its separate unrelated trades or businesses using the first two digits of the North American Industry Classification System code (NAICS 2-digit code) system. Organizations should do so by choosing the NAICS 2-digit code that most accurately describes the unrelated trade or business. Notably, the regulations do not adopt the approach taken by the § 199A regulations because, in the view of the IRS and Treasury, § 512(a)(6) and § 199A serve different purposes. The regulations are detailed and complex, and will not be discussed further here. They are, however, a must read for tax advisors to exempt organizations that have UBTI. The regulations are applicable to taxable years beginning on or after December 2, 2020. In addition, affected exempt organizations may choose to apply the regulations to taxable years beginning on or after January 1, 2018, and before December 2, 2020. Alternatively, affected exempt organizations may rely on a reasonable, good-faith interpretation of § 512(a)(6) for such taxable years. For this purpose, a reasonable good faith interpretation includes the methods of aggregating or identifying separate trades or businesses provided in [Notice 2018-67](#) or the previously published proposed regulations, [REG-106864-18, Unrelated Business Taxable Income Separately Computed for Each Trade or Business](#), 85 F.R. 23172 (4/24/20).

**d. Final guidance from Treasury and IRS admits Congress’s “airball” when enacting new Code § 4960.** [T.D. 9938, Unrelated Business Taxable Income Separately Computed for Each Trade or Business](#), 86 F.R. 6196 (1/19/21). Another change to the taxation of exempt organizations was the addition of new Code § 4960 by § 13602 of the [2017 Tax Cuts and Jobs Act](#). Code § 4960 imposes a 21 percent excise tax on “applicable tax-exempt organizations” (“ATEOs”) and broadly-defined “related organizations” paying over \$1 million annually to “covered employees.” In addition to § 527 political organizations and § 521 farmers cooperatives, ATEOs include the following two additional types of organizations: (i) those exempt from tax under § 501(a) (most nonprofits, including churches, hospitals, and private schools); and (ii) those “with income excluded from taxation under § 115(l)” (income of certain public utilities and income derived from “any essential governmental function and accruing to a State or any political subdivision thereof”). A “covered employee” is defined as any one of the five highest compensated employees of an ATEO either (i) for the current taxable year or (ii) for any year beginning after December 31, 2016. Licensed medical or veterinarian professionals, however, are excluded from the definition of “covered employee.” Treasury and the IRS issued proposed guidance regarding Code § 4960 in June of 2020, see [REG-122345-18, Tax on Excess Tax-Exempt Organization Executive Compensation](#), 85 F.R. 35746 (6/11/20), and finalized the regulations in early January 2021. See [T.D. 9938, Unrelated Business Taxable Income Separately Computed for Each Trade or Business](#), 86 F.R. 6196 (1/19/21). These proposed and then final regulations followed interim guidance issued early in 2019. See [Notice 2019-09](#), 2019-04 IRB 403 (1/22/19). The regulations are technical and extensive, so they will not be discussed in detail here. Importantly, though, new Code § 4960 essentially does not apply to governmental entities (including state colleges and universities) with highly-compensated executives (e.g., coaches), even though Congress apparently thought that it would. The reason such governmental entities generally escape Code § 4960 is because Congress attempted to describe them as organizations “with income excluded from taxation under § 115(l).” The IRS’s longstanding position, however, is that governmental entities (including state colleges and universities) which are not separately incorporated are exempt under the doctrine of implied statutory immunity notwithstanding § 115(l) (unless and until Congress enacts a specific statutory provision, like § 511(a)(2)(B) regarding UBIT, subjecting such state-affiliated organizations to tax). See Rev. Rul. 87-2, 1987-1 C.B. 18; Rev. Rul. 71-131, 1971 C.B. 29; Rev. Rul. 71-132, 1971-1 C.B. 29; G.C.M. 14407 (Jan. 28, 1935). See also Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Government Affiliates*, 23 J. Corp. Law 803 (1997). The preamble to the proposed regulations confirms this important point, stating that

a “governmental entity (including a state college or university) that does not have a determination letter recognizing its exemption from taxation under section 501(a) and that does not exclude income from gross income under section 115(1) is not an ATEO.” [REG-122345-18, Tax on Excess Tax-Exempt Organization Executive Compensation](#), 85 F.R. 35746 at 35747 (6/11/20). Furthermore, a state college or university that has secured exemption under § 501(a) (because it applied for tax-exempt status thereunder using IRS Form 1023 and received a determination letter) “may relinquish this status pursuant to the procedures described in section 3.01(12) of Rev. Proc. 2020-5 (2020-1 I.R.B. 241, 246) (or the analogous section in any successor revenue procedure).” *Id.* The final regulations are effective as of January 15, 2021, and apply to taxable years beginning after December 31, 2021.

## **B. Charitable Giving**

**1. What does “protected in perpetuity” mean? These cases provide some answers in the context of conservation easements.** It is well known that the IRS is battling syndicated conservation easements. Moreover, after recent victories, the IRS has announced a time-limited settlement offer to certain taxpayers with pending Tax Court cases involving syndicated conservation easements. *See* [IR 2020-130](#) (6/25/20). Other than challenging valuations, the IRS’s most successful strategy in combating syndicated conservation easements generally has centered around the “protected in perpetuity” requirement of § 170(h)(2)(C) and (h)(5)(A). The IRS has argued successfully in the Tax Court that the “protected in perpetuity” requirement is not met where the taxpayer’s easement deed fails to meet the strict requirements of the “extinguishment regulation.” *See* Reg. § 1.170A-14(g)(6)(ii). The extinguishment regulation ensures that conservation easement property is protected in perpetuity because, upon destruction or condemnation of the property and collection of any proceeds therefrom, the charitable donee must proportionately benefit. According to the IRS’s and Tax Court’s reading of the extinguishment regulation, the charitable donee’s proportionate benefit must be determined by a fraction determined at the time of the gift as follows: the value of the conservation easement as compared to the total value of the property subject to the conservation easement (hereinafter the “proportionate benefit fraction”). *See* [Coal Property Holdings, LLC v. Commissioner](#), 153 T.C. 126 (10/28/19). Thus, upon extinguishment of a conservation easement due to an unforeseen event such as condemnation, the charitable donee must be entitled to receive an amount equal to the product of the proportionate benefit fraction multiplied by the proceeds realized from the disposition of the property. As part of its litigation strategy against syndicated conservation easements, the IRS pounces upon any technical flaws in the deed’s extinguishment clause/proportionate benefit fraction language. In fact, the IRS recently has been successful in challenging extinguishment clause/proportionate benefit fraction language that either (i) would allow the donor to reclaim from the charitable donee property subject to a conservation easement by conveying to the donee substitute property in exchange therefor or (ii) would reduce the charitable donee’s benefit upon extinguishment of the conservation easement by the fair market value of post-contribution improvements made to the subject property after the date of the taxpayer-donor’s deductible gift. *See, e.g., Pine Mountain Preserve, LLLP v. Commissioner*, 151 T.C. 247 (12/27/18), including its companion case, *Pine Mountain Preserve, LLLP v. Commissioner*, T.C. Memo. 2018-214 (12/27/18) (deed allowed substituted property), *aff’d in part, vac’d in part, rev’d in part*, 978 F.3d 1200 (11th Cir. 10/22/20); and *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 9/14/18) (deed reduced charitable donee’s benefit for subsequent improvements made by taxpayer donor). The latter argument by the IRS—that a properly-drafted extinguishment clause/proportionate benefit fraction cannot give the donor credit for post-contribution improvements to the conservation easement property—is particularly potent. This argument by the IRS is the subject of the two Tax Court companion opinions rendered in *Oakbrook Land Holdings, LLC v. Commissioner*, as discussed below. Reportedly, many conservation easement deeds have such language, especially syndicated conservation easement deeds originating in the southeastern U.S. Hence, the Tax Court’s opinions in *Oakbrook Land Holdings, LLC v. Commissioner* are very important to the conservation easement industry. For a discussion of other IRS and Tax Court developments relating to conservation easements, see the Agricultural Law and Taxation Blog post of July 8, 2020, available [here](#).

**a. A crack in the IRS’s armor with respect to syndicated conservation easements? Or, a death knell for taxpayers? You be the judge.** [Oakbrook Land Holdings LLC v. Commissioner](#), 154 T.C. 180 (5/12/20), including the companion memorandum opinion [Oakbrook](#)

[Land Holdings LLC v. Commissioner](#), T.C. Memo 2020-54 (5/12/20). In these companion opinions totaling 172 pages, the Tax Court disallowed a taxpayer-donor's charitable contribution deduction because the language in the conservation easement deed was found to be defective under either of two theories argued by the IRS and supported by the Tax Court's reading of Reg. § 1.170A-14(g)(6)(ii). See below for further discussion. The taxpayer-donor's counter arguments, that the conservation easement deed's language was correct and that Reg. § 1.170A-14(g)(6)(ii) is invalid, failed to persuade the Tax Court. Just to keep us on our toes, perhaps, the Tax Court's decision resulted in two lengthy opinions. Judge Lauber wrote the majority opinion for the Tax Court's reviewed decision regarding one theory of the case, while Judge Holmes wrote a memorandum decision based upon another theory of the case. Interestingly, *Oakbrook Land Holdings* did not arise out of a syndicated conservation easement; however, it is very informative as to the IRS's litigation strategy with respect to syndicated conservation easements as well as the Tax Court's view of the law applicable to conservation easements generally.

*Facts.* The facts of *Oakbrook Land Holdings* are typical of recent conservation easement cases litigated in the Tax Court. The taxpayer-donor, Oakbrook Holdings LLC, acquired a 143-acre parcel of property near Chattanooga, Tennessee in 2007 for \$1.7 million. The plan was to develop the property for "higher-end, single family residences." In late 2008 Oakbrook Holdings LLC transferred approximately 37 acres of the property to related entities to allow a portion of the property to be developed without restrictions relating to the remainder of the property. The remaining 106 acres of the property then was subjected to a conservation easement in favor of Southeast Regional Land Conservancy (the "Conservancy"), a § 501(c)(3) organization. The taxpayer-donor, Oakbrook Holdings LLC, claimed a charitable contribution deduction of over \$9.5 million for the donated conservation easement even though the contribution occurred only a little over a year after Oakbrook Holdings LLC had acquired the property for \$1.7 million.

Oakbrook Holdings LLC, the taxpayer-donor, largely relied upon the charitable donee, the Conservancy, and its attorneys to draft the conservation easement deed. The Conservancy in turn relied upon language found in similar conservation easement deeds that have been executed and approved by numerous taxpayers and their attorneys. The deed provided as follows in relevant part:

This Conservation Easement gives rise to a real property right and interest immediately vested in [the Conservancy]. For purposes of this Conservation Easement, the fair market value of [the Conservancy]'s right and interest shall be equal to the difference between (a) the fair market value of the Conservation Area as if not burdened by this Conservation Easement and (b) the fair market value of the Conservation Area burdened by this Conservation Easement, as such values are determined as of the date of this Conservation Easement, (c) less amounts for improvements made by O[akbrook] in the Conservation Area subsequent to the date of this Conservation Easement, the amount of which will be determined by the value specified for these improvements in a condemnation award in the event all or part of the Conservation Area is taken in exercise of eminent domain as further described in this Article VI, Section B(3) below. If a change in conditions makes impossible or impractical any continued protection of the Conservation Area for conservation purposes, the restrictions contained herein may only be extinguished by judicial proceeding. Upon such proceeding, [the Conservancy], upon a subsequent sale, exchange or involuntary conversion of the Conservation Area, shall be entitled to a portion of the proceeds equal to the fair market value of the Conservation Easement as provided above. [The Conservancy] shall use its share of the proceeds in a manner consistent with the conservation purposes set forth in the Recitals herein.

Article VI, Section B(3) of the deed further stated:

Whenever all or part of the Conservation Area is taken in exercise of eminent domain \* \* \* so as to abrogate the restrictions imposed by this Conservation Easement, \* \* \* [the] proceeds shall be divided in accordance with the proportionate value of [the Conservancy]'s and O[akbrook]'s interests as specified above; all expenses including

attorneys fees incurred by O[akbrook] and [the Conservancy] in this action shall be paid out of the recovered proceeds to the extent not paid by the condemning authority.

*First argument of the IRS and taxpayer's response.* The IRS's first argument to disallow the taxpayer-donor's charitable contribution deduction was that the above-quoted language of the conservation easement deed only entitled the charitable donee, the Conservancy, to a fixed (not proportionate) benefit (i.e., historical value of the conservation easement at the time of the gift) upon the destruction or condemnation of the subject property. According to the IRS, Reg. § 1.170A-14(g)(6)(ii) requires that the charitable donee be entitled to a *proportionate* (i.e., fractional) benefit upon extinguishment of a conservation easement. Further, the IRS's position is that the amount of the benefit must be determined by applying the proportionate benefit fraction against the fair market value of the subject property at the time of the extinguishment. Put differently, the IRS contends that Reg. § 1.170A-14(g)(6)(ii) does not merely establish a baseline amount equal to the value of the conservation easement as the amount of the benefit to be received by the charitable donee upon extinguishment of a conservation easement. Rather, upon extinguishment of the easement, if the subject property has appreciated in value the charitable donee must be entitled to receive more than the claimed charitable contribution value of the conservation easement. (It is not entirely clear what the IRS's position would be under Reg. § 1.170A-14(g)(6)(ii) if upon extinguishment of the easement the subject property has decreased in value after the taxpayer-donor's gift, although consistency would argue that the charitable donee should receive less than the claimed charitable contribution value.)

On the other hand, the taxpayer-donor argued, of course, that the above-quoted language in the deed complied with Reg. § 1.170A-14(g)(6)(ii) because the regulation should be read to require only a fixed (not fractional) amount that must be received by the charitable-donee upon extinguishment of a conservation easement. In other words, the taxpayer-donor believed that Reg. § 1.170A-14(g)(6)(ii) was meant to protect the charitable donee's downside risk: i.e., that the event extinguishing the conservation easement would result in proceeds much less than the taxpayer-donor's claimed charitable contribution deduction. The taxpayer-donor's reading of Reg. § 1.170A-14(g)(6)(ii) was that the extinguishment clause in a conservation easement deed must entitle the charitable donee to an amount equal to the previously claimed charitable contribution deduction (or, if less, all of the proceeds from the disposition of the property).

*Memorandum Opinion of Judge Holmes.* In [Oakbrook Land Holdings LLC v. Commissioner](#), T.C. Memo 2020-54 (5/12/20), Judge Holmes, citing the Tax Court's prior decision in [Coal Property Holdings, LLC v. Commissioner](#), 153 T.C. 126 (10/28/19), agreed with the IRS's position regarding Reg. § 1.170A-14(g)(6)(ii) and the conservation easement language at issue, thereby disallowing the taxpayer-donor's more than \$9.7 million charitable contribution deduction. Judge Holmes reasoned that the language in the deed did not grant a fractional proportionate benefit to the Conservancy. It granted only a minimum benefit equal to the amount of the taxpayer-donor's claimed charitable contribution deduction. Judge Holmes agreed with the IRS that Reg. § 1.170A-14(g)(6)(ii) requires a fractional benefit, not a fixed amount. Other cases also have interpreted Reg. § 1.170A-14(g)(6) to require a fractional, not fixed, benefit in favor of the charitable donee. *See, e.g., PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 9/14/18). This aspect of the Tax Court's decision in [Oakbrook Land Holdings](#) is not novel, and presumably this lack of novelty is the reason for this memorandum decision written separately from the Tax Court's reviewed opinion written by Judge Lauber.

*Second argument of the IRS and taxpayer's response.* Alternatively, the IRS argued that the above-quoted language in the conservation easement deed was flawed in another respect. Specifically, the IRS contended that the deed's extinguishment language, which required that the charitable-donee's benefit upon destruction or condemnation of the property be reduced by the value of improvements to the property made by the taxpayer-donor after the contribution, was not allowed by the strict requirements of Reg. § 1.170A-14(g)(6)(ii). This position of the IRS is not explicitly supported by Reg. § 1.170A-14(g)(6)(ii) and is a novel argument by the IRS. The taxpayer-donor responded that to the extent Reg. § 1.170A-14(g)(6)(ii) is read to disallow such a reduction in the charitable-donee's benefit upon extinguishment of a conservation easement, the extinguishment regulation violates either the procedural or substantive requirements of the Administrative Procedures Act ("APA") and is invalid. This alternative argument by the IRS, and the taxpayer-donor's response, was the subject of the Tax Court's reviewed opinion by Judge Lauber, discussed below.

*Reviewed opinion of Judge Lauber.* In [Oakbrook Land Holdings LLC v. Commissioner](#), 154 T.C. 180 (5/12/20), a reviewed opinion (12-4-1) by Judge Lauber, the Tax Court agreed with the IRS's position concerning Reg. § 1.170A-14(g)(6)(ii) and post-contribution improvements to conservation easement property by a taxpayer-donor. We will spare the reader pages and pages of arguments and counter-arguments regarding the requirements of the APA. Suffice it to say that a majority of the Tax Court held that Reg. § 1.170A-14(g)(6)(ii) reflects a reasonable interpretation of the "protected in perpetuity" requirement of § 170(h)(2)(C) and (h)(5)(A). The majority also agreed with the IRS's position that Reg. § 1.170A-14(g)(6)(ii) does not permit the extinguishment clause of a conservation easement deed to reduce the charitable donee's proportionate benefit by the fair market value of post-contribution improvements to the subject property made by the donor. Hence, the majority disallowed the taxpayer-donor's claimed \$9.7 million plus charitable contribution deduction based upon the IRS's alternative argument (in addition to the grounds expressed in Judge Holmes's separate memorandum opinion).

*Concurring opinion of Judge Toro.* In a concurring opinion, Judge Toro, joined by Judge Urda and in part by Judges Gustafson and Jones, wrote that, although the majority reached the correct result for the reasons expressed in Judge Holmes's memorandum decision, the majority was mistaken concerning whether Reg. § 1.170A-14(g)(6)(ii) violates the APA and whether the IRS's interpretation of the extinguishment regulation (regarding post-contribution improvements made by a taxpayer-donor) was permissible.

*Dissenting opinion of Judge Holmes.* In an interesting twist, Judge Holmes (who held in favor of the IRS in his memorandum opinion) dissented from the Tax Court's reviewed opinion. Judge Holmes wrote: "Our decision today will likely deny any charitable deduction to hundreds or thousands of taxpayers who donated the conservation easements that protect perhaps millions of acres." And Judge Holmes made his views clear regarding the IRS's interpretation of Reg. § 1.170A-14(g)(6)(ii) to prohibit reduction of a charitable donee's extinguishment benefit for the value of improvements made by a taxpayer-donor and Treasury's compliance with the APA: "[I]f the majority is right, the Treasury Department can get by with the administrative-state equivalent of a quiet shrug, a knowing wink, and a silent fleeting glance from across a crowded room."

**b. The Eleventh Circuit has agreed that a conservation easement with an extinguishment clause that does not allow the charitable donee, in the event the easement is extinguished, to share in appreciation of the property due to improvements does not comply with applicable regulations.** [TOT Property Holdings, LLC v. Commissioner](#), 1 F.4th 1354 (11th Cir. 6/23/21). The taxpayer in this case donated to a qualifying organization (a land conservancy) a conservation easement on 652 acres of undeveloped land in Van Buren County, Tennessee. As required by Reg. § 1.170A-14(g)(6)(ii), the deed granting the easement addressed the rights of the donee organization in the event the easement was extinguished. The deed provided that, upon extinguishment of the easement, the donee organization would be entitled to a proportionate share of the sale proceeds resulting from the extinguishment. The proportionate share was to be determined by comparing, at the time of donation, (i) the value of the easement to (ii) the value of the property subject to the easement without reduction by the value of the easement. In other words, the donee's proportionate share of extinguishment proceeds would be determined by constructing a fraction, the numerator of which was the value of the easement at the time of donation and the denominator of which was the value of the entire property (without reduction by the value of the easement) at the time of donation. So far, so good. However, the deed provided that, if the easement were extinguished, the donee's proportionate share of sale proceeds would be determined by applying this fraction to:

the fair market value of the Property unencumbered by this Easement (minus any increase in value after the date of this grant attributable to improvements) ...

The effect of this language was to preclude the charitable donee from sharing, upon extinguishment of the easement, in any increase in value of the property attributable to post-donation improvements. In an opinion by Judge Anderson, the U.S. Court of Appeals for the Eleventh Circuit agreed with the IRS that this provision in the deed conveying the easement did not comply with Reg. § 1.170A-14(g)(6)(ii):

Appellants do not seriously dispute that the formula in ... the deed is different from [the] regulatory formula. Nor could they plausibly do so.... [T]he regulation does not

allow for “any increase in value after the date of th[e] grant attributable to improvements” to be subtracted from the extinguishment (e.g. condemnation) proceeds before the fraction is applied to the proceeds. No such “minus” language is included in the formula set out in § 1.170A-14(g)(6)(ii). Thus, the deed is different from and out of compliance with the formula set out in the regulation.

The court noted that its holding was consistent with the holding of the Fifth Circuit in *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018), and that of the Tax Court in *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019).

The court also rejected the taxpayer’s argument that the language in the deed complied with the applicable regulation because it stated that the donee organization’s proportionate share of proceeds resulting from extinguishment of the easement would be determined either in accordance with the deed or in accordance with Reg. § 1.170A-14 “if different.” The court referred to this provision as the “Treasury Regulation Override.” “For federal tax purposes,” the court observed, “courts and the IRS have refused to enforce a clause that purports to save an instrument from being out of compliance with the tax laws if the clause is operative by way of a condition subsequent.” The court concluded that the Treasury Regulation Override was a condition subsequent savings clause that did not bring the language in the deed into compliance with the applicable regulation.

The court also upheld the Tax Court’s valuation of the easement in question, the Tax Court’s imposition of accuracy-related penalties, and held that the IRS had complied with § 6751(b) by obtaining the required supervisory approval of the penalties.

- The taxpayer in this case did not challenge the validity of the regulation in question, Reg. § 1.170A-14(g)(6)(ii), under the Administrative Procedure Act (APA). In a subsequent case, *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21), the Eleventh Circuit held that the regulation was arbitrary and capricious under the APA for failing to comply with the APA’s procedural requirements and therefore is invalid.

**c. According to the Eleventh Circuit, Reg. § 1.170A-14(g)(6)(ii), as interpreted by the IRS, is arbitrary and capricious under the Administrative Procedure Act for failing to comply with procedural requirements and therefore is invalid.** [Hewitt v. Commissioner](#), 21 F.4th 1336 (11th Cir. 12/29/21), *rev’g*, T.C. Memo. 2020-89 (6/17/20). In an opinion by Judge Lagoa, the U.S. Court of Appeals for the Eleventh Circuit has held that Reg. § 1.170A-14(g)(6)(ii), as interpreted by the IRS, violates the Administrative Procedure Act (APA) and therefore is invalid. The taxpayers in this case donated to a qualifying organization a conservation easement on land in Randolph County, Alabama. Like the deed in *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 6/23/21) (discussed above), the deed conveying the easement in this case provided that, in the event of judicial extinguishment of the easement, the value of post-donation improvements to the property would be subtracted from the extinguishment proceeds before determining the donee’s share of the proceeds. The IRS argued that this subtraction of the value of post-donation improvements is not permitted by the relevant regulation, Reg. § 1.170A-14(g)(6)(ii). The Eleventh Circuit had agreed with the IRS on this issue in *TOT Property Holdings, LLC*. In this case, however, the taxpayers, unlike the taxpayers in *TOT Property Holdings, LLC*, argued that the regulation was invalid under the APA. The APA generally prescribes a three-step process for notice-and-comment rulemaking. First, the agency must issue a general notice of proposed rulemaking. Second, assuming notice is required, the agency must consider and respond to significant comments received during the period for public comment. Third, in issuing final rules, the agency must include a concise general statement of the rule’s basis and purpose. *See, e.g., Perez v. Mortgage Bankers Ass’n*, 575 U.S. 92, 96 (2015). The taxpayer argued that, in issuing Reg. § 1.170A-14(g)(6)(ii), Treasury had not complied with the second step because seven commenters, including the New York Land Conservancy (NYLC), had expressed concern about the required allocation of proceeds upon extinguishment of the easement reflected in the proposed version of the regulation. The NYLC specifically had commented on the issue of whether post-donation improvements to the property subject to the easement should be taken into account in determining the charitable donee’s proportionate share of extinguishment proceeds and had argued that such a requirement was undesirable to prospective donors and that the proposed version of the regulation should be revised. When the Treasury Department issued the final version of the regulation,

the preamble stated that Treasury had considered all comments submitted but did not specifically address or respond to the comments submitted on allocation of post-extinguishment proceeds. The Eleventh Circuit agreed with the taxpayer:

Simply put, NYLC’s comment was significant and required a response by Treasury to satisfy the APA’s procedural requirements. And the fact that Treasury stated that it had considered “all comments,” without more discussion, does not change our analysis, as it does not “enable [us] to see [NYLC’s] objections and why [Treasury] reacted to them as it did.”

(quoting *Lloyd Nolan Hosp. & Clinic v. Heckler*, 762 F.2d1561, 1566 (11th Cir. 1985).) Accordingly, the court held that the IRS’s interpretation of Reg. § 1.170A-14(g)(6)(ii) as precluding the subtraction of post-donation improvements to the easement property in determining the donee organization’s proportionate share of extinguishment proceeds is arbitrary and capricious and therefore invalid under the APA’s procedural requirements. The court therefore reversed the Tax Court’s decision that had disallowed the taxpayer’s charitable contribution deduction.

**d. The Sixth Circuit has disagreed with the Eleventh Circuit and has held that Treasury complied with the Administrative Procedure Act in issuing Reg. § 1.170A-14(g)(6)(ii) and that the regulation is valid.** [Oakbrook Land Holdings, LLC v. Commissioner](#), 28 F.4th 700 (6th Cir. 3/14/22), *aff’g*, 154 T.C. 180 (5/12/20). The taxpayers in this case donated to a qualifying organization a conservation easement on 106 acres of land on White Oak Mountain, an outcropping of the Appalachians near Chattanooga, Tennessee. As discussed above, the deed conveying the easement provided that, if the easement were to be extinguished, the donee organization’s proportionate share of the extinguishment proceeds would be determined by subtracting the value of any post-donation improvements to the property. The Tax Court had held in a reviewed opinion that Treasury had complied with the Administrative Procedure Act (APA) in issuing the regulation. In an opinion by Judge Moore, the U.S. Court of Appeals for the Sixth Circuit has affirmed the Tax Court’s decision. The taxpayers in this case, like those in [Hewitt v. Commissioner](#), 21 F.4th 1336 (11th Cir. 12/29/21), argued that Treasury had failed to comply with the APA in issuing the regulation. The APA generally prescribes a three-step process for notice-and-comment rulemaking. First, the agency must issue a general notice of proposed rulemaking. Second, assuming notice is required, the agency must consider and respond to significant comments received during the period for public comment. Third, in issuing final rules, the agency must include a concise general statement of the rule’s basis and purpose. *See, e.g., Perez v. Mortgage Bankers Ass’n*, 575 U.S. 92, 96 (2015). The taxpayer argued that, in issuing Reg. § 1.170A-14(g)(6)(ii), Treasury had not complied with either the second or third steps. With respect to the third step, the taxpayer argued that Treasury had not adequately explained the purpose and basis of the regulations because the preamble to the final version of the regulations stated only that the regulations “provide necessary guidance to the public for compliance with the law and affect donors and donees of qualified conservation contributions.” The court rejected this argument. Even without an ideal statement of basis and purpose for regulations, the court explained, a regulation can meet the requirement of including a concise statement of its basis and purpose if the basis and purpose are obvious. In its notice of proposed rulemaking for Reg. § 1.170A-14, Treasury had discussed the legislative history of § 170(h) and had described how Congress had shifted from limiting the deductibility of conservation easements to allowing them when the easement was perpetual. Here, the court reasoned,

the statutory text and the legislative history that Treasury contemplated in promulgating Treas. Reg. § 1.170A-14(g)(6)(ii) illuminate the regulation’s basis and purpose: to provide an administrable mechanism that would ensure that an easement’s conservation purpose as per I.R.C. § 170(h)(5)(A) continued to be protected should the interest be extinguished.

With respect to the second step for notice-and-comment rulemaking, the taxpayers argued that several commenters, including the New York Land Conservancy (NYLC), had expressed concern about the required allocation of proceeds upon extinguishment of the easement reflected in the proposed version of the regulation. The NYLC specifically had commented on the issue of whether post-donation improvements to the property subject to the easement should be taken into account in determining the

charitable donee's proportionate share of extinguishment proceeds and had argued that such a requirement was undesirable to prospective donors and that the proposed version of the regulation should be revised. When the Treasury Department issued the final version of the regulation, the preamble stated that Treasury had considered all comments submitted but did not specifically address or respond to the comments submitted on allocation of post-extinguishment proceeds. The court held that none of the comments identified by the taxpayers required a response by Treasury. None of the comments, the court observed, raised a concern that Reg. § 1.170A-14(g)(6)(ii), which addresses allocation of proceeds to the donee organization upon extinguishment of the easement, failed to satisfy the perpetuity requirement of § 170(h)(2)(C) and (h)(5)(A), which was Congress's central concern. The court rejected as unpersuasive the contrary decision of the Eleventh Circuit in *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21).

The court also rejected the taxpayer's argument that Reg. § 1.170A-14(g)(6)(ii) reflects an impermissible construction of § 170(h). The court assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 170(h)(5)(A), is ambiguous, and in step two that Reg. § 1.170A-14(g)(6)(ii) is a reasonable interpretation of the statute.

Finally, the court rejected as unpersuasive the taxpayer's argument that Treasury had acted arbitrarily or capriciously in issuing Reg. § 1.170A-14(g)(6)(ii) because it had provided no explanation for why it adopted the rule, and because it had failed to consider a variety of alternatives.

*Concurring opinion by Judge Guy.* In a concurring opinion, Judge Guy concluded that Reg. § 1.170A-14(g)(6)(ii) is procedurally invalid under the APA for substantially the same reasons articulated by the Eleventh Circuit in *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21). Nevertheless, Judge Guy concurred in the court's judgment affirming the Tax Court's decision. Judge Guy reasoned that the relevant statute, § 170(h)(2)(C), requires that the donee organization receive the fair market value of the easement upon judicial extinguishment of the easement, that this right be protected in perpetuity, and that the provisions in the deed conveying the easement in this case failed to comply with this requirement. In other words, Judge Guy reasoned that it is unnecessary to rely on Reg. § 1.170A-14(g)(6)(ii) to conclude that the easement in this case failed to satisfy the statutory requirement. The majority declined to consider this argument by the government because the government had failed to raise it in the Tax Court. Judge Guy observed that parties can be permitted to raise arguments for the first time on appeal in exceptional cases, and concluded that this was an exceptional case.

## X. TAX PROCEDURE

### A. Interest, Penalties, and Prosecutions

**1. Is the IRS ever going to learn that the § 6751(b) supervisory approval requirement is not met unless the required supervisory approval of a penalty occurs *before* the initial determination that formally communicates the penalty to the taxpayer?** Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 154 T.C. 68 (1/16/20). The taxpayer, a C corporation, failed to disclose its participation in a listed transaction as required by § 6011 and Reg. § 1.6011-4(a). The IRS revenue agent examining the taxpayer's return issued a 30-day letter to the taxpayer offering the opportunity for the taxpayer to appeal the proposal to the IRS Office of Appeals (IRS Appeals). The 30-day letter proposed to assess a penalty under § 6707A for failing to disclose a reportable transaction. Approximately three months after the 30-day letter was issued, the revenue agent's supervisor approved the penalty by signing a Civil Penalty Approval Form. Following unsuccessful discussions with IRS Appeals, the IRS assessed the penalty and issued a notice of levy. The taxpayer requested a collection due process (CDP) hearing with Appeals, following which Appeals issued a notice of determination sustaining the proposed levy. In response to the notice of determination, the taxpayer filed a petition in the Tax Court. In the Tax Court, the taxpayer filed a motion for summary judgment on the basis that the IRS had failed to comply with the supervisory approval requirement of § 6751(b). Section 6751(b)(1) requires that the "initial determination" of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The Tax Court (Judge Gustafson) granted the taxpayer's motion. The court first concluded that the supervisory approval requirement of § 6751(b) applies to the penalty imposed by

§ 6707A. Next the court concluded that the supervisory approval of the §6707A penalty in this case was not timely because it had not occurred before the IRS's initial determination of the penalty. The parties stipulated that the 30-day letter issued to the taxpayer reflected the IRS's initial determination of the penalty. The supervisory approval of the penalty occurred three months later and therefore, according to the court, was untimely. The IRS argued that the supervisory approval was timely because it occurred before the IRS's *assessment* of the penalty. In rejecting this argument, the court relied on its prior decisions interpreting § 6751(b), especially *Clay v. Commissioner*, 152 T.C. 23 (2019), in which the court held in a deficiency case "that when it is 'communicated to the taxpayer formally ... that penalties will be proposed', section 6751(b)(1) is implicated." In *Clay*, the IRS had issued a 30-day letter when it did not have in hand the required supervisory approval of the relevant penalty. The IRS can assess the penalty imposed by § 6707A without issuing a notice of deficiency. Nevertheless, the court observed "[t]hough *Clay* was a deficiency case, we did not intimate that our holding was limited to the deficiency context." The court summarized its holding in the present case as follows:

Accordingly, we now hold that in the case of the assessable penalty of section 6707A here at issue, section 6751(b)(1) requires the IRS to obtain written supervisory approval before it formally communicates to the taxpayer its determination that the taxpayer is liable for the penalty.

The court therefore concluded that it had been an abuse of discretion for the IRS Office of Appeals to determine that the IRS had complied with applicable laws and procedure in issuing the notice of levy. The court accordingly granted the taxpayer's motion for summary judgment.

**a. "We are all textualists now," says the Ninth Circuit. When the IRS need not issue a notice of deficiency before assessing a penalty, the language of § 6751(b) contains no requirement that supervisory approval be obtained before the IRS formally communicates the penalty to the taxpayer.** [Laidlaw's Harley Davidson Sales, Inc. v. Commissioner](#), 29 F.4th 1066 (9th Cir. 3/25/22), *rev'g* 154 T.C. 68 (1/16/20). In an opinion by Judge Bea, the U.S. Court of Appeals for the Ninth Circuit has reversed the decision of the Tax Court and held that, when the IRS need not issue a notice of deficiency before assessing a penalty, the IRS can comply with the supervisory approval requirement of § 6751(b) by obtaining supervisory approval of the penalty before assessment of the penalty provided that approval occurs when the supervisor still has discretion whether to approve the penalty. As previously discussed, the taxpayer, a C corporation, failed to disclose its participation in a listed transaction as required by § 6011 and Reg. § 1.6011-4(a). The IRS revenue agent examining the taxpayer's return issued a 30-day letter to the taxpayer offering the opportunity for the taxpayer to appeal the proposal to the IRS Office of Appeals (IRS Appeals). The 30-day letter proposed to assess a penalty under § 6707A for failing to disclose a reportable transaction. After the taxpayer had submitted a letter protesting the proposed penalty and requesting a conference with IRS Appeals, and approximately three months after the revenue agent issued the 30-day letter, the revenue agent's supervisor approved the proposed penalty by signing Form 300, Civil Penalty Approval Form. The Tax Court held that § 6751(b)(1) required the IRS to obtain written supervisory approval before it formally communicated to the taxpayer its determination that the taxpayer was liable for the penalty, i.e., before the revenue agent issued the 30-day letter. On appeal, the government argued that § 6751(b) required only that the necessary supervisory approval be secured before the IRS's *assessment* of the penalty as long as the supervisory approval occurs at a time when the supervisor still has discretion whether to approve the penalty. The Ninth Circuit agreed. In agreeing with the government, the court rejected the Tax Court's holding that § 6751(b) requires supervisory approval of the *initial determination* of the assessment of the penalty and therefore requires supervisory approval before the IRS formally communicates the penalty to the taxpayer. According to the Ninth Circuit, "[t]he problem with Taxpayer's and the Tax Court's interpretation is that it has no basis in the text of the statute." The court acknowledged the legislative history of § 6751(b), which indicates that Congress enacted the provision to prevent IRS revenue agents from threatening penalties as a means of encouraging taxpayers to settle. But the text of the statute as written, concluded the Ninth Circuit, does not support the interpretation of the statute advanced by the Tax Court and the taxpayer. The court summarized its holding as follows:

Accordingly, we hold that § 6751(b)(1) requires written supervisory approval before the assessment of the penalty or, if earlier, before the relevant supervisor loses

discretion whether to approve the penalty assessment. Since, here, Supervisor Korzec gave written approval of the initial penalty determination before the penalty was assessed and while she had discretion to withhold approval, the IRS satisfied § 6751(b)(1).

The court was careful to acknowledge that supervisory approval might be required at an earlier time when the IRS must issue a notice of deficiency before assessing a penalty because, “once the notice is sent, the Commissioner begins to lose discretion over whether the penalty is assessed.” The IRS can assess the penalty in this case, imposed by § 6707A, without issuing a notice of deficiency.

*Dissenting opinion by Judge Berzon.* In a dissenting opinion, Judge Berzon emphasized that the 30-day letter the revenue agent sent to the taxpayer was an operative determination. The letter indicated that, if the taxpayer took no action in response, the penalty would be assessed. Judge Berzon analyzed the text of the statute and its legislative history and concluded as follows:

In my view, then, the statute means what it says: a supervisor must personally approve the “initial determination” of a penalty by a subordinate, or else no penalty can be assessed based on that determination, whether the proposed penalty is objected to or not. 26 U.S.C. §§ 6751(b)(1). That meaning is consistent with Congress's purpose of preventing threatened penalties never approved by supervisory personnel from being used as a “bargaining chip” by lower-level staff, S. Rep. No. 105-174, at 65 (1998); see *Chai v. Commissioner*, 851 F.3d 190, 219 (2d Cir. 2017), which is exactly what happened here.

Because the 30-day letter was an operative determination, according to the dissent, “supervisory approval was required at a time when it would be meaningful-before the letter was sent.”

**2. IRS revenue agents really need to learn to obtain the required supervisory approval of penalties before communicating the penalties to taxpayers.** [Beland v. Commissioner](#), 156 T.C. No. 5 (3/1/21). The issue in this case was whether the IRS was precluded from asserting penalties because it had failed to comply with the requirement of § 6751(b)(1) that the initial determination of the assessment of a penalty be “personally approved (in writing) by the immediate supervisor of the individual making such determination.” The revenue agent auditing the 2011 return of the taxpayers, a married couple, issued an administrative summons to the taxpayers to appear. Pursuant to the summons, the taxpayers met with the revenue agent for a closing conference, which is held during the closing phase of an examination. During the conference, the revenue agent presented Form 4549, Income Tax Examination Changes, commonly referred to as the revenue agent’s report, which included a fraud penalty. The taxpayers declined to sign the revenue agent’s report or to consent to an extension of the limitations period on assessment. Following the meeting, the revenue agent sent the examination case file and a civil penalty approval form to a General Manager for approval. The General Manager signed the civil penalty approval form. The Tax Court (Judge Greaves) held that the IRS was precluded from asserting the fraud penalty. Among other authorities, the court relied on its prior decision in *Belair Woods, LLC v. Commissioner*, 154 T.C. No. 1 (1/6/20), in which the court had held that initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. In this case, the court held, the initial determination of the penalty was the revenue agent’s report, which was presented to the taxpayers during the closing conference. Because the IRS failed to secure the required supervisory approval before the initial determination of the penalty, § 6751(b)(1) precluded the IRS from asserting the penalty.

**3. Tax Court has discretion to allow taxpayer to withdraw petition to abate interest.** [Mainstay Business Solutions v. Commissioner](#), 156 T.C. 98 (3/4/21). In this case, the taxpayer, Mainstay Business Solutions, sought to withdraw its petition requesting review of the IRS’s failure to abate interest. Mainstay filed Form 843, Claim for Refund and Request for Abatement, for numerous quarterly tax periods ending in 2009, 2010, and 2011. Mainstay then petitioned the court pursuant to § 6404(h) to review the IRS’s failure to abate interest. After filing its petition in the Tax Court, Mainstay moved to withdraw the petition and dismiss the action. In general, the Tax Court has jurisdiction pursuant to § 6404(h)(1) to determine whether the IRS’s failure to abate interest was an abuse of discretion. In an ordinary deficiency case, § 7459(d) provides that the Tax Court’s decision

to dismiss a proceeding is a binding decision that the deficiency is the amount determined by the IRS. In a deficiency case, a taxpayer may not withdraw a petition in order to avoid a decision by the Tax Court. However, in a sequence of non-deficiency cases since the enactment of § 6404 in 1996, the Tax Court has concluded that a taxpayer may withdraw its petition in cases seeking review of collection actions, determinations of innocent spouse relief, and whistleblower award determinations. See *Wagner v. Commissioner*, 118 T.C. 330 (2002), *Davidson v. Commissioner*, 144 T.C. 273 (2015), *Jacobson v. Commissioner*, 148 T.C. 68 (2017). Because there is no specific Tax Court Rule that controls whether a taxpayer can withdraw the petition in these types of non-deficiency actions, the Tax Court looks to the Federal Rules of Civil Procedure (FRCP) for guidance. Under the FRCP, a civil action may be dismissed voluntarily without a court order under two circumstances. First, an action can be dismissed if the plaintiff files a notice of dismissal before the opposing party serves either an answer or a motion for summary judgment. Second, an action can be dismissed if the plaintiff files a stipulation of dismissal signed by all parties who have appeared. Fed. R. Civ. P. 41(a)(1)(A). In all other circumstances a plaintiff is allowed to dismiss a civil action voluntarily only through a court order. Fed. R. Civ. P. 41(a)(2). Following these rules and the court's precedents in *Wagner*, *Davidson*, and *Jacobson*, Judge Kerrigan held that the Tax Court has authority to allow a petition to be withdrawn voluntarily in a case reviewing the Secretary's failure to abate interest. The Court concluded that the IRS would not be prejudiced if the court were to treat Mainstay's proceeding as if it had never been commenced. Thus, in the absence of any objection by the IRS, Judge Kerrigan granted Mainstay's motion to withdraw its petition and dismiss the case.

**4. Can you avoid penalties by relying on your attorney or CPA to file an extension request? No, says the Claims Court. An executor who relied on an attorney to file an extension request for an estate tax return did not have a reasonable cause defense to late-filing and late payment penalties.** [Andrews v. United States](#), 153 Fed. Cl. 665 (5/12/21). The plaintiff, who was the executor of an estate, brought this action seeking a refund of late-filing and late-payment penalties assessed by the IRS against the estate. The estate's return on Form 706 was due on May 8, 2016. The plaintiff retained an estate planning law firm to assist in preparing Form 706 and authorized the firm to file Form 4768 to obtain an automatic six-month extension of time to file. The plaintiff asserts that the attorney who was to file for the extension failed to do so and, after the May 8, 2016, filing deadline, filed Form 706 late and reported tax due of approximately \$3 million. The IRS assessed a late-filing penalty of just over \$400,000 and a late-payment penalty of just over \$75,000. The estate paid the tax due and all penalties and interest, filed an administrative claim for refund of the refund of the penalties and, in this action, challenges the IRS's failure to issue the refund. The government moved to dismiss for failure to state a claim on the ground that the estate could not establish a reasonable cause defense to the penalties. In an opinion by Judge Davis, the U.S. Court of Federal Claims granted the government's motion to dismiss. In reaching its conclusion, the court relied on the U.S. Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985). In *Boyle*, the Court held that "failure to make a timely filing of a tax return is not excused by [a] taxpayer's reliance on an agent." The Court in *Boyle* distinguished relying on an agent from situations in which a taxpayer relies on the mistaken advice of counsel concerning a question of tax law, which courts have held can constitute reasonable cause. In this case, the Court of Federal Claims held, the executor of the estate had not relied on mistaken advice of counsel, but rather had delegated responsibility for filing an extension request. Under the standard set forth in *Boyle*, the court held, such delegation to an agent does not give rise to a reasonable cause defense to penalties. Accordingly, the court granted the government's motion to dismiss.

**5. Tax Court also has discretion to grant taxpayer's motion to dismiss its petition for an award of administrative costs.** [Stein v. Commissioner](#), 156 T.C. 167 (6/17/21). Following the Tax Court's decision in *Mainstay Business Solutions v. Commissioner*, 156 T.C. 98 (3/4/21), discussed above, Judge Gale allowed the petitioners, a married couple (the Steins), to withdraw their petition requesting review of the IRS's denial of their application for an award of reasonable administrative costs. Section 7430(a)(1) provides that a taxpayer who prevails in an administrative proceeding before the IRS regarding "the determination, collection, or refund of any tax, interest, or penalty" may be entitled to an award of reasonable costs incurred in connection with the proceeding. A taxpayer requests such an award by filing a written application with the IRS. Pursuant to § 7430(f)(2), the Tax Court has jurisdiction to review the IRS's denial of a taxpayer's timely filed application for an award

of costs. After the IRS denied the Steins' application for an award of administrative costs, they filed a petition in the Tax Court seeking review of the IRS's decision. After the IRS filed an answer and without any objection from the IRS, the Steins moved to voluntarily dismiss the case. The narrow issue to be decided was whether the Tax Court had authority to grant a taxpayer's motion to dismiss such a proceeding without entering a decision. Applying Judge Kerrigan's analysis in *Mainstay Business Solutions v. Commissioner*, Judge Gale concluded that the Steins' original petition did not invoke the Tax Court's deficiency jurisdiction. Judge Gale reasoned that if a taxpayer may withdraw its petition seeking review of the IRS' failure to abate interest, collection actions, determinations of innocent spouse relief, and whistleblower award determinations without implicating the Court's deficiency jurisdiction, the Steins could similarly withdraw their petition in this administrative costs case. See *Mainstay Business Solutions v. Commissioner*, 156 T.C. 98 (3/4/21), *Wagner v. Commissioner*, 118 T.C. 330 (2002), *Davidson v. Commissioner*, 144 T.C. 273 (2015), *Jacobson v. Commissioner*, 148 T.C. 68 (2017). Because there is no specific Tax Court Rule that controls whether a taxpayer can withdraw the petition in these types of non-deficiency actions, the Tax Court looks to the Federal Rules of Civil Procedure (FRCP) for guidance. Under the FRCP, a civil action may be dismissed voluntarily without a court order under two circumstances. First, an action can be dismissed if the plaintiff files a notice of dismissal before the opposing party serves either an answer or a motion for summary judgment. Second, an action can be dismissed if the plaintiff files a stipulation of dismissal signed by all parties who have appeared. Fed. R. Civ. P. 41(a)(1)(A). In all other circumstances a plaintiff is allowed to dismiss a civil action voluntarily only through a court order. Fed. R. Civ. P. 41(a)(2). Consistent with the FRCP and the Tax Court's prior precedents, Judge Gale held that the IRS would not be prejudiced if the court were to treat this action as if it had never been commenced. Thus, in the absence of any objection by the IRS, the court granted the Steins' motion to withdraw their petition and dismiss this case.

**6. Can't we cut this guy a break? No, says the Fifth Circuit. Even though the taxpayer was incarcerated and the person he appointed as his attorney-in-fact to file his returns and manage his affairs failed to do so and embezzled hundreds of thousands of dollars, the taxpayer could not establish a reasonable cause defense to penalties.** [Lindsay v. United States](#), 4 F.4th 292 (5th Cir. 7/9/21). The taxpayer was incarcerated from 2013 to 2015. He appointed an individual, Keith Bertelson, to act as his attorney-in-fact under a power of attorney that gave Bertelson authority to manage the taxpayer's affairs. Bertelson failed to file the taxpayer's returns and pay taxes due as he had been directed. Bertelson also embezzled the taxpayer's funds. The taxpayer ultimately recovered more than \$700,000 in actual damages from Bertelson and \$1 million in punitive damages. After being released, the taxpayer filed late returns for 2012 through 2015. The IRS assessed late-filing and late-payment penalties of more than \$400,000. After filing an administrative claim for refund of the penalties, the taxpayer brought this action seeking a refund on the basis that his incarceration qualified as a "disability." In an opinion by Judge Stewart, the U.S. Court of Appeals for the Fifth Circuit rejected the taxpayer's argument. The court relied on the U.S. Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985). In *Boyle*, the Court held that "failure to make a timely filing of a tax return is not excused by [a] taxpayer's reliance on an agent." The Court in *Boyle* distinguished relying on an agent from situations in which a taxpayer relies on the mistaken advice of counsel concerning a question of tax law, which courts have held can constitute reasonable cause. In this case, the Fifth Circuit concluded, the taxpayer had not relied on mistaken advice of counsel, but rather had delegated responsibility for filing his tax returns. Under the standard set forth in *Boyle*, the court held, such delegation to an agent does not give rise to a reasonable cause defense to penalties. The court also concluded that this was not a situation in which the taxpayer was incapable of meeting his filing obligations and therefore did not fall into the category of situations in which courts have recognized a reasonable cause defense for taxpayers who are not physically or mentally capable of complying with a filing deadline. Accordingly, the court granted the government's motion to dismiss.

**7. Updated instructions on how to rat yourself out.** [Rev. Proc. 2021-52](#), 2021-51 I.R.B. 883 (12/16/21). This revenue procedure updates Rev. Proc. 2020-54, 2020-53 I.R.B. 1806, and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to

unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return. A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position. The revenue procedure applies to any income tax return filed on a 2021 tax form for a taxable year beginning in 2021 and to any income tax return filed on a 2021 tax form in 2022 for a short taxable year beginning in 2022.

**B. Discovery: Summonses and FOIA**

**C. Litigation Costs**

**D. Statutory Notice of Deficiency**

**E. Statute of Limitations**

**F. Liens and Collections**

**1. Coworking might carry some tax risk. A notice of intent to levy sent by certified mail to shared office space and signed for by someone unaffiliated with the taxpayer triggered the 30-day period for requesting a CDP hearing.** [Ramey v. Commissioner](#), 156 T.C. No. 1 (1/14/21). On July 13, 2018, the IRS mailed to the taxpayer a notice of intent to levy. The notice of intent to levy informed the taxpayer that he could request a collection due process (CDP) hearing by mailing Form 12153 to the IRS by August 12, 2018. The IRS mailed the notice by certified mail with a return receipt requested. The taxpayer did not challenge the address to which the notice was sent. An individual signed for the notice, but the taxpayer maintained that several businesses used the same address and that the individual who signed was not his employee and was not authorized to receive mail on his behalf. The taxpayer actually received the notice shortly before the August 12 deadline to request a CDP hearing. The taxpayer mailed Form 12153 to the IRS after the August 12 deadline and the IRS Appeals Office therefore treated his submission as untimely and provided an “equivalent hearing” pursuant to Reg. § 301.6330-1(i)(1). Following the hearing, the IRS Appeals Office issued a “Decision Letter on Equivalent Hearing Under Internal Revenue Code Sections 6320 and/or 6330” upholding the proposed collection action. The taxpayer filed a petition in the Tax Court seeking review of the decision letter. The IRS moved to dismiss for lack of subject matter jurisdiction on the ground that it had not issued a notice of determination following a CDP hearing and that a decision letter following an equivalent hearing is not subject to judicial review. The taxpayer responded that the notice of intent to levy mailed by the IRS was invalid because it had not been properly served and had been signed for by a “random person.” The Tax Court (Judge Toro) granted the IRS’s motion to dismiss. The court reasoned that § 6330(d)(1) grants the Tax Court jurisdiction to review a determination made by IRS Appeals under § 6330, but that the court’s jurisdiction is contingent on both the issuance of a valid notice of determination by IRS Appeals and the filing of a timely petition (within 30 days) by the taxpayer. In this case, the court observed, the IRS had not issued a notice of determination. Nevertheless, the court inquired whether the taxpayer had timely requested a CDP hearing by filing Form 12153 because, in prior decisions, the court had concluded that, if the IRS Appeals Office incorrectly concludes that the taxpayer’s request for a CDP hearing was untimely and issues a decision letter, the court would treat the decision letter as a notice of determination that confers jurisdiction on the court. *See Craig v. Commissioner*, 119 T.C. 252 (2002); *Andre v. Commissioner*, 127 T.C. 68 (2006). In this case, the court concluded, the taxpayer’s request for a CDP hearing was untimely. The court rejected the taxpayer’s argument that the notice of levy was deficient because he did not sign for it or receive it in a timely manner and the person who did sign for it had no authority to receive it. The court observed that, under § 6330(a)(2), there are three ways in which the IRS can provide notice of its intent to levy. The third authorized method is for the notice to be “‘sent by certified or registered mail, return receipt requested,’ to the taxpayer’s last known address.” According to the court, this method

focuses on the sending of the notice, not the taxpayer’s receipt of it. It describes the type of USPS service the IRS must select—certified or registered mail, return receipt

requested. ... The primary responsibility of the IRS under this method of service is to place the notice in the hands of the USPS. So long as the IRS properly addresses the notice to the taxpayer's last known address and selects the correct type of service from the USPS ... the IRS complies with the terms of the statute.

This conclusion, the court observed, is reflected in the regulations under § 6330, which provide that “[a]ctual receipt is not a prerequisite to the validity of the CDP [n]otice.” Reg. § 301.6330-1(a)(3), Q&A 9. Accordingly, the court concluded, the IRS’s mailing of the notice of intent to levy started the running of the 30-day period for the taxpayer to request a CDP hearing and the taxpayer’s request was untimely. The court noted that the taxpayer was not left without an opportunity to seek judicial review of his tax obligations because he could pay the tax in question, seek a refund, and then bring a refund action in a U.S. District Court or the U.S. Court of Federal Claims.

**2. The 30-day period for requesting review in the Tax Court of a notice of determination following a CDP hearing is jurisdictional and not subject to equitable tolling.** Boechler, P.C. v. Commissioner, 967 F.3d 760 (8th Cir. 7/24/20), *aff’g* Boechler, P.C. v. Commissioner, No. 18578-17L (U.S. Tax Court (2/15/19)). Following a collection due process hearing, the IRS issued a notice of determination upholding proposed collection action. The notice informed the taxpayer, a law firm in Fargo, North Dakota, that, if it wished to contest the determination, it could do so by filing a petition with the United States Tax Court within a 30-day period beginning the day after the date of the letter. The IRS mailed the notice on July 28, 2017. The 30-day period expired on August 27, 2017, but because this date fell on a Sunday, the taxpayer had until the following day, August 28, to file his petition. The taxpayer mailed its petition to the Tax Court on August 29, 2017, which was one day late. The Tax Court (Judge Carluzzo) granted the government’s motion to dismiss for lack of subject matter jurisdiction. On appeal, the taxpayer argued that the 30-day period specified in § 6330(d)(1) for filing his Tax Court petition should be equitably tolled. In an opinion by Judge Erickson, the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court’s decision. The court held that the 30-day period specified in § 6330(d)(1) is jurisdictional and therefore is not subject to equitable tolling. In reaching this conclusion, the court relied on the plain language of § 6330(d)(1), which provides:

The person may, within 30 days of a determination under this section, petition the Tax Court for review of such determination (and the Tax Court shall have jurisdiction with respect to such matter).

This provision, the court reasoned, “is a rare instance where Congress clearly expressed its intent to make the filing deadline jurisdictional.” According to the court, the parenthetical expression regarding the Tax Court’s jurisdiction “is clearly jurisdictional and renders the remainder of the sentence jurisdictional.” Because the 30-day period specified in § 6330(d)(1) is jurisdictional, the court concluded, it is not subject to equitable tolling. In reaching this conclusion, the court found persuasive the reasoning of the U.S. Court of Appeals for the Ninth Circuit in Duggan v. Commissioner, 879 F.3d 1029 (9th Cir. 2018), in which the Ninth Circuit similarly held that the 30-day period specified in § 6330(d)(1) is jurisdictional and therefore not subject to equitable tolling. *See also* Cunningham v. Commissioner, 716 Fed. Appx. 182 (4th Cir. 2018) (holding that, assuming without deciding that the 30-day period specified in § 6330(d)(1) is not jurisdictional and therefore is subject to equitable tolling, the taxpayer had not established circumstances warranting equitable tolling). The Eighth Circuit found unpersuasive the taxpayer’s reliance on Myers v. Commissioner, 928 F.3d 1025 (D.C. Cir. 2019), in which the D.C. Circuit held that a similarly worded 30-day limitations period in § 7623(b)(4) for filing a Tax Court petition to challenge an adverse IRS determination regarding entitlement to a whistleblower award was not jurisdictional and was subject to equitable tolling.

**a. We are sure that Justice Barrett was thrilled to be assigned to write, as one of her first opinions, an opinion on a technical issue of tax procedure. The U.S. Supreme Court has reversed the Eighth Circuit and held that the 30-day period for requesting review in the Tax Court of a notice of determination following a CDP hearing is not jurisdictional and is subject to equitable tolling.** Boechler, P.C. v. Commissioner, \_\_\_ S. Ct. \_\_\_, 129 A.F.T.R.2d 2022-1489 (4/21/22). In a unanimous opinion by Justice Barrett, the U.S. Supreme Court has reversed the Eighth Circuit and held that the 30-day period specified in § 6330(d)(1) for requesting review in the Tax Court

of a notice of determination following a CDP hearing is not jurisdictional and is subject to equitable tolling. The Court began with the proposition that a procedural requirement is jurisdictional only if Congress clearly states that the provision is jurisdictional. The provision in question, § 6330(d)(1), provides:

The person may, within 30 days of a determination under this section, petition the Tax Court for review of such determination (and the Tax Court shall have jurisdiction with respect to such matter).

Although the parenthetical expression at the end of the provision refers to the Tax Court having jurisdiction, the Court reasoned that whether the provision is jurisdictional depends on whether the phrase “such matter” at the end of the provision refers to the entire first clause of the sentence (as the government argued) or instead refers to the immediately preceding phrase that states “petition the Tax Court” (as the taxpayer argued). In other words, the question is whether the provision indicates that the Tax Court has jurisdiction over the taxpayer’s petition, or instead indicates that the Tax Court has jurisdiction only if the taxpayer complies with the 30-day period for requesting review. The Court reasoned that the provision “does not clearly mandate the jurisdictional reading,” but that the non-jurisdictional reading “is hardly a slam dunk for Boechler.” Nevertheless, the Court concluded that “Boechler’s interpretation has a small edge.” According to the Court, there are multiple plausible interpretations of the phrase “such matter,” and “[w]here multiple plausible interpretations exist—only one of which is jurisdictional—it is difficult to make the case that the jurisdictional reading is clear.” Further, the Court reasoned, other tax provisions enacted around the same time as § 6330(d)(1) are much more clear that the filing deadlines they contain are jurisdictional. For example, § 6015(e)(1)(A), which governs the filing of petitions in the Tax Court by taxpayers seeking innocent spouse protection, provides:

In addition to any other remedy provided by law, the individual may petition the Tax Court (and the Tax Court shall have jurisdiction) to determine the appropriate relief available to the individual under this section *if such petition is filed* ... [within a 90-day period]

(Emphasis added.) Such provisions “accentuate the lack of clarity in § 6330(d)(1).”

Having concluded that the 30-day period specified in § 6330(d)(1) is not jurisdictional, the Court turned to the issue of whether this 30-day period is subject to equitable tolling. The Court previously had held in *Irwin v. Department of Veterans Affairs*, 498 U.S. 89 (1990), that non-jurisdictional limitations periods are presumptively subject to equitable tolling, and the Court saw “nothing to rebut the presumption here.” The Court rejected the government’s argument that the 30-day limitations period set forth in § 6330(d)(1) is similar to the limitations periods for filing claims for refund in § 6511, which the Court had held were not subject to equitable tolling in *United States v. Brockamp*, 519 U.S. 347 (1997):<sup>3</sup>

Section 6330(d)(1)’s deadline is a far cry from the one in *Brockamp*. This deadline is not written in “emphatic form” or with “detailed” and “technical” language, nor is it reiterated multiple times. The deadline admits of a single exception (as opposed to *Brockamp*’s six), which applies if a taxpayer is prohibited from filing a petition with the Tax Court because of a bankruptcy proceeding. §6330(d)(2). That makes this case less like *Brockamp* and more like *Holland v. Florida*, 560 U. S. 631 (2010), in which we applied equitable tolling to a deadline with a single statutory exception.

Accordingly, the Court reversed the judgment of the Eighth Circuit and remanded for further proceedings, which will require a determination of whether the taxpayer’s circumstances warrant equitable tolling of § 6330(d)(1)’s 30-day period.

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<sup>3</sup> See generally Bruce A. McGovern, *The New Provision for Tolling the Limitations Periods for Seeking Tax Refunds: Its History, Operation and Policy, and Suggestions for Reform*, 65 Mo. L. Rev. 797 (2000) (discussing equitable tolling and the U.S. Supreme Court’s decision in *Brockamp*).

**3. A taxpayer who failed to request a CDP hearing in response to a notice of federal tax lien was barred by § 6330(c)(2)(B) from challenging his underlying tax liability when he later received a notice of levy and requested a CDP hearing because the prior opportunity for a CDP hearing provided the taxpayer with an opportunity to contest his underlying tax liability.** [Jeffers v. CIR](#), 992 F.3d 649 (7th Cir. 3/30/21). Section 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer’s underlying tax liability in a CDP hearing only “if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability.” In this case, the IRS assessed additional tax with respect to the taxpayer’s 2008 return and the taxpayer filed a 2009 return on which he reported that he owed more than \$12,000 in tax, which he did not pay. The IRS later mailed to the taxpayer a notice of federal tax lien with respect to both years. The notice informed the taxpayer of his right to request a collection due process (CDP) hearing but the taxpayer did not request one. He then filed amended returns claiming additional refunds with respect to both years. Before the amended returns were processed, the IRS issued a final notice of intent to levy, in response to which the taxpayer requested a CDP hearing. In the CDP hearing, the IRS Settlement Officer took the position that § 6330(c)(2)(B) precluded the taxpayer from challenging the underlying tax liability for both years because the taxpayer previously had been provided the option to request a CDP hearing in response to the notice of federal tax lien, which meant that the taxpayer had a prior opportunity to dispute the underlying liability within the meaning of the statute. Following the CDP hearing, the IRS issued a notice of determination upholding the collection action and the taxpayer filed a petition in the Tax Court. The Tax Court (Judge Paris) granted the government’s motion for summary judgment and held that the taxpayer had a prior opportunity to contest the underlying liability and therefore was precluded by § 6330(c)(2)(B) from contesting the liability in the CDP hearing that resulted in the notice of determination. In an opinion by Judge Manion, the U.S. Court of Appeals for the Seventh Circuit affirmed. The relevant regulation, Reg. § 301.6330-1(e)(3), Q&A E7, provides:

If the taxpayer previously received a CDP Notice under section 6320 [the provision for notice of a federal lien] with respect to the same tax and tax period and did not request a CDP hearing with respect to that earlier CDP Notice, the taxpayer had a prior opportunity to dispute the existence or amount of underlying tax liability.

In this case, the court reasoned, the taxpayer had previously received a CDP notice with respect to the same tax and tax periods and had failed to request a CDP hearing,, and therefore had a prior opportunity to dispute the underlying liability. The court assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 6330(c)(2)(B), is ambiguous, and in step two that Reg. § 301.6330-1 is a reasonable interpretation of the statute.

**4. Economic hardship relief from a levy is not available to a corporate taxpayer.** [Seminole Nursing Home, Inc. v. Commissioner](#), 12 F.4th 1150 (10th Cir. 9/2/21), *aff’g* T.C. Memo. 2017-102 (6/5/17). The taxpayer, a corporation that operated a nursing home in rural Oklahoma, failed to pay its federal withholding and employment taxes in the amount of just over \$60,000 for the fourth quarter of 2013. In response to the Service’s final notice of intent to levy, the taxpayer requested a collection due process (CDP) hearing, proposed an installment agreement, and submitted a letter to the IRS settlement officer challenging the appropriateness of the levy on the grounds of economic hardship. The taxpayer argued that it was operating at a loss and could not “provide essential care services to the patients residing at [its] nursing facility” if the Service were permitted to levy. The taxpayer’s assets included more than \$313,000 in accounts receivable from Medicare and Medicaid. At the CDP hearing, the IRS settlement officer rejected the proposed installment agreement on the grounds that the taxpayer had sufficient assets to pay its outstanding tax liability and that the taxpayer was not current with its federal employment tax deposits for 2014. The IRS settlement officer also declined to consider the economic hardship argument because, under the relevant regulation, Reg. § 301.6343-1(b)(4)(i), relief is available only on account of economic hardship of an individual taxpayer. The regulation provides that the Service must release a levy if one of several conditions is satisfied, including the following:

The levy is creating an economic hardship due to the financial condition of an individual taxpayer. This condition applies if satisfaction of the levy in whole or in part

will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses.

The IRS settlement officer issued a notice of determination upholding the collection action. The taxpayer filed a petition in the Tax Court and moved for summary judgment on the grounds that the regulation's limitation of economic hardship relief to individuals is contrary to the statute (§ 6343(a)(1)(D)) and therefore invalid and that the settlement officer had abused her discretion by failing to consider its request for economic hardship relief. The Tax Court previously had upheld the validity of Reg. § 301.6343-1(b)(4)(i) in *Lindsay Manor Nursing Home, Inc. v. Commissioner*, 148 T.C. 235 (2017), *vacated as moot*, 725 Fed. Appx. 713 (10th Cir. 2018), and in this case the Tax Court (Judge Paris) adhered to its prior decision. Following a remand to the IRS Appeals Office and the IRS's issuance of a supplemental notice of determination upholding the collection action, the Tax Court, in an unpublished order, sustained the IRS's notice of determination. *Seminole Nursing Home, Inc. v. Commissioner*, No. 24577-14L (2/21/20).

On appeal, in an opinion by Judge Hartz, the U.S. Court of Appeals for the Tenth Circuit upheld the validity of the regulation and concluded that the settlement officer had not abused her discretion in sustaining the collection action. The relevant statute, § 6343(a)(1)(D), provides that, "under regulations prescribed by the secretary," a levy shall be released if "the Secretary has determined that such levy is creating an economic hardship due to the financial condition of the taxpayer." The regulation in question interprets the economic hardship exception as being available only to individual taxpayers. The court assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 6343(a)(1)(D), is ambiguous, and in step two that Reg. § 301.6343-1(b)(4)(i) is a permissible construction of the statute. In its analysis of *Chevron* step one, the court examined not only the plain language of the statute but also its structure and apparent purpose. The court reasoned:

In what sense, though, might a corporation suffer economic hardship that could reasonably excuse releasing a tax levy on its assets? Say the corporation is in absolutely dire straits; it cannot survive even if the levy is released, or even if the tax liability is canceled altogether. In that circumstance, what purpose could possibly be served by preventing the IRS from seizing corporate assets under the levy? Perhaps another creditor of the corporation would benefit because it could collect through assets that would otherwise be seized by the IRS. But benefiting other creditors (likely at the expense of the IRS) could hardly be the purpose of the economic-hardship exception. This example points up an essential difference between an individual and a nonindividual entity.

Accordingly, the court affirmed the decision of the Tax Court.

**5. If a taxpayer responds to a notice of intent to levy by timely filing Form 12153 to request a hearing, the taxpayer has requested a collection due process hearing, not an equivalent hearing, even if the taxpayer checks the box indicating they are requesting an equivalent hearing.** *Ruhaak v. Commissioner*, 157 T.C. No. 9 (11/16/21). The IRS issued a final notice of intent to levy with respect to the taxpayer's 2013 and 2014 taxable years. In response, the taxpayer filed Form 12153, which is the form used to request a collection due process (CDP) hearing before an IRS Appeals Officer. The taxpayer submitted Form 12153 within the 30-day period required by § 6330(a)(2), (a)(3), and (b)(1) to request a CDP hearing. On Form 12153, the taxpayer checked the box on the line labeled "Equivalent Hearing" that states "I would like an Equivalent Hearing - I would like a hearing equivalent to a CDP Hearing if my request for a CDP hearing does not meet the requirements for a timely CDP Hearing." Although a CDP hearing and an equivalent hearing are conducted in the same manner, there are two principal differences: (1) a request for a CDP hearing suspends the running of the limitations period for the IRS to collect tax but a request for an equivalent hearing does not, and (2) when the IRS issues a notice of determination that reflects its decision following a CDP hearing, the taxpayer has the right to seek review in the Tax Court pursuant to § 6330(d)(1), but the taxpayer has no right of judicial review following an equivalent hearing. The taxpayer in this case explained

that he had requested an equivalent hearing so that he could present to Appeals his views on the morality of paying Federal income tax but without the possibility of subsequent Tax Court litigation or a fine.

The Tax Court (Judge Gale) observed that one reason the taxpayer may have requested an equivalent hearing was to avoid the \$5,000 penalty of § 6702(b) for making a “specified frivolous submission.” The IRS’s position, as reflected in the Internal Revenue Manual, is that, although the penalty can apply to a timely requested CDP hearing, the IRS will not impose the penalty when the taxpayer has requested an equivalent hearing. When the taxpayer failed to submit information requested by the IRS Appeals Officer assigned to conduct the hearing, the IRS issued a notice of determination upholding the collection action. The taxpayer then sought review of the notice of determination in the Tax Court. The taxpayer argued that he had requested an equivalent hearing because he had complied with Reg. § 301.6330-1(i)(1), (2), Q&A-I7, Q&A-I9, which provides that a taxpayer who fails to timely request a CDP hearing may instead request a similar administrative hearing, called an “equivalent hearing,” within the one-year period following the mailing date of the written levy notice. In other words, the taxpayer argued that a request submitted within the 30-day period for requesting a CDP hearing is necessarily submitted within the one-year period following the mailing date of the written levy notice, and that he had indicated on Form 12153 that he was requesting an equivalent hearing. The Tax Court rejected this argument and held that the taxpayer’s timely request on Form 12153 was a request for a CDP hearing, and not a request for an equivalent hearing, despite the taxpayer’s indication on Form 12153 that he was requesting an equivalent hearing in the event his request did not meet the requirements for a timely CDP hearing. The court interpreted Reg. § 301.6330-1(i)(1) to mean that

only those taxpayers who fail to timely request a CDP hearing are eligible to request an equivalent hearing. Logically, a taxpayer cannot yet have failed to make a timely request for a CDP hearing before the 30-day period for requesting a CDP hearing has expired.

After concluding that the taxpayer had requested a CDP hearing, the court reviewed the IRS’s determination that the levy against the taxpayer should be upheld. The court upheld the IRS’s position. The court also considered whether to impose penalties under § 6673, which authorizes the Tax Court to impose a penalty of up to \$25,000 against a taxpayer who advances a frivolous or groundless position in proceedings before the court or who institutes such proceedings primarily for delay. The court observed that this was the third CDP case that the taxpayer had filed in the Tax Court and that the court had imposed penalties under § 6673 in the taxpayer’s most recent case. The court determined, however, that the taxpayer’s position in this case that he had requested an equivalent hearing was not frivolous. At the same time, the court made clear to the taxpayer that “advancing frivolous arguments relating to his conscientious objection to the payment of Federal taxes is likely to result in the imposition of a significant section 6673 penalty against him.”

### **G. Innocent Spouse**

**1. If you miss the deadline to file a petition in the Tax Court seeking review of the IRS’s denial of the taxpayer’s request for innocent spouse protection, you just might want to submit a second request. If the IRS responds with a final determination regarding the second request, you can seek review by filing a petition in the Tax Court.** [Vera v. Commissioner](#), 157 T.C. 78 (8/23/21). The taxpayer filed joint returns with her then-husband for 2010 and 2013. She later submitted to the IRS a claim on Form 8857 seeking innocent spouse relief for 2013. The IRS issued a final determination denying her request. The taxpayer filed a petition in the Tax Court seeking review of this determination, but the Tax Court dismissed the petition for lack of jurisdiction because, pursuant to § 6015(e)(1), petitions seeking review of innocent spouse determinations must be filed no later than the 90th day after the date the IRS mails the determination, and the taxpayer had filed her petition on the 91st day after the IRS mailed the determination. The taxpayer later submitted to the IRS on Form 8857 a request for innocent spouse relief for 2010, but she included with her request a number of documents related to 2013, including the previous request for innocent spouse relief she had submitted for 2013. The IRS issued a final determination denying her request. The determination, issued as Letter 3288, Final Appeals Determination, referred in the header only to 2010, but the substance of the determination addressed both 2010 and 2013. For example, the letter stated “For tax year 2013, you

didn't comply with all income tax laws for the tax years that followed the years that are the subject of your claim." The taxpayer filed a timely petition in the Tax Court seeking review of this determination and specified in her petition that she was contesting the determination as to both 2010 and 2013. The IRS moved to dismiss as to 2013 on the basis that the IRS's determination was not a second determination for 2013. The Tax Court (Judge Buch) denied the motion and held that the court had jurisdiction as to both 2010 and 2013 because the IRS's determination was a final determination as to both years. Under § 6015(e)(1), the Tax Court has jurisdiction to review a "final determination" by the IRS regarding the taxpayer's eligibility for innocent spouse relief. The court noted that "[f]inal determinations in innocent spouse cases are typically singular, conclusive decisions." Nevertheless, the court observed, there is no prohibition on the issuance of more than one final determination and the regulations under § 6015 contemplate that the IRS will issue a second final determination in some circumstances. The court recognized the policy concern that taxpayers should not be able to defeat or extend the 90-day period for filing a petition in the Tax Court by submitting duplicative claims for innocent spouse relief. In this case, the court reasoned, the IRS could have avoided this policy concern by issuing something other than a final determination in response to the taxpayer's second request for innocent spouse relief for 2013. The IRS had done so in *Barnes v. Commissioner*, 130 T.C. 248 (2008). In that case, after the IRS issued a final determination denying the taxpayer's request for innocent spouse relief, the taxpayer submitted a second request for the same year. The IRS responded by issuing Letter 3657C, No Consideration Innocent Spouse, stating that the taxpayer had not met the basic eligibility requirements for relief because her claim had previously been considered and denied. The court in *Barnes* concluded that this letter was not a final determination and that the court therefore had no jurisdiction to consider the taxpayer's petition. In the same way, the IRS could have avoided issuing a second final determination in this case for 2013 by issuing Letter 3657C for that year. The IRS argued that its references to 2013 in the final determination were an error. "Error or not," the court responded, "the Commissioner's notice is unambiguous in its denial as to both 2010 and 2013." Accordingly, the court concluded, it had jurisdiction to consider the taxpayer's petition regarding both years.

**2. The Tax Court loses jurisdiction over a taxpayer's petition seeking innocent spouse relief if a refund action is filed for the years in question.** [Coggin v. Commissioner](#), 157 T.C. No. 12 (12/8/21). Prior to his death, the taxpayer's late husband filed joint federal income tax returns late for the years 2001 through 2009 and made late full or partial payments for those years but did not pay any interest or penalties. Following her husband's death, the taxpayer learned for the first time of the joint returns and the tax liabilities arising from them. She filed returns for all years in question with the filing status of married filing separately. The court's opinion is not clear whether these returns were original returns or amended returns. The returns filed by the taxpayer claimed refunds for the years 2001 through 2007. The IRS issued a notice of disallowance as to three of the years for which the taxpayer sought refunds and, in response, the taxpayer filed a complaint in a federal district court seeking refunds for 2001 through 2007. Her complaint asserted that the joint returns filed by her late husband had been filed without her knowledge or consent and therefore were invalid and that she was entitled to refunds based on the separate returns she had filed. In its answer in federal district court, the government asserted counterclaims seeking to reduce the taxpayer's liabilities for 2002 through 2009 to judgment. The federal district court granted the government's motion for summary judgment and dismissed the taxpayer's refund claims on the basis that the returns filed by the taxpayer's late husband were valid joint returns. The court also ordered that the government's counterclaims proceed to trial. However, the federal district court did not enter a final appealable order or judgment as to the taxpayer's refund claims. The taxpayer then filed an administrative claim for innocent spouse relief for 2001 through 2009 on Form 8857 pursuant to § 6015. The federal district court granted the taxpayer's motion for a stay of proceedings pending the outcome of the taxpayer's request for innocent spouse relief. The IRS did not issue a notice of determination denying the taxpayer's request for innocent spouse relief; instead, the U.S. Justice Department Tax Division sent a letter to the taxpayer's attorney denying her request for innocent spouse relief. In response, the taxpayer filed a petition in the Tax Court asking the court to determine that she is entitled to innocent spouse relief for 2001 through 2009. The Tax Court (Judge Weiler) granted the IRS's motion to dismiss for lack of jurisdiction. Section 6015(e)(1) provides that the Tax Court has jurisdiction to determine whether a taxpayer is entitled to innocent spouse relief if the taxpayer files a petition within specified time periods. However, § 6015(e)(3) provides that, if either individual who filed the joint return in question files a suit for

refund in a federal district court or the United States Court of Federal Claims, then the Tax Court loses jurisdiction over the taxpayer's petition seeking innocent spouse relief to the extent the court in which the refund action was filed acquires jurisdiction over the years that are the subject of the refund suit. In this case, the Tax Court concluded, the federal district court in which the taxpayer had filed her refund action acquired jurisdiction over her refund claims for the years 2001 through 2007 and retained jurisdiction because that court had not entered judgment as to her refund claims. Although the taxpayer had not asserted her entitlement to innocent spouse protection in the federal district court action, the Tax Court also observed that the federal district court had not ruled on the taxpayer's request for innocent spouse relief. As to the years 2008 and 2009, however, the Tax Court observed that the federal district court did not have or claim to have jurisdiction over refund claims of the taxpayer for 2008 and 2009. Accordingly, the Tax Court retained jurisdiction over the taxpayer's petition seeking innocent spouse protection for these years.

## **H. Miscellaneous**

**1. Micro-captive insurance transactions are “transactions of interest” that might be on their way to being listed.** Notice 2016-66, 2016-47 I.R.B. 745 (11/1/16). This notice identifies certain captive insurance arrangements, referred to as “micro-captive transactions,” as transactions of interest for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code. Generally, these arrangements involve a person who owns an insured business and that same person or a related person also owns an interest in the insurance company providing coverage. The insured business deducts the premiums paid to the insurance company, and the insurance company, by making the election under § 831(b) to be taxed only on taxable investment income, excludes the premiums from gross income. An insurance company making the § 831(b) election can receive up to \$2.2 million in premiums annually (adjusted for inflation after 2015). The notice describes the coverage under these arrangements as having one or more of the following characteristics:

- (1) the coverage involves an implausible risk;
- (2) the coverage does not match a business need or risk of Insured;
- (3) the description of the scope of the coverage in the Contract is vague, ambiguous, or illusory; or
- (4) the coverage duplicates coverage provided to Insured by an unrelated, commercial insurance company, and the policy with the commercial insurer often has a far smaller premium.

The Treasury Department and the IRS believe these transactions have a potential for tax avoidance or evasion but lack enough information to determine whether the transactions should be identified specifically as a tax avoidance transaction. Transactions that are the same as, or substantially similar to, the transaction described in § 2.01 of the notice are identified as “transactions of interest” for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 effective November 1, 2016. Persons entering into these transactions after November 1, 2006, must disclose the transaction as described in Reg. § 1.6011-4.

The Treasury Department and the IRS believe these transactions have a potential for tax avoidance or evasion but lack enough information to determine whether the transactions should be identified specifically as a tax avoidance transaction. Transactions that are the same as, or substantially similar to, the transaction described in § 2.01 of the notice are identified as “transactions of interest” for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 effective November 1, 2016. Persons entering into these transactions after November 1, 2006, must disclose the transaction as described in Reg. § 1.6011-4.

**a. Participants in micro-captive insurance transactions have until May 1, 2017, to disclose their participation in years for which returns were filed before November 1, 2016.** Notice 2017-8, 2017-3 I.R.B. 423 (12/29/16). This notice extends the due date for participants to disclose their participation in the micro-captive insurance transactions described in Notice 2016-66, 2016-47 I.R.B. 745 (11/1/16). Generally, under Reg. § 1.6011-4(e)(2)(i), if a transaction becomes a transaction of interest or a listed transaction after a taxpayer has filed a return reflecting the taxpayer's participation in the transaction, then the taxpayer must disclose the transaction for any year for which the limitations period on assessment was open on the date the transaction was identified as a listed transaction or transaction of interest within 90 calendar days after the date on which the transaction was identified. This meant that, for open years for which returns already had been filed on November

1, 2016 (the date on which Notice 2016-66 was issued), disclosures were due on January 30, 2017. In this notice, the IRS has extended the due date from January 30 to May 1, 2017.

**b. Sixth Circuit sides with the IRS against micro-captive advisor’s attack on Notice 2016-66 and “reportable transactions.”** [CIC Services, LLC v. Internal Revenue Service](#), 925 F.3d 247 (6th Cir. 5/22/19). In a 2-1 decision reflected in an opinion by Judge Clay, the U.S. Court of Appeals for the Sixth Circuit affirmed the U.S. District Court’s dismissal of a lawsuit against the IRS challenging the IRS’s categorization of certain micro-captive insurance arrangements as “reportable transactions” in [Notice 2016-66](#), 2016-47 I.R.B. 745. The plaintiff, CIC Services, LLC, advises taxpayers with respect to micro-captive insurance arrangements. Generally, these arrangements involve a taxpayer who owns an insured business while that same taxpayer or a related person also owns an interest in an insurance company providing coverage to the business. The insured business deducts the premiums paid to the insurance company, and the insurance company, by making the election under § 831(b) to be taxed only on taxable investment income, excludes the premiums from gross income. In 2019, an insurance company making the § 831(b) election could receive up to \$2.3 million in excludable premiums. Back in 2016, the IRS issued [Notice 2016-66](#), 2016-47 I.R.B. 745, which identified certain of these micro-captive insurance arrangements as abusive and thus “transactions of interest” for purposes of the “reportable transaction” rules of Code §§ 6111 and 6112 and Reg. § 1.6011-4(b)(6). Significant penalties can be imposed upon taxpayers and their material advisers for failing to comply with the “reportable transaction” rules. The plaintiff took offense at the IRS’s position regarding micro-captives and filed suit in the U.S. District Court for the Eastern District of Tennessee to enjoin enforcement of [Notice 2016-66](#). The plaintiff alleged that the IRS had promulgated [Notice 2016-66](#) in violation of the Administrative Procedure Act, 5 U.S.C. § 500 *et seq.* and the Congressional Review Act, 5 U.S.C. § 801 *et seq.* The IRS countered that the plaintiff’s complaint was barred by the Anti-Injunction Act, 26 U.S.C. § 7421(a), and the tax exception to the Declaratory Judgment Act, 28 U.S.C. § 2201 (together, the “AIA”). Generally, the AIA bars lawsuits filed “for the purpose of restraining the assessment or collection of any tax” by the IRS. Responding to the IRS, the plaintiff characterized its suit as one relating to tax reporting requirements, not tax assessment and collection. Plaintiff therefore contended that its lawsuit was not barred by the AIA. The IRS, on the other hand, argued that the case ultimately was about tax assessment and collection because the penalties imposed under the “reportable transaction” regime are treated as taxes for federal income tax purposes. The plaintiff cited as support for its argument the U.S. Supreme Court’s decision in *Direct Marketing Ass’n v. Brohl*, 575 U.S. \_\_\_, 135 S.Ct. 1124 (2015), which allowed a lawsuit to proceed against Colorado state tax authorities despite the Tax Injunction Act (“TIA”). The TIA, which protects state tax assessments and collections, is modeled on the AIA. The IRS, on the other hand, argued that the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Florida Bankers Ass’n v. U.S. Dep’t of Treasury*, 799 F.3d 1065 (Fed. Cir. 2015), which distinguished *Direct Marketing*, reflected the proper analysis. The court in *Florida Bankers* held that the AIA applied to bar a suit seeking to enjoin the IRS’s enforcement of certain penalties. The suit was barred by the AIA, according to the court in *Florida Marketing*, because the penalties at issue in that case were treated as federal income taxes for assessment and collection purposes, unlike the action challenged in *Direct Marketing*. Writing for the majority, Judge Clay rejected the plaintiff’s *Direct Marketing* argument and agreed with the IRS’s *Florida Bankers Ass’n* argument. Judge Clay reasoned that, like the penalties at issue in *Florida Bankers Ass’n*, the “reportable transaction” penalties are located in Chapter 68, Subchapter B of the Code and thus are treated as taxes for federal income tax purposes. Therefore, the decision of the U.S. Court of Appeals for the District of Columbia Circuit in *Florida Bankers Ass’n v. U.S. Dep’t of Treasury* is directly on point. Judge Clay also ruled that the plaintiff’s lawsuit did not fall within any of the exceptions to the AIA. Hence, the AIA barred the plaintiff’s lawsuit because the plaintiff, by seeking to enjoin enforcement of [Notice 2016-66](#), is indirectly attempting to thwart the IRS’s assessment and collection of a tax.

- Judge Nalhandian dissented and would have held that the suit was not barred by the AIA. He reasoned that the suit involved a challenge to a tax reporting requirement, albeit one with a penalty attached for noncompliance, and that the AIA does not bar challenges to tax reporting requirements.

**c. The IRS is making time-limited settlement offers to those with micro-captive insurance arrangements.** [IR-2019-157](#) (9/16/19). The IRS has announced that it has begun sending time-limited settlement offers to certain taxpayers with micro-captive insurance arrangements. The IRS has done so following three recent decisions of the U.S. Tax Court that disallowed the tax benefits associated with these arrangements. See [Syzygy Ins. Co., Inc. v. Commissioner](#), T.C. Memo. 2019-34 (4/10/19); [Reserve Mechanical Corp. v. Commissioner](#), T.C. Memo. 2018-86 (6/18/18); [Avrahami v. Commissioner](#), 149 T.C. No. 7 (8/21/2017). The [terms of the offer](#), which must be accepted within thirty days of the date of the letter making the offer, generally are as follows: (1) the IRS will deny 90 percent of any deductions claimed for captive insurance premiums; (2) the captive insurance company won't be required to recognize taxable income for received premiums; (3) the captive must already be liquidated, will be required to liquidate, or agree to a deemed liquidation that results in dividend income for the shareholders; (4) the captive will not be required to recognize taxable income for received premiums; (5) accuracy-related penalties are reduced to a rate of 10 percent and can be reduced to 5 percent or 0 percent if certain conditions are met; (6) if none of the parties to the micro-captive insurance transaction disclosed it as required by Notice 2016-66, a single penalty of \$5,000 will be applied under § 6707A (Penalty for Failure to Include Reportable Transaction Information with Return), and (7) additions to tax for failure to file or pay tax under § 6651 and failure to pay estimated income tax under §§ 6654 and 6655 may apply.

**d. Approximately 80 percent of taxpayers receiving micro-captive insurance settlement offers accepted them. The IRS is establishing 12 new examination teams that are expected to open audits related to thousands of taxpayers.** [IR-2020-26](#) (1/31/20). The IRS previously announced that it had begun sending time-limited settlement offers to certain taxpayers with micro-captive insurance arrangements. The IRS has now announced that “[n]early 80% of taxpayers who received offer letters elected to accept the settlement terms.” The announcement also informs taxpayers that “the IRS is establishing 12 new examination teams that are expected to open audits related to thousands of taxpayers in coming months.” Finally, the announcement reminds taxpayers that Notice 2016-66 requires disclosure of micro-captive insurance transactions with the IRS Office of Tax Shelter Analysis and that failure to do so can result in significant penalties.

- The authors understand that, in March 2020, the IRS issued Letter 6336 to thousands of taxpayers seeking information about their participation in micro-captive insurance transactions. The letters initially asked for a response by May 4, 2020, which subsequently was extended to June 4, 2020.

**e. The U.S. Supreme Court revives a taxpayer's challenge to Notice 2016-66.** [CIC Services, LLC v. Internal Revenue Service](#), 141 S. Ct. 1582 (5/17/21). In a unanimous opinion by Justice Kagan, the U.S. Supreme Court reversed the decision of the U.S. Court of Appeals for the Sixth Circuit and held that the AIA did not bar the suit by CIC Services, LLC, challenging the IRS's categorization in [Notice 2016-66](#), 2016-47 I.R.B. 745, of certain micro-captive insurance arrangements as “transactions of interest” for the purposes of §§ 6011 and 6012 and Regulation § 1.6011-4, which impose disclosure and information maintenance and reporting requirements, failure to comply with which results in the imposition of penalties. The Court reasoned that a suit to enjoin a reporting requirement is not an action to restrain the assessment or collection of a tax, even if the information will help the IRS collect future tax revenue, such as by identifying sham insurance transactions. Although non-compliance with the notice's reporting requirement could result in penalties, the Court concluded that this did not change the result because the suit contested the legality of the notice, not of the statutory penalty that served as a way to enforce it.

**2. You say “FBAR.” We say “FUBAR.” Although Treasury has failed to update relevant FBAR regulations, the penalty for willful violations is not capped at \$100,000 per account, says the Federal Circuit.** [Norman v. United States](#), 942 F.3d 1111 (Fed. Cir. 11/8/19), *aff'g* 138 Fed. Cl. 189 (7/31/18). The issue in this case is whether substantial foreign bank account reporting (“FBAR”) penalties assessed by the Service were reduced. Under 31 U.S.C. § 5321(a)(5)(A), the Secretary of the Treasury “may impose” a penalty for FBAR violations, and pursuant to administrative orders, the authority to impose FBAR penalties has been delegated by the Secretary to the Service. Further, under the *current* version of 31 U.S.C. § 5321(a)(5)(B)(i), the normal penalty for an FBAR violation is \$10,000 per offending account; however, the penalty for a *willful* FBAR violation “shall

be increased to the greater of” \$100,000 or 50 percent of the balance in the offending account at the time of the violation. *See* 31 U.S.C. § 5321(a)(5)(C). These minimum and maximum penalties for willful FBAR violations were changed by the American Jobs Creation Act of 2004 (“AJCA”), Pub. L. No. 108-357, § 821, 118 Stat. 1418 (2004). The prior version of 31 U.S.C. § 5321(a)(5) provided that the penalty for *willful* FBAR violations was the greater of \$25,000 or the balance of the unreported account up to \$100,000. Treasury regulations issued under the pre-AJCA version of 31 U.S.C. § 5321(a)(5), reflecting the law at the time, capped the penalty for willful FBAR violations to \$100,000 per account. *See* 31 C.F.R. § 1010.820(g). In this case, the government assessed a penalty of \$803,500 for failure to file an FBAR in 2007 with respect to a Swiss Bank account. The taxpayer argued that the “may impose” language of the relevant statute, 31 U.S.C. § 5321(a)(5), provides the Secretary of the Treasury with discretion to determine the amount of assessable FBAR penalties and that, because the outdated Treasury regulations had not been amended to reflect the AJCA’s increase in the minimum and maximum FBAR penalties, the Service’s authority was limited to the amount prescribed by the existing regulations. The court reasoned that the amended statute, which provides that the amount of penalties for willful FBAR violations *shall be* increased to the greater of \$100,000 or 50 percent of the account value, is mandatory and removed Treasury’s discretion to provide for a smaller penalty by regulation. According to the court, the statute gives Treasury discretion *whether* to impose a penalty in particular cases, but not discretion to set a cap on the penalty that is different than the cap set forth in the statute.

- *Recklessness as willfulness.* The relevant statute provides an enhanced penalty for a person who “willfully” fails to comply with the requirement to file an FBAR. The court considered whether a taxpayer who *recklessly* fails to comply with the requirement to file an FBAR can be treated as having committed a *willful* violation. The taxpayer argued “that willfulness in this context require[d] a showing of actual knowledge of the obligation to file an FBAR.” The court disagreed. The court relied on the U.S. Supreme Court’s decision in *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 57 (2007), in which the Court had observed that, when willfulness is a statutory condition of civil (as opposed to criminal) liability, the Court had “generally taken it to cover not only knowing violations of a standard, but reckless ones as well.” Accordingly, in this case, the court held, “willfulness in the context of [31 U.S.C.] § 5321(a)(5) includes recklessness.” The court observed that its interpretation of the statute was consistent with prior decisions of the U.S. Courts of Appeals for the Third and Fourth Circuits. *See Bedrosian v. United States*, 912 F.3d 144 (3d Cir. 2018); *United States v. Williams*, 489 F. Appx. 655 (4th Cir. 2012). The court examined the taxpayer’s conduct, which included false statements to the IRS about her foreign account, and concluded that the U.S. Court of Federal Claims had not clearly erred in determining that she had willfully violated the requirement to file an FBAR. Specifically, the court rejected the taxpayer’s argument that her failure could not be willful because she had not read her federal income tax return before signing it.

- *Other courts have concluded that the penalty for willful violations is not capped at \$100,000.* Several federal district courts have considered whether the outdated Treasury regulation limits the penalty for a willful FBAR violation to \$100,000 per account and reached different conclusions. For cases holding that the outdated FBAR regulations limit the penalty for willful FBAR violations to \$100,000 per account, see *United States v. Wadhan*, 325 F. Supp. 3d 1136 (D. Colo. 7/18/18); *United States v. Colliot*, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18). For cases holding that the outdated FBAR regulations do *not* limit the penalty for willful FBAR violations, see *United States v. Schoenfeld*, 396 F. Supp. 3d 1064 (M.D. Fla. 6/25/19); *United States v. Park*, 389 F. Supp. 3d 561 (N.D. Ill. 5/24/19); *United States v. Garrity*, 123 A.F.T.R.2d 2019-941 (D. Conn. 2/28/19); *Kimble v. United States*, 141 Fed. Cl. 373 (12/27/18).

**a. The Fourth Circuit agrees that recklessness is sufficient to establish a willful FBAR violation and that the penalty for a willful FBAR violation is not capped at \$100,000.** *United States v. Horowitz*, 978 F.3d 80 (4th Cir. 10/10/20). In an opinion by Judge Niemeyer, the U.S. Court of Appeals for the Fourth Circuit held that (1) recklessness is sufficient to establish a willful FBAR violation, and (2) the penalty for a willful FBAR violation is not capped at \$100,000. With respect to the first issue, the court adopted the same line of reasoning as the U.S. Court of Appeals for the Federal Circuit in *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 11/8/19), i.e., the court relied on the U.S. Supreme Court’s decision in *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47,

57 (2007), in which the Court had observed that, when willfulness is a statutory condition of civil (as opposed to criminal) liability, the Court had “generally taken it to cover not only knowing violations of a standard, but reckless ones as well.” The court provided further guidance on the meaning of the term “recklessness”:

In the civil context, “recklessness” encompasses an objective standard—specifically, “[t]he civil law generally calls a person reckless who acts or (if the person has a duty to act) fails to act in the face of an unjustifiably high risk of harm that is either known or so obvious that it should be known.” *Farmer v. Brennan*, 511 U.S. 825, 836 (1994); *see also Safeco*, 551 U.S. at 68 (same). In this respect, civil recklessness contrasts with criminal recklessness and willful blindness, as both of those concepts incorporate a subjective standard.

In this case, the court concluded, the taxpayers, who were aware that their Swiss bank account was earning interest and that interest was taxable income and who failed to disclose the foreign account to the accountant preparing their tax return, had been reckless and therefore willful in failing to file an FBAR.

The court also rejected the taxpayer’s argument that, because the “may impose” language of 31 U.S.C. § 5321(a)(5)(A) leaves the amount of assessable FBAR penalties to the discretion of the Secretary of the Treasury and the (albeit outdated) Treasury regulations had not been amended to reflect the AJCA’s increase in the minimum and maximum FBAR penalties, the IRS’s authority was limited to the amount prescribed by the existing regulations. The existing regulations limit the FBAR penalty for willful violations to \$100,000 per unreported account. The court reasoned that the relevant statute did not authorize the Secretary of the Treasury to impose a lower maximum penalty for willful FBAR operations. According to the court, “the 1987 regulation on which the Horowitzes rely was abrogated by Congress’s 2004 amendment to the statute and therefore is no longer valid.”

**b. The Eleventh Circuit agrees: recklessness is sufficient to establish a willful FBAR violation and the penalty for a willful FBAR violation is not limited to \$100,000.** [United States v. Rum](#), 995 F.3d 882 (11th Cir. 4/23/21). In a per curiam opinion, the U.S. Court of Appeals for the Eleventh Circuit has held that (1) recklessness is sufficient to establish a willful FBAR violation, and (2) the penalty for a willful FBAR violation is not capped at \$100,000. With respect to the first issue, the court adopted the same line of reasoning as the U.S. Courts of Appeals for the Federal and Fourth Circuits in *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 11/8/19), and *United States v. Horowitz*, 978 F.3d 80 (4th Cir. 10/10/20), i.e., the court relied on the U.S. Supreme Court’s decision in *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 57 (2007), in which the Court had observed that, when willfulness is a statutory condition of civil (as opposed to criminal) liability, the Court had “generally taken it to cover not only knowing violations of a standard, but reckless ones as well.” For purposes of determining whether a reckless (and therefore willful) FBAR had violation occurred, the Eleventh Circuit adopted the meaning of recklessness set forth in *Safeco*:

The *Safeco* Court stated that “[w]hile the term recklessness is not self-defining, the common law has generally understood it in the sphere of civil liability as conduct violating an objective standard: action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known.” 551 U.S. at 68, 127 S. Ct. at 2215 (internal quotations and citations omitted).

In this case, the taxpayer had filed tax returns for many years on which he indicated that he had no interest in a foreign financial account despite the fact that he had a Swiss bank account at UBS. He also reported the account for some purposes, such as to demonstrate his financial strength when obtaining a mortgage, but not for others, such as applying for financial aid for his children’s college costs. According to the Eleventh Circuit, the District Court had not erred in granting summary judgment to the government on the issue of whether the taxpayer had acted recklessly and therefore willfully in failing to file FBARs.

The court also rejected the taxpayer’s argument that, because the “may impose” language of 31 U.S.C. § 5321(a)(5)(A) leaves the amount of assessable FBAR penalties to the discretion of the Secretary of the Treasury and the (albeit outdated) Treasury regulations had not been amended to reflect the AJCA’s

increase in the minimum and maximum FBAR penalties, the IRS's authority was limited to the amount prescribed by the existing regulations:

The plain text of § 5321(a)(5)(C) makes it clear that a willful penalty may exceed \$100,000 because it states that the maximum penalty “shall be . . . the greater of (I) \$100,000, or (II) 50 percent of the amount determined under subparagraph (D),” which is the balance of the account.

**c. The Second Circuit also holds that the penalty for a willful FBAR violation is not capped at \$100,000.** [United States v. Kahn](#), 5 F.4th 167 (2d Cir. 7/13/21). In an opinion by Judge KeARSE, the U.S. Court of Appeals for the Second Circuit has agreed with the other federal courts of appeal that have considered the issue and held that the penalty for willful FBAR violations is not capped at \$100,000 per account. The court concluded that the 2004 amendments to 31 U.S.C. § 5321(a)(5)(C) rendered invalid the 1987 Treasury regulation that limits the penalty for willful FBAR violations to \$100,000 per account.

- *Dissenting opinion by Judge Menashi.* In a dissenting opinion, Judge Menashi argued that the regulation does not conflict with the statute and that the Treasury Department was bound by its own regulation:

The Treasury Department's current regulations provide that the penalty for Harold Kahn's willful failure to file a Report of Foreign Bank and Financial Accounts (“FBAR”) may not exceed \$100,000. *See* 31 C.F.R. § 1010.820(g)(2). This penalty falls within the statutorily authorized range. *See* 31 U.S.C. § 5321(a)(5). While the governing statute also authorizes penalties greater than \$100,000, it nowhere mandates that the Secretary impose a higher fine. *See id.* In fact, the statute gives the Secretary discretion to impose no fine at all. *See id.* § 5321(a)(5)(A). The current regulation therefore does not conflict with the governing statute and the Secretary must adhere to that regulation as long as it remains in effect.

**d. Better late than never? FinCEN finally has amended the relevant regulations to remove the provision that limited the penalty for a willful FBAR violation.** [RIN 1507-AB54, Bank Secrecy Act Regulations—Reports of Foreign Financial Accounts Civil Penalties](#), 86 F.R. 72844 (12/23/21). More than seventeen years after Congress changed the minimum and maximum penalties for willful FBAR violations in the American Jobs Creation Act of 2004, the Financial Crimes Enforcement Network (FinCEN) has amended the relevant regulations to remove 31 C.F.R. § 1010.820(g), which limited the penalty for willful FBAR violations to \$100,000 per account. The stated rationale for the removal is that the 2004 amendments to the statute, 31 U.S.C. § 5321(a)(5), rendered this part of the regulation obsolete. The Administrative Procedure Act permits an agency to find that notice and public procedure on the notice are impracticable, unnecessary, or contrary to the public interest. Because the statutory change rendered this provision of the regulations obsolete, FinCEN “determined that publishing a notice of proposed rulemaking and providing opportunity for public comment [were] unnecessary.” This amendment of the regulations is effective on December 23, 2021. Nevertheless, because the prior regulation was rendered obsolete by a 2004 statute, the government's position presumably is that the statutory rule, rather than the now-repealed provision of the regulations, applies for prior years as well beginning on the effective date of the statutory change.

**3. Tax Court retains jurisdiction in a § 7345 passport revocation case to review IRS's certification of taxpayer's “seriously delinquent” tax liability, but finds case is moot.** [Ruesch v. Commissioner](#), 154 T.C. 289 (6/25/20). Section 7345, which addresses the revocation or denial of passports for seriously delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America's Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015). It provides that, if the IRS certifies that an individual has a “seriously delinquent tax debt,” the Secretary of the Treasury must notify the Secretary of State “for action with respect to denial, revocation, or limitation of a passport.” § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of \$50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such certification may petition the Tax Court to determine if it was made erroneously. § 7345(e)(1). If the Tax Court finds the certification was either made in error or that the IRS has since reversed its certification, the court may then notify the State Department that the revocation of the taxpayer's

passport should be cancelled. § 7345(c). This is a case of first impression in which the Tax Court interprets the requirements of § 7345. The Tax Court (Judge Lauber) held that, while the Tax Court had jurisdiction to review Ms. Ruesch's challenge to the IRS's certification of her tax liabilities as being a "seriously delinquent tax debt," the controversy was moot because the IRS had reversed its certification as being erroneous. Further, the IRS had properly notified the Secretary of State of its reversal. The IRS had assessed \$160,000 in penalties for failing to file proper information returns for a period of years. *See* § 6038. Thereafter, the IRS sent a final notice of intent to levy and Ms. Ruesch properly appealed the penalty amounts with the IRS's Collection Appeals Program (CAP). In a series of errors, the IRS mistakenly misclassified the CAP appeal as a Collection Due Process (CDP) hearing. Committing yet further errors, the IRS failed to properly record Ms. Ruesch's later request for a CDP hearing and never offered Ms. Ruesch her CDP hearing. The IRS then certified Ms. Ruesch's liability to the Secretary of State as a "seriously delinquent tax debt" under § 7345(b). Discovering their many errors as well as the oversight of Ms. Ruesch's timely requested a CDP hearing, the IRS determined her tax debt was not "seriously delinquent" and reversed the certification. Because, under § 7345, the Tax Court's jurisdiction in passport revocation cases is limited to reviewing the IRS's certification of the taxpayer's liabilities as "seriously delinquent," the only relief the Tax Court may grant is to issue an order to the IRS to notify the Secretary of State that the IRS's certification was in error. Since the IRS had already notified the Secretary of State of the error, the Tax Court could not offer any additional relief. Judge Lauber, therefore, found the controversy was not ripe to be heard and the issues were moot.

**a. The Second Circuit has agreed with the Tax Court that the taxpayer's challenge to the IRS's certification that she had a seriously delinquent tax debt was moot, but has reminded the Tax Court that determinations of mootness must precede determinations of subject matter jurisdiction.** [Ruesch v. Commissioner](#), 129 A.F.T.R.2d 2022-509 (2d Cir. 1/27/22), *aff'g in part, vacating and remanding in part* 154 T.C. 289 (6/25/20). In a per curiam opinion, the U.S. Court of Appeals for the Second Circuit has affirmed the Tax Court's decision to the extent that the Tax Court's decision dismissed as moot the taxpayer's challenge to the IRS's certification pursuant to § 7345(a) that she had a seriously delinquent tax debt. The Second Circuit agreed with the Tax Court that, because the IRS had reversed its certification, her challenge to the certification in the Tax Court was moot. In reaching this conclusion, the Second Circuit rejected the taxpayer's argument that an exception to mootness, the voluntary cessation doctrine, allowed the taxpayer to continue to pursue her challenge in the Tax Court. The voluntary cessation doctrine applies when a defendant voluntarily ceases the offending conduct and is intended to prevent defendants from avoiding judicial review temporarily changing their behavior. According to the Second Circuit, however, the voluntary cessation doctrine is not absolute and a case can still be moot if two requirements are met: (1) the defendant demonstrates that interim relief or events have irrevocably and completely eradicated the effects of the alleged violation, and (2) there is no reasonable expectation that the allegedly offending conduct will recur. In this case, the court reasoned, both requirements were satisfied. The IRS's reversal of its certification completely eradicated the effect of the erroneous certification and there was no reasonable expectation that the alleged offending conduct will recur because the IRS was barred by statute from certifying her as having a seriously delinquent tax debt while her collection due process hearing with IRS Appeals was pending.

The taxpayer also had sought in the Tax Court to contest the underlying penalties the IRS had imposed and that led to certification of a seriously delinquent tax debt. The Tax Court had dismissed these claims for lack of subject matter jurisdiction because § 7345 does not confer jurisdiction on the Tax Court to consider challenges to the underlying liabilities that lead to certification. The Second Circuit, however, held that the Tax Court should instead have dismissed those claims as moot. The taxpayer, the court reasoned, had already received all the relief to which she was entitled under § 7345, i.e., reversal of the IRS's certification, which rendered moot any challenges to the underlying liability for penalties. According to the court:

questions relating to Article III jurisdiction, including those concerning the doctrine of mootness, ... are antecedent to and should ordinarily be decided before other issues such as statutory jurisdiction or the merits ....

**4. Tax Court lacks jurisdiction in a whistleblower case finding a preliminary award recommendation does not constitute a “determination.”** [McCrory v. Commissioner](#), 156 T.C. 90 (3/2/21). The petitioner, Ms. McCrory, filed numerous Forms 211, Application for Award for Original Information, with the IRS’s Whistleblower Office (WBO). These forms asserted that various taxpayers had underreported their tax obligations. The WBO initially sent a letter to Ms. McCrory, which contained a preliminary award recommendation of \$962.92. The letter also included a Summary Report form. The Summary Report form presented Ms. McCrory with two options. If she agreed with the award, she should check a box indicating her agreement, sign, and return the form to the WBO. Alternatively, if Ms. McCrory disagreed with the award, she should check the other box, sign, date, and return. Rather than check one of the two boxes, Ms. McCrory created a third box on the Summary Report form, checked it, and indicated in an accompanying letter that she neither agreed nor disagreed and that she needed more facts to decide. She also indicated that she would like to review the administrative file. The WBO declined to allow Ms. McCrory to review the administrative file. In response, Ms. McCrory filed a petition with the Tax Court requesting disclosure of information explaining the IRS decision-making process regarding the preliminary award recommendation. The WBO then suspended further consideration of the petitioner’s claim. In the Tax Court, the IRS moved to dismiss Ms. McCrory’s petition on the basis that the Tax Court lacked jurisdiction. The issue presented to the Tax Court was whether the preliminary award recommendation issued to Ms. McCrory constituted a “determination” within the meaning of § 7623(b)(4). Section 7623(b)(4) provides that any determination regarding awards to whistleblowers may, within 30 days of such determination, be appealed to the Tax Court, which has jurisdiction. Thus, in general, the Tax Court’s jurisdiction in whistleblower cases is established when the Commissioner of the IRS issues a written notice containing a determination. *Cooper v. Commissioner*, 135 T.C. 70, 75 (2010). In *Whistleblower 4496-15W*, 148 T.C. 425, 430 (2017), the Tax Court concluded that neither the WBO’s issuance of the preliminary award recommendation nor the acceptance of the award by a whistleblower constituted a determination. The court reasoned in *Whistleblower 4496-15W* that there cannot be a “determination” and, therefore, no jurisdiction, where the amount of the award remained subject to conditions that might result in future reductions in the award. Consistent with the reasoning in *Whistleblower 4469-15W*, the IRS argued that the Tax Court lacked jurisdiction in this case because the preliminary award recommendation received by Ms. McCrory did not constitute a determination. The Tax Court (Judge Nega) agreed with the IRS and held that the preliminary award recommendation issued by the IRS to Ms. McCrory did not qualify as a “determination” within the meaning of § 7623(b)(4) because it was not a final administrative decision regarding Ms. McCrory’s whistleblower claims. The letter received by Ms. McCrory specifically indicated that the preliminary award recommendation was preliminary because the determination of the tax was not final at that time. Thus, because the amount of the award recommended in the letter was not final and because the amount of the award remained subject to change, there could not have been a final determination of the award. Because no determination was issued to Ms. McCrory, the Tax Court lacked jurisdiction over the matter.

**5. Surely it’s not constitutional for the government to revoke or refuse to issue an individual’s passport just for having a seriously delinquent tax debt? Isn’t there some sort of fundamental right to travel? Don’t pack your bags just yet.** Section 7345, which addresses the revocation or denial of passports for seriously delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America’s Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015). It provides that, if the IRS certifies that an individual has a “seriously delinquent tax debt,” the Secretary of the Treasury must notify the Secretary of State “for action with respect to denial, revocation, or limitation of a passport.” § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of \$50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such a certification may petition the Tax Court (or bring an action in a U.S. District Court) to determine if the certification was made erroneously. § 7345(e)(1). If the Tax Court concludes the certification was either made in error or that the IRS has since reversed its certification, the court may order the Secretary of the Treasury to notify the State Department that the certification was erroneous. § 7345(e)(2). In the following cases, the courts have addressed the constitutionality of this regime.

**a. Section 7345 does not prohibit international travel and therefore cannot violate either the Due Process Clause of the Fifth Amendment or the Universal Declaration of**

**Human Rights, says the Tax Court.** [Rowen v. Commissioner](#), 156 T.C. No. 8 (3/30/21). The opinion of the Tax Court (Judge Toro) in this case begins as follows:

For more than two decades, petitioner, Robert Rowen, failed to pay his Federal tax as required by law. The Internal Revenue Service (“IRS”) attempted to collect the outstanding amounts through its usual means—sending demands, filing liens, attempting to levy on assets—all without much success. In 2018, when Dr. Rowen’s outstanding tax balance was close to \$500,000, the Commissioner of Internal Revenue turned to a new tool in his collection toolbox—section 7345.

The petitioner, Dr. Rowen, was a medical doctor licensed in California who frequently traveled to developing countries to offer medical services free of charge to underserved populations. Pursuant to § 7345, the IRS issued a notice of certification of a “seriously delinquent tax debt” and notified the Secretary of State that his passport should be revoked. As permitted by § 7345(e)(1), Dr. Rowen filed a petition in the Tax Court and asked the court to determine that the IRS’s certification of his tax debt as seriously delinquent was erroneous. He argued that § 7345 is unconstitutional because it prohibits international travel in violation of his rights under the Due Process Clause of the Fifth Amendment. He also argued that the statute “violates his human rights under the Universal Declaration of Human Rights (‘UDHR’).” The Tax Court rejected both arguments. The court noted that an uncodified provision of the 2015 Fixing America’s Surface Transportation Act (FAST Act) authorizes the *Secretary of State* to revoke or deny the passport of an individual who has been certified as having a seriously delinquent tax debt. The Tax Court reasoned that, because § 7345 authorizes the IRS Commissioner only to certify that an individual has a seriously delinquent tax and leaves all passport-related decisions to the Secretary of State for action pursuant to the uncodified provision of the FAST Act, § 7345 does not prohibit international travel and therefore cannot violate either the Due Process Clause of the Fifth Amendment or the Universal Declaration of Human Rights.

**b. Section 7345 survives a constitutional challenge.** [Maehr v. United States](#), 5 F.4th 1100 (10th Cir. 7/20/21). The plaintiff in this case had approximately \$250,000 in unpaid federal tax liabilities from 2011. In 2018, pursuant to § 7345, the IRS issued a notice of certification of a “seriously delinquent tax debt” and notified the Secretary of State that his passport should be revoked. The State Department then revoked his passport. The plaintiff brought this action in federal district court challenging the authority of the State Department to revoke passports on the basis of tax liabilities. The U.S. District Court concluded it did not have subject-matter jurisdiction over the plaintiff’s claims and granted the government’s motion to dismiss for failure to state a claim. On appeal, in an opinion by Judge Lucero, the U.S. Court of Appeals for the Tenth Circuit first concluded that the District Court did have subject matter jurisdiction over the action. The court then addressed the merits of the plaintiff’s claims. Specifically, the Tenth Circuit unanimously rejected two of the plaintiff’s arguments. The plaintiff argued that “the Privileges and Immunities Clause of Article IV, Section 2 and the Privileges or Immunities Clause of the Fourteenth Amendment encompass the right to international travel and thereby limit the federal government’s ability to restrict such travel.” The court rejected this argument because the Privileges and Immunities clauses apply only to the states and not to the federal government and do not protect the right to international travel. The court also rejected the plaintiff’s argument that the court should review the State Department’s revocation of his passport under a standard similar to the standard used by courts to review a writ of *ne exeat republica*. “A writ of *ne exeat republica* is a form of injunctive relief ordering the person to whom it is addressed not to leave the jurisdiction of the court or the state, for example, to aid the sovereign to compel a citizen to pay his taxes.” *United States v. Barrett*, 113 A.F.T.R.2d 2014-749 (D. Colo. 1/29/14). The court concluded that, for several reasons, a writ of *ne exeat republica*, an equitable, common-law remedy, is readily distinguishable from the legislatively-authorized passport revocation provided for in the 2015 FAST Act. In a separate opinion written by Judge Matheson that was the majority opinion of the court on the issue, the court also rejected the plaintiff’s argument that the State Department’s revocation of his passport violated his rights under the Due Process Clause of the Fifth Amendment. Specifically, the court concluded that international travel is not a fundamental right that must be reviewed under so-called strict scrutiny. If the court’s standard of review were strict scrutiny, then any legislative infringement of a fundamental right must be narrowly tailored to serve a compelling government interest. Instead, the court held, because international travel is not a fundamental right, the

constitutionality of § 7345 must be determined under a rational basis standard of review. Under this standard, the court noted, “we will uphold a law “if there is any reasonably conceivable state of facts that could provide a rational basis for the [infringement].” See *FCC v. Beach Comm’ns, Inc.*, 508 U.S. 307, 313 (1993).” Section 7345, the court concluded, meets this standard. The federal government has a legitimate interest in raising revenue through taxes and “Congress’s decision to further this legitimate interest by providing for revocation of passports for those who have a “seriously delinquent tax debt,” 26 U.S.C. § 7345(a), is rational.”

- In a lengthy concurring opinion, Judge Lucero advocated the view that the proper standard of review for the plaintiff’s Fifth Amendment claims is intermediate scrutiny, which falls between the rational basis and strict scrutiny standards. Because neither party argued for that standard of review, Judge Lucero concurred in the court’s judgment.

**6. Married taxpayers who receive separate but substantially identical notices of certification of a “seriously delinquent” tax debt in a § 7345 passport revocation case may file a joint petition challenging the certification in the Tax Court.** [\*García v. Commissioner\*](#), 157 T.C. No. 1 (7/19/21). Section 7345, which addresses the revocation or denial of passports for seriously delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America’s Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015). It provides that, if the IRS certifies that an individual has a “seriously delinquent tax debt,” the Secretary of the Treasury must notify the Secretary of State “for action with respect to denial, revocation, or limitation of a passport.” § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of \$50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such a certification may petition the Tax Court to determine if the certification was made erroneously. § 7345(e)(1). If the Tax Court concludes the certification was either made in error or that the IRS has since reversed its certification, the court may then order the Secretary of the Treasury to notify the State Department that the certification was erroneous. § 7345(e)(2). In this case, the taxpayers, a married couple, filed a joint federal income tax return for 2012. The IRS issued a notice of certification of a seriously delinquent tax debt to the wife showing an unpaid tax liability of \$583,803, and subsequently issued a substantially identical notice to the husband showing the same delinquent tax debt. The taxpayers jointly petitioned the Tax Court and sought review of the certifications. The taxpayers asserted that they had submitted an offer-in-compromise that the IRS had failed to consider. The IRS subsequently determined that the taxpayers’ offer-in-compromise was processable and remained pending and that the pendency of their offer suspended collection of their tax debt so that the debt was not “seriously delinquent.” Accordingly, the IRS reversed the certifications and notified the Secretary of State. Because the certifications had been reversed, the IRS moved to dismiss the case on the ground of mootness. The Tax Court (Judge Lauber) first addressed an issue of first impression, which was whether the taxpayers could file a joint petition seeking review of the IRS’s certification of a seriously delinquent tax debt. Neither § 7345 nor the Tax Court’s Rules provide guidance on this question. The court noted that Tax Court Rule 34(a)(1) permits a married couple to file a joint petition in a deficiency action, i.e., when the IRS has issued joint or separate notices of deficiency for a year to a married couple that has filed a joint return. The court concluded that “equity and common sense” support extending this permission to challenges to notices of certification of seriously delinquent tax debts:

In this case petitioners received substantially identical notices of certification from the IRS. These notices informed them that they had a delinquent tax debt of \$583,803, stemming from an unpaid joint Federal income tax liability for 2012, and that the IRS had certified to the State Department that they were persons owing a “seriously delinquent tax debt.” Both petitioners presented the same question: “whether the certification was erroneous.” See sec. 7345(e)(1). And both petitioners presented the same argument: that the certifications were “prematurely issued” because they had submitted an offer-in-compromise that remained pending at the IRS.

...

... It is natural for spouses to file a joint petition in these circumstances.

To hold that the taxpayers could not file a joint petition, the court reasoned, “would occasion unnecessary delay and expense.”

Because, under § 7345, the Tax Court’s jurisdiction in passport revocation cases is limited to reviewing the IRS’s certification of the taxpayer’s liabilities as “seriously delinquent,” the only relief the Tax Court may grant is to issue an order to the IRS to notify the Secretary of State that the IRS’s certification was in error. Since the IRS had already notified the Secretary of State of the error, the Tax Court could not offer any additional relief. The court therefore concluded that the issues were moot and granted the government’s motion to dismiss.

- The Tax Court previously had ruled that a taxpayer’s challenge to the IRS’s certification of a tax debt as seriously delinquent should be dismissed as moot when the IRS had reversed the certification. See *Ruesch v. Commissioner*, 154 T.C. 289 (6/25/20).

**7. Taxpayers did not duly file their refund claim because their attorney, rather than the taxpayers, signed their amended returns claiming refunds.** *Brown v. United States*, 22 F.4th 1008 (Fed. Cir. 1/5/22). The taxpayers were U.S. citizens living and working in Australia for Raytheon Corporation. They filed amended returns for 2015 and 2016 claiming refunds on the basis that they were entitled to the foreign earned income exclusion of § 911. The amended returns were signed by their attorney but no power of attorney accompanied the returns. In this litigation, the U.S. Court of Federal Claims granted the government’s motion to dismiss for lack of subject matter jurisdiction on the ground that the returns were not “duly filed” as required by § 7422, which provides:

No suit or proceeding shall be maintained ... until a claim for refund ... has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

The U.S. Court of Appeals for the Federal Circuit has affirmed the Claims Court’s decision. The court held that the “duly filed” requirement of § 7422 is not jurisdictional, but rather more akin to a claims processing rule. Nevertheless, the court agreed with the government that the taxpayer’s refund claims were not duly filed because the taxpayers had not personally signed the returns or signed them in a manner that complied with applicable regulations. The applicable regulations provide:

No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed before the expiration of such period. The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. *The statement of the grounds and facts must be verified by a written declaration that it is made under the penalties of perjury.* A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit.

Reg. § 301.6402-2(b)(1) (emphasis added). This requirement can be satisfied when a taxpayer’s legal representative certifies the claim if the representative attaches evidence of a valid power of attorney. In this case, however, the attorney who prepared and signed the returns in question did not submit a power of attorney to the IRS. Because the taxpayers had failed to comply with the regulation’s requirement, they had not “duly filed” their claim for refund within the meaning of § 7422. Accordingly, the court affirmed on the basis that the taxpayers had failed to state a claim on which relief could be granted.

**8. The Tax Court lacks jurisdiction to review the IRS Whistleblower Office’s threshold rejection of an application for a whistleblower award for failure to meet minimum threshold criteria for such claims.** *Li v. Commissioner*, 22 F.4th 1014 (D.C. Cir. 1/11/22). The petitioner, Ms. Li, filed Form 211, Application for Award for Original Information, with the IRS’s Whistleblower Office (WBO) asserting four tax violations by a third party. The WBO concluded that Ms. Li’s allegations were “speculative and/or did not provide specific or credible information regarding tax underpayments or violations of internal revenue laws,” and that she therefore was not eligible for an award. Therefore, the WBO did not forward her form to an IRS examiner for any potential action against the target taxpayer. The IRS informed her of this in a letter that stated that she could appeal the decision to the U.S. Tax Court. Ms. Li filed a petition in the Tax Court, which held that the IRS did not abuse its discretion in rejecting her application for an award. On appeal, the U.S. Court of Appeals for the D.C. Circuit (Judge Sentelle) dismissed the appeal for lack of jurisdiction and remanded to the

Tax Court with a direction for the Tax Court to do the same. For the Tax Court to have jurisdiction in a whistleblower case, the court reasoned, § 7623(b)(4) requires that there be a “determination” regarding an award. In this case, the court held, the IRS WBO’s rejection of a claim for failure to meet the minimum threshold criteria for a claim is not a determination and therefore the Tax Court has no jurisdiction. In reaching this conclusion, the court rejected and characterized as “wrongly decided” the Tax Court’s decisions in *Cooper v. Commissioner*, 135 T.C. 70 (2010), and *Lacey v. Commissioner*, 153 T.C. 146 (2019).

**XI. WITHHOLDING AND EXCISE TAXES**

**A. Employment Taxes**

**B. Self-employment Taxes**

**C. Excise Taxes**

**XII. TAX LEGISLATION**

**A. Enacted**

**1. The American Rescue Plan provides significant tax benefits for many taxpayers.** The [American Rescue Plan Act of 2021](#), Pub. L. No. 117-2, signed by the President on March 11, 2021, made several significant changes. The changes made by this legislation include expanding credits such as the child tax credit and earned income credit, suspending the requirement to repay excess advance premium tax credit payments, and providing exclusions for up to \$10,200 of unemployment compensation and for cancellation of student loans.

**2. The Infrastructure Investment and Jobs Act ends the employee retention credit of Code § 3134 for the fourth quarter of 2021.** The [Infrastructure Investment and Jobs Act](#), Pub. L. No. 117-58, signed by the President on November 15, 2021, contains relatively few significant tax provisions but section 80604 of the legislation ends the employee retention credit of Code § 3134 for the fourth quarter of 2021.

# Recent Developments in Federal Income Taxation

Bruce A. McGovern

Professor of Law and Director, Tax Clinic

South Texas College of Law Houston

Houston, Texas

Oregon Tax Institute

June 3, 2022

## Section 174: Capitalization of Research or Experimental Expenditures

### *Outline: item B.1, page 3*

- The 2017 Tax Cuts and Jobs Act, § 13206, amended Code § 174 to require the capitalization and amortization of specified research or experimental expenditures.
- The amortization period is 5 years (15 years for expenditures attributable to foreign research), beginning at the midpoint of the year in which the expenditures are paid or incurred.
- Applies to amounts paid or incurred in tax years beginning after 2021.
- The term “specified research or experimental expenditures”:
  - Defined as research or experimental expenditures paid or incurred by the taxpayer during a tax year in connection with taxpayer’s trade or business.
  - Includes expenditures for software development.
  - Includes depreciation and depletion
  - Does not include:
    - Amounts paid or incurred for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas) <sup>2</sup>

**Mylan, Inc. v. Commissioner,  
156 T.C. No. 10 (4/27/21)  
Outline: item B.2, page 4**

- The taxpayer was a manufacturer of brand-name and generic drugs.
- The taxpayer sought FDA approval of generic drugs by submitting Abbreviated New Drug Applications (ANDAs).
- As required by the ANDA process, the taxpayer:
  - Certified to the FDA that existing patents on the drugs were invalid or would not be infringed by the sale or use of the generic version of the drug, and
  - Sent notice letters to the holders of the patents informing them of the certification.
- Issues: (1) were legal expenses incurred to prepare the notice letters capital expenditures? (2) were legal expenses incurred to defend patent infringement suits brought in response to the notice letters capital expenditures?
- Held: (1) Yes. The legal expenses facilitated acquisition of an intangible (an FDA-approved ANDA); (2) No. The legal expenses are a cost incurred to protect business profits, not to defend or perfect title.

3

**Deduction of Costs Paid with PPP Loan Proceeds  
Notice 2020-32, 2020-21 I.R.B. 837 (5/1/20)  
Outline: item D.1, page 5**

- Federally-backed loans made to businesses under the Paycheck Protection Program (PPP) must be used to fund payroll and certain other expenses.
- Businesses that use the loans in this manner can apply to have the loans forgiven.
- CARES Act § 1106(i) provides that any income arising from having PPP loans forgiven is excluded from gross income.
- Issue: can a business that has a PPP loan forgiven deduct expenses funded with the loan proceeds?
- Notice 2020-32: No. Section 265 precludes a deduction.
  - Section 265(a)(1): disallows a deduction for “any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest wholly exempt from the taxes imposed by this subtitle.”

4

## **Deduction of Costs Paid with PPP Loan Proceeds Legislative Relief**

### ***Outline: item D.1.c, page 7***

- Taxpayer Certainty and Disaster Tax Relief Act (12/27/20):
  - Legislatively changes the result in Notice 2020-32
    - “no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income [of the forgiveness of a PPP loan]”
  - In the case of partnerships and subchapter S corporations:
    - Any amount forgiven is treated as tax-exempt income
    - This has the effect of providing a basis increase to the partners or shareholders.
  - Applies retroactively as if included in the CARES Act.
- Weird aspect? See Rev. Proc. 2021-20, item d, page 8 (can deduct 2020 expenses on 2021 return).

5

## **Reporting of PPP Loan Forgiveness**

### ***Outline: item D.1.e, page 8***

- Partnerships:
  - Schedule K-1: Box 18, Code B (other nontaxable income)
  - Rev. Proc. 2021-48, 2021-49 I.R.B. 835 (11/18/21)
    - Governs timing of reporting PPP Loan forgiveness
    - Taxpayers may treat such income as received or accrued when:
      1. expenses eligible for forgiveness are paid or incurred;
      2. an application for PPP loan forgiveness is filed; or
      3. PPP loan forgiveness is granted.

6

## Reporting of PPP Loan Forgiveness

### *Outline: item D.1.f, page 9*

- Partnerships:
  - Rev. Proc. 2021-49, 2021-49 I.R.B. 838 (11/18/21)
    - Prescribes how partners and partnerships may:
      - allocate among partners under § 704(b) their distributive share of PPP loan forgiveness tax-exempt income and deductions resulting from expenditures attributable to the use of forgiven PPP loans, and
      - make corresponding adjustments to the partners' bases in their partnership interests under § 705.

7

## Reporting of PPP Loan Forgiveness

### *Outline: item D.1.g, page 9*

- Partnerships:
  - Rev. Proc. 2021-50, 2021-49 I.R.B. 844 (11/18/21)
    - This revenue procedure allows eligible partnerships to file amended partnership returns for taxable years ending after March 27, 2020 using a Form 1065, U.S. Return of Partnership Income (Form 1065), with the “Amended Return” box checked, and issue an amended Schedule K-1, Partner’s Share of Income, Deductions, Credits, etc. (Schedule K-1), to each of its partners.
    - An eligible partnership may file an amended return under Rev. Proc. 2021-48, if the requirements of section 3 of this revenue procedure are met.
    - In order to take advantage of the option to amend provided in this revenue procedure, amended partnership returns must be filed, and corresponding Schedules K-1 must be furnished, on or before December 31, 2021.

8

## **Reporting of PPP Loan Forgiveness** *[Not in outline]*

- S corporations:
  - Schedule K-1: Box 16, Code B (other nontaxable income)
- Sole proprietorships (including disregarded entities)
  - No place to report this on Form 1040 or Schedule C
  - Instructions to 2021 Form 1040:
    - If taxpayer has tax-exempt income resulting from the forgiveness of a PPP Loan, attach a statement to the return reporting each taxable year for which taxpayer is applying Rev. Proc. 2021-48 (timing of PPP loan forgiveness) and certain other information.

9

## **100% Deduction of Restaurant Business Meals** *Outline: item D.2, page 10*

- Taxpayer Certainty and Disaster Tax Relief Act of 2020.
  - Part of the 2021 Consolidated Appropriations Act, Pub. L. No. 116-260, enacted on December 27, 2020.
- Amends § 274(n)(2)
  - Provides exceptions to normal 50 percent limitation on deducting business meals
  - Legislation adds a new exception:
    - Can deduct 100% of the cost of food or beverages provided by a restaurant paid or incurred before January 1, 2023
    - Applies to amounts paid or incurred after December 31, 2020.
- Notice 2021-25, 2021-17 I.R.B. 1118 (4/8/21).
  - A restaurant is “a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business’s premises.”
  - Your favorite food truck and street vendors are “restaurants,” but Whole Foods is not. Caterers that don’t operate restaurants? Who knows? <sup>10</sup>

## **100% Deduction of Restaurant Business Meals**

### ***Outline: item D.2.b, page 10***

- Notice 2021-63, 2021-49 I.R.B. 835 (11/16/21).
  - Allows taxpayers to treat the meal portion of a per diem rate or allowance as being attributable to food or beverages provided by a restaurant.
  - Effect: can deduct 100% of the meal portion of a per diem even if the employee is not actually eating at a restaurant

11

## **San Jose Wellness v. Commissioner,**

### **156 T.C. No. 4 (2/17/21)**

### ***Outline: item D.3, page 10***

- Section 280E disallows any deduction or credit otherwise allowable if:
  - such amount is “paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances ....”
- The taxpayer, a corporation, was engaged in a medical marijuana business in California.
- Issues:
  1. Does § 280E disallow deductions for depreciation?
  2. Does § 280E disallow deductions for charitable contributions?
- Held: (1) Yes. Depreciation is “paid or incurred during the taxable year” and is subject to § 280E. (2) Yes. The taxpayer’s charitable contributions were paid or incurred “in carrying on any trade or business” and are disallowed by § 280E.

12

**Notice 2022-3**

**2022-2 I.R.B. 308 (12/17/21)**

***Outline: item D.4, page 11***

- Standard mileage rate for business miles in 2022 goes up to 58.5 cents per mile (from 56 cents in 2021).
- Medical/moving rate for 2022 goes up to 18 cents per mile (from 16 cents in 2021).
- Charitable mileage rate remains fixed by § 170(i) at 14 cents.
- The portion of the business standard mileage rate treated as depreciation remains the same at 26 cents per mile for 2022 (unchanged from 2021).
- Reminders:
  - Unreimbursed employee business expenses are miscellaneous itemized deductions and therefore not deductible through 2025.
  - Moving expenses are not deductible through 2025 except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station.

13

**Notice 2021-49, 2021-34 I.R.B. 316 (8/4/21)**

**Employee Retention Credit**

***Outline: item F.1, page 13***

- Background:
  - Employee retention credit first enacted in the CARES Act (2020), modified by the Taxpayer Certainty and Disaster Tax Relief Act (2020), and extended by the American Rescue Plan (2021).
  - Businesses must qualify, generally by experiencing reduction in gross receipts compared to same calendar quarter in 2019
  - Credit generally is 70% of qualified wages paid to each employee capped at \$10,000 of wages per employee in each quarter
  - Maximum credit per quarter therefore is \$7,000 per employee

14

**Notice 2021-49, 2021-34 I.R.B. 316 (8/4/21)**

**Employee Retention Credit**

***Outline: item F.1, page 13***

- Background (cont'd):
  - For “recovery startup businesses,” the credit again is up to \$7,000 per employee, per quarter, with a maximum credit of \$50,000 per quarter, for the last two quarters of 2021.
  - A recovery start-up business is one that:
    1. Began operations on or after February 15, 2020,
    2. Maintains average annual gross receipts that do not exceed \$1 million;
    3. Employs one or more employees (other than 50% owners); and
    4. Does not otherwise qualify for the Employee Retention Credit (i.e., its business operations were not fully or partially suspended due to government orders nor did they experience a decline in gross receipts).

15

**Notice 2021-49, 2021-34 I.R.B. 316 (8/4/21)**

**Employee Retention Credit**

***Outline: item F.1, page 13***

- The notice provides guidance on several important issues, including:
  - The definition of a “full-time employee” for purposes of the employee retention credit.
  - Whether cash tips can be treated as qualified wages.
  - Whether wages paid to an employee who owns more than 50 percent (majority owner) or to the spouse of a majority owner may be treated as qualified wages.
- **Note:** infrastructure bill eliminated the credit for last 3 months of 2021 (Oct.-Dec.) except for “recovery startup businesses”

16

**Rev. Proc. 2021-33, 2021-34 I.R.B. 327 (8/10/21)**

**Employee Retention Credit**

***Outline: item F.1.a, page 14***

- This revenue procedure provides a safe harbor for determining eligibility for the employee retention credit.
- Employers may be eligible for the ERC if they experience a specified reduction in gross receipts.
  - For example, for the first two quarters of 2021, an employer generally is an eligible employer based on a decline in gross receipts if its gross receipts for the calendar quarter are less than 80 percent of its gross receipts for the same calendar quarter in 2019.
- Under the normal rules for determining gross receipts, forgiveness of a PPP loan would be included in gross receipts.
- The safe harbor permits employers to exclude forgiveness of a PPP loan from gross receipts.
- Similar treatment applies to two federal grants that normally would be included in gross receipts (shuttered venue operators grant and restaurant revitalization grant).

17

**Notice 2021-65, 2021-51 I.R.B. 880 (12/6/21)**

**Employee Retention Credit**

***Outline: item F.1.b, page 14***

- This notice clarifies steps employers (other than recovery startup businesses) should take if they:
  - paid wages after Sept. 30, 2021,
  - received an advance payment of the ERC for those wages or reduced employment tax deposits in anticipation of the credit for the fourth quarter of 2021, and
  - are now ineligible for the credit due to the change in the law.
- Employers (other than RSBs) that received advance payments for fourth quarter wages of 2021 will avoid failure-to-pay penalties if they repay those amounts by the due date of their employment tax returns.
- Employers (other than RSBs) that reduced deposits on or before Dec. 20, 2021, for wages paid during fourth calendar quarter of 2021 in anticipation of receiving the ERC, will not be subject to a failure-to-deposit penalty with respect to the retained deposits if they take specified steps.

18

**Hussey v. Commissioner,  
156 T.C. No. 12 (6/24/21)  
Outline: item H.1, page 15**

- The taxpayer sold 15 investment properties in short sales in 2012.
  - The lending bank cancelled \$754,054 of debt and issued 15 Forms 1099-C reflecting cancellation of debt income.
  - Taxpayer’s amended 2012 return excluded \$685,281 of COD from income.
  - Taxpayer and the government agreed the debt was qualified real property business indebtedness (QRPBI) and was excludable under § 108(a)(1)(D).
  - Section 108(c)(1) requires a reduction in basis of depreciable real property in the amount of the excluded QRPBI.
- **Issue:** did the taxpayer have to reduce the basis of the depreciable real property sold in 2012, or the basis of such property still held in 2013?
- **Held:** the basis of the property sold in 2012. Although § 1017(a) generally requires reduction in the basis of property held in the subsequent year, an exception in § 1017(b)(3)(F)(iii) requires reduction of the basis of property sold before the subsequent year if that property is taken into account in applying the § 108(c)(2)(B) limit on the exclusion of QRPBI.

19

**De Los Santos v. Commissioner,  
156 T.C. No. 9 (4/12/21)  
Outline: item A.1, page 16**

- The taxpayer was the sole shareholder of an S corporation. He and his wife were employees of the corporation.
- Pursuant to a welfare benefit plan, the S corporation paid the premiums on a life insurance contract insuring the taxpayer’s life.
- The court had previously ruled that the plan was a compensatory split-dollar life insurance arrangement.
- **Issue:** are the economic benefits of the split dollar life-insurance arrangement treated as compensation to the taxpayer or instead as corporate distributions?
- **Held:** As compensation to the taxpayer. If a corporation provides a benefit to a shareholder in the shareholder’s capacity as an employee, the payment does not constitute a distribution subject to the rules of § 301. Here, the benefits are guaranteed payments under § 707(c).
  - Court rejects the Sixth Circuit’s contrary conclusion in *Machacek v. Commissioner*, 906 F.3d 429 (6th Cir. 2018).

20

**Notice 2021-61**  
**2021-47 I.R.B. 738 (11/4/21)**  
***Outline: item B.1, page 18***

- Sets forth inflation-adjusted figures for benefits and contributions under qualified retirement plans for 2022.
- Among other figures:
  - Elective deferrals to 401(k) plans: increased to \$20,500 (from \$19,500).
    - catch-up provision for employees age 50 and older of \$6,500 (unchanged).
  - IRA contributions: \$6,000 (unchanged)

21

**McNulty v. Commissioner,**  
**157 T.C. No. 10 (11/18/21)**  
***Outline: item D.1, page 19***

- The taxpayers, a married couple, established self-directed individual retirement accounts (IRAs).
  - They used the services of Check Book IRA LLC (Check Book), through its website.
  - The IRA became the sole member of a limited liability company (LLC) and transferred assets to the LLC.
  - Ms. McNulty and her husband were the LLC's managers.
  - The LLC invested in American Eagle Gold coins, which were shipped to the taxpayers' residence and kept in a safe there.
- Issue: did Ms. McNulty receive taxable distributions equal to the cost of the American Eagle Gold coins (\$374,000 for 2015 and \$37,380 for 2016)?
- Held: Yes. "An owner of a self-directed IRA may not take actual and unfettered possession of the IRA assets."
  - Taxpayers also were subject to accuracy-related penalties for substantial understatement of income tax.

22

## **American Rescue Plan 2021 (Mar. 2021)**

### **Cancellation of Student Loans**

#### ***Outline: item B.1, page 20***

- Section 9675 of the American Rescue Plan of 2021 amends Code § 108(f)(5) to provide that the cancellation of student loans is excluded from gross income.
- The definition of qualifying loans is broad enough to cover the vast majority of postsecondary educational loans.
- The exclusion does not apply if the lender is an educational organization or a private lender and the cancellation is on account of services performed for the lender.
- New § 108(f)(5) applies to discharges of loans that occur after December 31, 2020 and before January 1, 2026.
- Notice 2022-1 (12/21/21): instructs lenders that cancel student loans described in § 108(f)(5) not to issue Form 1099-C through 2025.

23

## **Rev. Proc. 2021-45**

### **2021-48 I.R.B. 764 (11/10/21)**

#### ***Outline: item D.1, page 20***

- Sets forth inflation-adjusted figures for 2022
- Among other figures:
  - Standard deduction for 2022 is \$25,900/\$19,400/\$12,950
  - [Standard deduction for 2021 is \$25,100/\$18,800/\$12,550]

24

## **American Rescue Plan 2021 (Mar. 2021)**

### **Child Tax Credit of § 24**

#### ***Outline: item D.2, page 20***

- The 2021 American Rescue Plan:
  - For taxable years beginning in 2021:
    - Increases the child tax credit amount to \$3,600 in the case of a qualifying child younger than 6 at the end of 2021, and to \$3,000 in the case of other qualifying children.
    - Enlarges the definition of a qualifying child to include children who have not attained the age of 18 by the end of 2021 (rather than 17, as under the usual child tax credit rules).
    - Reduces the phase-out thresholds for the increased (\$3,600/\$3,000) CTC and preserves the existing \$2,000 CTC for those with higher incomes.
    - Provides for advance, monthly payment of 50 percent of a taxpayer's expected 2021 CTC with reconciliation on 2021 returns.
  - New CTC portal on IRS website (item a, outline page 21)

25

## **Milkovich v. United States,**

### **28 F.4th 1 (9th Cir. 3/2/22)**

#### ***Outline: item D.3, page 22***

- Taxpayers received a discharge in a chapter 7 bankruptcy proceeding.
- They sold their home in a short sale. The proceeds went to the mortgage lender, which applied \$115,000 towards accrued but unpaid interest.
- Held: the taxpayers are entitled to deduct the mortgage interest.
  - *Estate of Franklin* (lack of economic substance) does not preclude a deduction.
  - Section 265 does not preclude a deduction.
  - Dissenting opinion by Judge Stearns.

26

**Leyh v. Commissioner**  
**157 T.C. No. 7 (10/4/21).**  
***Outline: item E.1, page 23***

- In a written agreement, the taxpayer agreed to pay alimony to his wife until their final divorce decree.
- In 2015, the taxpayer paid \$10,683 for his wife’s health insurance premiums as pretax payroll reductions from his wages through his employer’s cafeteria plan.
- The taxpayer excluded from his gross income the health care coverage premiums he and his wife received through his employer’s cafeteria plan and also claimed a deduction for the \$10,683 as alimony.
- **Issue:** Can the taxpayer deduct the amount paid as alimony?
- **Held:** Yes. This situation does not present an impermissible “double deduction” or its equivalent. His wife is required to include the payments in gross income. Section 265, which precludes deduction of amounts attributable to tax-exempt income, does not preclude a deduction.
  - In the 2017 Tax Cuts and Jobs Act, Congress repealed §§ 71 and 215 for divorce or separation instruments executed or modified after 2018.

27

**Aspro, Inc. v. Commissioner**  
**32 F.4th 673 (8th Cir. 4/26/22).**  
***Outline: item B.1.a, page 25***

- Aspro was an Iowa C corporation for federal tax purposes engaged in the asphalt paving business.
- The company had three shareholders: Jackson Enterprises, Corp. (40%) (Jackson), Mannatt’s Enterprises, Inc. (40%), and Mr. Dakovich, Aspro’s president (20%).
- Each year relevant to this dispute, the shareholders received, among other forms of payment, substantial management fees that were deducted by Aspro.
- **Issues:**
  1. Whether the payments of “management fees” to its shareholders were in fact distributions of earnings, or
  2. Whether such fees were reasonable compensation for services rendered by Mr. Dakovich?
- **Held:** Aspro failed to show the management fees were paid wholly for services and agreed with the IRS that Aspro could not deduct management fees. Further, that Mr. Dakovich’s compensation was unreasonably high. As such, the payments were considered to be constructive dividends.

28

## Plentywood Drug, Inc. v. Commissioner

T.C. Memo. 2021-45 (4/26/21).

*Outline: item B.2, page 26*

- Plentywood Drug, Inc. is a Montana C corporation that operates a pharmacy in a building that the corporation occupies as a tenant.
- The corporation leased the building from its four shareholders (two married couples).
- The corporation paid rent of \$83,548 in one year and \$192,000 in two other years.
- **Issue:** is the rent paid by the corporation a fair market rent?
- **Held:** No.
  - The court did not accept the expert methodology used by either side.
  - Instead, court focused on the Post Office building in the small town in which the pharmacy was located as the most comparable property.
  - A fair market rent was \$171,187.50. Additional amounts paid by the corporation were constructive dividends to the shareholders.
  - Court declined to impose accuracy-related penalties.

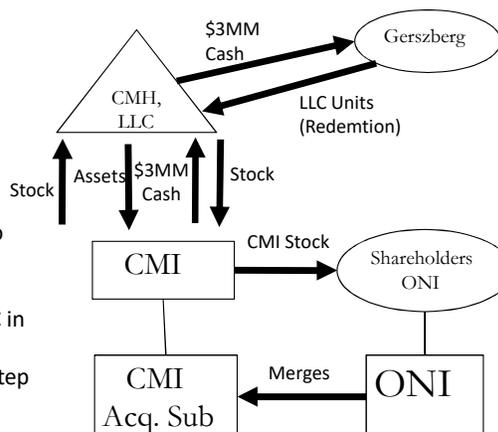
29

## Complex Media, Inc. v. Comm’r,

T.C. Memo. 2021-14 (3/31/21).

*Outline: item E.1, page 27*

- CMI forms Acquisition Sub.
- ONI merges into Acq. Sub. with ONI S/Hs receiving CMI stock
- ONI ceases to exist and ONI shareholders become shareholders of CMI.
- CMI distributes stock to CMH, LLC in exchange for \$7.6 MM of assets in purported §351 contrib.
  - CMI/CMH, LLC transaction documents agree to treat this step as a §351 nonrecognition transaction
- CMI simultaneously distributes \$3MM to CMH, LLC in redemption of CMI stock just received.
  - CMI/CMH, LLC documents agree to treat this step as a redemption separate from the §351 transaction.
  - However, on its tax return, CMH, LLC reports this step as taxable boot as part of the §351 transaction.
- CMH, LLC distributes \$3MM to Gerszberg in redemption of all of his partnership units.



30

**Summa Holdings, Inc. v. Commissioner,  
848 F.3d 779 (6th Cir. 2/16/17)  
Outline: item H.1.a, page 30**

- Members of the Benenson family owned C corporation stock.
  - Two family members established Roth IRAs, which (through a holding company) held the shares of a domestic international sales corporation (DISC).
  - The C corporation paid \$5.2 million in deductible commissions to the DISC, which excluded them from income. The DISC paid dividends to the Roth IRAs, triggering UBIT.
  - IRS asserted that the structure impermissibly avoided the contribution limits for Roth IRAs, and that the substance-over-form doctrine required recharacterization of the corporation's commission payments as nondeductible dividends.
- Held: IRS cannot use the substance-over-form doctrine to recharacterize the C corporation's commission payments. 31

**Benenson v. Commissioner,  
887 F.3d 511 (1st Cir. 4/6/18)  
910 F.3d 690 (2d Cir. 12/14/18)  
Outline: item H.1.b-c, pages 31 – 32**

- Shareholders in the *Summa Holdings* case appealed the Tax Court's decision to the First and Second Circuits.
  - The Sixth Circuit ruled on the tax consequences to the C corporation that operated the family business.
  - These shareholders resided in the First and Second Circuits.
- The First and Second Circuits followed the Sixth Circuit in rejecting application of the substance over form doctrine.
- Held: the shareholders are not treated as receiving a deemed distribution and as making an excess Roth IRA contribution.

32

**Mazzei v. Commissioner,  
998 F.3d 1041 (9th Cir. 6/2/21)  
Outline: item H.1.d, page 32**

- Members of the Mazzei family owned S corporation stock.
  - Two family members established Roth IRAs, which bought shares in a newly-formed foreign sales corporation (FSC) for \$500. [FSCs since repealed.]
  - The S corporation paid over \$500k in deductible commissions to the FSC during years 1998 to 2002. Roth IRAs grew and paid no tax on dividends from FSC.
  - IRS asserted that the structure impermissibly avoided the contribution limits for Roth IRAs.
- Held: Tax Court erred in concluding Roth IRAs were not the true owners of FSC stock. Tax Court’s decision reversed; IRS position rejected.

33

**TCJA New Section 1061 and Carried Interests  
TD 9945, Guidance Under § 1061 (1/19/21)  
Outline: item B.1, page 34**

- New § 1061 introduced three-year holding period for carried interests in partnerships (and allocations with respect thereto) to qualify for preferential LTCG rates.
- Final regulations issued 1/19/21. [item a, page 34]
  - Thirty-four defined terms created in regs.
  - Basically, transmutes otherwise LTCG into STCG to extent gain exceeds gain from property held three years or more.
  - In other words, regs “back out” the § 1061 gain.
  - Does not apply to transmute § 1231 gain even if held less than three years.
  - Doubles down on S corporation loophole (sure to be litigated).

34

**Hohl v. Commissioner,  
T.C. Memo. 2021-5 (1/13/21)**

***Outline: item C.1, page 36***

- One partner (Rodriguez-10%) transferred substantial amounts to a partnership (Echo) with three other partners (30% each), Hohl, Blake, and Bohls.
- The transfers were recorded on the partnership’s books as loans.
- The partnership tax returns consistently showed a note payable to Mr. Rodriguez.
- Messrs. Hohl, Blake, and Bowles’ capital accounts were all based upon their respective contributions of services and therefore were zero.
- Echo reported a net loss each year from deductions taken for guaranteed payments resulting in negative capital account balances for all partners.
- After several years, Echo’s trade or business failed, and Echo filed a final return.
  - The partnership did not report or allocate to partners any discharge of indebtedness income.
  - The IRS increased Mr. Hohl’s and Mr. Blake’s income by the amount of each partner’s negative capital account balance, which represented their share of Echo’s COD income.
- Issue: were Rodriguez’s transfers to the partnership loans or capital contributions?
- Held: loans. When it became certain Echo would not repay the debt to Rodriguez, Echo and its partners realized income from the discharge of indebtedness. <sup>35</sup>

***Negative Tax Capital Accounts of Partners***

***Outline: item G.1, pages 37 – 45***

- The 2018 Instructions for Form 1065 and accompanying Schedule K-1 required a partnership that does not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner’s *tax basis capital* both at the beginning of the year and at the end of the year if either amount is negative.
- Notice 2019-20, 2019-14 I.R.B. 927 (3/7/19), and FAQ on IRS website provide guidance on tax capital accounts.
- Draft 2019 Form 1065 and Schedule K-1 *required* partnerships to report *tax capital accounts* on Schedule K-1 (item b, page 39)
  - Several other significant changes
- Notice 2019-66, 2019-52 I.R.B. 1509 (12/9/19): defers requirement of tax basis capital accounts to partnership tax years beginning after 2019 (item c, page 40)
- Notice 2020-43, 2020-27 I.R.B. 1 (6/5/20): proposes that partnerships use only certain exclusive methods for reporting tax capital accounts. Rejects a transactional approach to determining such accounts. (item d, page 41) <sup>36</sup>

***Instructions - 2020 Form 1065 & Schedule K-1***  
***Outline: item G.1.e, page 43***

- Require partnerships to report each partner’s capital account on a tax basis regardless of whether the account is negative.
- Each partner’s tax capital account must be determined using a transactional approach.
- Beginning tax capital accounts for 2020:
  - If partnership reported tax capital accounts in prior year, or maintained books and records for tax capital accounts:
    - Beginning tax capital account for 2020 will be prior-year ending tax capital account.
  - If partnership did not report tax capital accounts in prior year and did not maintain books and records for tax capital accounts:
    - Beginning tax capital account can be determined for 2020 only using a transactional approach or one of three alternative methods:
      - Modified outside basis method
      - Modified previously taxed capital method
      - Section 704(b) method

37

***Penalty Relief - 2020 Form 1065 & Schedule K-1***  
***Outline: item G.1.f, page 43***

- Notice 2021-13, 2021-6 I.R.B. 832 (1/20/21).
  - Provides relief from certain penalties for failure to provide timely and accurate payee statements (i.e., Schedule K-1s).
  - A partnership is not subject to penalties under §§ 6698, 6721, or 6722 due to misreporting of its partners’ beginning capital account balances on 2020 Schedules K-1 if it can show that it took ordinary and prudent business care in following the 2020 Form 1065 Instructions to report its partners’ beginning capital account balances using any one of the permissible methods for determining beginning tax capital accounts in the instructions to Form 1065.
  - In addition, a partnership will not be subject to such penalties due to the inclusion of incorrect information in reporting its partners’ ending capital account balances on Schedules K-1 in taxable year 2020 (or beginning or ending capital account balances in subsequent years) to the extent attributable solely to the incorrect information reported as the beginning capital account balance for 2020.
  - A partnership that fails to timely file or include beginning and ending capital accounts on a 2020 Form 1065 or Schedules K-1 is not eligible for the relief.

## Conservation Easements

### ***Outline: item B.1, pages 47-53***

- IRS has made a series of attacks on charitable contribution deductions for conservation easements
- Most successful IRS strategy: easement does not protect the property in perpetuity, as required by § 170(h)(2)(C) and (h)(5)(A).
- Recent cases disallowing large charitable contribution deductions for conservation easements:
  - *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 6/23/21).
  - *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 3/14/22)
  - Both cases disallowed donor's charitable contribution deduction because extinguishment language in the deed dictating what would happen if the easement were extinguished:
    - Failed to preserve donee's proportionate benefit, as required by Reg. § 1.170A-14(g)(6)(ii) .
    - Required that charitable-donee's benefit upon destruction or condemnation of the property be reduced by value of improvements to the property made by the taxpayer-donor after the contribution, contrary to Reg. § 1.170A-14(g)(6)(ii).

39

## Conservation Easements

### ***Outline: item B.1, pages 47-53***

- Issue: did Treasury comply with the Administrative Procedure Act in issuing Reg. § 1.170A-14(g)(6)(ii)?
  - IRS interprets the regulation as requiring that, in the event the easement is extinguished, the charitable-donee share in post-donation increases in value of the property attributable to improvements made by the taxpayer-donor after the contribution.
- *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21):
  - Holds that Reg. § 1.170A-14(g)(6)(ii), as interpreted by the IRS, is arbitrary and capricious under the APA for failing to comply with procedural requirements and therefore is invalid.
- *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 3/14/22):
  - Holds that Treasury complied with the APA in issuing Reg. § 1.170A-14(g)(6)(ii) and that the regulation is valid.

40

**Laidlaw’s Harley Davidson Sales, Inc. v. Comm’r**  
**29 F.4<sup>th</sup> 1066 (9<sup>th</sup> Cir. 3/25/22)**  
***Outline Item A.1.a, page 54***

- An IRS revenue agent sent a 30-day letter informing the taxpayer that the IRS would assess a penalty under § 6707A for failure to report a listed transaction if the taxpayer did not respond.
- The revenue agent’s supervisor did not approve the penalty until after the 30-day letter was sent and the taxpayer had filed a protest with IRS appeals.
- Issue: Whether the IRS complied with requirement of § 6751(b)(1) that the “initial determination” of the assessment of a penalty be “personally approved (in writing) by the immediate supervisor of the individual making such determination.”
- Held: Yes. Contrary decision of U.S. Tax Court (154 T.C. 68 (1/16/20)) reversed.
  - When the IRS need not issue a notice of deficiency before assessing a penalty, the language of § 6751(b) contains no requirement that supervisory approval be obtained before the IRS formally communicates the penalty to the taxpayer.
  - Section 6751(b)(1) requires written supervisory approval before the assessment of the penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment.
    - The IRS complied with this requirement.

41

**Beland v. Commissioner**  
**156 T.C. No. 5 (3/1/21)**  
***Outline Item A.2, page 55***

- Issue: Whether the IRS complied with the requirement of § 6751(b)(1) that the initial determination of the assessment of a penalty be “personally approved (in writing) by the immediate supervisor of the individual making such determination.”
- Held: No.
  - The court concluded that the IRS made its initial determination of the assessment of penalties when the IRS revenue agent presented Form 4549, Income Tax Examination Changes, during a closing conference with taxpayers.
  - Because this initial determination to assert penalties occurred before the supervisor signed the Civil Penalty Approval Form, the IRS had failed to satisfy its burden of production under § 6751(b) and the taxpayer, therefore, was not liable for a fraud penalty.

42

**Andrews v. United States,  
15 Fed. Cl. 665 (5/12/21)  
Outline: item A.4, page 56**

- The executor of an estate authorized an attorney to file a request for an automatic 6-month extension of time to file the estate's return on Form 706.
- The attorney allegedly failed to do so and filed the return late reporting tax liability of \$3 million.
- The IRS assessed a late-filing penalty of just over \$400,000 and a late-payment penalty of just over \$75,000.
- Issue: did the estate have a reasonable cause defense to the penalties because it had relied on counsel?
- Held: No. Under the U.S. Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985), relying on an agent to file a return does not excuse late filing. The estate did not rely on mistaken legal advice, which can give rise to reasonable cause.

43

**Lindsay v. United States,  
4 F.4th 292 (5th Cir. 7/9/21)  
Outline: item A.6, page 57**

- The taxpayer was incarcerated and appointed an individual (Bertelson) as his attorney-in-fact to manage his affairs.
- Bertelson failed to file the taxpayer's tax returns and embezzled hundreds of thousands of dollars.
- The IRS assessed late-filing and late-payment penalties of more than \$400,000.
- Issue: did the taxpayer have a reasonable cause defense to the penalties because he was under a disability (incarceration)?
- Held: No. Under the U.S. Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985), relying on agent to file a return does not excuse late filing. The taxpayer did not rely on mistaken legal advice, which can give rise to reasonable cause.

44

**Ramey v. Commissioner,  
156 T.C. No. 1 (1/14/21)  
Outline: item F.1, page 58**

- The IRS mailed a notice of intent to levy to the taxpayer by certified mail, return receipt requested.
  - Taxpayer had 30 days, until August 12, 2018, to request a collection due process (CDP) hearing by mailing Form 12153.
- Taxpayer did not challenge the address to which the notice of intent to levy was sent.
  - But maintained that several businesses used this address and that the person who signed for the notice was not affiliated with the taxpayer.
- Taxpayer mailed Form 12153 after date for requesting a CDP hearing and received “equivalent hearing” upholding the proposed collection activity
- Issue: did the notice of intent to levy trigger the running of the 30-day period to request a CDP hearing?
- Held: Yes. Under § 6330(a)(2), the focus is on whether the IRS sent the notice by certified or registered mail, not on taxpayer’s receipt.<sup>45</sup>

**Boechler, P.C. v. Commissioner  
\_\_ U.S. \_\_ (4/21/22)  
Outline: item F.2.a, page 59**

- Following a collection due process (CDP) hearing, the IRS issued a notice of determination upholding proposed collection action.
- Under § 6330(d)(1), the taxpayer had 30 days to contest the determination by filing a petition with the U.S. Tax Court.
- The 30-day period expired on August 28, 2017.
- Taxpayer:
  - Mailed his petition to the Tax Court on August 29, 2017 (one-day late).
  - Argued that the 30-day period should be equitably tolled.
- Issue: is the 30-day period for filing a Tax Court petition to contest an IRS notice of determination jurisdictional and therefore not subject to equitable tolling?
- Held: No. This 30-day period is not jurisdictional and is subject to equitable tolling.

46

**Seminole Nursing Home, Inc. v. Comm’r,  
12 F.4th 1150 (9/2/21)**

***Outline: item F.4, page 61***

- In response to a final notice of intent to levy for unpaid employment taxes, the taxpayer, a corporation, requested a collection due process hearing.
- In the CDP hearing, the taxpayer requested relief from the levy on the grounds of economic hardship.
  - The IRS Settlement Officer refused to consider economic hardship because, under Reg. § 301.6343-1(b)(4)(i), such relief is available only to individual taxpayers.
- Issue: is the regulation a valid interpretation of the statute?
- Held: Yes. The regulation is entitled to Chevron deference and, in Chevron step 2, is a permissible construction of the statute.

47

**Ruhaak v. Commissioner  
157 T.C. No. 9 (11/16/21).**

***Outline: item F.5, page 62***

- The IRS issued a final notice of intent to levy for 2013 and 2014.
- The taxpayer filed Form 12153, the form used to request a collection due process (CDP) hearing before an IRS Appeals Officer.
  - The taxpayer submitted Form 12153 within the 30-day period required by § 6330(a)(2), (a)(3), and (b)(1) to request a CDP hearing.
  - On Form 12153, the taxpayer checked a box indicating that he would like an equivalent hearing if his request did not meet the requirements for a timely CDP hearing.
- Issue: had the taxpayer requested an equivalent hearing rather than a CDP hearing?
- Held: no, the taxpayer requested a CDP hearing.
  - Only those taxpayers who fail to timely request a CDP hearing are eligible to request an equivalent hearing.
  - This was the third CDP case the taxpayer had filed in the Tax Court. Most recently, the court had imposed penalties under § 6673 (up to \$25,000) for asserting a frivolous position but declined to do so in this case.

48

## FBAR Penalties

### Outline: item H.2, page 62

- Under 31 U.S.C. § 5321(a)(5)(A), the Secretary of the Treasury “may impose” a penalty for FBAR violations.
  - Pursuant to administrative orders, the authority to impose FBAR penalties has been delegated by the Secretary to the IRS.
- Maximum penalties:
  - Before the American Jobs Creation Act of 2004 (“AJCA”), 31 U.S.C. § 5321(a)(5) provided that the penalty for *willful* FBAR violations was the greater of \$25,000 or the balance of the unreported account up to \$100,000.
  - After the AJCA of 2004, the *normal* penalty for an FBAR violation is \$10,000 per offending account, but the penalty for a *willful* FBAR violation “*shall be increased to the greater of*” \$100,000 or 50 percent of the balance in the offending account at the time of the violation.
- The relevant regulation, 31 C.F.R. § 1010.820(g), reflects pre-ACJA law and caps the penalty for willful FBAR violations to \$100,000 per account.
- Issue: can the government impose the higher, current statutory penalty?
  - Yes. *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 11/8/19)
  - Yes. *United States v. Horowitz*, 978 F.3d 80 (4th Cir. 10/10/20).
  - Yes. *United States v. Rum*, 995 F.3d 882 (11th Cir. 4/23/21).
  - Yes. *United States v. Kahn*, 5 F.4th 167 (2d Cir. 7/13/21).

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## FBAR Penalties

### Outline: item H.2.d, page 70

- FinCEN finally has updated the regulations
  - December 2021: Financial Crimes Enforcement Network (FinCEN) amended the relevant regulations to remove 31 C.F.R. § 1010.820(g), which limited the penalty for willful FBAR violations to \$100,000 per account.
  - This amendment of the regulations is effective on December 23, 2021.
  - The prior regulation was rendered obsolete by a 2004 statute.
    - Therefore, the government’s position presumably is that the statutory rule, rather than the now-repealed provision of the regulations, applies for prior years as well beginning on the effective date of the statutory change.

50

**Rowen v. Commissioner,  
156 T.C. No. 8 (3/30/21)  
Outline: item H.5.a, page 72**

- The petitioner was a medical doctor licensed in California who frequently traveled to developing countries to offer medical services free of charge to underserved populations.
- He had unpaid federal tax liabilities for more than two decades of \$500,000.
- Pursuant to § 7345, the IRS issued a notice of certification of a “seriously delinquent tax debt” and notified the Secretary of State that his passport should be revoked.
- The taxpayer petitioned the Tax Court for review of the certification.
- **Issues:** (1) is § 7345 unconstitutional because it prohibits international travel in violation of the Due Process Clause of the Fifth Amendment; (2) does the statute violate taxpayer’s human rights under the Universal Declaration of Human Rights?
- **Held:** No. Section 7345 authorizes the IRS Commissioner only to certify that an individual has a seriously delinquent tax and leaves all passport-related decisions to the Secretary of State.

51

**Maehr v. United States,  
5 F.4th 1100 (10th Cir. 7/20/21)  
Outline: item H.5.b, page 73**

- The plaintiff had unpaid federal tax liabilities of roughly \$250,000.
- Pursuant to § 7345, the IRS issued a notice of certification of a “seriously delinquent tax debt” and notified the Secretary of State.
- The State Department revoked the plaintiff’s passport.
- The plaintiff challenged the revocation in a U.S. District Court.
- **Issues:** (1) do the Privileges and Immunities clauses limit the federal government’s right to restrict travel, (2) should the court review the revocation under standard similar to that used in reviewing a writ of *ne exeat republica*, and (3) is § 7345 unconstitutional because it violates the Due Process Clause of the Fifth Amendment?
- **Held:** (1) No. The Privileges and Immunities clauses apply only to the states, not the federal government; (2) No. Passport revocation is different from a writ of *ne exeat republica*; (3) No. International travel is not a “fundamental right,” and therefore a rational basis standard of review applies, which § 7345 meets.

52

**Brown v. United States,  
22 F.4<sup>th</sup> 1008 (Fed. Cir. 1/5/22)  
Outline: item H.7, page 75**

- **Held:** taxpayers did not “duly file” their amended returns claiming refunds because the taxpayers did not sign them. Their attorney signed them and did not submit a power of attorney. Refund action dismissed.

53

**Li v. Commissioner  
22 F.4<sup>th</sup> 1014 (D.C. Cir. 1/11/22)  
Outline: item H.8, page 75**

- The petitioner filed Form 211, Application for Award for Original Information, with the IRS’s Whistleblower Office (WBO).
  - These forms asserted that a third party had underreported tax obligations.
- The WBO concluded that Ms. Li’s allegations were “speculative and/or did not provide specific or credible information regarding tax underpayments or violations of internal revenue laws,” and that she therefore was not eligible for an award.
- **Issue:** does the Tax Court have jurisdiction to review a rejection of a whistleblower claim for failure to satisfy the threshold criteria?
- **Held:** No.
  - Pursuant to § 7623(b)(4), the Tax Court has jurisdiction to review only a “determination” by the IRS in a whistleblower case.
  - Rejects contrary decisions in *Cooper v. Commissioner*, 135 T.C. 70 (2010), and *Lacey v. Commissioner*, 153 T.C. 146 (2019).

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